PRIVATE FOREIGN INVESTMENT:

Part of the Problem or Part of the Solution?

Roy Culpeper

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Roy Culpeper[1]

Introduction

An increasingly significant source of capital for developing countries is private foreign investment (PFI), the subject of this edition of the Canadian Development Report. Under what conditions can PFI contribute to economic growth and development, raising living standards, and facilitating poverty reduction?

It is clear that, in spite of falling considerably from a peak of US$285.1 billion in 1997, during the past five years net private capital flows have amounted to more than combined net official flows (aid grants and loans) and worker remittances, the two other major sources (Table 1). These capital flows are comparable in magnitude with net merchandise trade balances in recent years. (In 2001, aggregate developing country export earnings were US$1,500 billion and imports US$1,341 billion.)

Private foreign investment is financed by either debt or equity; these "pure" forms of financing are typically mixed in any single investment transaction. Debt financing may be arranged through loans from foreign banks, or sales of bonds to foreign investors ("portfolio lending"). Equity financing may form a significant part of foreign direct investment (FDI), whereby a foreign firm establishes or acquires a production facility in a developing country; or it may

Table 1 **Net capital flows to developing countries**
(US $billions)

	1999	2000	2001	2002	2003
Net private flows (debt+equity)	194.7	191.8	152.8	143.3	163.0
Net official flows (aid+debt)	42.9	23.4	57.5	49.0	32.0
Worker remittances	64.6	64.5	72.3	80.0	na
Merchandise trade balance	99.0	194.0	159.3	174.7	159.5

Source: World Bank, Global Development Finance, p.8, Table 1.1; p. 194 Table A.194. Washington, DC, 2003.

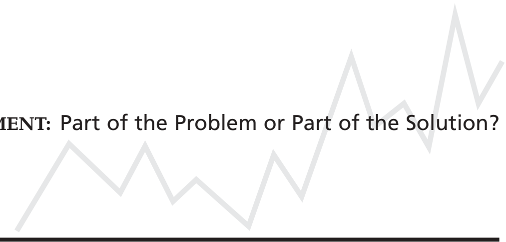


Table 2 **Private capital flows to developing countries**
(US$billions)

	1999	2000	2001	2002	2003
Net Equity Flows:					
Net FDI inflows	179.3	160.6	171.7	143.0	145.0
Net portfolio equity inflows	15.0	26.0	6.0	9.4	13.0
Net Debt Flows:					
Bonds	29.6	17.4	10.1	18.6	
Banks	-5.9	2.6	-11.8	-16.0	
Others	-1.8	-5.5	-7.0	-5.5	
Net short-term flows	-21.4	-9.4	-16.2	-6.1	

Source: World Bank, Global Development Finance, p. 8, Table 1.1. Washington, D.C., 2003

involve the purchase of shares in a developing-country firm by foreign investors ("portfolio equity"). It is clear that FDI has constituted the bulk of private capital inflows to developing countries in recent years (Table 2). Among the various categories of PFI, this report puts emphasis on FDI, because of many advantages over "pure" debt financing. However, FDI itself typically comes in bundles of equity finance and borrowing. Indeed, as Chapter 2 of this edition of the *CDR* shows for a sample of seven poor countries, almost two-thirds of what is recorded as "FDI" is actually financed through debt, particularly intracompany loans, rather than "pure equity finance."[2]

There are several reasons why an analysis of private foreign investment is topical. First, there has been a veritable explosion in PFI, particularly FDI, since 1990, providing a substantial and growing proportion of investment in many developing countries, including some of the poorest. Second, most developing countries have reversed earlier policies of constraint, or even hostility, toward foreign investment, common until the 1980s. Now, in contrast, they actively seek and compete with each other for PFI, often as part of economic reform programs involving liberalization and privatization. Third, while PFI flows have exploded in the last decade, aid flows have been almost stagnant due to "donor fatigue," fiscal constraints, and growing questions about the effectiveness of aid. Even though FDI has fallen somewhat from its peak of US$179.3 billion in 1999, it still considerably exceeds net flows of aid and loans from official sources such as aid agencies and multilateral banks, which peaked at US$57.5 billion in 2001.[3] In turn, donors have put growing emphasis on PFI to meet the needs of developing countries for external capital.

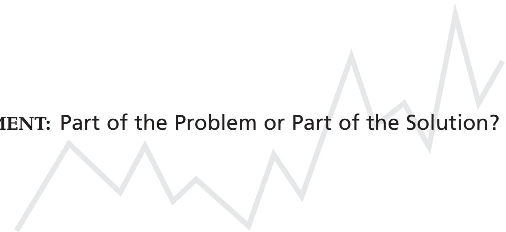
Fourth, there are mounting criticisms of the impact of PFI on developing countries because of instances of corruption, environmental degradation, or armed conflict instigated by

struggles over high-valued foreign investments. Moreover, PFI often has little impact on poverty reduction and other fundamental objectives of development, or worse, it undermines those objectives. Nigeria, for example, has received a significant amount of foreign investment in the oil sector, generating US$300 billion in oil revenues over the past 25 years; yet its per capita income is still less than $1 a day.

Finally, the international policy framework governing private investment flows is as yet rudimentary. Unsuccessful attempts have been made both in the Organisation for Economic Co-operation and Development (OECD) and at the World Trade Organization (WTO) (most recently at the Cancun meeting in September 2003) to craft a multilateral investment framework. Multilateral organizations such as the United Nations and the OECD, and some industrial countries, encourage "corporate social responsibility" on the part of businesses contemplating or undertaking investment in developing countries (for example, through the Global Compact, discussed below). But there is typically little scope for enforcing such corporate codes of conduct; guidelines are voluntarily adopted by such businesses and implemented on a self-regulated basis.

In this edition of the *CDR* we emphasize both the opportunities for, and pitfalls of, private foreign investment particularly in the world's poorest countries,[4] because these are the countries facing both the greatest need for external resources and the most formidable challenges of development. Given the inadequacy of foreign aid, and the difficulties of domestic resource mobilization in such countries, to what extent can PFI fill the gap? Furthermore, how can PFI help meet the fundamental objectives of development (including poverty reduction) and avoid contributing to environmental degradation or armed conflict? In other words, can PFI be part of the solution rather than part of the problem? These are the basic questions posed by this volume. We take the view that while private foreign investment can indeed be harmful, it could instead, under the right circumstances, be helpful for development. The challenge for developing countries, foreign investors, their home countries, and international agencies is to identify and implement policies that prevent or mitigate harmful impacts while greatly encouraging positive impacts.

This introductory chapter sets out the context for these questions and some of the issues they raise for national and international policy. Chapter 2 examines the perception and reality of private capital flows to poor countries. On the basis of investor surveys, the chapter presents a description of what is happening with respect to private foreign investment flows to poor countries, why it is happening, and capacity-building needs to manage such flows more adequately. Chapter 3 is a case study of a poor country—Tanzania—presenting and analyzing data on PFI flows, its impact, and the policy implications for the Government of Tanzania, foreign investors, and international agencies. Finally, the



Statistical Annex presents updated information on Canada's relations with the developing world.

The remainder of this introductory chapter reviews recent events to help explain why PFI has become so prominent in current policy debates about development. It then examines the international framework for PFI, and the rationale for increasing the flow of PFI to the poorest countries. Subsequently, it reviews criticisms of PFI and some responses, and concludes by drawing some policy implications for developing and donor countries, multilateral organizations, transnational corporations, and private foreign investors.

Background

The poorest developing countries do not presently receive a large volume of private foreign investment compared to other parts of the world. FDI inflows are strongly skewed to China and the more advanced developing countries (or advanced regions of those countries). In contrast, Africa and the least-developed countries (LDCs)[5] tend to receive a small proportion of total FDI flows. For example, in 2002 China received US$53 billion compared to US$11 billion for the whole African continent (down from US$19 billion in 2001) and US$5.2 billion for the 49 LDCs (US$5.6 billion in 2001).[6] (United Nations 2003: 9, 252). The top 10 recipients of FDI over the period 1992-2001, in descending order, were China, Brazil, Mexico, Argentina, Poland, Chile, Malaysia, Thailand, the Czech Republic, and Venezuela, none of them among the poorest developing countries.

However, the absolute magnitude of FDI flows is not indicative of their potential impact on individual developing countries. Relative to the size of their economies as measured by gross domestic product (GDP), the inward stock of FDI in the LDCs as a group is as significant as in Mexico, a middle-income country. For China, the world's most populous country, an inflow of US$53 billion is relatively less significant than much smaller inflows can be to very poor, more sparsely populated countries, such as Chad, Equatorial Guinea, and Lesotho. Similarly, the stock of FDI relative to GDP is larger in the Republic of the Congo (Brazzaville) than in Brazil (Table 3).

Moreover, during the 1990s FDI flows to the LDCs grew relative to official development assistance (ODA),

Table 3 **FDI stocks as a percentage of GDP (2002)**

Middle-Income Countries:	
China	36.2
Brazil	52.1
Mexico	24.0
Poorest Countries:	
Chad	78.4
Congo (Brazzaville)	69.5
Equatorial Guinea	92.8
Lesotho	75.3
Memo:	
Developed Countries	18.7
Developing Countries	36.0
LDCs	23.4

Source: United Nations, *World Investment Report 2003*, Table B6.

Table 4 **FDI inflows and ODA flows to LDCs, 1990-99**
(US$billions)

	1990	1995	1996	1997	1998	1999
FDI inflows	0.6	2.0	2.3	3.1	3.9	5.2
Total ODA	16.7	17.2	14.1	13.0	12.6	11.6

Source: United Nations, FDI in Least Developed Countries at a Glance (New York and Geneva: UNCTAD, 2003), p. 3.

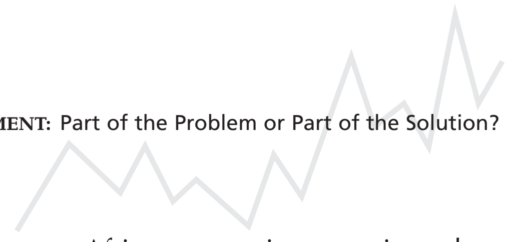
as foreign aid declined. In 1990, FDI was insignificant in both absolute and relative terms; by the end of the decade, ODA had declined by one-third and FDI was almost half as large (Table 4).

In the current decade, faced both with diminishing ODA and FDI inflows, developing countries, including the poorest, are stepping up their efforts to attract foreign investment through further liberalization or promotional measures. As a recent UN report put it, "financial incentives and bidding wars for large FDI projects have increased as competition intensified. Investment Promotion Agencies, growing apace in recent years, are devoting more resources to targeting greenfield[7] investors and to mounting after-care services for existing ones."[8]

Private foreign investment: The opportunities

Private foreign investment, and particularly foreign direct investment, can benefit developing countries in a number of ways. As a source of external capital for development, FDI is focused on long-term returns, making it more appropriate for developing countries than short- or medium-term debt, although, as mentioned, FDI can be funded predominantly by debt rather than pure equity, so it is hardly immune to debt crises. Most of all, it may provide access to the markets, technology, and skills eagerly sought by developing countries. There is some statistical evidence that it contributes to the economic growth of host countries, although the presence of other factors is important, for example, the level of schooling.[9]

More generally, the impact of FDI must be situated in the changing global context of growth and development, in which the creation and diffusion of knowledge have become central. "Knowledge" in this sense refers not only to technical know-how related to production (engineering, design, R&D), but also to management, industrial organization, and institutional and international relationships. The successful absorption and adaptation of knowledge to the local circumstances of developing countries requires continuous learning to take



place, particularly given increasingly competitive and changing markets. Accordingly, the level of schooling may enhance the positive impact of FDI on economic growth. The rapid growth and development experienced by East Asian countries is instructive. Skills absorbed in earlier clusters of FDI involving more basic technologies were then applied to more complex technologies imported with subsequent clusters. Hence, the contribution of FDI goes well beyond filling a resource gap faced by developing countries, by offering possibilities for technological spillovers and learning, and greater access to non-traditional export markets.[10]

In other words, if the poorest developing countries emulated the experience of some East Asian economies, FDI would facilitate a dynamic process of learning, technological absorption and rapid development. It is true that only a few African countries have experienced some success in this regard—Mauritius, Botswana and, much more recently, Uganda, are principal examples. Moreover their rapid growth has so far been sustained only over a few years, and is attributable to a number of factors, in addition to inflows of FDI, including higher domestic investment and growing foreign trade.

Nonetheless, for the poorest countries, FDI could in the right circumstances present a range of potential opportunities for future growth and development. Such opportunities are likely to vary considerably between countries, depending on their particular circumstances. For example, as many African countries are oriented toward resource-based activities, most of the FDI in these countries[11] has tended to flow into resource extraction. While FDI in resource extraction has been associated with a number of severe problems (more on this below), countries that are hosts to such FDI could foster diversification into downstream processing. Mining firms could invest in metal processing facilities; oil firms in petrochemicals; timber firms in wood and paper products; and agriculture-based firms in agribusiness.

In countries that are resource-scarce, the opportunities are more likely to be oriented toward serving the domestic market (particularly for large countries) or the export market (for smaller countries). Such countries could benefit from FDI in the manufacturing, construction and service sectors. Whether in resource-related industries or those oriented toward domestic or export markets, FDI would help provide employment (including skilled jobs), stimulate demand for products or services from local firms, generate tax revenue, and help diversify the economy and reduce dependence on commodity production.

Thus, a strategy to attract FDI would best be attuned to the particular needs and potentials in each poor country, focusing on its sectoral and market opportunities. In turn, such a strategy might be oriented toward FDI from particular source countries and firms, rather than a catch-all approach aimed at attracting inward investment in general. It would also need to be coordinated with parallel strategies to invest in infrastructure and, in education and

skills upgrading, in order to facilitate the activities of the foreign firms considering investment.[12]

Private foreign investment: The challenges

Notwithstanding its many real and potential benefits, however, PFI also presents a number of challenges that can undermine or threaten development objectives such as poverty reduction, good governance, political stability and environmental sustainability.

To begin with, foreign investment is meritorious only if it complements and supports a country's broader investment and development strategy.[13] Foreign direct investment can crowd out domestic investment by driving domestic firms out of business, especially if foreign firms engage in unfair anti-competitive practices. In addition, through intrafirm transactions of various kinds ("transfer pricing"), transnational corporations can artificially increase costs, lower profits and thereby evade taxes or exchange regulations in particular jurisdictions. Such techniques can also minimize the income share accruing to local joint owners, or put pressure on host governments and/or local trade unions. Unfortunately, many developing countries lack effective tax audit systems to monitor or police such behaviour.[14]

Particularly important to developing country hosts are the ability to raise public revenues through taxation of foreign affiliates; the creation or expansion of skilled employment; forging or enhancing linkages with local enterprises; marketing, and facilitating access for, exports; and transferring technology. However, when negotiating with companies or with industrial countries, the poorest countries are typically in a weaker bargaining position than developing countries such as China, Brazil, or Mexico, which offer larger domestic markets, more skilled workers, and better infrastructure.

As Chapter 3 of this report indicates, extremely poor developing countries such as Tanzania also face a challenge in attracting private foreign investment to help the sectors and regions most in need of capital. The agricultural sector and rural areas are typically home to the majority of the poor in such countries. Yet FDI tends to flow to urban areas and sectors that are relatively better off. If a country lacks the means to steer FDI toward poor sectors and regions, it must depend on "trickle-down" effects whereby incomes and jobs created by FDI in favoured sectors and regions spill over, indirectly and eventually, to the poor. Host countries can facilitate the process of positive spillovers through investment in education and infrastructure to increase the employability of the poor and to forge linkages between FDI and disadvantaged regions and sectors.[15]

A substantial proportion of PFI flows into the resource extraction sectors in the poorest countries (particularly for the production of oil, gas and minerals) accounting for 65 per

cent of all FDI in Africa during the 1990s. Dependence on oil exports has not been kind to any developing countries. Instead of growing out of poverty, oil producers throughout the developing world, from the Middle East to Latin America, have experienced development failure, with plunging per capita incomes, corruption, authoritarianism, and violent conflict. Indeed, Nigeria, sub-Saharan Africa's largest oil producer, has performed worse in terms of basic social indicators than the region as a whole, illustrating what some critics call "the paradox of plenty."[16]

To make matters worse, some resource extraction activity in the poorest countries has been illegal and involves the confiscation of natural wealth by foreign agents. In June 2000, the United Nations Security Council, alarmed by the ravages of the civil war in the Democratic Republic of the Congo, commissioned a panel of experts to review the role of the illegal exploitation of natural resources in the conflict. The panel's three reports, the final one released in October 2003, described the exploitation of the Congo's natural resources as a form of "mass-scale looting." The reports indicated that at least US$5 billion of the Congo's assets had been transferred to networks of political, military and commercial interests, involving Congolese elites, foreign armies from Rwanda, Uganda and Zimbabwe, and a number of foreign companies. Moreover, the panel confirmed that the illegal exploitation of resources was fueling the civil war in the country, which had caused the death of more than 3.5 million Congolese.[17]

There appears to be a growing linkage between failed states, civil conflict, and resource exploitation (legal or illegal), particularly in Africa. The poorer a country, the weaker its state and economy, and the more extensive its natural resource base, the greater is its risk of civil war. Conflict is also more likely in countries that depend heavily on natural resource exports, because rebel groups can extort gains from this trade to finance their operations. Civil wars now last eight years on average, about twice as long as those during the 1980s. Global markets in both natural resources and arms make rebellion easier to finance and equip. Greed for resources rather than grievance among ethnic groups has been a principal factor contributing to state failure and civil war. Thus, diamonds financed the UNITA rebel group in Angola and the Revolutionary United Front in Sierra Leone, while timber financed the Khmer Rouge in Cambodia.[18]

The link between resource exploitation and violence in poor countries is not a recent phenomenon, but dates back to colonial days, as amply demonstrated in the histories of the Congo, the Sudan, Angola, Nigeria, and Sierra Leone. National governments (including Canada's) in which resource-extracting companies in question are domiciled, claim they cannot do anything in order to curb the behaviour of such companies, and that international action is necessary. But such action is hampered by the absence of a legal framework to monitor and sanction criminal, inhuman, or illegal behaviour.[19]

A North-South Institute study questioned whether resource exploitation activities do in fact contribute to poverty reduction and development in the broadest sense, taking into account the destructive social and environmental impacts that such activities sometimes inflict. Indigenous peoples appear to be particularly vulnerable to the negative impacts of resource exploitation, largely because they are not well equipped to enter into dialogue and negotiations with resource extraction firms. When mining firms "consult" indigenous communities as potential "stakeholders" in a mining development, they overlook—and sometimes violate—both the traditional and legal rights to development on their lands, and are too apt to consider the lack of objection to be equivalent to "consent."[20]

The international framework

A comprehensive international legal framework for private foreign investment does not as yet exist. During the late 1990s the OECD's attempts to draft a multilateral investment agreement (MAI) met with considerable opposition from civil society organizations and some governments, primarily on the grounds that it would emphasize the rights (rather than the obligations) of investors and the obligations (rather than the rights) of host governments. The MAI was accordingly abandoned by the OECD in 1998, but debates persist as to the appropriate balance between rights and obligations of investors and host governments. Subsequently at the global level, efforts have been made by developed and some developing countries to include a multilateral investment agreement under the Doha multilateral trade round, but negotiations stalled in September 2003 at Cancun. However, the WTO had already become involved because of the impact on international trade of many governments' policies toward investment in their countries.

The agreement on Trade-Related Investment Measures (TRIMs) emerged in 1995 from the Uruguay Round of multilateral trade negotiations. The TRIMs agreement was not concerned with the regulation of foreign investment as such, but with the discriminatory treatment of imported and exported goods. In particular, the agreement focuses on policies requiring investing firms to purchase domestic rather than imported products (i.e., "local content" rules) or trade-balancing rules requiring firms to limit their imports to the value of their exports. Such rules imposed by governments on investors can be barriers to trade by discriminating in favour of domestic products and against imports. Nonetheless, many countries (developed countries in the past[21] and many developing countries today) use such measures to stimulate linkages with the local economy as part of an industrial development strategy. For this reason, many developing countries resisted the TRIMs agreement when it was negotiated, and countries such as Brazil and India have sought to reopen it to provide them with more space for their development policies.[22]

Meanwhile, international investment negotiations were also taking place at the regional and bilateral levels, typically as part of trade agreements. For example, Chapter 11 of the North American Free Trade Agreement (which came into force in 1994) provides foreign investors with a number of rights, including the right to compensation in the event that host governments enact policy changes that, in their view, expropriate their right to make profits.[23]

Similarly, bilateral investment treaties (BITs) typically give investors the right to sue governments if the latter undertake actions deemed to substantially expropriate the investors' interests. Over the past decade there has been an enormous proliferation of such treaties: by the end of 2002, some 2,181 had been signed.

Bilateral investment treaties lay out certain principles regarding the treatment of foreign investment, the transfer of funds, expropriation, and mechanisms for dispute settlement. The centrepiece of a BIT is the assurance it gives foreign investors as to their property rights. Typically there is a clause that gives the investor the right to sue the host government if actions taken by the government are deemed to substantially expropriate the business of the firm. This represents a significant enhancement of the rights of foreign investors, who would otherwise be limited by the traditional principle of sovereign immunity against prosecution by foreign parties. As to what is deemed to be "expropriation," BITs commonly include "indirect" expropriation caused, for example, by changes in health or environmental regulations, which may be viewed by foreign investors as an impairment of the value of their investment. As such, investors can sue for compensation up to the entire value of the investment.

The key motivation of developing countries in negotiating BITs is to attract greater flows of FDI. Yet, statistical evidence on the large number of BITs clearly suggests that signing such treaties does not lead to greater FDI inflows. On the other hand, it is clear that BITs significantly constrain host countries' latitude to introduce legislative or regulatory changes that are in the public interest but that might also expose them to potentially costly lawsuits. Therefore the advantages of such treaties seem questionable.[24]

Given the widespread liberalization of investment regimes and proliferation of BITs, the fact that such measures do not seem to have increased the volume of FDI flows has made developing countries skeptical about the need for a multilateral framework for investment in the WTO. Indeed, African representatives at the WTO expressed their opposition to the inclusion of an investment agreement in the Doha round, expressing concerns that their limited financial and human resources should not be further diluted by negotiating an agreement that would bring them limited benefits.[25] In any event, the trade negotiations stalled in Cancun; hence, a multilateral investment agreement remains both contentious and elusive.

Moreover, the issue that led to the demise of the OECD's MAI—that of an appropriate balance between the

rights and obligations of foreign investors, on the one hand, and host governments, on the other—persists. The regional and bilateral manifestations of investment treaties continue to privilege investors' rights over those of the host government and emphasize the host's obligations over those of investors. As if to compensate for this imbalance, several well-intentioned business firms have endorsed the need for codes of conduct to foster "corporate social responsibility." However, such codes are voluntary and not typically subject to independent monitoring or enforcement. Similarly, the UN's Global Compact (discussed below) embodies the principles of self-regulation and voluntarism and lacks accountability or enforcement mechanisms.

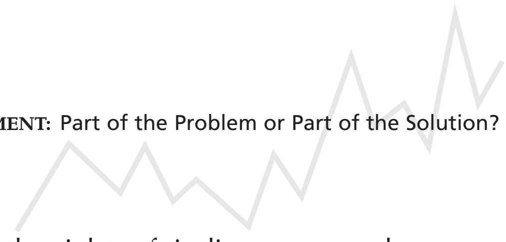
Toward development-friendly private foreign investment

If private foreign investment is to be more compatible with equitable and sustainable development in the poorest countries, a number of issues must be addressed. How can natural resource extraction support, rather than undermine, development? How can transnational investors and host governments be made more transparent in their financial dealings? What is the potential of codes of conduct to change corporate behaviour? What other instruments exist to stimulate "higher quality" foreign investment flows to the poorest countries? The following examples suggest growing awareness of the problems, but solutions will require far-reaching changes in the policies and behaviour of national governments, international agencies, and corporations.

Natural resource extraction vs. sustainable development

In June 2000, the World Bank launched a review of the Bank's support of oil, gas, and mining projects and their impact on development. The review addressed the following questions: Can extractive industry projects be compatible with the World Bank's goals of sustainable development and poverty reduction? Is it possible to translate resource wealth into sustainable development and strong poverty reduction in resource-rich countries? What are the key reasons that extractive industries do not make a positive contribution to sustainable development and poverty reduction?

Questions about the World Bank's future role in the extractive industry sector were also posed. The review brought down its report in December 2003, after undertaking several consultations, commissioning background research, and visiting some field sites. It concluded that extractive industries could contribute to poverty reduction through sustainable development, but only under strong "enabling conditions": pro-poor public and corporate governance to maximize poverty alleviation through sustainable development; much more effective social and environmental policies; and respect for human rights. The report went on to indicate that



"serious reforms" in the World Bank's operations and incentive systems were needed if it was to promote these conditions.[26]

While the Extractive Industries Review (EIR) poses serious challenges for the policies and behaviour of governments, industry and international agencies in the future, it also overlooks the legacy of 20 years of "economic reforms" on the capacities of developing countries to manage the economic, social, and environmental demands they face. Such reforms, characterized by economic liberalization, deregulation and privatization, were urged (and continue to be urged) upon developing countries by the World Bank and the International Monetary Fund (IMF), typically leading to the downsizing of the state and a diminution of its capacity. As Chapter 2 of this report indicates, for example, the governments of the poorest countries typically lack any capacity to monitor, much less to effectively manage, inflows and outflows of private foreign investment.[27]

In its recent study on mining and indigenous communities in South America, The North-South Institute emphasized the need for free and informed consent by potentially affected communities prior to any decision authorizing a mining venture on indigenous lands. Moreover, it recommended that mining companies and local governments recognize that indigenous peoples hold traditional rights, including the right of refusal of mining development on their lands. "Corporate social responsibility," the study suggested, is not a substitute for governments' social responsibilities to uphold their obligations toward, and the rights of, indigenous people. Pointing to the striking imbalance in negotiating power between aboriginal communities and mining companies, the study also recommended providing resources to strengthen the decision-making capacity and governance of such communities. Finally, given that violent conflict is frequently exacerbated by the presence of mining, and that aboriginal peoples are often the targets of violence and human rights abuses, the study recommended imposing "no-go" regions for mining development.[28]

Increasing transparency vs. corruption

The corruption, mismanagement and misallocation of revenues generated by natural resource extraction has led many civil society groups to call on governments and resource companies alike to be more transparent in their financial dealings. In June 2002, more than 130 groups launched the "Publish What You Pay" campaign, demanding mandatory disclosure by resource extraction companies (oil and gas, mining) of fees, taxes, royalties, and other payments made to host governments. Disclosure of such information on a voluntary basis has failed because it puts compliant firms at a competitive disadvantage to non-compliant firms. Mandatory disclosure would put civil society and the public in host countries in a stronger position to call their own governments to account for all the revenues they receive. Mandatory disclosure would work best if all the major home countries in which the resource firms are domiciled made it a requirement for listing on the stock exchange.

However, such a requirement will take a high degree of political will and consensus among the leading industrial countries.

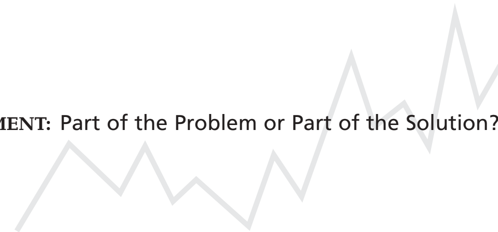
It was only as recently as 1999 that a "Convention on Combating Bribery of Foreign Public Officials in International Business Transactions" came into force in the OECD. By the end of 2003, the Convention had been ratified and transposed into domestic legislation by all 30 OECD countries plus four non-members (Argentina, Brazil, Bulgaria and Chile). The overall purpose of the Convention is to prevent bribery in international business transactions by requiring countries to establish in their national laws, the criminal offence of bribing a foreign public official, and to have in place adequate sanctions and reliable means for detecting and enforcing the offence. Its relatively recent arrival on the international scene, and the tardiness of a number of countries in ratifying the Convention, mean that it is too early to tell how effective this initiative is in tackling bribery and corruption.

Corporate social responsibility vs. codes of conduct

At the World Economic Forum in 1999, UN Secretary-General Kofi Annan invited businesses around the world to enter into a compact, to help make globalization more stable and inclusive, by embedding markets in shared values and through collaborative action in support of UN goals. The Global Compact, launched as a voluntary initiative in July 2000, is viewed as a process of change toward responsible global corporate citizenship, in which human rights, labour standards, and environmental priorities are integrated into participating companies' operating policies and procedures, and introduced to their personnel, suppliers, clients, and the public at large.

The Global Compact fosters a network-based approach at the local, national, regional and global levels, in which leadership, dialogue, learning, and collaborative action is emphasized. The compact pursues two complementary goals: first, to make the principles of sustainability and inclusiveness, particularly for the world's poorest people, part of business strategy and operations; and second, to facilitate cooperative and collective problem solving among different stakeholders, including labour unions, civil society organizations, business schools, and UN agencies.

The Global Compact depends on voluntary compliance with its principles. But it provides no mechanism to ensure that companies actually respect the principles in practice. Indeed, its voluntary nature allows companies to claim progress on social issues while avoiding accountability. The Global Compact stands in sharp contrast to earlier attempts by the UN to establish an enforceable and comprehensive code of conduct for transnational corporations. In the 1970s, calls by developing countries for a New International Economic Order led the UN to set up a Commission on Transnational Corporations, which made an enforceable code of conduct



one of its chief priorities. In the 1980s the developed countries began to criticize this initiative, which was at odds with the "Washington Consensus," with its emphasis on liberalization and greater openness toward trade and foreign investment. The UN officially abandoned its draft code at the 1992 Conference on Environment and Development (the Earth Summit) held in Rio de Janeiro. In effect, the Earth Summit marked a shift from international regulation to self-regulation and corporate social responsibility. However, unless mechanisms of accountability and enforcement are developed, and the Global Compact has much more universal coverage rather than the 1,000 or so firms that have so far signed up, it is doubtful that such voluntary measures will make much of a difference.

Mitigating investors' risks to attract "higher-quality" investment

Given the numerous problems associated with natural resource extraction, how can the poorest countries encourage private foreign investment in other sectors such as infrastructure, manufacturing, and services? Such "higher-quality" investment in the poorest countries could, perhaps, be stimulated through the provision of insurance against a range of non-commercial risks including confiscation, expropriation, nationalization, breach of contract, civil war, and natural calamity.

Private insurance markets fail to adequately cover such risks. Therefore insurance must be provided by public sector agencies such as the World Bank's affiliate, the Multilateral Investment Guarantee Agency (MIGA), established in 1988 to facilitate new flows of FDI to developing countries. It does so by providing insurance against the non-commercial risks of expropriation, war and civil disturbance, breach of contract, and currency transfer. Between 1990 and 2001 MIGA provided US$9 billion in insurance cover for investments in 78 developing countries, and estimated that it facilitated US$41 billion in FDI in that period, although this amounted only to 2 per cent of the stock of developing country FDI.

Other multilateral agencies, for example the regional development banks and the World Bank Group's International Finance Corporation, have also recently begun to provide some non-commercial risk mitigation facilities to support FDI. In addition, a number of bilateral export credit agencies such as the Overseas Private Investment Corporation (OPIC) in the US, Export Development Canada, Coface in France, and the Export Credit Guarantee Department in the UK provide risk insurance for foreign investment, primarily from their own countries.

While measures to mitigate risk can stimulate some inflows of FDI to the poorest countries in the short to medium term, there are important caveats. Private foreign investment in utilities and infrastructure facilities is increasingly being financed through the World Bank under "output-based aid" schemes, whereby aid funds are used to subsidize the operating costs of privatized water or electrical utilities, for example. In effect, such

arrangements amount to scarce aid funds helping to ensure an adequate rate of return for private foreign investors operating the utilities under contract to local governments. There is an obvious opportunity cost—the aid funds could be reallocated to health or other priority expenditures. Thus, in states that typically lack regulatory capacity and where corporate transparency is absent, privatization or contracting out is less appealing than efficient public service provision.[29]

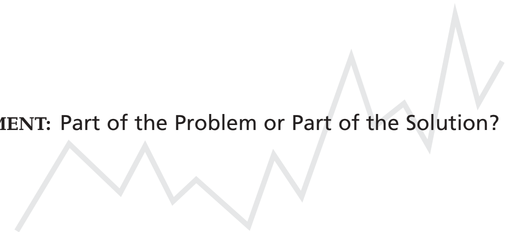
More generally, there is little if any emphasis given to whether or how investments guaranteed or supported by such risk-mitigation facilities, particularly by bilateral agencies, are supportive of recipient countries' development strategies. In theory, the programs of the multilateral agencies facilitating FDI require consistency with poverty reduction and other fundamental development objectives, but as the debate leading to the Extractive Industries Review demonstrated, such requirements are often not observed in practice.

In the final analysis, the only way to mitigate or reduce non-commercial (including political) risk is not through insurance or guarantee mechanisms, but through transforming political, administrative, legislative and judicial environments and behaviour in the poorest countries in order to reduce both the reality and perception of such risks. However, that entails considerable institution- and capacity-building, which can take many years or even decades.[30]

Conclusions and recommendations

The world's poorest countries face daunting challenges. They seek economic growth, diversification and poverty reduction. They must at the same time contend with a number of threats, including HIV/AIDS and other pandemics, violent conflicts, and natural disasters. As they strive to attract FDI and other private foreign investment, they must also maintain sufficient space to pursue broader development-oriented policies. A checklist of policy challenges includes:[31]

- determining whether and how FDI fits in with a country's unique development opportunities and objectives
- choosing quality over quantity of investment
- reducing conflict and corruption
- providing appropriate infrastructure, education, and skills
- implementing FDI policies consistently and efficiently
- understanding the pros and cons of international investment agreements;
- facilitating trade
- providing a transparent and appropriate incentive, tax and regulatory framework and
- promoting linkages with the local economy, as currently allowed under the trade-related investment measures (TRIMs) agreement.



How to ensure that PFI fits in with a country's development opportunities and objectives? To do so properly would require both a better understanding and clearer expectations of what PFI in general, and each investment in particular, contributes to development—in terms of poverty reduction, income and employment creation, skills training, creating linkages to the local economy, and the achievement of the Millennium Development Goals embraced by the international community.[32] It would likely also require more dialogue with foreign investors to ensure they are aware of the country's development objectives and can position their projects to help attain them. But foreign direct investment will not necessarily, or everywhere, lead to sustainable development and poverty reduction or avoid debt problems. This calls for action on the part of developing countries, developed countries, and international agencies.

Recommendation 1: Considerably more care should be exercised when incentives are offered to foreign investors by developing countries. Private foreign investment should be consistent with national poverty reduction strategies, with strategies to achieve the Millennium Development Goals, and with broader development objectives, including the stimulation of domestic investment and capital markets, and efforts to mobilize revenue for governments through taxation.

Furthermore, private foreign investment is not a substitute for official development assistance to the poorest countries, even though it can represent a significant presence in the domestic economy of very poor countries. Moreover, initiatives to mitigate the risk of foreign investors, or to "partner" ODA and FDI through public/private partnerships (PPPs), are not panaceas and may simply shift risks onto developing country governments and peoples.

Recommendation 2: Developing countries should mitigate risks for their own benefit rather than primarily for the sake of attracting FDI. Particular deals with foreign investors through privatization should always be assessed relative to alternatives, for example reforming public sector utilities to increase their efficiency and effectiveness. The opportunity cost of diverting scarce ODA should also be assessed before entering into public-private partnerships.

Recommendation 3: Developed countries' export credit and investment insurance agencies, and international agencies that offer insurance or risk mitigation programs for investment in the poorest countries, should endeavour to ensure that the investments they facilitate are supportive of the development prospects of host countries. Such agencies should also make support to beneficiary firms and investors conditional on their observance of codes of conduct.

As concluded by the Extractive Industries Review, considerable capacity-building is required in the poorest countries to ensure they have the ability to monitor, regulate, tax, and administer foreign investment efficiently and effectively to reap the

maximum benefit while being fair, consistent, and transparent to the foreign investors.

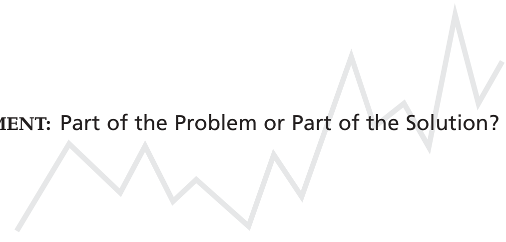
Recommendation 4: Donors must invest heavily in LDC capacity to strengthen their abilities to effectively and efficiently administer and regulate private foreign investment, whether in the natural resource extraction sector, in infrastructure, or other sectors. Donors should also be prepared to assist poor countries in identifying the opportunity cost of FDI (for example, in infrastructure and finance) and efficient alternatives to it, whether through private domestic investment or public investment.

National laws governing corporate behaviour abroad and voluntary approaches to corporate social responsibility, including the OECD Guidelines on Multinational Enterprises and the UN's Global Compact, are clearly inadequate to prevent or punish those who degrade the environment, provide support to civil strife or violent conflict, or undermine human rights. Instead, there is a need for a more universal and mandatory approach that can be enforced.

Recommendation 5: There is an urgent need for a mandatory and enforceable code of behaviour accepted by all firms in all countries under the umbrella of the UN's Global Compact, which should develop a capacity to monitor and enforce the code. The code should adopt the recommendations of the "Publish What You Pay" campaign in order to make financial transactions between foreign investors and host governments more transparent.

There are serious shortcomings in the legal framework governing international investment. Regional trade agreements and bilateral investment treaties have privileged investors' rights over those of host governments and have seriously eroded the latters' ability to regulate or legislate in the public interest. Moreover, the multilateral agreement on trade-related investment measures (TRIMs) seriously impairs developing countries' policies aimed at fostering their own industries. Available evidence suggests that these agreements or treaties have not led to a greater inflow of foreign investment, which makes their rationale very questionable.

Recommendation 6: There should be a moratorium on further investment treaties or agreements at the bilateral, regional or multilateral levels. If the negotiations on the Doha round or Free Trade Agreement of the Americas resume, a multilateral investment framework must be taken off the agenda. The TRIMs agreement should be reopened and "special and differential treatment" applied to the poorest countries, to exempt them from the TRIMs agreement for the foreseeable future. In the longer term, there is a case for a multilateral investment agreement that allows governments to require foreign investors to behave responsibly and that prohibits the competitive use of subsidies and tax incentives.



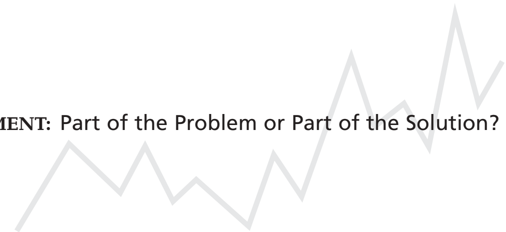
ANNEX
The Millennium Development Goals

In September 2000, 147 world leaders gathered in New York and agreed on the Millennium Declaration, outlining their collective commitment to sustainable development and poverty reduction. In December 2000 the UN General Assembly asked the Secretary-General to prepare a road map for the implementation of the declaration. Building upon previous work undertaken by the OECD, the annex to this road map sets out eight Millennium Development Goals, along with 18 targets and 48 indicators to measure progress toward them. A powerful momentum is building behind these goals. They are becoming a measure of the commitment of donor countries and a measure of the success, or failure, of development assistance.

Goals	Targets
1. Eradicate extreme poverty and hunger	• Halve, between 1990 and 2015, the proportion of people whose income is less than $1 per day. • Halve, between 1990 and 2015, the proportion of people who suffer from hunger.
2. Achieve universal primary education	• Ensure that by 2015 children everywhere—boys and girls alike—will be able to complete a full course of primary schooling.
3. Promote gender equality and empower women	• Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
4. Reduce child mortality	• Reduce by two-thirds, between 1990 and 2015, the under-5 mortality rate.
5. Improve maternal health	• Reduce by three-fourths, between 1990 and 2015, the maternal mortality ratio.
6. Combat HIV/AIDS, malaria, and other diseases	• Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. • Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.
7. Ensure environmental sustainability	• Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources.

	• Halve by 2015 the proportion of people without sustainable access to safe drinking water. • By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.
8. Develop a global partnership for development	• Develop further an open, rule-based, predictable, non-discriminatory trading and financial system (includes a commitment to good governance, development, and poverty reduction, both nationally and internationally). • Address the special needs of the LDCs. This includes tariff- and quota-free access for their exports, enhanced debt relief for heavily indebted poor countries, cancellation of official bilateral debt, and more generous official development assistance for countries committed to poverty reduction. • Address the special needs of landlocked countries and small island developing states. • Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long-term. • In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. • In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. • In cooperation with the private sector, make available the benefits of new technologies, especially information and communication.

Source: CIDA, Expanding Opportunities: Framework for Private Sector Development. Appendix 1. For more information, visit: http://www.un.org/millenniumgoals/



Biography

Roy Culpeper is the President and Chief Executive Officer of The North-South Institute (NSI). Dr. Culpeper joined The North-South Institute in 1986 and was Vice-President and Coordinator of Research from 1991 until 1995, when he was appointed President. Dr. Culpeper received his PhD in Economics from the University of Toronto in 1975. Before joining the Institute, his work experience included positions in the Manitoba government's Cabinet Planning Secretariat, the federal Department of Finance, and the Department of External Affairs and International Trade. From 1983 to 1986, Dr. Culpeper was advisor to the Canadian Executive Director at the World Bank in Washington. At the Institute, he has conducted research on a broad range of issues relating to international finance and, from 1993 to 1995, he directed the Institute's largest-ever project, a comprehensive study of four regional development banks.

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Footnotes

1 The report builds on the conference organized by The North-South Institute at Wilton Park, UK in March 2003, and on the policy brief based on the conferences (Schmidt and Culpeper, 2003). I am grateful for comments on a previous draft from Gerry Helleiner, Bonnie Campbell, Ann Weston, Heather Gibb and Viviane Weitzner.

2 Accordingly, the data presented in Table 2 (as with data presented by most official agencies such as the World Bank) overstates the total volume of "equity" flows and understates the total volume of debt flows.

3 World Bank, *Global Development Finance*, Washington DC, 2003.

4 In this chapter "the poorest countries" include, principally, the 49 least-developed countries (LDCs) (see endnote 5). However, we also include other low-income countries of sub-Saharan Africa (for example Nigeria, Kenya, and Ghana) not included in the LDC list and other low income countries (for example, Bolivia, Honduras, and Nicaragua).

5 Least-developed countries include: Afghanistan, Angola, Bangladesh, Benin, Bhutan, Burkina Faso, Burundi, Cambodia, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of Congo, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Haiti, Kiribati, Lao People's Democratic Republic, Lesotho, Liberia, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Samoa, São Tomé and Principe, Senegal, Sierra Leone, Solomon Islands, Somalia, Sudan, Togo, Tuvalu, Uganda, United Republic of Tanzania, Vanuatu, Yemen and Zambia. The criteria for LDCs, established by the UN, include inter

alia countries with extremely low per capita incomes as well as small island and landlocked countries.

6 United Nations, World Investment Report. FDI Policies for Development: National International Perspectives (New York and Geneva: UNCTAD, 2003), pp. 9; 252.

7 A "greenfield" investment typically involves the installation of new production facilities. In contrast, a merger or acquisition (M&A) involves the purchase of existing privately owned facilities, and privatization involves the purchase of state-owned facilities. According to the World Bank (2003:105), data for 2002 suggests that greenfield investment accounted for only 43 per cent of FDI for all developing countries. However, according to the UN (2001: 7) 90 per cent of FDI flows to the LDCs during the 1990s was through greenfield investment rather than M&As or privatization.

8 United Nations, *World Investment Report 2003*, p. 12.

9 World Bank, *Global Development Finance*, p. 2; United Nations, World Investment Report. Foreign Direct Investment and the Challenge of Development (New York and Geneva: UNCTAD, 1999).

10 John H. Dunning and K.A. Hamdani (eds), *The New Globalism and Developing Countries* (Tokyo, New York, Paris: United Nations University Presss, 1997).

11 For example, Democratic Republic of the Congo, Gabon, Guinea, Liberia, Namibia, Nigeria, Zambia and Zimbabwe.

12 John Cantwell, "Globalization and Development in Africa," in Dunning and Hamdani, *The New Globalism and Developing Countries*, 1997, pp. 170-77.

13 Dani Rodrik, *The New Global Economy and Developing Countries: Making Openness Work.* Policy Essay No. 24 (Washington, DC: Overseas Development Council, 1999).

14 G.K. Helleiner, "Transnational Corporations and Direct Foreign Investment," Chapter 27 in Chenery and Srinivasan (eds), Handbook of Development Economics (Amsterdam: North-Holland, 1989), p. 1,465; Parris, Brett (2003). "Risky Development: Export Concentration, Foreign Investment and Policy Conditionality." East Burwood: World Vision Australia.

15 United Nations, *World Investment Report. Promoting Linkages* (New York and Geneva: UNCTAD, 2001b).

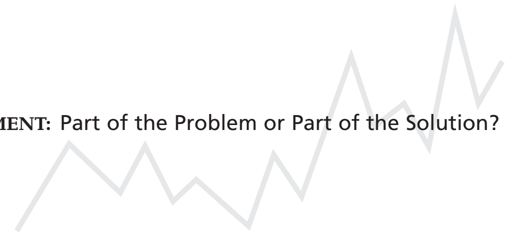
16 Ian Gary and T.L. Karl, *Bottom of the Barrel: Africa's Oil Boom and the Poor* (Baltimore: Catholic Relief Services, 2003).

17 UN Security Council, *Reports of the Panel of Experts on the Illegal Exploitation of Natural Resources and Other Forms of Wealth of the Democratic Republic of the Congo.* Documents S/2001/357, S/2002/1146, S/20031027 (New York: United Nations, 2001, 2002, 2003).

18 Paul Collier, "The Market for Civil War." *Foreign Policy (May/June 2003a) and Breaking the Conflict Trap: Civil War and Development Policy* (Washington, DC: The World Bank and Oxford University, 2003b).

19 Madelaine Drohan, Making a *Killing: How and Why Corporations use Armed Force to do Business* (Toronto: Random House Canada, 2003), pp. 323-24.

20 Viviane Weitzner, "Cutting-Edge Policies on Indigenous Peoples and Mining: Key Lessons for the World Summit and Beyond." Policy Brief (Ottawa: The North-South Institute, 2002).



21 Canada's Auto Pact, which was negotiated in the 1960s, featured local content requirements in order to expand the automobile manufacturing sector in Canada, which it did with enormous success. Such a policy would not be allowed today under the TRIMs agreement.

22 Developing countries were given a transitional period of five years (and least-developed countries, seven years) to eliminate such TRIMs, although this transition could be extended upon request to the WTO by countries experiencing difficulties in implementing the agreement.

23 For example, US-based Metalclad Corporation sued the Mexican government for US$17 million when the state government issued a decree forbidding the company to establish a waste management facility on its site.

24 Mary Hallward-Dreimeier, "Do Bilateral Investment Treaties Attract FDI? Only a bit...and they could bite" (Washington, DC: World Bank, June 2003), pp. 4-5; 22-23.

25 Ann Weston and Chantal Blouin, "Canada and the WTO Development Agenda," in The North-South Institute, *From Doha to Cancun: Development and the WTO.* Canadian Development Report 2003 Ottawa: The North-South Institute, 2003, p. 56.

26 World Bank, Extractive Industries Review, "Striking a Better Balance." Final Report, Executive Summary and Annexes (December 2003). Available at http://www.eireview.org/EIRFinalReport.html

27 Bonnie Campbell et al., "Factoring in governance is not enough: Mining codes in Africa, policy reform and corporate responsibility." *Minerals and Energy,* vol. 18, no. 3 (2003).

28 Weitzner, 2002.

29 Tim Kessler and Nancy Alexander, "Vanishing Acts: How Downsizing Governments 'Contract Out' Water and Electricity Services." (July 2003). Available at http://www.nsi-ins.ca/ensi/pdf/vanishing_acts.pdf

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31 D.W. te Velde, "Foreign Direct Investment for Development: Policy Challenges for Sub-Saharan African Countries" (London: Overseas Development Institute, 2002).

32 See Annex, this chapter, p. 20 and 21.