

Capital Flows and Factor Markets



3.1 Introduction

Capital flows in the form of FDI, ODA, remittances, and to a much lesser extent, portfolio investments, have important implications for both domestic investment and local labour markets in Africa. Capital flows can stimulate domestic investment and productivity, resulting in job creation in the host country. Causality also runs in the other direction insofar as the characteristics of factor markets, especially labour market conditions, influence the type, the amount and the stability of inflows. In an increasingly competitive global economy, the level of education and skills of the labour force are important determinants of private capital flows.

The aim of this chapter is to summarize these different linkages between capital flows and factor markets with a view to highlighting areas that African governments can target to harness the benefits of capital flows. The key messages emanating from this chapter are:

- Capital flows can potentially have significant effects on domestic investment and employment, and hence, on development in general;
- Factor costs and regulations are important determinants of capital inflows;
- African governments need to establish policies to enhance the effects of capital flows on overall development and poverty reduction including measures such as promoting foreign investment in labour-intensive sectors, improving the functioning of the domestic labour market, and investing in education and skills; and
- African countries also need to channel ODA flows and remittances towards investment-related activities, which stimulate economic growth and job creation.

The remainder of the chapter is structured as follows: in section 3.2 the relationship between domestic labour markets and FDI is explored, addressing both the impact of labour costs and institutions on capital flows, an issue also taken up in chapter 2 of this report. Conversely, the effects of FDI on the labour market in terms of job creation and wages are also explored. In section 3.3, the linkages between FDI and domestic investment are investigated. Section 3.4 examines the connection between ODA and domestic factor markets, while section 3.5 discusses the links between

“*In an increasingly competitive global economy, the level of education and skills of the labour force are important determinants of private capital flows*”

remittances and factor markets. Section 3.6 presents the case studies of Ethiopia and Ghana to illustrate some of the relationships between FDI and domestic factor markets. Section 3.7 concludes and provides policy recommendations.

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3.2 Foreign direct investment (FDI) and domestic labour markets

In this section, four aspects of the relationship between FDI and domestic labour markets are considered:

- How labour market conditions and regulations affect FDI;
- The role of human capital in determining FDI flows;
- The impact of FDI on the quantity and quality of employment; and
- The impact of FDI on the level and distribution of wages.

The impact of local labour market conditions and regulations on FDI

As summarized in chapter 2, empirical research has identified various factors that determine the type, magnitude, stability and destination of foreign investment. These include economic growth and per capita income, infrastructure, the degree of industrialization, government policies and incentives, and labour market conditions and regulations (Javorcik and Spatareanu 2005; Billington 1999).

The focus in this section is on the role of domestic labour markets, which consist of two components: the direct cost of labour (wage and non-wage remuneration, taxation, social security contributions and insurance); and the indirect costs stemming from labour market regulations such as legislation relating to hiring, firing, hours worked, and unionization.

Labour costs are an important determinant of foreign investment

Foreign investors can be attracted to a particular location because of low wages, which imply higher profitability of investment. A skilled labour force may also be a magnet for foreign companies as this translates into higher productivity of investment. The combination of labour costs, skills and productivity constitutes a decisive factor for foreign investors.

The importance of labour costs as a determinant also depends on the type of FDI. As discussed in chapter 2, there are two main types of FDI: vertical and horizontal FDI. In the first type, multinational corporations (MNCs) are attracted to a specific location because of factor price differences – in this context, relative wages. In the case of

horizontal FDI, MNCs invest in different locations as a consequence of costly trade barriers; that is, investments are market seeking. Thus, an increase in labour costs is expected to have a stronger negative effect on vertical FDI than on horizontal investments (Kucera 2002).

The empirical evidence for the impact of labour costs on FDI flows is, however, at best mixed. For example, Asiedu (2002) reports that different cross-country studies find that labour costs can have either a positive, negative or insignificant effect on FDI. However, as argued in Kucera (2002), the evidence “leans towards suggesting that higher labour costs negatively affect FDI” (Kucera *ibid*, p.4). The effects are even stronger in studies that have controlled for differences in labour productivity.

Excessive regulation may be an even greater deterrent of FDI

The cost of labour for investors is also influenced by the nature of labour market regulations in place, and in particular, the flexibility of employment. For example, employment protection can deter employers in general from hiring workers (OECD 2004). If legislation prevents or constrains dismissal, employers will subsequently have lower incentives to hire in the first place. These regulations can affect the incentives for foreign companies to invest in a specific location.

Labour laws can also potentially have a positive effect on economic growth and ultimately, on foreign investment. As summarized in Kucera (2002), labour standards (freedom of association, collective bargaining, prevention of child labour and gender discrimination) can impact economic growth through a number of channels. For example, labour laws that reduce gender inequality or promote economic and political stability can increase economic growth, and as a consequence, private capital flows. In terms of more direct linkages, preventing industrial disputes can help attract foreign companies to invest, which appears to be a barrier for investors in countries such as South Africa (Asiedu 2005).

Javorcik and Spatareanu (2005) offer one of the few studies that investigate the impact of labour-market regulations on FDI. Using firm-level data for 19 Western and Eastern European countries, these authors find that greater labour market flexibility in the host country in absolute and relative terms is correlated with higher FDI flows. In contrast, Kucera (2002) finds no support for the hypothesis that foreign investors favour countries with lower labour standards. The results in this study, in fact, indicate that unionization rates are not related to FDI flows, while the correlation between FDI and stronger civil liberties and political rights is positive. This evidence suggests that the benefits of sound labour standards outweigh the costs.

The relationship between labour market regulations and FDI in Africa

FDI in Africa has largely been concentrated in the natural resources sector, which is capital-intensive. Therefore, wages and other characteristics of the labour market are unlikely to have had a significant impact on investment. The empirical evidence for

“Labour laws that reduce gender inequality or promote economic and political stability can increase economic growth”

the impact of labour market regulations is, unfortunately, scarce, especially for African countries.

Looking at available country-level data, African countries appear to have a high degree of labour market regulation compared with other regions. The average employment rigidity index in 38 African countries, where adequate data are available, is 53.2 on a scale from 0 to 100, the highest of all regions.¹ In comparison, the average stands at 26.2 in East Asia and Pacific and 40.3 in Latin America and the Caribbean. For the SSA subregion, the index ranges from 10 in Zambia, the African country with the most flexible labour market, to 90 in Niger and Democratic Republic of Congo, countries with the most rigid labour regulations.

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Two other indicators of rigidities in the labour market compiled as part of the World Bank's *Doing Business Database* are hiring costs as a percentage of salary and firing costs in terms of number of weeks of wages. Hiring costs in Africa are, on average, 12.8 per cent of the salary, though it ranges from 0 in Botswana, Ethiopia and Lesotho to 27.4 in Benin and 27.5 in Algeria. Similarly, while the average cost of firing amounts to 55.3 weeks of wages, it varies from only 4 weeks in Nigeria to 176 weeks in Zambia and 188.3 weeks in Sierra Leone. High hiring and firing costs are a deterrent for foreign investors.

However, the enforcement of labour market regulations is typically weak in most African countries. For example, in Niger, the rate of compliance with the minimum wage and hours of work regulations is only 2 per cent, with only slightly higher rates for compliance with social security obligations and health and safety rules (Maldonado 1995). As a consequence, such policies may not have any discernible impact on capital flows.

FDI and labour market outcomes

One of the key benefits of foreign investment is job creation, though this is by no means guaranteed, since the impact of FDI on the domestic labour market can be positive, neutral or negative. Assuming that unskilled labour is the abundant factor in developing countries, FDI should theoretically be concentrated in sectors that use low-skilled labour intensively, such as textiles and simple assembly operations (Vivarelli 2004). This implies that foreign investment increases the demand for unskilled workers, and as a result, their wages.

However, as underscored in chapter 2 of this report, the majority of recent FDI flows to Africa have been concentrated in the natural resources sector. Therefore, the employment effects of such investments are unlikely to be large. Nonetheless, African countries need to be aware of the employment impact of FDI in order to focus poli-

¹ See the World Bank's *Doing Business Database* for more information: <http://rru.worldbank.org/DoingBusiness/>. The index is an average of three sub-indexes: a difficulty-of-hiring index, a rigidity-of-hours index, and a difficulty-of-firing index.

cies on attracting investments to more labour-intensive industries. Specifically, the number of jobs created depends on a range of factors including the following:

- The proportion of foreign workers brought in by the foreign-owned company, which determines the potential number of jobs available for local workers;
- Greenfield investments, which entail an increase in the host country's capital stock, are more likely to create jobs, while mergers and acquisitions tend to result in redundancies (Lall 2004);
- The more capital-intensive the technology used in production, for example in the natural resource sector, the smaller the employment effects resulting from the investment;
- For vertical FDI, an important issue is the orientation of trade and industrial policies in the host country. In countries with export-oriented regimes and a ready supply of cheap labour, foreign investment is likely to generate a significant number of jobs (Lall 2004). Of course, these factors are important determinants of FDI in the first place;
- Higher productivity of foreign investment reduces the demand for labour; and
- The labour market conditions in terms of costs and regulations also influence the number of jobs created through foreign investment. If hiring costs are high, for example, companies generally will hire fewer employees and substitute capital for labour.

Over the long-term, the direct employment effects of foreign investment hinge on such factors as how the company continues to invest in technology and capacity, the growth in product demand, the supply of skills, wage development, other input costs and labour market regulations, the availability of infrastructure, and changes to the global market (UNCTAD 1999).

Besides the jobs directly created by foreign-owned companies, FDI also contributes to employment through indirect channels, which can in fact be larger than the direct effects, resulting in large multiplier effects. Some examples include (see UNCTAD 1999 and Lall 2004):

- Jobs created in vertically linked firms and through sub-contracting, which depends on the demand by foreign-owned companies for materials, services and components sourced locally;
- There can be positive (technology spillovers) effects on domestic competition;
- At the same time, since foreign companies tend to be more efficient, their entry into the market could push domestic companies out of the market, resulting in job losses. The debate about the evidence for “crowding-out” is explored further in section 3.3 below;

“*Capital flows can also increase incomes, consumption and investment, which in turn stimulate job creation*”

“African countries with more FDI tend also to experience higher rates of employment growth”

- Over the longer term, more FDI could be attracted in order to supply the initial investment or to compete with the incumbent. These investments have corresponding effects on employment in the host country; and
- Finally, capital flows can also increase incomes and subsequently consumption and investment, which in turn stimulate job creation.

The employment effects of FDI

There is very little quantification of the impact of FDI on employment in African countries. A study by Iyanda (1999) on FDI flows in Namibia reveals that for every worker employed by a foreign affiliate, another 2-4 jobs were created. In comparison, the more general study by Aaron (1999) finds that FDI in developing countries created about 26 million direct and 41.6 indirect jobs in 1997, suggesting a multiplier effect of 1.6.

Using a sample of SSA in the *World Bank Development Indicators Database* reveals that there is evidence of a positive correlation between the growth of the labour force and the ratio of FDI to GDP over the 1990-2002 period. This suggests that African countries, which attract higher inflows of foreign investment, tend also to experience higher rates of employment growth.

Another question explored in the literature is whether FDI generates more employment than domestic investment. In this regard, Spiezia (2004) finds that the impact of FDI on employment is increasing with per capita income, and in low-income countries, the effect of FDI is in fact insignificant. However, our own evidence using a sample of SSA countries suggests that there is a significant impact of FDI on the growth of the labour force, though the magnitude of this effect is smaller than it is for domestic investment (table 3.1).²

Table 3.1
Estimates of employment effects of foreign versus domestic investment in sub-Saharan African countries, 1990-2002

Dependent variable: growth of labour force	
Covariate	Coefficient
FDI/GDP	0.036** (0.011)
DI/GDP	0.048* (0.015)
R ²	0.11
F	3.64**
No. of observations	363

* - significant at 10%

** - significant at 5%; robust standard errors are provided in parentheses; the econometric specification includes time dummies; FDI = foreign direct investment and DI=domestic investment.

2 However, once time-invariant effects such as country-specific factors are controlled for, the coefficient estimates for both variables FDI/GDP and DI/GDP become insignificant.

Capital flows have implications for both wages and inequality

In addition to their impact on employment, FDI flows can also affect the level and distribution of wages. It is possible that foreign companies pay higher wages and provide better conditions than their domestic counterparts. Alternatively, these companies could take advantage of lax regulations and excess supply of labour to keep wages down for certain types of workers, sometimes below the level in the local labour market. However, the literature finds quite unanimously that multinational corporations pay higher wages than their domestic counterparts (Lipsey 2002). The various hypotheses explaining the existence of a wage premium in foreign-owned firms are listed in box 3.1.

Using data on individual wages in the manufacturing industry for five African countries (Cameroon, Ghana, Kenya, Zambia and Zimbabwe) in the early 1990s, te Velde and Morrissey (2003) investigate whether foreign-owned firms pay higher wages. They find that foreign ownership is indeed associated with a wage premium of 20-40 per cent, though these figures drop to 8-23 per cent once sectoral and regional location are accounted for in the econometric analysis. Moreover, the wage premium increases with educational attainment suggested that skilled workers benefited the most. Asiedu (2004) presents evidence that suggests that the wage premium ranges from 10 per cent in Côte d'Ivoire to about 130 per cent in Morocco.

FDI can also result in higher wages in domestic firms as a consequence of spillovers, which are feasible in labour markets where the supply of labour is not perfectly elastic. The empirical evidence for this effect is mixed according to Lipsey (2002), but overall,

Box 3.1

Wage premiums in foreign-owned enterprises

There are a number of hypotheses put forward as explanations for a wage premium in foreign-owned firms:

- Foreign firms may pay wages that are higher than the market-clearing rate – referred to as efficiency wages – to ensure higher productivity of workers. Reasons for such efficiency wages include:
 - Higher wages increase worker's effort in a situation where monitoring is imperfect;
 - Higher wages can improve loyalty and reduce worker turnover;
 - Higher wages attract better workers; and
 - Higher wages ensure that workers are well fed and more productive.
- Foreign-owned firms pay higher wages because they acquire higher-wage plants or firms or because they are concentrated in high-wage industries or regions of a country (Lipsey 2002).
- MNCs are more profitable and share rents with their workers (Scheve and Slaughter 2003).

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FDI activity tends to have a positive impact on average wages (including wages in both foreign- and domestic-owned firms). However, this could reduce competitiveness in the tradable sector and contribute to job losses in the domestic economy.

Foreign investment can affect the distribution of wages through its relative demand for skills, and so impact within-country on income inequality. For example, if FDI is more skill-intensive than domestic investments on aggregate in the host country, such investments increase the demand for the relatively skilled workers and, correspondingly, their wages. Vivarelli (2004) summarizes the empirical evidence from various studies and concludes that there is no clear link between FDI flows and within-country inequality.

Implications for the status of vulnerable groups

Related to this distributional aspect is how capital flows affect specific groups in the economy, particularly women. For example, some argue that capital flows such as FDI have improved the situation of women by creating jobs for them, particularly in export processing zones (EPZs), which in turn provide these women with a better status in society, besides assisting their families in getting out of poverty. In contrast, it has also been suggested that foreign investors seek low-cost locations and employ women because they are able to pay them lower wages and subject them to harsher working conditions (UNCTAD 1999).

More generally, foreign investment can influence the conditions in the workplace in such areas as job security, hours worked, provisions for holidays, sick/maternity/paternity leave, and occupational health and safety.

African labour markets are typically segmented such that a minority work in the formal economy, where conditions and salaries tend to be better, while the rest of the population are confined to the informal segment, which is characterized by lower wages, longer hours, less security and little protection. Since foreign companies are more likely to form linkages with domestic enterprises in the formal economy, foreign investment will help to improve opportunities in this segment of the domestic economy. This implies that FDI may contribute to increasing formalization of the economy. However, in the case of African economies, such formalization is constrained by over-regulation, poor infrastructure, lack of access to an educated labour force, and other constraints.

Human capital and FDI

Skills and education are important determinants of FDI

The importance of human capital for FDI has increased as economies have shifted more and more to knowledge-intensive production technologies. As a consequence, multinational corporations are increasingly looking for a well-educated labour force,

not just low labour costs. In fact, the availability and cost of low-skilled workers is now less relevant for FDI than the availability of high-skilled workers. Foreign investors are seeking the right combination of wages, skills and productivity. This may explain why countries such as India have attracted significant inflows of FDI in the IT sector, which requires a stock of well-trained scientists and technicians.

A number of studies have investigated the role of human capital as a determinant of FDI.³ Borensztein et al. (1998) find that there is a strong complementary effect between FDI and human capital such that investments have high productivity only when the host country has a minimum threshold stock of human capital. Noorbakhsh et al. (2001) also find that human capital is one of the more important determinants of FDI inflows. The results show that the impact of education was the strongest in the early 1990s (the latest period in the study) reflecting the shift of investments to services and technology-intensive manufacturing. Asiedu (2005) finds that having an educated population helps attract FDI inflows to African countries, in addition to the presence of natural resources and large markets, low inflation, good infrastructure, openness to FDI, good governance, political stability and a reliable legal system.

Human capital in Africa remains at low levels, though countries have made considerable progress in recent years. In particular, the literature suggests that governments need to focus on not only expanding access to education, but also on developing curricula that are aligned with the demands of employers.



Foreign investors are seeking the right combination of wages, skills and productivity

FDI can also contribute to human resource development in the host country

In general, firms in both developed and developing countries under-invest in training because of market failures resulting from credit constraints, lack of information/awareness and labour turnover. These constraints are less binding for larger firms, implying that most foreign-owned companies are in a better position to train in comparison with domestic firms. MNCs are in particular keen on developing the skills of their local employees through education and training (Noorbakhsh et al. 1999; Miyamoto 2003).

Asiedu (2004) presents figures on the provision of formal training to workers in four Africa countries (Ghana, Kenya, Zambia and Zimbabwe), which illustrate that foreign-owned firms are more likely to train their employees than their domestic counterparts. For example, in 1995, 46.2 per cent of wholly foreign-owned firms in Kenya provided training compared with 16.1 per cent of wholly domestic-owned firms.

Governments should encourage multinationals to undertake human resource development in order to facilitate technology transfer. Such training spillovers can occur via vertical (backward and forward) linkages with domestic firms. Spillovers can also result from employees of multinational corporations (MNCs) seeking work in domestic enterprises (labour turnover) or from those starting up their own spin-offs (Miyamoto 2003).

³ See Miyamoto (2003) for a review of the literature

3.3 FDI and domestic investment

There has been a considerable debate about the relationship between foreign capital and domestic investment. In this debate, the two key questions asked are: (a) Does FDI “crowd-out” or “crowd-in” domestic investment? And (b) How does domestic investment influence foreign capital flows?

The impact of FDI on domestic investment

Crowding-in or crowding-out?

The question is whether foreign investment leads to a decrease in domestic investment activity, which is termed crowding-out, or in an increase, i.e. crowding-in (UNCTAD 1999). Crowding-out or crowding-in of domestic investment can occur via product markets or financial markets (UNCTAD, *ibid*). In the first case, foreign investment can stimulate domestic investment activity through downstream or upstream linkages. For instance, a multinational corporation may source raw materials from domestic suppliers or it may outsource particular activities to firms in the host country. However, in many African countries, the bulk of FDI has flowed into the natural resources sector, which has few linkages, and therefore, the indirect effect of FDI on domestic investment is likely to be marginal in such economies.

Foreign investment can also have adverse effects on financial markets in the host country. If MNCs borrow in the domestic financial market, this can push up interest rates, which subsequently crowds out borrowing by domestic companies. Moreover, if the capital flows coming into the country are relatively large, this may lead to an appreciation of the real exchange rate and reduce export competitiveness and incentives for domestic investment (UNCTAD 1999). This latter effect is stronger for M&As than for new investments (Agosin and Mayer 2000).

Agosin and Mayer (2000) suggest that if FDI in developing countries follows existing sectoral composition (investing in established sectors), foreign capital is more likely to result in crowding-out since the foreign investors will be competing with domestic producers. Crowding-in is more likely to occur when the investments are made in non-existing sectors, so that MNCs introduce new goods and services, which do not compete with domestic firms and displace them from the market.

Another possible mechanism for crowding-out stems from the preferential treatment provided to foreign investors in terms of tax breaks, cash grants, duty exemptions and subsidies, which are not available for local investors. The main justification for providing such incentives to promote inward FDI is to take advantage of spillovers of foreign technology and skills to local industry (Blomstroem and Kokko 2003). However, this differential treatment of investors can increase the competitiveness of foreign companies and contribute to crowding-out of domestic firms in the local market.

“Crowding-out or crowding-in of domestic investment can occur via product markets or financial markets”

The 2003 UNCTAD *World Investment Report* highlights a number of mechanisms for crowding-out. Firstly, local firms are crowded out of the market because foreign-owned firms are more efficient and produce goods of better quality. Secondly, domestic firms are displaced because MNCs have better access to financial resources. Finally, foreign-owned firms may engage in anti-competitive behaviour (UNCTAD 2003b). The first scenario has a positive initial impact on welfare, while the second and third have a negative effect. Therefore, it is important to be able to distinguish between the two channels, though this is empirically difficult to identify. If FDI has a negative impact on domestic investment, African governments clearly need to consider the appropriateness of such projects.

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Does foreign investment crowd-in or crowd-out

FDI tends to stimulate domestic investment (Spiezia 2004). Borensztein et al. (1998) find, for example, that for every dollar of FDI, there is a corresponding increase in total investment by between \$1.5 and \$2.3. The results presented in Bosworth and Collins (1999) indicate that FDI and international bank lending have the largest impact on domestic investment, while the effects of portfolio flows are weaker.

The *World Investment Report 2003* produced by UNCTAD (2003b) reviews the evidence for crowding-out and finds that it is mixed. In the earlier *World Investment Report 1999*, econometric evidence was presented showing that the effect of FDI is mostly neutral, with some cases of crowding-out and some of crowding-in (UNCTAD 1999).

Agosin and Mayer (2000) find a neutral impact of FDI on total investment in Africa, but crowding-in in the Asian region and crowding-out in Latin America during the period 1970-1996.

However, breaking down the period into smaller intervals does indicate, for example, that FDI in Africa crowded in domestic investments after 1975. Disaggregating the data to the country-level reveals even more heterogeneity in the impact of FDI on domestic investment. In terms of the African countries used in the sample, there is evidence of crowding-in in Côte d'Ivoire, Ghana and Senegal, crowding-out in the Central African Republic, Nigeria, Sierra Leone and Zimbabwe, while the effect is neutral in Gabon, Kenya, Morocco, Niger and Tunisia.

Capital flows, instability and domestic investment

Another channel for external capital flows to affect domestic investment is through the volatility of flows, in addition to the levels (Fosu 1991, 2001). An explanation for this effect is provided by the option value of theory of investment (Dixit and Pindyck 1994). This approach considers the impact of uncertainty on investment that is irreversible, which implies that it is easier to increase the capital stock than to sell it. Con-

sequently, there is an option value to waiting rather than investing. For example, if domestic suppliers base their (irreversible) investment decision on their expectations about FDI in a particular industry, uncertainty about these flows would deter them from carrying out such an investment.

Furthermore, instability in the exchange rate generated by external capital flows can have a negative impact on investment. Bleaney and Greenaway (2001) find supportive evidence for this effect in a sample of 14 SSA countries over the period from 1980 to 1995.

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Instability in the exchange rate generated by external capital flows can have a negative impact on investment
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The domestic investment climate influences capital flows

A good investment climate is essential for growth of the private sector, which plays a pivotal role in job creation and, hence, poverty reduction in all developing economies. Such an investment climate depends both on factors that governments cannot influence, such as geography and consumer preferences and those that are determined by government policies and laws. The latter includes macroeconomic and political stability, security of property rights, sensible regulation and taxation, provision of infrastructure, functioning finance and labour markets, a skilled labour force and good governance aspects such as low levels of corruption (World Bank 2005). The presence of such an investment climate will help promote domestic investment and, ultimately, economic growth. This subsequently acts as a positive signal for foreign investors and helps to attract FDI.

Besides this indirect link, it is also possible that foreign companies seek out joint ventures with domestic partners, which is often the initial form of foreign investment allowed by governments of developing countries.

3.4 Official development assistance and domestic factor markets

To identify the impact of ODA on domestic labour markets and investment activity, it is necessary to start with the general debate about aid flows and economic growth, before turning to specific linkages.

Aid can theoretically stimulate growth, investment and job creation

One of the most discussed and analysed issues facing governments, donors and researchers is whether aid promotes economic growth. This relationship was for a considerable time based on the two-gap model first proposed by Chenery and Stout (1966), in which the gaps between savings and investment and between foreign exchange earn-

ings and import requirements were shown to constrain economic growth (Dollar and Easterly 1999, Gomanee et al. 2005 and Gupta et al. 2006). In such a situation, flows of capital in the form of aid can finance these gaps, resulting in higher levels of investment and, ultimately, in increased economic growth.

Another mechanism for aid inflows to increase domestic investment is through the relationship between public investment financed by aid flows and private investment. Similar to the crowding-out hypothesis for FDI flows, it is possible that aid-financed public investment can stimulate or hinder private investment. For instance, aid could finance infrastructure investments, which in turn support private investors. There is empirical evidence to suggest that public investment in SSA tends to crowd in private investment, reflecting the complementarity of the two types of investment (Gupta et al. 2006). Evidently, the size of the effect will depend on how much aid is allocated to public investment. As discussed in chapter 2, only 14 per cent of ODA in Africa in 2001/2002 went to economic infrastructure and services.

Therefore, apart from the direct hiring of personnel in the host country, aid flows can potentially stimulate job creation through increased (public and private) investment and accelerated economic growth.

Aid flows can potentially stimulate job creation through increased investment and accelerated economic growth

Aid flows can also negatively affect the economy

However, aid may also have a negative impact on the recipient country's economy. The general argument here is that aid inflows increase the demand for non-tradable resources such as skilled labour and public services including health care and education. If there is little excess supply of these inputs in the economy, the increased demand will push up prices of the non-tradables vis-à-vis tradables. The subsequent appreciation of the real exchange rate (RER) in turn damages the competitiveness of the tradable goods sector, an effect referred to as "Dutch Disease". This loss of competitiveness leads to a fall in investment and job destruction in the tradable sector, and ultimately, to reallocation of resources to the non-tradable sector. This effect is likely to be stronger when trade is restricted, the economy is close to full capacity, and consumers are constrained in switching between domestic and imported goods (Gupta et al. 2006). Overall, the impact of aid will depend on the type of assistance, how it is spent and the efficiency of the expenditure.

Summary of the evidence on the aid-growth relationship

Burnside and Dollar (2000) find that the relationship between aid and growth is indeed positive, though more recent studies suggest that there is no clear association. Focusing on the investment channel, Gomanee et al. (2005) find that foreign aid has a significant positive effect on growth in a sample of 25 SSA countries over the

period from 1970 to 1997. The results indicate that a one percentage point increase in the aid/GNP ratio is associated with a one-quarter of a percentage point increase in growth.

Rajan and Subramanian (2005) explore the channel through which aid affects competitiveness and hence economic growth via wage inflation, which results from increased labour demand, especially for skilled labour. Based on this hypothesis, the authors investigate whether labour-intensive industries, i.e. those more affected by higher wages, grow relatively slower in countries with high aid inflows. The results indicate that aid inflows are indeed associated with a decline in the share of labour-intensive and tradable industries in the manufacturing sector.

Aid affects the real exchange rate and its subsequent impact on economic growth; (Gupta et al. 2006) report that the relationship between aid inflows and real exchange rate appreciation is ambiguous, with some studies showing positive effects, while others find negative effects. For instance, a study by the IMF found that a surge in aid in five African countries (Ethiopia, Ghana, Mozambique, Tanzania, Uganda) actually resulted in a depreciation, not an appreciation, in the real exchange rate in the following year, by between 1.5-6.5 per cent (IMF 2005a).⁴

Other studies have focused on the direct impact of real exchange rate appreciation on economic growth. Using a panel of 14 SSA countries over the period 1980-1995, Bleaney and Greenaway (2001) find that both growth and investment are negatively affected by an overvalued real exchange rate, while investment is also hindered by real exchange rate instability.

3.5 Remittances also play an important role in investment and job creation

Remittances can promote development

By reducing budget constraints, remittances can play an important role in financing development through their impact on savings and investment. The resources provided by remittances can subsequently support consumption, housing, education and small business formation (IMF 2005b). Moreover, remittances can serve as insurance against risk in carrying out new productive activities and setting up businesses (World Bank 2003). Overall, remittances can directly promote investment and job creation, and indirectly via its long-term positive effects on economic growth. Hence, remittances in Africa can contribute to poverty reduction, an issue discussed in chapter 2.

As also discussed in chapter 2 of this report, remittances are an important source of capital in Africa. Though approximately 80 per cent of remittances are used for

⁴ See Kasekende and Atingi-Ego (1999) for evidence on the situation in Uganda

consumption and schooling, they are also increasingly being allocated to investment. For example, the impact of remittances is now evident in the construction sector in many African countries, particularly in real estate, which is a major employer of unskilled workers in urban areas. However, even if remittances are used for consumption smoothing, they can increase the demand for local products, and through multiplier effects, promote employment and investment. Moreover, by investing in the human capital of family members through funding of education, the remittances can improve the productivity and employment chances of the next generation.

Though most remittances target family members, it is also possible to mobilize remittances from a community of migrants, which can subsequently be used for more substantial projects. The Mexican hometown associations in the United States are a good example of how collective remittances can be used for both charitable purposes and to finance productive investments (box 3.2).

“*Remittances can improve the productivity and employment chances of the next generation*”

Potential adverse effects of remittances

One potential negative effect of remittances is through the “Dutch Disease” channel discussed above, in relation to the impact of aid on economic competitiveness. However, it is generally found that, unlike ODA or natural resource revenues, remittances do not have any adverse effects on a country’s competitiveness (IMF 2005b). For instance, Rajan and Subramanian (2005) find that, contrary to the results for aid, there is no evidence that remittances in SSA reduce competitiveness of the tradable sector via an appreciation of the real exchange rate. Remittances can be distinguished from other forms of capital flows since they are not subject to conditionalities or repayments, and there are no leakages as the resources go directly to the targeted recipient.

The role of domestic factor markets in determining remittances

The conditions in the labour market and the availability of investment opportunities can act as a determinant of remittances. Firstly, if the domestic labour market is characterized by unemployment or underemployment, the incentive in the first place to migrate is higher. Once the migrants are located overseas, they continue to support family members remaining behind who lack decent employment opportunities. Secondly, higher returns to capital in the migrant’s home country should encourage more investment-oriented remittances. This in turn requires a conducive investment climate and an efficient financial system to attract investments to the country.

Box 3.2

Mobilizing remittances through collective migrant organizations

Remittances are typically transfers from migrants to other individuals or families in their country of origin. However, through community associations, church groups, refugee organizations, ethnic professional bodies and even virtual organizations, migrants also transfer collective remittances, usually targeting their community as a whole back home.

The most prominent example of this type of initiative are the hometown associations established by Mexicans in the United States, which have financed projects in Mexico in a number of areas such as charity, infrastructure such as road construction and provision of water and other utilities, and human development.

Numerous African migrant associations have also emerged in recent years. For example, many French migrants originating from the Kayes region of Mali have formed such associations, which have contributed, in turn, to the development of villages and rural areas back in Mali. It is estimated that over a period of ten years, these organizations financed a total of 146 projects representing 16.6 million francs, and have funded around 64 per cent of the infrastructure in the villages of the Kayes region.

Sources: Inter-American Development Bank website; Libercier and Schneider (1996); Sander and Maimbo (2003)

“Migrants also transfer collective remittances, usually targeting their community as a whole back home”

3.6 Case studies: FDI, domestic investment and job creation in Ethiopia and Ghana

This section presents two African case studies – Ethiopia and Ghana – to highlight in particular the relationship between FDI and domestic investment and job creation.

Ethiopia

Investment conditions in Ethiopia

As a resource-poor country that receives considerable external capital inflows, Ethiopia is a useful case study to discuss the effects of FDI on domestic investment and the local labour market.

Although the private sector remains undeveloped, the Government has made considerable attempts in recent years to attract private capital flows in the form of FDI. UNCTAD/ICC (2004) identifies three main positive factors that should attract foreign investment to the country: market size (Ethiopia is the second largest African country), climate, a reasonable business environment, and low levels of corruption. The key sectors for foreign investment are agriculture and agro-based industries (flo-

riculture and horticulture), mining and hydropower, light manufacturing including leather goods and ready-made garments, tourism, and other services.

The Ethiopian Government provides some incentives for foreign investors including some exemption from import and export duties and profit tax.

The Ethiopian labour market

Labour costs are on average low in Ethiopia. According to the *World Development Indicators*, the average GDP per worker in Ethiopia was \$1,716.1 in 2004, well below the SSA average of \$4,412.3.⁵ However, adjusting for labour productivity reveals that other developing countries are more competitive in terms of labour costs. This is an important factor in determining labour-intensive foreign investment.

One of the primary causes of low productivity in Ethiopia is the inadequate level of human capital. In fact, in all dimensions of education, Ethiopia lags behind the African region. For example, the net enrolment rate (NER) in primary school is only 46.4 per cent in Ethiopia, compared with an average of 64.1 per cent in SSA.⁶ Moreover, only 50.6 per cent of that age group finish primary school in Ethiopia, compared with 61.7 per cent in the whole region. In terms of outcomes, the adult literacy rate in Ethiopia was 41.5 per cent on average for the period 2000-2004, which is 23 percentage points lower than the rate for the SSA region.

As highlighted in section 3.2, another important determinant of foreign investment is labour-market regulation. The principle source of labour law in Ethiopia is the new Labour Proclamation adopted in 2004. Subsequently, the Labour Proclamation incorporates a number of articles that address dismissal protection, regulation of severance pay and compensation, disability payments and dependent benefits.⁷ There is, however, no minimum wage legislation in Ethiopia, and thus, foreign investors are not constrained from setting low wages for unskilled workers, who are in excess supply in the country.

The Labour Proclamation also provides a full guarantee for freedom of association and introduces a system of collective bargaining and settlements of labour disputes. The Ethiopian legislation also regulates fixed-term contracts. Gender equality is guaranteed by the Constitution, while the Labour Proclamation has provisions for penalizing sexual discrimination in the workplace. Ethiopia has also ratified 21 ILO conventions.

With respect to the labour market rigidities stemming from the Labour Proclamation and other forms of legislation, Ethiopia fares quite well in comparison with the rest of

5 Note that this does not control for differences in sectoral composition of output. Figures are in constant 2000 international \$ in purchasing power parity terms.

6 The net enrolment rate (NER) is the number of pupils in the theoretical age group who are enrolled expressed as a percentage of the same population. Figures are for 2004.

Source: *World Development Indicators*, online database.

7 See <http://www.ilo.org/public/english/dialogue/ifpdial/II/observatory/profiles/eth.htm>

“ Since 2000, FDI is helping to raise GCF in the Ethiopian economy ”

SSA. Ethiopia has a value of 41 for the overall rigidity of employment index, which is lower than the regional average of 53.1. The other sub-indexes (difficulty of hiring, difficulty of firing, and rigidity of hours) are all below the average for SSA. Hiring cost as a percentage of the salary in Ethiopia is zero while it is 11.8 per cent in SSA. Firing costs (weeks of wages) represent 40.2 weeks of salary compared with an average of 53.4 weeks for the SSA as whole.

At least on paper, Ethiopia has put labour laws in place and standards that provide protection for workers without overly restricting the functioning of the labour market. However, as often is the case, in countries where legal systems and enforcement are weak, compliance with these provisions is typically lax. These issues raise the question of whether or not these laws are binding and, in turn, whether they create costs for foreign companies, thus deterring foreign investment in Ethiopia. Moreover, these laws only apply to the formal sector, which accounts for a small proportion of employment in Africa, particularly in Ethiopia.

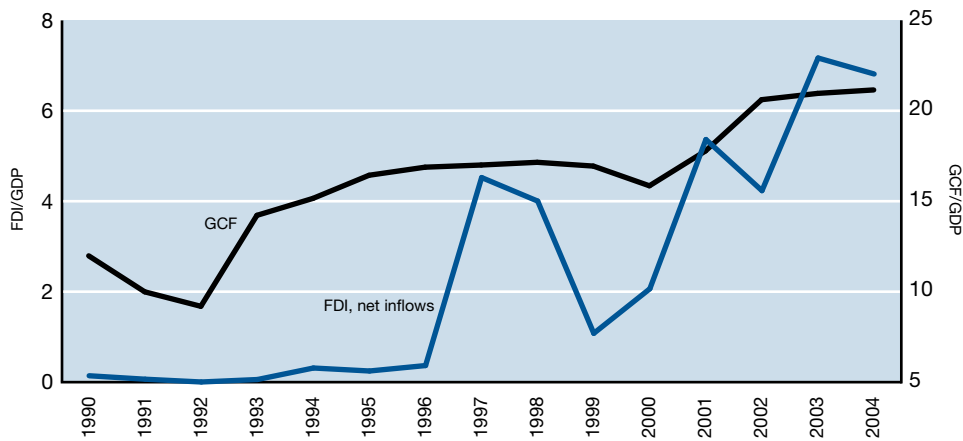
FDI and domestic investment in Ethiopia

Following the reforms undertaken in the early 1990s, net FDI inflows into Ethiopia accelerated in 1997 when it reached \$289 million (4.5 per cent of GDP), before falling again in 1999.⁸ Foreign investment has recovered since the war with Eritrea and as of 2004 inflows amounted to \$545 million or 6.8 per cent of GDP. Figure 3.1 illustrates the trends in both net FDI inflows and gross capital formation (GCF) as a percentage of GDP over the period 1990-2004. There appears to be evidence that since 2000 FDI is helping to raise GCF in the Ethiopian economy.

⁸ The spike in FDI inflows in 1997 and 1998 was the result of a large hotel investment.

Figure 3.1

Net FDI inflows and gross capital formation in Ethiopia (\$US), 1990-2004
(% of GDP)



Source: World Bank, 2006

Turning to the data from the Ethiopian Investment Commission as reproduced in table 3.2, there were a total of 318 foreign projects in operation over the period July 1992-July 2005, with 272 (85.5 per cent) being wholly foreign owned and the remainder joint ventures with a domestic firm. This compares with 2,444 domestic private and 22 public investment projects. The average capital invested in foreign projects was 28.41 million birr (\$3.28 million at current prices) per wholly foreign owned and 34.74 million birr (\$4.01 million) for joint ventures. In comparison, domestic projects were much smaller, averaging 6.28 million birr (\$0.72 million). Over the period 1998/1999 – 2004/2005, FDI in Ethiopia was concentrated in cash crops farming, accounting for 16 per cent of flows.

Table 3.2
Investment projects in operation in Ethiopia – July 1992 to July 2005

	Domestic		Foreign		Public	Grand total
		Wholly Foreign	Joint with Domestic	Total No.		
Total no. of projects	2,444	272	46	318	22	2,784
Average						
Capital (million birr)	6.28	28.41	34.74	29.33	211.04	10.53
Total employment (number of workers)	159.52	223.34	138.70	211.09	218.73	165.88
Permanent workers	37.17	120.08	104.33	117.81	192.23	47.61
Temporary workers	122.35	103.25	34.37	93.29	26.50	118.28
Share of temporary workers	76.70	46.23	24.78	44.19	12.12	71.30
Labour intensity (worker per million birr)	25.4	7.9	4.0	7.2	1.0	15.8

Source: Ethiopian Investment Commission (EIC); Capital in million of birr

One direct channel of the impact of FDI on domestic investment is through joint ventures. According to EIC data, 14.5 per cent or 46 projects in Ethiopia over the period July 1992 to July 2005 were joint ventures. These investments with domestic partners averaged 34.7 million birr, generating 138.7 jobs per project.

FDI and job creation in Ethiopia

Foreign investment projects in Ethiopia created a total of 67,128 jobs from July 1992 to July 2005, representing 14.5 per cent of all jobs created during this period.⁹ In comparison, domestic and public projects generated 389,876 and 4,812 jobs, respectively. On average, each foreign project generated 211 jobs, 118 permanent positions and 93 temporary jobs. Domestic investments resulted in fewer jobs (average 160), while public projects tended to employ more workers (219).

The labour intensity (the ratio of workers to capital invested) is highest in domestic projects (25.4 workers per million birr), which also have the highest share of tempo-

⁹ 90.5 per cent were in wholly foreign-owned projects. Total number of jobs created (foreign, domestic and public) from July 1992 to July 2005 = 461,816.

rary workers, the majority of whom are unskilled. Foreign investment projects are less labour-intensive than domestic investment, though more so than public projects. For every million birr invested by a foreign company in wholly-owned projects in Ethiopia, 4 jobs are created, compared with 25 jobs in domestic-owned projects.

Over the period 1998/1999-2004/2005, FDI in Ethiopia created the most jobs (temporary and permanent) in the cash crops sector (79,338 jobs), followed by real estate development (37,397 jobs). Both these sectors are labour-intensive and largely employ unskilled workers.

Therefore, these figures indicate that, in general, foreign investments in Ethiopia are an important vehicle for job creation and may also contribute to decreasing inequality through increased relative demand for unskilled workers. However, domestic investment remains more labour intensive and therefore has a larger impact on employment in terms of quantity, though not necessarily in terms of decent jobs.

“ Foreign investments in Ethiopia are an important vehicle for job creation ”

Ghana

Investment conditions in Ghana

In comparison to Ethiopia, Ghana is a country rich in natural resources, particularly gold. However, Ghana has had difficulties in attracting sustained inflows of FDI, in spite of the potential in the mining sector. Other promising but still undeveloped sectors for attracting FDI are agro-processing and agriculture, and light manufacturing for local and regional markets (UNCTAD 2003a).

The Ghanaian Government adopted a new mining law in 1986, which motivated a substantial increase of foreign investment in the mining sector. Subsequently, the Government promulgated the Investment Promotion Centre Act 1994 to regulate FDI in all sectors except in minerals, oil and gas, and free trade zones (FTZs), with the aim of facilitating the setting-up of businesses and attracting FDI. Incentives are also provided for would-be foreign investors in the form of tax holidays, capital allowances, location incentives, and customs duty exemptions. There are also special incentives for exporters and in the FTZs. However, investors, especially in the FTZs, have pointed out that these targeted incentives do not adequately compensate for the poor infrastructure and other constraining factors (UNCTAD 2003a).

Another important channel for attracting FDI in Ghana has been privatization, which reached its peak with the partial sale of the Ashanti Goldfields Corporation (AGC) to the South African mining company Lonmin for \$233 million in 1994 (UNCTAD 2003a).

The Ghanaian labour market

Labour costs are higher in Ghana than in Ethiopia and in SSA on average. However, the Ghanaian labour force is also much more educated with the adult literacy rate reaching 74 per cent, compared with 41.5 per cent in Ethiopia (period 2000-2004). Nonetheless, foreign investors state that the level of education and skills is still too insufficient to meet their requirements (UNCTAD 2003a).

With regards to labour laws in Ghana, labour rights provisions are generally negotiated under firm-specific collective bargaining agreements, which can be complicated and lengthy (UNCTAD 2003a). Ghana also has in place a minimum wage, though its level is low (around US\$1.30 per day in 2003) and is therefore unlikely to have a substantial effect on the demand for unskilled workers.

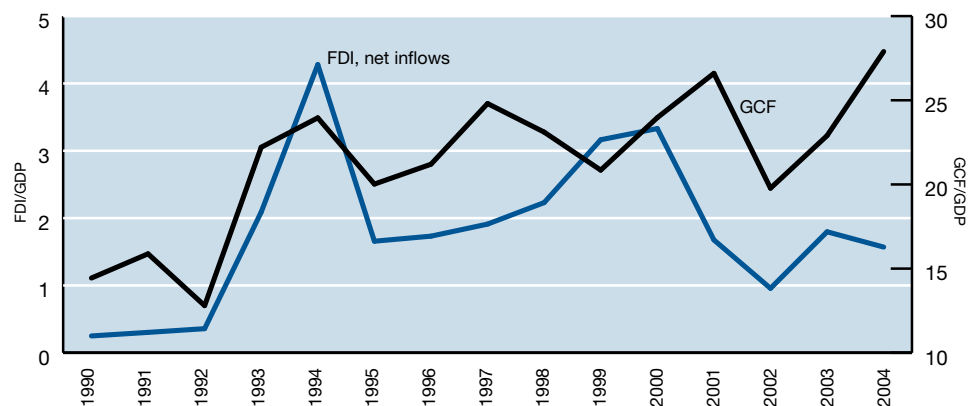
In general, Ghanaian employment regulations are less restrictive than the regional average. The employment rigidity index is 34 for Ghana, compared to 41 for Ethiopia and 53 for SSA. Specifically, hiring is more flexible and the number of hours worked less rigid in Ghana, though firing is more constrained in comparison with Ethiopia.

The impact of FDI on domestic investment in Ghana

After peaking at \$233 million or 4.3 per cent of GDP in 1994, FDI in Ghana has fluctuated considerably (figure 3.2). As illustrated in figure 3.3, the contribution of FDI to gross capital formation in Ghana exceeded that of Ethiopia from 1990 to 1996, before the ratio in Ethiopia increased rapidly to over 25 per cent. FDI is now clearly a more important source of capital formation in Ethiopia than in Ghana.

Figure 3.2

Net FDI and gross capital formation in Ghana (\$US), 1990-2004 (% GDP)



Source: World Bank, 2006

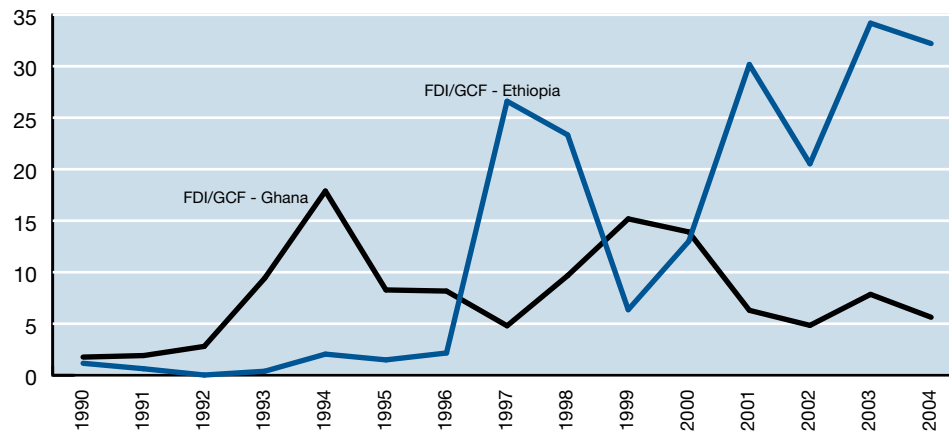
FDI and job creation in Ghana

Given that most of FDI in Ghana has been confined historically to the natural resources sector, it is not surprising that foreign projects have not resulted in significant job creation. Most jobs created by FDI in Ghana were therefore as a result of projects in other sectors. It is encouraging that recent data reveal that the manufacturing and service sectors have attracted the largest share of foreign investment (GIPC 2005). For example, over the period January 2001 to September 2005, the majority of jobs in new foreign projects were created in the manufacturing sector (table 3.3). In comparison, domestic projects resulted in more jobs in the service sector. Overall, these figures illustrate that though FDI created a total of 2,844 jobs over the almost 5-year period, the number is dwarfed by those created in domestic projects (38,562 jobs).

“The majority of jobs in new foreign projects in Ghana were created in the manufacturing sector”

Figure 3.3

FDI's contribution to gross capital formation in Ghana and Ethiopia, 1990-2004 (% GCF)



Source: World Bank, 2006

“
The impact of
FDI on job creation
also includes jobs
created indirectly
through linkages and
multiplier effects
”

Table 3.3

Employment creation in foreign versus domestic projects in Ghana, January 2001 – September 2005

Sector	Domestic		Foreign	
	Number of jobs	Share	Number of jobs	Share
Manufacturing	10,511	27.3	877	30.8
Services	11,517	29.9	587	20.6
Building and construction	4,185	10.8	341	12.00
Agriculture	4,375	11.3	217	7.6
Tourism	2,929	7.6	275	9.7
General trade	4,041	10.5	453	15.9
Export trade	1,004	2.6	94	3.3
Total	38,562	100.0	2,844	100.0

Source: GIPC (2005)

The impact of FDI on job creation is not confined to its direct effect on employment, but also includes jobs created indirectly through linkages and multiplier effects. Box 3.3 provides an example of these direct and indirect effects in the case of Unilever’s investment in Ghana.

Box 3.3

Unilever’s subsidiary creates thousands of jobs in Ghana

Unilever Ghana Ltd. operates a highly integrated business in Ghana, involving the purchase of raw materials, the processing, packaging and subsequent distribution of soap and cleaning products. Altogether, Unilever employs around 1,200 farmers in Ghana in two oil palm plantations in addition to another 800 in their processing factory. Moreover, it is estimated that for every worker directly employed with Unilever, an extra three are employed indirectly through an independent entrepreneurs’ distribution network.

Source: UNCTAD (2003a)

3.7 Conclusion and policy recommendations

Based on the analysis in this chapter, a number of key findings can be highlighted:

- Since most FDI in Africa has been concentrated in the natural resources sector, few jobs have been created by such investments. There is some evidence that foreign firms pay a wage premium in Africa;
- Labour costs and regulations in African countries are important determinants of capital flows and a constraint to FDI;
- Undeveloped human capital is a major constraint to foreign investment in African countries;
- The investment climate in Africa remains a deterrent to both domestic and foreign investment; and
- Though official development aid and workers' remittances are important in Africa, evidence of their relationship with domestic labour markets and investment remains limited.

Overall, African governments need to promote capital flows to increase economic growth and job creation, and reduce poverty. The following policy recommendations are part of this agenda:

- The first and overriding priority is to develop a conducive investment climate through good governance, sensible regulation and taxation, infrastructure, access to finance and investment in education and skill development;
- Through the use of targeted policies and incentives, governments should encourage investments in more labour-intensive sectors such as food processing, manufacturing and services (tourism);
- Labour market regulations should be streamlined to encourage investment by both domestic and foreign firms, while protecting workers' rights;
- Governments should improve employment conditions especially in the informal sector;
- Governments should invest more in education and skills in order to attract investments in higher value-added activities. Training at the firm level and by private providers should also be encouraged;
- Governments should ensure that favourable treatment of foreign investment does not provide unfair advantage to foreign investors vis-à-vis domestic investors; and
- Governments should design incentives to encourage more investment-oriented remittances. Financial institutions may play an important role in facilitating transfers of remittances and in designing investment instruments targeting the Diaspora.

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