Foreign Direct Investment for Development

Policy Challenges for Sub-Saharan African Countries

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Introduction

At least two issues make Foreign Direct Investment (FDI) a hotly debated issue in the Sub-Saharan African (SSA) context: 1) SSA countries attract only a small share of total FDI flows and 2) Concerns exist as to whether FDI really leads to economic and social development in SSA. This paper discusses these issues on the basis of ten challenges faced by SSA policy makers to make FDI work for development.

Ten policy challenges to make FDI work for development: a summary

1. Determine whether and how FDI fits in with development objectives
2. Think in terms of quality, not quantity
3. Prepare well
4. Reduce conflict and corruption
5. Provide appropriate infrastructure and appropriate skills
6. Implement FDI policies consistently and actively
7. Understand the pros and cons of international investment agreements
8. Facilitate trade
9. Provide a transparent and appropriate incentive and regulatory framework
10. Promote linkages within available means

We do not contend that the list of challenges in this paper offers sufficient or even necessary guidelines for SSA countries wanting to attract FDI. Rather, it is a checklist for those countries in need of appropriate policies to make FDI work for development. Each country will have different answers and priorities in relation to these challenges, but here we mention challenges in the more general context of Sub-Saharan Africa.

We focus on what host countries can do to influence FDI. This leaves aside whether and how regulation and voluntary initiatives at regional or global level can affect the level and impact of FDI. Actions at national and international level may not be substitutes but can act as complements.

Host country policies need to address information gaps in the international investment process (e.g. Lall, 2000), market failures in the market for skills and technologies which limit the possibilities for TNCs to upgrade and finally, capture possible externalities associated with TNCs, for instance in the form of promoting linkages between TNCs and local firms.

1. Determine whether and how FDI fits in with development objectives

FDI is not a solution to all development problems. Nor is domestic investment, aid or government expenditure. However, in order to find solutions to development issues, it is important to realise that FDI is *different* from local investment, external aid flows, or portfolio inflows. The existence of such differences requires that a country examines how FDI fits in with development objectives. For instance, while FDI can lead to capital intensive projects that embody state-of-the-art technology with regards to the extraction of resources, FDI in the garments and textiles industry is likely to lead to employment intensive, but technologically less-advanced production processes.

One type of FDI cannot always serve separate development objectives. FDI in the extractive industries may help to achieve the objective of exploiting natural resources for economic development; attracting FDI in the textiles industry helps to achieve the objectives of low-skill job creation and exports; and attracting FDI in the high-tech industry can lead to further innovation, exports and high-skill job creation. Any SSA country is unlikely to be in a position to attract all these types of FDI and achieve the various development objectives at the same time. Clear choices need to be made.

Depending on a country's factor endowments (skills, natural resources, capital) and its development objectives (poverty reduction, growth, job creation, financing a current account deficit, etc,), a government (whether in Africa or elsewhere) should determine what type of FDI is needed and how the positive and negative, long-run and short-run characteristics of the various types of FDI fit in. FDI and other types of policies follow on from this. For instance, FDI in the textile industry helps to create low-skill jobs and to reduce poverty, but without further policy intervention is unlikely to lead to significant growth in the long-run. FDI attracted by privatisation of state utilities may enhance efficiency, but does not guarantee affordability of services for all without proper regulation or competition policy.

2. Think in terms of quality, not quantity

According to UNCTAD, Africa, excl. South Africa, attracted $8198 million ($5582 million for SSA) of FDI inflows in 2000; representing 0.65% (0.44 for SSA) of total FDI flows and 3.4% (2.3 for SSA) of total developing country FDI inflows. The main recipients were Angola ($1800 million), Egypt ($1235 million) and Nigeria ($1000 million). Given the low share of FDI flows, there are concerns that 'Africa is marginalised' in the global economy.

However, there are various reasons why a low share in total FDI flows should be of little concern to policy makers. For instance, the stock of FDI (accumulated inflows), which is arguably a better measure of the 'port to new ideas and technologies' than flows, scaled by the market size (which is low for SSA countries), is higher for SSA than for the developing (or developed) world as a whole. On this measure, Angola, Equatorial Guinea, Lesotho and Liberia received more FDI than e.g. Singapore.

Inward FDI stocks, as a% of GDP by region and county

	1980	1985	1990	1995	1998	1999
Developed countries	4.7	6.1	8.3	8.8	12.1	14.5
Developing countries	5.4	9.1	10.5	13.4	20	28.0
Africa*	6	9.5	12.4	19.9	21.1	21.0
SSA	4.9	8.7	14.3	23.5	27.7	29.9
Nigeria	2.6	5.5	28.3	50	50.5	50.5
South and East Asia	7.9	9.7	11.2	15	23.3	23.3
Central and East Europe			1.5	5.2	12.1	12.1
Latin America and Carib	5.7	8.6	10.5	11.9	19.5	19.5

Source: UNCTAD (2001) * excl. South Africa

Furthermore, the key is not quantity, but quality of FDI: what can FDI do for a country's development objectives. In other words, a dollar of oil investment may do less to Equitorial Guinea's development in the long-run compared to one dollar in the hard disc industry for Singaporean development, because of differences in profit repatriation (75 cents for every dollar invested in Africa was repatriated compared to 37 cents on average for all countries: UNCTAD), contribution to human capital development, linkages with the local economy etc. Nearly two thirds of the stock of US FDI in Africa was located in the petroleum industry in 1999 (compared to 9% world-wide), over 40% of UK FDI in Africa was in the mining and quarrying industry (compared to 20% world-wide). Natural resources FDI may offer short-run benefits, while other types of FDI may offer long-run benefits.

3. Prepare well

There is macro-evidence that FDI is associated with faster economic growth in developing countries (and SSA), but it is not clear whether this is due to a composition effect, with TNCs locating in high-value added sectors, or due to TNCs transferring skills and superior techniques to a local economy, or both. Importantly, the existing evidence also suggests that the impact of FDI on development is a process characterised by informational market failures requiring policy interventions. Competition, education or technology policy is required to raise the capacity of the local economy to absorb positive spillovers and mitigate negative aspects.

A link clearly exists between FDI, trade and domestic policies. Relying on one type of policies should not deter the implementation of other types of policies. East Asian countries (Taiwan and South Korea) show that good domestic policy (e.g. providing the right type of education) permits countries to benefit from trade liberalisation. The real issue is which policies should have priority in terms of timing and implementation. Countries wanting to follow WTO rules should take action domestically to reap benefits from increased trade and investment opportunities.

GATT/WTO agreements related to FDI and domestic policy action

(situation October 2001)

WTO agreement	Exceptions	Possible direct effects on domestic policy (apart from administrative effects)	Complementary domestic policy required to react to new agreements
Trade Related Investment Measures (TRIMS)	Affects trade in goods only; exceptions for least developed countries (until 2002).	Abolishing performance requirements on TNC affiliates (e.g. local content or export requirements).	Domestic policy towards TNC-SME linkage creation
Trade Related Intellectual Property Rights (TRIPS)	Delayed implementation of agreement in developing countries until 2005 (food, chemical and pharmaceutical sector), and until 2006 for least developed countries; certain exceptions possible.	Upward harmonisation of national legislation with regard to IP protection and patent law towards developed country standards; change in certain R&D activities	Support for domestic technological activity (e.g. R&D subsidies); implementation of effective competition policy.
Subsidies and Countervailing Measures (SCM)	Affects trade in goods only; export performance subsidies permissible for countries with GNP per capita less than $1000 per year	Reducing export and domestic subsidies (e.g. for attracting foreign investors)	Upgrade potential and existing exporters, providing a favourable environment for skill and technological upgrading; implement anti-dumping legislation.
Agreement on Trade in Services (GATS)	Voluntary commitments and flexibility for individual developing countries; but once signed up MFN, national treatment and market access principles apply; does not include procurement of government services, but does FDI in services	Removal of regulation	GATS commitments can speed up or lock in privatisation policies; privatised 'utilities' are sometimes monopolies and hence need to be regulated. Subsidies may also be needed to ensure services for all.
Agreement on Textiles and Clothing (ATC)	Successor of MFA agreement governing a large portion of trade in textiles and clothing. Members to bring textiles and clothing sectors under WTO rules in steps until 2004, but with 'safeguards' during transitional phase.	Reduction in quotas on textiles and clothing imports by members	Improve supply-side constraints (infrastructure, access to inputs, marketing facilities and standards control) to benefit from export opportunities after liberalisation (especially those countries losing preferential access).

Based on Morrissey and Te Velde (2001)

4. Reduce conflict and corruption

Research suggests that conflict and corruption deter foreign investment (e.g. Wei, 2000). For a firm, paying bribes is like paying a tax, but then the firm is faced with more uncertainty. Transparency International collects data on the perception of corruption, mainly on the basis of private sector surveys. Corruption is defined as the misuse of entrusted power for private gain and ranks from 10 (no corruption) to 0 (highly corrupt). The table shows the ranking of 91 countries.

In general, African countries score low. Only Botswana (rank 26), Namibia (30) and South Africa (38) are ranked in the top 50. Countries such as Nigeria, Uganda, Kenya and Cameroon are found at the bottom. While it is more difficult and uncertain to do business in a country with more corruption and conflict, some investment is likely to take place regardless. In particular, FDI in the extractive industries does not have a choice but to locate near the available natural resources (e.g. Nigeria, Angola etc.).

However, certainty in future operations is required for FDI in activities such as manufacturing and services. In particular, FDI in manufacturing (garments, assembly operations) can often choose between locations, and the 'footloose' investor is likely to choose a country with less corruption and conflict to avoid taking too much risk. Corruption and conflict are important elements of

political risk assessments, which in turn determine investor perceptions of the business climate in a country. With only limited available information, such perceptions are difficult to change and are sometimes applied to countries or regions with a good economic business climate in practice. With few natural resources and lots of corruption and conflict, countries may not appear on an investor's shortlist.

Corruption Perception Index 2001 – Transparency International

1	Finland	9.9
2	Denmark	9.5
3	New Zealand	9.4
4	Iceland	9.2
	Singapore	9.2
6	Sweden	9.0
7	Canada	8.9
	Netherlands	8.8
9	Luxembourg	8.7
10	Norway	8.6
11	Australia	8.5
12	Switzerland	8.4
13	United Kingdom	8.3
14	Hong Kong	7.9
15	Austria	7.8
16	Israel	7.6
	United States	7.6
18	Chile	7.5
	Ireland	7.5
20	Germany	7.4
21	Japan	7.1
22	Spain	7.0
23	France	6.7
24	Belgium	6.6
25	Portugal	6.3
26	Botswana	6.0
27	Taiwan	5.9
28	Estonia	5.6
29	Italy	5.5
30	Namibia	5.4
31	Hungary	5.3
	Trinidad &Tob	5.3
	Tunisia	5.3
34	Slovenia	5.2
35	Uruguay	5.1
36	Malaysia	5.0
37	Jordan	4.9
38	Lithuania	4.8
	South Africa	4.8
40	Costa Rica	4.5
	Mauritius	4.5
42	Greece	4.2
	South Korea	4.2
44	Peru	4.1
	Poland	4.1
46	Brazil	4.0
47	Bulgaria	3.9
	Croatia	3.9
	Czech Rep	3.9
50	Colombia	3.8
51	Mexico	3.7
	Panama	3.7
	Slovak Rep	3.7
54	Egypt	3.6
	El Salvad	3.6
	Turkey	3.6
57	Argentina	3.5
	China	3.5
59	Ghana	3.4
	Latvia	3.4
61	Malawi	3.2
	Thailand	3.2
63	Dom. Rep	3.1
	Moldova	3.1
65	Guatemala	2.9
	Philippines	2.9
	Senegal	2.9
	Zimbabwe	2.9
69	Romania	2.8
	Venezuela	2.8
71	Honduras	2.7
	India	2.7
	Kazakhstan	2.7
	Uzbekistan	2.7
75	Vietnam	2.6
	Zambia	2.6
77	Côte d´Ivoire	2.4
	Nicaragua	2.4
79	Ecuador	2.3
	Pakistan	2.3
	Russia	2.3
82	Tanzania	2.2
83	Ukraine	2.1
84	Azerbaijan	2.0
	Bolivia	2.0
	Cameroon	2.0
	Kenya	2.0
88	Indonesia	1.9
	Uganda	1.9
90	Nigeria	1.0
91	Bangladesh	0.4

5. Provide appropriate infrastructure and skills

Research shows that infrastructure and skills are important determinants of FDI (Wheeler and Mody, 1992, and Noorbaksch, 2001). Surveys show that a low level of appropriate skills is one of the main barriers to investing in Africa. In addition, if there is no proper infrastructure, investors have to build their own in order to produce, transport, sell or export their products.

At the same time, infrastructure and skills help to absorb the positive effects from FDI (e.g. Borensztein *et al*, 1998). With a more skilled workforce and a better infrastructure (ports, roads water pipelines, electricity and telecommunications), local firms can more easily capture knowledge spillovers, for instance through becoming local suppliers.

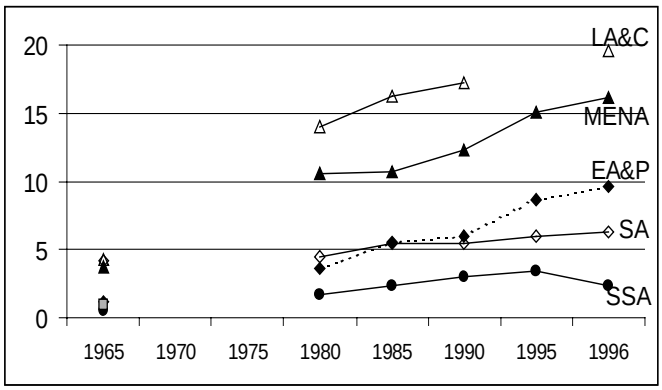
The state of the infrastructure and educational attainment or enrolment rates in Africa compares unfavourably with those of other regions and the situation has become worse during the past decade. Some African countries have relatively good infrastructure facilities (South Africa,

Mauritius) but many have facilities that provide an environment disabling for productive activities(e.g. Cameroon, Ethiopia, Nigeria and Uganda).

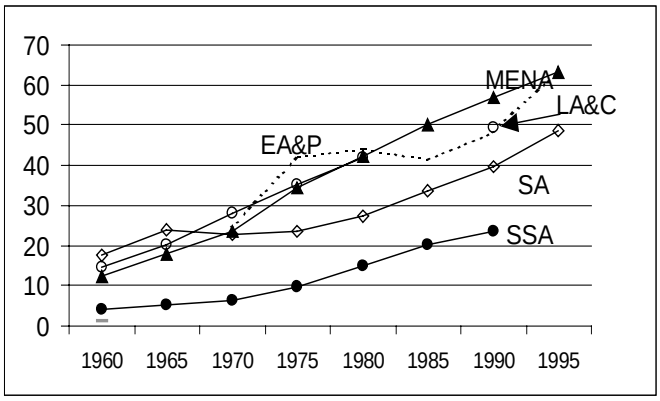
While the provision of good quality and appropriate basic education is important, attention should also be focused at high-level specialised training in technical subjects to meet the needs of the industry. However, the encouragement of training is more effective when basic skills are already available.

Enrolment rates (% of age groups)

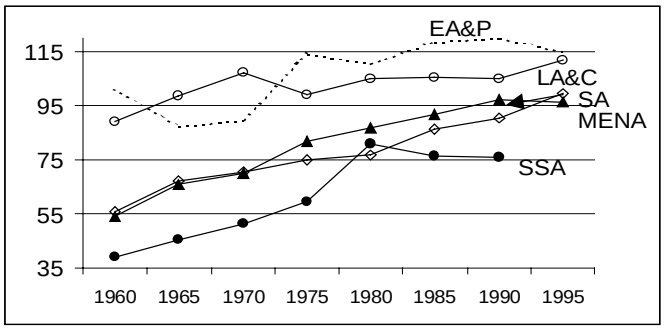
Tertiary education



Secondary education



Primary education



LA&C = Latin America and Caribbean EA&P = East Asian and the Pacific SA = South Asia
SSA = Sub-Saharan Africa MENA = Middle East and North Africa
Source: World Development Indicators 2000

Selected indicators of infrastructure, by region

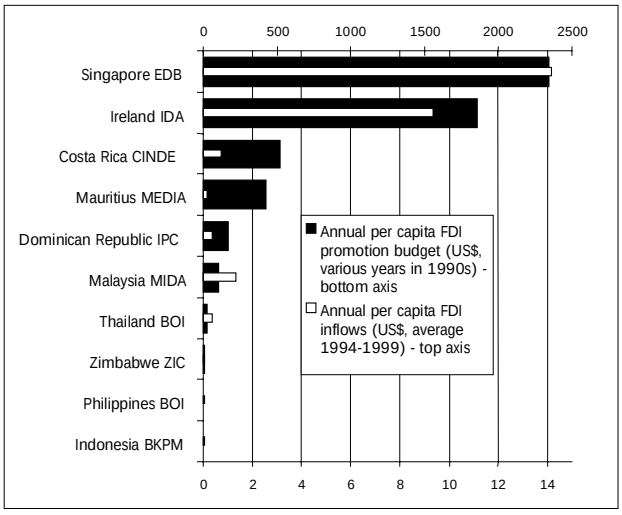
	Telephone mainlines per 1000 inhabitants		% road paved	
	1975	**1997**	**1990**	**1996**
World	62.37	118.43	39.05	44.40
Sub-Saharan Africa (SSA)	6.90	16.13	16.60	15.75
South Asia (SA)	2.30	18.35	37.50	40.75
Middle East & North Africa (MENA)	12.97	74.90	67.00	50.20
Latin America & Caribbean (LA&C)	28.57	110.20	21.90	25.95
East Asia & Pacific (EA&P)	2.18	50.16	17.20	9.85

Source: World Development Indicators, 2000.

6. Implement FDI policies consistently and actively

A simple change in the law to allow foreign ownership in certain industries may do little to attract foreign investors. If a country really wants to attract FDI, a change in law needs to be followed by a consistent and active implementation of a range of FDI policies. This involves the setting-up of an effective and aggressive Investment Promotion Agency (IPA) that targets particular firms and industries that fit in with the FDI strategy. The targeting of star transnational corporations (TNCs) has preceded episodes of successfully attracting FDI in Costa Rica, Ireland and Singapore. IPAs in these countries had significant influence over policy (in order to plan for a demand for skilled labour), engaged in significant FDI promotion activities (site visits, match-making, etc), helped with obtaining permits, and were able to follow a strategy consistently over 40 years.

Is FDI promotion (excl. grants and fiscal incentives) successful?



Sources: see references in Te Velde, 2001

There are concerns that many African IPAs are not the one-stop centres that investors like to see. Obtaining permits is difficult and takes a long time.African IPAs often lack the funds for consistent implementation of FDI promotion policy. Many also appear to lack a targeted and long-term focus that is required to attract TNCs. Others do not have sufficient power to decide on relevant issues. In addition to a consistent implementation of FDI promotion efforts, it is also important that government policy in other fields (e.g. policy related to education, technology, competition or privatisation) is implemented consistently without engaging in policy reversals. Policy reversals often create an uncertain and business-unfriendly world. The successful countries

of today have in the past gone through periods (sometimes over 5 years) when their investment strategies did not pay off. It is useful to define an FDI strategy, and stand by the implementation of policies to achieve this strategy until better strategies arise.

7. Understand the pros and cons of international investment agreements

The past decade has seen rapid changes in the international regulatory framework for FDI in Africa. Almost all African countries have signed Bilateral Investment Treaties with other countries aimed at protecting and promoting FDI and clarifying the terms under which FDI can take place between partner countries. By 1999, African countries had signed 335 BITs, most of which were signed in the last decade. The conclusion of double taxation treaties, avoiding companies to pay taxes twice, has also risen sharply, but appears to be concentrated in countries such as Egypt, Mauritius, South Africa and Tunisia.

Most African countries have also signed the Convention on the Multilateral Investment Guarantee Agency (MIGA) and on the Settlement of Investment Disputes Between States and Nationals of Other States. Since 1991, MIGA has issued $400 million in coverage in Africa which is around 8% of the total exposure. It has facilitated $3.7 billion in FDI in 19 African countries. Bilateral export credit agencies are also involved in investment insurance. For example, the maximum investment exposure by the UK ECGD increased from £205 million in 1995/1996 to £797 million in 1999/2000. However, only 7.5% went to just four African countries (South Africa, Egypt, Morocco and Zimbabwe).

The international regulatory changes should make African countries more attractive for investors by offering contract stability. For instance, research shows that the US FDI responds positively to the conclusion of BITs (Blonigen and Davies, 2000). However, while some argue that African countries are rated more risky than is warranted by economic fundamentals and hence there is a potential role for political risk insurers, others suggest that economic variables are the primary determinants of risk ratings, and political variables merely reinforce the picture sketched by economic variables. International political risk insurance should not become a substitute for good economic fundamentals, to avoid that foreign investors are lured into economically or politically risky projects. Political risk insurance is useful for countries that want to lock-in economic reforms and improve their image, but probably not for countries whose business environment in disabling or for countries involved in frequent policy reversals.

8. Facilitate trade

Foreign investors are usually more trade intensive than local firms. TNC affiliates may depend on capital goods imported from their parents' network, they may export natural resources overseas or they may use cheap labour to produce competitive products for export. For these reasons, TNCs are relatively sensitive to conditions that facilitate trade: ports, customs regulation, tariffs, roads.

Surveys can help to assess how managers perceive the business environment in Africa compared to the rest of the world, with the caveat that surveys are subjective. While many obstacles are perceived as similar, foreign trade and exchange regulations, infrastructure, inflation, crime and corruption are considered worse in the African context. It would thus be helpful if countries integrate more with other countries and provide a good quality infrastructure. In order to facilitate

FDI inflows in the presence of a weak infrastructure, African governments have set up export processing zones (EPZ). EPZs offer special tax incentives, streamlined customs procedures, low tariffs and specialised infrastructure. However, with the exception of Mauritius, African EPZs have failed to make a significant impact on economic development. EPZs elsewhere have been more successful. Costa Rica, Singapore and Malaysia have used EPZs as a first set up the ladder to diversify from garments into more complicated manufacturing operations.

Research suggests (e.g. ILO, 1998, Madani, 1999) that EPZs have been most successful in countries that started out with minimum basic conditions in place (infrastructure, stability, some trade liberalisation, etc.); when zones are well managed with few administrative burdens and streamlined customs procedures; when zones are built in appropriate locations, with reliable infrastructure and utilities; and when zones were aimed at specific industries.

World Bank Survey of managers considering an obstacle to doing business (very) strong (1997)

	Africa	Worldwide
Regulations for starting new business	17	18
Price controls	13	13
Foreign trade regulations	27	18
Financing	45	41
Labour regulations	21	25
Foreign currency regulations	27	21
Tax regulations or high taxes	59	58
Inadequate physical infrastructure	50	39
Policy instability	28	32
Safety or environm regulations	22	19
Inflation	47	35
General uncertainty cost of regulations	28	27
Crime and theft	49	37
Corruption	60	46
Terrorism	13	13

Selected African export processing zones – impact and incentives

	employment	% of labour force	incentives
Cameroon	2567	0.04%	10-year tax holiday, duty-free imports and exports
Egypt	67000	0.28%	tax and duty exempt
Kenya	3000	0.02%	10-year tax holiday, duty-free imports
Madagascar	25000	0.35%	5-year tax holiday, duty-free imports and exports
Mauritius (1995)	82000	17.36%	10 to 20-year tax holiday, no customs duty
Namibia (1996)	2000	0.31%	tax exempt, liberal customs regulations
Senegal (1990)	600	0.02%	tax and import duty exempt, unrestricted profit repatriation
Togo	10000	0.53%	10-year tax holiday, duty-free imports

Source: UNCTAD, World Development Indicators 2000 and author's own calculations

9. Provide a transparent and appropriate incentive and regulatory framework

Governments have offered various incentives schemes to attract investors, ranging from corporate tax holidays, exemptions for taxes and import/export duties, to offering pure grants. TNCs in the natural resources industry hope to repatriate large sums of profits without paying taxes, and are sometimes prevented from disclosing taxes paid. However, tax experts indicate that many TNCs are interested in predictable tax regimes, especially in low-income countries, rather than unpredictable tax rates. Of course, corporate taxes should not be too high from a business

perspective. With respect to pure grants, research indicates that offering grants is questionable in terms of efficiency and effectiveness (Hanson, 2000), and for many governments beyond their budgetary means.

On the other hand, governments can improve the regulatory framework by removing unnecessary regulations (some, such as environmental regulations, may still be necessary). There is still a wide difference in regulations between countries, and investor roadmaps show the extent to which some of these regulations are unnecessary. In Ghana and Uganda it can take one or two years to establish a business and become operational, 18 months to three years in Tanzania and Mozambique, six months to one year in Namibia, but only six months in Malaysia. This sends the wrong signal to other potential investors. Whilst some regulations hinder foreign as well as domestic firms, some hit foreign firms particularly hard such as expatriate work permits and access to land. In many African countries, freehold ownership for foreigners is prohibited or requires explicit approval, which may involve long delays varying considerably across countries (up to two years in Ghana, several years in Mozambique, no freehold ownership in Namibia, up to three years in Tanzania, up to 8 years in Kenya and up to six months in Uganda).

Policy related to FDI should not stop when TNCs begin their operations. There are various measures that can be used to upgrade the operations by TNCs. For instance, the tax/subsidy system can be used to encourage training or to foster relationships with research institutes.

10. Promote linkages within available means

Linkages between TNCs and SMEs (small and medium sized enterprises) can bring positive effects for SMEs directly through employment and indirectly through technology and skill transfer and access to export markets and finance. However, linkages in many African countries appear to be underdeveloped.

Linkages in African countries can be underdeveloped for various reasons. Most TNCs in Africa locate in sectors with relatively low linkage possibilities (natural resources and textiles), while Asian and Latin American countries have also attracted linkage intensive TNCs (electronics and automobile industry). In addition, linkage creation depends on TNC strategies and level of development of the host country. TNCs are willing to source locally when reliable, good quality and cheap products are available. Sometimes TNCs are willing to assist in the development of local suppliers. However, there is also a role for government policy.

There are two WTO agreements that may limit the means available to governments to strengthen TNC-SME linkages. The TRIMs (Trade-related-investment-measures) Agreement bans the imposition of performance requirements TNCs, such as local content requirements. Further the Agreement on Subsidies prohibits subsidies contingent on the use of domestic goods or export performance. Exemptions or grace periods can apply to both agreements, particularly for least developed countries. A review of the TRIMs Agreement is scheduled.

However, various other options still exist for government policy to strengthen TNC-SME linkages. These include national linkage programmes and support services that help to upgrade technology and skills in SMEs. Some countries have established national linkage programme promoting linkages between TNCs and SMEs through matchmaking, organising fairs, offering training,

quality certification, etc. Examples can be found in Costa Rica, Malaysia, Mexico, Singapore and Thailand, but no significant initiatives exist in African countries. Policy is most important to improve the capabilities in (potential) local suppliers, reduce information failures between buyers and sellers, and to reduce the costs and risks of setting-up linkages.

Conclusions

This paper suggested ten general areas which pose a challenge to policy makers in Sub-Saharan Africa concerned with Foreign Direct Investment (FDI). If FDI is expected to play a role in achieving the country's development objectives then an active policy is required to attract FDI and to make FDI work for development. If not, many of the challenges in this paper may also be seen as part of a general development agenda that fosters (domestic) private investment. Of course, the details and relative importance of these will differ by country and there are exceptions. This paper set out challenges in general terms.

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