Private foreign investment in the poorest countries

Rodney Schmidt and Roy Culpeper

The North-South Institute
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Prologue

On March 24, 2003, 55 people gathered at the Wilton Park conference facility in Sussex, England, to look for ways private foreign investment can contribute more to growth and development in the poorest countries. Some of these people came from developing countries, where they work for government, private businesses, including some owned by foreigners, and non-governmental organizations (NGOs). Others came from international businesses. Still others came from governments and development agencies in rich countries, the World Bank and universities.

The group reviewed patterns of private foreign investment since the beginning of the 1990s and shared knowledge about, and experience with, its impact in poor countries. It identified the key influences on foreign investment, and evaluated the main initiatives taken to both increase investment in poor countries and improve its contribution to development.

The analysis and recommendations presented here are inspired by the Wilton Park discussions. Some of the perspectives and conclusions are well-understood and firmly rooted in experience, though not necessarily reflected in the policies of official development agencies, lending institutions, or poor country governments. Others are more speculative, and not universally agreed either at the conference or among the broader investment and development communities. These are all issues that pre-occupy those searching for answers for poor countries.

The issue of private foreign investment is particularly topical in view of the discussions taking place at the World Trade Organization (WTO). At the Cancun Ministerial meeting in September 2003 many developed member countries, including Canada, as well as some developing countries, favour the negotiation of an international

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1 The conference was financially supported by the International Development Research Centre, Canada, through its project 'Global Financial Governance Initiative', by the Norwegian Ministry of Foreign Affairs, the Swedish International Development Agency, and the UK Department for International Development. For a complete report of the discussion please refer to http://www.wiltonpark.org.uk/web/welcome.html

2 Following the World Bank, low-income countries, or the "poorest" countries, had a Gross Domestic Product (GDP) per person of not more than US$ 745 in 2001. The low-income and middle-income countries together are the developing countries. Of the largest developing countries, China, Brazil, and Mexico are middle-income while India is low-income.
investment agreement that would aim at facilitating private foreign investment in the developing world. Several developing countries, however, are not convinced that multilateral rules limiting their capacity to discriminate in favour of their domestic firms would stimulate further foreign investment flows and contribute to national development efforts. They are also concerned about maintaining their regulatory authority over foreign as well as domestic firms.

Introduction

Development in the poor countries of the world, most of them in sub-Saharan Africa, has stalled. In the past five decades these countries have not been able to grow fast or long enough to lift most of their people permanently out of poverty. There are many reasons for this, including bad government, bad luck, and growth policies that are poorly understood by both local governments and international development institutions such as the International Monetary Fund (IMF) and the World Bank. Another important reason is the breadth of poverty itself. There isn’t enough money to invest in large public projects, such as roads, clinics, schools, water and sanitation, power, and telecommunications. There isn’t enough money or know-how to invest in private business projects, such as natural resource extraction or new and non-traditional manufacturing and services.

In September 2000, an extraordinary "Millennium Summit" was convened at the United Nations (UN) General Assembly, bringing together all of the world’s leaders to endorse a set of Millennium Development Goals, including the halving (or better) of world poverty levels by the year 2015. In March 2002, the UN convened a follow-up international conference on Financing for Development in Monterrey, Mexico, to find the resources needed to pay for the Millennium Development Goals. UN Secretary-General Kofi Annan and World Bank President James Wolfensohn, among others, hoped that the Monterrey conference would convince donors to double the level of their foreign aid, from $50 billion (where it has stood for a decade) to $100 billion. Instead, donors agreed to increase their aid commitments over several years by only $12 billion. To fill the remaining large resource gap the "Monterrey Consensus" recommended raising domestic savings in the developing countries, increasing trade between developing and rich countries, and attracting more private foreign investment to developing countries.

The shift in emphasis from foreign aid to other forms of development financing is part of a basic change in attitudes toward development over the last decade. More attention is now put to encouraging private enterprises to take the lead role in growth and development. By de-regulating the domestic economy, liberalizing foreign trade, and welcoming foreign investment, for example, it is believed that there will be more investment, greater productivity, more employment, and steadily growing incomes.
In contrast to foreign aid, the amount of money from foreign investment potentially available to poor countries is practically unlimited in relation to the size of their economies. In addition, foreign investment can bring benefits usually not available from foreign aid or from domestic finance, such as new technology, new ways of organizing companies, and new access to markets in rich countries. Can private foreign investment help poor countries finally escape the poverty trap? Will foreign investment largely replace foreign aid, or can they work together to magnify the impact on growth and development?

Summary of findings

The most important foreign capital flows to poor countries since the late 1980s are foreign aid, workers' remittances, and foreign direct investment (FDI), in that order. Over this time, foreign aid fell slightly as workers' remittances and FDI rose substantially, but FDI continued to lag the others in importance.

FDI flows, measured relative to Gross National Product (GNP), rose steadily and significantly to all developing countries from 1990 to 1997. Throughout this period, the share going to middle-income countries exceeded that to poor countries by a steady one per cent of GNP or so. In 1997, with the Asian financial crisis, however, FDI to poor and middle-income countries diverged. In middle-income countries it continued to rise rapidly, while flows to poor countries declined decisively and almost continuously to 2001. Among developing countries, especially poor countries, most FDI concentrates in a few countries, and in these it is a large share of the economy. In individual poor countries, FDI is quite unstable.

Besides the addition to development resources in poor countries, FDI is believed to make other important contributions to growth and development. First, it can raise tax revenues, create employment, and open new markets for exports. Second, FDI can finance projects which require a large initial investment, too large for the government or domestic financial system. Third, it can lift productivity and competitiveness by adding to the stock of capital equipment and introducing new technology. However, FDI tends to reinforce existing patterns of economic structure, by concentrating in a single sector, usually resource extraction with few links to the rest of the economy.

FDI responds to political, economic, and infrastructural features of developing countries. In addition to social and political stability, it is attracted by ready markets, high rates of return, inexpensive and skilled labour, and cheap local inputs. It is deterred by inadequate or expensive infrastructure and business and political, social, and general economic risk. Since the Asian crisis a major obstacle to foreign investment in poor countries is the misperception that the risk of investing in poor countries is very high. Recently FDI has been associated with privatization programs, especially in telecommunications, electricity, and transport. FDI in infrastructure and public services...
is also being subsidized by foreign aid, to guarantee borrowed funds and support client payments.

Since poor countries face a variety of circumstances, complex factors influence the amount of FDI flowing to individual countries. The dominant factors are basic political and economic features rather than policy incentives such as streamlined investment regulations and protections or tax holidays.

Initiatives to increase the quantity and quality of FDI are threefold: international treaties to protect the rights of foreign investors; voluntary guidelines for investor behavior in poor countries; and official donor guarantees and subsidies to foreign investments in infrastructure and public services.

**Lessons for foreign investment policy**

For the poorest developing countries, private foreign investment is not an end in itself, but a means of supporting development objectives. The aim is not to maximize foreign investment, but to enable countries to grow out of poverty.

International treaties to protect the rights of foreign investors, such as the proposed Multilateral Investment Agreement, do not increase investment in poor countries. They may instead reduce the development impact of existing investment if they prevent host governments from regulating foreign investors.

International guidelines for investor behaviour in poor countries recognize the primacy of the development impact of foreign investment. However, the disposition of rich countries to international treaties to protect investors, but voluntary agreements to protect poor countries, is unbalanced. Voluntary agreements do not work where most needed, and expose reputable foreign investors to unfair competition from those who are less scrupulous.

Donor initiatives to reduce commercial risk for investors could be an innovative way to provide social and economic facilities and services traditionally delivered by the government. By installing supporting infrastructure, they could also help attract additional foreign investment to more traditional private sector activities. However, if such donor initiatives take the form of subsidies to foreign investors they are not likely to be any more sustainable than the government subsidies to state-owned enterprises that they replace. Poor governments also lack capacity to monitor foreign service providers and enforce contract terms, including adequate delivery of services to poor communities.

Moreover, the focus of donors on commercial risk facing foreign investors discriminates against domestic investors. An alternative approach to support domestic
and foreign investment in directly productive activities would be to address non-commercial macroeconomic risk that affects the whole economy, such as the risk that unstable foreign aid, or private capital flows, or volatile international commodity prices will reduce growth or start a recession.

For example, rich countries can increase the returns to investment in agriculture in poor countries by eliminating agricultural subsidies and barriers to trade in their own countries. Currently rich countries work at cross-purposes by simultaneously trying to entice foreign investment to poor countries and undermining the very activities in which poor countries have the comparative advantage and which could make the greatest contribution to reducing poverty.

Instead of offering tax holidays to attract foreign investment, poor countries should tax existing investments and use the revenues to foster fiscal stability, build infrastructure, and spend on health, education, and training for the labour force. Poor countries should also build their capacity to measure and monitor FDI, both to enforce regulations and to disseminate accurate information to potential foreign investors about the prospects and risks of investing in poor countries.

**Recommendations**

Given these lessons the authors urge the Canadian government and other donors to adopt a policy direction based on the following recommendations:

1) For the poorest countries, private foreign investment should be seen, not as an end in itself, but as a means of supporting other development initiatives such as poverty reduction or the Millennium Development Goals.

2) To increase the development impact of private foreign investment, international treaties must allow host governments to regulate foreign investors. Ownership of development policies and strategies — a principle on which there is consensus, at least in the aid community — should extend beyond the public sector and aid-financed activities to policies relating to private foreign investment.

3) Governments of poor countries and donors should invest in capacity to monitor private foreign investment and to build at least the most basic knowledge regarding the level of private foreign investment stocks and flows.

4) The focus of donors on the commercial risk facing foreign investors discriminates against domestic investors. An alternative to support both domestic and foreign investment in directly productive activities would be to address non-commercial macroeconomic risk, including unstable foreign aid and private capital flows, and volatile commodity prices. For example, the Chilean tax on volatile, short-term...
capital flows and countercyclical aid funding, like the IMF’s former Compensatory Financing Facility or the European Union’s STABEX would help reduce macroeconomic risk.

5) Rich countries can and should increase the returns to investment in agriculture in poor countries by eliminating agricultural subsidies and barriers to trade in their own countries.

6) Poor countries should target the foreign investors which are most likely to respond, such as the national diaspora. African and Asian emigrants to North America and Europe are likely more familiar with the risks and more knowledgeable about the local investment opportunities in their countries of origin than other potential foreign investors.

7) FDI could play a greater role in creating value chains in the poorest countries — by purchasing inputs locally or engaging in processing or other productive activities related to the core operation — thereby creating more local jobs and incomes.

8) More generally, governments of poor countries should integrate private foreign investment into poverty reduction strategies (PRSPs), which at present rarely mention the expected role or contribution of private foreign investment.

Patterns of private foreign investment

Many types of private foreign investment flow among and between developed and developing countries, each type displaying different characteristics and responding to different influences. Most foreign investment flows between rich countries, especially to the United States. Most investment to developing countries comes from rich countries and goes to a few middle-income ones, such as China, Brazil, or Mexico. Low-income developing countries, which we call ‘poor’, receive a very small share of global private foreign investment flows, but these still sometimes have a large impact on their economies, with greater or lesser benefits depending on the type of flow.

The most important foreign capital flows to poor countries since the late 1980s are foreign aid, money sent home by nationals working abroad (workers’ remittances), and foreign direct investment, in that order (Figure 1). Of these, only the last qualifies as private foreign investment, although workers’ remittances are often also invested. Over this time, foreign aid fell slightly as workers’ remittances and FDI rose substantially, but FDI continued to lag the others in importance. Another form of private foreign investment, private net foreign debt borrowing, was always insubstantial, but turned

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*We always refer to net flows, that is, gross inflows less gross outflows, unless we specify otherwise.*
negative in the second half of the 1990s, after the Asian economic and financial crisis in 1997, as poor countries began paying back more debt than borrowing anew from international banks.

**Figure 1: Capital flows to poor countries**

![Chart of capital flows to poor countries](chart.png)


FDI flows, measured relative to GNP, rose steadily and significantly to all developing countries from 1990 to 1997 (Figure 2). Throughout this period, the share going to middle-income countries exceeded that to poor countries by a steady one per cent of GNP or so. In 1997, however, FDI to poor and middle-income countries diverged. That was the year of the Asian crisis, followed in 1998 by foreign exchange and economic crises in Russia and Brazil, and collapsing stock markets and an extended slowdown in economic growth in the rich countries. FDI in middle-income countries continued to rise rapidly, except for a dip in 2000, while flows to poor countries declined decisively and almost continuously to 2001.

The average flow as a share of GNP to poor countries in 1999 was 3.9 per cent, compared to 4.5 per cent for middle-income countries (Table 1). Comparing these to the median flows of 1.3 per cent and 2.6 per cent respectively indicates that in each group a few countries receive much more FDI than the others. Among poor countries the top five received enormous quantities, and the top ten significantly higher than most middle-income countries. The list of the top ten poor country recipients is remarkably stable over the last part of the 1990s, and by casual observation these countries do not seem to share many features of economic structure or performance.
Figure 2: FDI flows to developing countries

Table 1: Top 10 poor country FDI recipients (% of GNP)

<table>
<thead>
<tr>
<th>1997</th>
<th>1998</th>
<th>1999</th>
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<tbody>
<tr>
<td>Azerbaijan (29.0)</td>
<td>Angola (36.4)</td>
<td>Angola (83.3)</td>
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<tr>
<td>Lesotho (18.9)</td>
<td>Azerbaijan (25.7)</td>
<td>Azerbaijan (14.8)</td>
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<tr>
<td>Vietnam (9.9)</td>
<td>Lesotho (22.8)</td>
<td>Lesotho (14.7)</td>
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<tr>
<td>Nicaragua (9.8)</td>
<td>Armenia (11.5)</td>
<td>Nicaragua (14.7)</td>
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<tr>
<td>Solomon Islands (9.6)</td>
<td>Nicaragua (9.8)</td>
<td>Mozambique (10.3)</td>
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<tr>
<td>Angola (9.4)</td>
<td>Zimbabwe (7.5)</td>
<td>Lao PDR (5.7)</td>
</tr>
<tr>
<td>Georgia (6.7)</td>
<td>Georgia (7.4)</td>
<td>Vietnam (5.6)</td>
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<tr>
<td>Cambodia (6.7)</td>
<td>Vietnam (7.3)</td>
<td>Zambia (5.4)</td>
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<tr>
<td>Zambia (5.6)</td>
<td>Kyrgyz Republic (7.0)</td>
<td>Sudan (4.2)</td>
</tr>
<tr>
<td>Lao PDR (5.0)</td>
<td>Zambia (6.5)</td>
<td>Cambodia (4.1)</td>
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<td>...</td>
<td>...</td>
<td>Poor countries</td>
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<tr>
<td></td>
<td></td>
<td>(average): 3.9</td>
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<td></td>
<td></td>
<td>(median): 1.3</td>
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<td>Middle-income countries</td>
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<td></td>
<td></td>
<td>(average): 4.5</td>
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<td></td>
<td>(median): 2.6</td>
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</tbody>
</table>

Note: These indicate relative not absolute ranking.
The sources of FDI to poor countries appear to be broadening since 1995 to include other developing countries, usually in the same region as the recipient. In a sample of 31 developing countries conducted in 2000, about a third of FDI originated in other developing countries, the largest developing country sources being Korea, India, Malaysia, and South Africa.4

Information on the sectoral breakdown of FDI flows is only available for a few poor countries. It suggests that FDI tends to target a single sector or industry, although the chosen sector differs across the countries. In the Solomon Islands most goes to fisheries; in Lao PDR it goes to agriculture; in Angola to oil; in Cambodia and Uganda to manufacturing; in Cape Verde and Nepal to services; and in Ethiopia to the hotel industry.5

Among all developing countries FDI is starting to diversify from traditional sectors (mining, hydrocarbons, manufacturing, and transport) to new sectors, such as infrastructure (electricity, telecommunications, water, and toll roads, tunnels, and bridges), information technology, and public services such as health care, education, water, sanitation, and waste disposal. In this, FDI was helped by privatization programs. By 1999 FDI in services accounted for 37 per cent of stocks in developing countries.6

**Impacts of foreign direct investment**

For poor countries as a group, and for all developing countries, FDI was relatively stable and growing for much of the 1990s, especially compared to other private capital flows such as debt and portfolio equity. Indeed, along with workers’ remittances, FDI is often cited as a welcome counter-weight to such instability. But for individual poor countries, FDI is often unstable, posing important challenges to macroeconomic management and stability. The average annual fluctuation of FDI around the average flow between 1989 and 1999 was 247 per cent (the median was 104 per cent).7 In a few years for a few countries FDI was negative, but for most countries the fluctuations usually occurred on the upper side of the average, as FDI grew over the decade.

Besides the addition to macroeconomic resources in poor countries, FDI is believed to make other important contributions to growth and development. First, it can raise tax revenues, create employment, and open new markets for exports. In practice, though, performance in these areas does not always meet expectations. Poor countries often compete to offer tax holidays as a way to attract investment. Employment may actually be lost, if foreigners buy and re-structure inefficient existing enterprises, often previously owned by the state. New export opportunities hardly make up for markets lost to subsidies and protection in rich countries, especially in agriculture or traditional industries such as steel.

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6 World Bank, Global Economic Prospects and the Developing Countries 2003: Investing to Unlock Global Opportunities, chapter two.
Second, FDI can help breach investment thresholds. In poor countries especially, where government revenues are small or the domestic financial system is shallow, foreign companies may be the only ones to invest in projects with a high minimum financing threshold, such as infrastructure or natural resource extraction. It can also help start an investment and growth dynamic that attracts further domestic and foreign investment.

Finally, FDI can lift productivity and competitiveness by adding to the stock of capital equipment in the economy, introducing new technology in production and new organizational structures and management methods in companies, and training employees.

FDI tends to reinforce existing patterns of economic structure. It concentrates in one or a few sectors, often in industries with few linkages to the rest of the economy, such as natural resources or light manufacturing (behind protective tariffs) for the domestic market. FDI also concentrates in regions which already have the best infrastructure and human capital. The agricultural sector and rural areas are particularly neglected.

**Influences on foreign investment**

Foreign investors look for a strong “investment climate” in developing countries. This is where society and politics are stable and there is "good governance", such that the economy is managed well, the public service is efficient, flexible, and honest, laws and regulations are not unduly intrusive or directive, and contracts are enforced in the courts.

FDI responds most to political, economic, and infrastructural features. In addition to social and political stability, it is attracted by ready markets, high rates of return, inexpensive and skilled labour, and cheap local inputs. It is deterred by inadequate or expensive infrastructure and risk.

Opportunities to sell products in large or profitable markets occur domestically, in the poor country receiving the investment, or abroad, including investors’ home countries. Domestically, markets are created by a large or growing middle-class in the population or by protection such as high tariffs or heavy regulations for imported goods. Globally, markets are created by special trading rules imposed by rich countries providing for quotas or low tariff rates on goods imported from all or particular poor countries.

Poor countries usually have small overall quantities of capital equipment, such as large machinery and modern production lines, and generally low levels of technology in production. The rate of return on new foreign investment can then be very high. This is especially true of capital-intensive industries, which explains why foreign investment in poor countries often concentrates on natural resource extraction.
On the one hand, foreign investors often cite high initial investment costs in poor countries as a deterrent. These include complicated and lengthy company registration procedures and intrusive rules for the location and manner of investment, and the need to install infrastructure specifically for the investment. On the other hand, foreign investors are attracted to low production costs obtaining, where an educated and disciplined labour force is willing to work at low wages, an availability of competent managers. These features may be offset if power, especially electricity, is expensive, as is often the case in poor countries. Foreign investors do not respond much to special public incentives such as tax holidays.

Risk refers to events or situations which may threaten committed investments or the expected return on the investment. Political upheaval may upset established laws, agreements, or business practices. Pandemics such as HIV/Aids, malaria, or tuberculosis, or high levels of corruption and crime may threaten the normal conduct of business or domestic markets for products. Macroeconomic shocks such as a financial or foreign exchange crisis, a fall in the international terms of trade, or fluctuations in disbursements of foreign assistance, may threaten the general economy.

Since the Asian crisis in 1997, many in the international community view investment in poor countries as prohibitively risky. To a large extent, such views are mistaken, since actual investment in poor countries remains fairly high, and since the attitudes of existing foreign investors are generally positive and improving. For example, an East Africa survey of domestic and foreign investors conducted by the Development Finance Institute (DFI) in 2002 found that 70-85 per cent of the 2,600 respondents were optimistic about their investments and expected to expand them.

The factors influencing the amount of FDI in poor countries do not operate in a straightforward manner. Poor countries tend to face a variety of circumstances. For example, Bangladesh receives a large amount of FDI and portfolio capital. These played an important role in Bangladesh's fast growth in the 1990s, despite this country being highly corrupt with sometimes unpredictable investment laws and a potentially unstable financial system. However Bangladesh has a skilled, low-cost labour force and a large domestic market. Sudan and Angola have long suffered severe military conflicts, yet receive a great deal of FDI in the lucrative oil industry.

Poor countries which go to great lengths to improve their investment climate and provide tax incentives are often disappointed with the response if some of the other dominant influences on FDI are absent. In general, FDI disproportionately goes to higher income developing countries, with or without good investment climates, because they tend to have bigger markets, low-cost locally available intermediate goods, an educated labour force with competent managers, and better infrastructure. FDI does not respond to the amount of foreign aid a country receives.8

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Foreign investment initiatives

Current initiatives by various groups to address FDI in developing countries have three purposes. One approach, backed by rich country governments representing investors, is to agree on bilateral and multilateral investment treaties to protect the interests of foreign investors. This is also seen as a way of increasing the amount of FDI in poor countries by reducing investment risk. A second approach, pursued jointly by the industrialized and developing countries, is to recognize guidelines and conventions protecting the interests of poor countries hosting foreign investment and increasing the beneficial impact of FDI on local communities. Finally, a third approach by poor country governments and international donors is to use privatization programs and foreign aid to induce FDI to develop infrastructure and provide services that have been traditionally provided by governments.

International treaties for foreign investment intend to enhance the interests of foreign investors. For example, investor country governments now propose to negotiate a “Multilateral Investment Agreement” at the Doha Round of the World Trade Organization (WTO). The key provisions would likely be: opening up previously restricted sectors, such as public and private services, to foreign investment; ending differences in conditions and regulations applied by host country governments between domestic and foreign investors (non-discrimination); protecting property rights and the right to repatriate profits; and removing controls on cross-border capital flows generally.

Certain UN organizations and the OECD have since the late 1970s established guidelines for foreign investors in poor countries. These agreements, which are voluntary, seek to protect developing countries from irresponsible or damaging behavior or effects of foreign investment, particularly in the face of weak capacity of most poor countries to monitor and enforce such regulations. The guidelines specify that foreign investors should respect host countries’ developmental goals, observe their domestic laws, respect fundamental human rights, adhere to socio-cultural objectives and values, abstain from corrupt practices, and observe consumer and environmental protection objectives. The OECD Guidelines cover a range of additional issues including general policy, information disclosure, competition, financing, taxation, employment and industrial relations, the environment, and science and technology.

A recent initiative of this type is the UN’s Global Compact (Box i), launched in July 2000 as a voluntary effort by investors from both rich and poor countries to increase the development impact of FDI. The rationale is that, since international businesses are the main beneficiaries of globalization, it is in their interest to see that globalization is not undermined or rendered illegitimate by neglect of social and environmental concerns or of the people and communities that lose from globalization.
The UN Global Compact is guided by nine basic principles governing international corporate behavior. Foreign investors agree to:

- protect international human rights
- avoid human rights abuses
- uphold free association and collective bargaining
- eliminate all forms of forced and compulsory labour
- help abolish child labour
- eliminate discrimination in respect of employment and occupation
- support a precautionary approach to environmental challenges
- promote greater environmental responsibility
- encourage development and diffusion of environmentally friendly technologies.

Participating businesses are to include activities related to the Global Compact in their annual reports.

In the last decade, foreign investment in developing countries was often associated with privatization programs, especially of state-owned enterprises in telecommunications, electricity, and transport sectors. The association is helped by a recent push by official development agencies to mobilize the private sector more effectively in the development effort. In poor countries, most state-owned enterprises are sold to foreign investors because domestic investors have too little entrepreneurial and financial resources. Donors, led by the World Bank, are attempting to engage foreign investors to build essential infrastructure for development, such as public utilities, power, water, and transport. These tend to be very large, lumpy investment projects, requiring long gestation periods before the payoff. Governments of and banks in poor countries can neither finance such investments themselves nor borrow internationally at low terms with long maturities.

To obtain more FDI in infrastructure and services, international donors are trying to reduce commercial risk for foreign investors. This refers to the possibility that, after the investor has committed a large amount of fixed capital in a large power or water project, for example, customers will default on service payments. Customers may be too poor to pay, or the government itself may not be able to honour purchase guarantees during times of economic distress.

Donors reduce commercial risk for foreign investors in two ways, by guaranteeing private international loans and by directly paying for services delivered (output-based aid). Donors are also teaming up with private enterprises to launch special investment funds to seek investment opportunities, invest directly through partnerships with the private sector, or guarantee long-term loans to foreign investors. (see Box 2)

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Box 1

The UN Global Compact is guided by nine basic principles governing international corporate behavior. Foreign investors agree to:

- protect international human rights
- avoid human rights abuses
- uphold free association and collective bargaining
- eliminate all forms of forced and compulsory labour
- help abolish child labour
- eliminate discrimination in respect of employment and occupation
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Box 2

When Canada launched the Africa Action Plan at the Group of Eight Summit of heads of state in 2002, it also created an Investment Fund for Africa. The Canadian government will contribute CAD $100 million to the Fund, and at least that amount again will be contributed by private investors. The Fund provides capital for direct investment in Africa to promote economic development. Starting in 2003, the money will be invested commercially and in public-private partnerships in sectors that are key to Africa’s economic development, such as transportation, water supply, and energy.

The Emerging Africa Infrastructure Fund, set up in 2002 with initial capital of US $ 305 million, will be the first to provide long-term debt capital to Sub-Saharan Africa for private investment in infrastructure. The Fund is financed by the Department for International Development (UK), development finance institutions from Germany, The Netherlands, and South Africa, and by Standard Bank Group and Barclays Bank.

By helping to evaluate, structure, and negotiate investments and providing guarantees, the Fund will reduce the risk of international lending to large infrastructure companies investing in Africa, allowing them to obtain competitive lending rates and terms of up to 15 years. The Fund focuses on investments in power generation, transmission, and distribution, telecommunications, roads, railways, and ports, gas pipelines, and water supply, distribution, and treatment.

Foreign investment and development

For the poor countries, FDI is not a goal in its own right. Just as trade is recognized in the Agreements of the WTO as an instrument for growth and development, so FDI is valued as it contributes to rising standards of living and falling poverty by improving productivity throughout the economy, diversifying into new sectors and exports, creating employment, and sustaining growth.

From this point of view, negotiating international treaties to protect the rights of investors is not a priority. On the one hand, establishing such rights does not increase investment in poor countries.

[M]erely creating new protections does not seem to be strongly associated with increased investment flows...[T]he overall additional stimulus of multilateral rules over and above unilateral reforms would probably be small — and virtually nonexistent for low-income developing countries.10

On the other hand, investment treaties reduce the development impact of existing FDI if they prevent host governments from applying reasonable and transparent conditions on foreign investors. Such conditions include limiting foreign ownership, requiring that a share of inputs to production be obtained domestically, or that a share of output be exported, and ensuring that technology or managerial skills are transferred.

10 World Bank, Global Economic Prospects and the Developing Countries 2003: Investing to Unlock Global Opportunities, p. 133.
to domestic counterparts. These steps enhance the economic benefits of FDI, rather than simply setting guidelines to limit possible negative side-effects.

There is a striking difference in the approach to protecting the rights of foreign investors compared to the approach to circumscribe the behavior of foreign investors in poor countries. Investors’ rights can be enforced, whereas observing the rights of poor countries is voluntary. Voluntary agreements do not work in situations where they are most needed, where businesses with short-term profit-taking horizons and local business and political elites benefit from corruption and secret deals. They also expose reputable foreign investors to unfair competitive behavior from less scrupulous investors.

Donor initiatives to reduce commercial risk for investors appear to be an innovative way to elicit private resources for what are traditionally public investment programs, while avoiding the corruption and inefficiency that often characterizes large public utilities and state-owned enterprises in poor countries. By building infrastructure and delivering services that would not otherwise occur, they contribute to development and help attract additional foreign investment to the more traditional private sector enterprises.

The collaboration between poor country governments, rich country donors, and foreign investors consists of providing subsidies to providers of infrastructure and services in poor countries. Are these subsidies to foreign investors more efficient and more sustainable than the subsidies poor country governments previously gave to state-owned enterprises to deliver the same services? Do poor country governments have the capacity to monitor the performance of private service providers and enforce contract terms, including adequate delivery of services to poor communities?

A prime justification for appealing to foreign investors to subscribe to domestic privatization programs is to share the risk between the public and private sectors, and between domestic and foreign investors. In practice, however, in poor countries only foreign investors participate in privatization programs, and they must be induced to do so by off-loading risk to the recipient government and to donors and official lenders through guarantee arrangements. This creates moral hazard – the private enterprise obtains the profits, while the government and donor community carry the risk. Combined with weak monitoring and contract enforcement, foreign investors have a large incentive to undertake projects that are riskier than necessary, generate large profits if successful, and minimize service delivery.

The focus of the donors on commercial risk discriminates against domestic investors. An alternative approach to support investment from domestic and foreign sources, and to more effectively mobilize the private sector for growth and development, would be to address macroeconomic risk. This would be directed toward increasing the

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stability and predictability of foreign aid itself, reducing the volatility of commodity prices and the international terms of trade, and preventing financial and foreign exchange crises.

Rich countries can increase the returns to domestic and foreign investment in agriculture, one of the most important sectors from the perspective of development and poverty reduction, by drastically reducing subsidies and barriers to trade in their own countries. Currently rich countries work at cross-purposes by simultaneously trying to entice FDI to poor countries for development and undermining the very economic activities in which poor countries have the comparative advantage.

Poor countries can enhance the contribution of FDI to development themselves. Rather than offering tax holidays to attract new FDI, host governments should tax existing FDI and use the revenues to foster fiscal stability, invest in infrastructure for production, and spend on health, education, and training for the labour force.

Host governments should also re-build their capacity to measure and monitor FDI, both to enforce regulations and to disseminate accurate information to potential foreign investors about the prospects and risks of investing in poor countries. In approaching foreign investors, poor countries should target certain types which are most likely to respond. Particularly important are the national diaspora, a very large group in some poor countries such as Vietnam and the Asian community in Uganda.
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