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ECONOMIC DEVELOPMENT IN AFRICA

RETHINKING THE ROLE OF FOREIGN DIRECT INVESTMENT*

Overview by the UNCTAD secretariat**

Executive summary

Many African countries have in recent years implemented policies for attracting FDI as a development finance vehicle of choice in an attempt to, *inter alia*, avoid further indebtedness, create jobs, acquire new technologies, build linkages with the rest of the economy and reduce poverty. These policies have not, in most cases, had the desired results either in increasing FDI flows to productive sectors or in ensuring more rapid growth and reducing poverty. This year's report, contained in document UNCTAD/GDS/AFRICA/2005/1, proceeds from the need for a more critical approach to evaluating the size, quality and impact of FDI in African countries, and suggests that policy makers should pay careful attention to its costs and benefits as much as to ways and means to attract it. It argues for a more balanced and more strategic approach to FDI, one tailored to African economic conditions and development challenges.

* The information in this document should not be quoted by the press before 13 September 2005.

** This document should be read in conjunction with UNCTAD/GDS/AFRICA/2005/1.

The investment climate and FDI: Conventional wisdom

1. It is now generally accepted among policy makers at the national and international levels that efforts to meet the Millennium Development Goals (MDGs) in Africa are being seriously hampered by severe financing constraints and the difficulty of raising annual growth to a rate of at least 7 per cent and sustaining it at that level. In this context, attracting foreign direct investment (FDI) has assumed an increasingly prominent place in strategies of economic renewal for the region. This is in part because FDI is perceived to be a non-debt-creating financial flow. Perhaps more importantly, FDI is assumed to be an engine of growth, crowding in domestic investment, transferring technological know-how and workplace skills, stimulating new export opportunities and providing higher-paying jobs. Accordingly, getting the investment climate right for Africa has become synonymous with attracting more FDI.
2. This approach has its roots in the debt crisis of the early 1980s, when the architects of structural adjustment saw increased FDI as the key to a sustained economic recovery. Getting prices right through responsible macroeconomic policies combined with a rapid pace of liberalization, deregulation and, above all, privatization would not only lead to more efficient use of existing resources in Africa but also attract FDI in conformity with “market fundamentals”. Despite the efforts of African governments over two decades to comply with this policy advice, poverty increased, growth performance was disappointing, and FDI flows failed to match expectations. In response, a second generation of reforms introduced in the late 1990s has sought to address shortcomings in programme design and implementation by placing much more emphasis on policy ownership and poverty reduction. However, the macroeconomic content of the reforms was left largely intact.
3. For this approach, the relatively low level and declining share of FDI flows to Africa are taken as symptomatic of the region’s weak investment climate, and as a principal reason why its growth performance labours under a narrow export base and low productivity levels. The contrast between relatively high returns on FDI in Africa and the persistently low level of actual flows is seen as both indicative of past policy mistakes and suggestive of the potential rewards awaiting the region if it can introduce “credible” policies which encourage faster integration into the global economy and improve its governance image in the eyes of international business. However, there are both theoretical and empirical reasons for doubting this conclusion.

Why history matters as much as geography in Africa’s FDI profile

4. The claim that “governance failures” are the main reason why FDI has bypassed Africa does not square up with the region’s compliance in pursuing adjustment programmes and the accompanying close surveillance by international financial institutions. These programmes have been applied more repeatedly and vigorously in Africa than elsewhere, and the fact that the expected FDI inflows have still not materialized raises questions about the role of governance, at least as this has been conventionally defined. Certainly, the identification of a good business climate with weak state institutions is misleading, and in more balanced empirical assessments of their competitiveness scorecard, many African countries do not perform unduly poorly with regard to the governance components.

5. In fact, regional comparisons are not really the right place to begin an examination of FDI flows, simply because they tend to deflect attention from more fundamental determinants. Over the past three decades, Africa's shares of world output and trade have exhibited sharply declining trends, and per capita incomes in many countries have stagnated or even declined. Against this backdrop, the scale of FDI to Africa hardly appears surprising and it is perhaps just as appropriate to ask how Africa has been able to attract so much FDI as why it has attracted so little.

6. In the search for explanations of poor economic performance, much has been made of Africa's unfavourable geography, including its distance from leading markets, the number of land-locked countries, low population density and unfavourable climatic conditions. However, it is not geography by itself that explains the region's FDI pattern, but rather its intertwining with a colonial history which effected a perverse insertion into the international division of labour whereby rich-country markets were linked to nationals of those same rich countries producing abroad, whether in firms or farms. The persistent legacy of that history includes the region's dependence on a small number of home countries for trade and FDI, limited intra-regional economic relations and the predominance of small domestic markets.

7. This particular combination of geographical, historical and structural forces in Africa has traditionally attracted FDI into enclaves of export-oriented primary production, using a good deal of imported technology, with limited linkages to the rest of the economy and with little reinvested profits. Such FDI has also tended to be more volatile than in other sectors, particularly manufacturing, given the combination of capital-intensive projects and the sensitivity of profits to fluctuating world prices, often assuming a boom-bust cycle, with potentially adverse consequences for investment in other sectors. Recent years have seen a re-emergence of these features across the region.

Why the adjustment-FDI nexus has not stimulated economic growth in Africa

8. In the interplay of linkages that make up a virtuous growth regime, capital accumulation holds a central place in Africa, as elsewhere. This is potentially good news given that in the right environment and with appropriate policy measures, domestic and foreign savings can be directed quite rapidly toward productive opportunities. The idea that FDI will crowd-in domestic investment in Africa is central to the conventional policy story. However, the evidence for this is not conclusive, and a high share of domestic capital formation is generally a prerequisite for the positive impact of FDI to outweigh any negative effects. Given a weak domestic accumulation dynamic, it is also possible that the two sets of investment decisions have different effects on long-term growth prospects.

9. Consequently, attracting FDI is not the same thing as building a dynamic investment climate. Indeed, a growing body of opinion now recognizes that the scale of and benefits from FDI depend on a variety of macroeconomic, institutional and structural conditions being present in the host economy and achieving certain thresholds. FDI is in effect more of a lag than a lead variable in the development process. Not surprisingly, once growth, per capita income and economic structure are controlled for, Africa does not appear to be an outlier in the FDI story.

10. The real problem for Africa is that the period since 1980 has been one of both slower and more volatile growth, not only in comparison to dynamic developing regions but also compared to the region's own previous 20-year economic record. The persistent drop in the share of fixed capital formation (particularly public investment) in output,

deindustrialization, and the growth of the informal economy are some of the trends common across the region that are closely associated with the growth slowdown under adjustment programmes. Moreover, differences in productivity and export performance in the industrial sector explain much of the variance in growth performance within Africa over the post-debt crisis period.

11. Africa's growth slowdown was already apparent in the late 1970s, but the debt crisis of the early 1980s marked a watershed. The sharp deterioration in the external environment not only shattered the profitability of the fledgling manufacturing sector, choking investment prospects and increasing its vulnerability to further shocks, but also constrained investment in the primary sector, where much production was organized through state-owned companies. A vicious downward spiral followed, with mounting indebtedness further constraining investment, diversification and income growth. For many countries in the region, a reversion to commodity dependence was unavoidable, with an attendant exposure to high price volatility, mainly from supply shocks, even as real prices continued their secular decline.

12. This weak investment and diversification dynamic has had a direct bearing on the kind of FDI attracted to the region, as well as its impact. Such conditions are inherently hostile to market-seeking FDI, all the more so as trade barriers have begun to decline across the region. But export-oriented FDI is also unlikely to find this an attractive setting, given that low wages are only one element of cost competitiveness. Robust local markets and the availability of intermediate inputs or low unit labour costs carry much less importance in the extractive sectors, such as mining, where the emergent profit-investment nexus responds more to external market demand and financial pressures. From the early 1990s, both the global and local conditions in this sector began to shift in favour of renewed FDI in developing countries, including Africa.

13. While there are expectations of linkages, spillovers and crowding in of domestic investment, in practice these are often quite limited. Ideally, the reinvestment of profits, or the absorption of profits by fiscal measures and their utilization for financing development, should provide channels to bolster investment, incomes and savings. However, the nature of the rents generated in the extractive sector can often divert the efforts of local entrepreneurs away from wealth creation through new productive capacity into strategies for their capture and redistribution. Manufacturing is likely to be most vulnerable, and this will be intensified by policies pushing for rapid trade liberalization in the context of weak state support for local industry. Weak local industry, in turn, reinforces the tendency of enclaves to rely on imported capital and intermediate and consumer goods, as well as further encouraging the channelling of savings into more speculative high-return activities. Under these conditions, and all the more likely under premature financial liberalization, capital outflows can further weaken the kind of profit-investment nexus needed to establish a sustainable growth path.

14. Thus, to date, and in the context of two decades of liberal reforms, FDI to Africa appears to have reinforced a pattern of adjustment that privileges external integration at the expense of internal integration. Behind this pattern lies a policy philosophy which contrasts the efficiency of foreign firms with the distortionary economic impact of the state. This dichotomy is no longer helpful to thinking about the development challenges facing most African countries, including with respect to FDI. Indeed, while adjustment programmes have been designed and promoted with the aim, *inter alia*, of attracting foreign investors, their negative impact on growth prospects goes much further in explaining the region's poor FDI performance than the governance failures routinely compiled to describe Africa's weak investment climate.

Benefits and costs of FDI for African development

15. It is generally accepted that FDI carries costs as well as benefits for the host country. The initial inflow of capital from FDI is a benefit; the subsequent outflow of profits is a cost. The production of foreign subsidiaries may be a benefit, but if it displaces existing local production, there is an offsetting cost. Similarly, extra exports may require higher imports of equipment, materials or components. Where the firm does not create new assets, but merely takes over existing ones, the net benefits may be particularly hard to discern.

16. Following independence, disappointing returns (in terms of jobs, fiscal revenues and foreign-exchange earnings) from hosting FDI provoked a series of state interventions in Africa, including nationalization of existing plant and equipment, not only in an effort to bolster reinvested profits and help build local linkages but also to affirm national sovereignty over politically sensitive and strategic parts of the economy, particularly natural resources. The record of these interventions was mixed. Many state-owned enterprises proved to be high-cost and low-productivity operations and a drain on the public purse, often acting as a conduit for siphoning away rents to politically favoured groups and individuals. However, a number of countries did make more effective use of their primary rents through a combination of public intervention and market-based incentives, including with FDI. Botswana and Mauritius stand out in this regard.

17. Recently, surges of FDI into the extractive sector in some African countries have spurred growth recoveries and have been welcomed as a potential source of increased employment, government revenues and foreign exchange and as a catalyst for a more diversified industrialization path. There has also been a good deal of optimism expressed that corporate behaviour and market conditions are, if not fully favourable, at least more benign than in the past.

18. In the case of mining, changes to the mining codes have orchestrated a steady state withdrawal from the sector. While these changes have gone through various stages, the underlying rationale has been to shift government objectives towards generating tax revenues, with privatization as the main policy pillar. In the perceived absence of local entrepreneurs who might take over previously state-owned enterprises, the emphasis has increasingly been on attracting new high-risk capital from foreign mining companies. To do so, legal, employment, financial and fiscal frameworks have been further amended to accommodate corporate objectives. In return, governments are expected to receive a “fair” share of the increased rents generated in the sector.

19. As a result of the reforms, Africa has certainly become much more “attractive” as a location for mining FDI, leading some observers to warn of a new “scramble” for Africa’s natural resources. In any event, successfully attracting FDI can only be part of the story. Governments typically have a wide set of economic goals in mind when designing strategies to best exploit these assets. These range from maximizing the value of locally retained earnings and the creation of forward and backward linkages to the economy to technology transfer, job creation, and minimizing environmental damage and social impact (including the expectation that firms, regardless of their ownership, will compensate for damages incurred).

20. Reconciling these interests with the profit-making objectives of mining transnational corporations (TNCs) is far from straightforward. At one level, governments share an interest in maximizing export and fiscal revenue, particularly as a means to breaking potentially binding savings and balance-of-payments constraints on faster growth in the early stages of development. Still, relying on FDI means governments will have to balance their

expectations with those of the industry. In doing so, governments are invariably faced not only with trade-offs vis-à-vis support for other sectors but also with locational incentives offered by other countries. Consequently, and perhaps more than in any other industry, mining is subject to complex bargaining pressures over the terms of investment and with it conceptually different tax regimes aimed at reconciling the interests of the different actors involved.

21. Still, from the host country's perspective, in order to assess the outcome of the reforms and incentives extended to attract FDI, governments need to consider whether these have been commensurate with the desired outcomes outlined above. This requires policy makers to ask a series of fundamental questions with relevance beyond FDI in the extractive sectors – regarding the likely extent of positive spillovers and linkages generated by FDI, and whether domestic firms are positioned to benefit; the likelihood and extent of increased import dependence and profit repatriation; possible impacts on costs and profitability for domestic firms; and the potential problems of nurturing future generations of domestic firms once TNCs gain a dominant position.

22. Already, in the case of extractive industries, some observers have described the incentive competition as a “winner's curse” whereby investment competition among host countries can trigger a “a race to the bottom” both in the more static sense of forgone fiscal earnings and in terms of giving up policy options which would be needed to organize a more dynamic long-term growth path. Certainly, the tax incentives provided to mining TNCs carry an immediate opportunity cost in terms of lost government revenues. Consequently, and particularly given the limited employment and linkage effects associated with FDI in this sector, much would appear to hinge on significantly augmented government revenues over the longer run.

23. Recent evidence from a number of African countries where profit–investment–export nexuses in the mining sector have recently been established around attracting FDI suggest that, to date, the trade-off has not been a favourable one for these host countries, given the revenues actually generated from their export booms, and particularly when environmental and social costs are factored into the calculation. But this conclusion appears also to extend to more recent episodes of expansion in the oil and gas sectors in Africa.

24. In the light of the growing demand for energy, metals and ores, the challenge for policy makers in Africa's resource-rich countries would therefore appear to be how to avoid the longstanding problems of enclavism while maximizing benefits from this sector and minimizing their costs. This is likely to involve a reversal of the current sectoral approach to attracting FDI in favour of a holistic one that emphasizes the sector's contribution to much broader development objectives through backward and forward linkages to the rest of the economy, including higher-value-added processing activities.

Rethinking policy approaches to making FDI work for African development

25. Three main conclusions can be drawn from resituating the role of FDI in the broader context of African development – conclusions that can help structure thinking about alternative policy frameworks. First, not only is the story of attracting FDI through greater openness and downsizing the state open to serious empirical reservations, it also tends to

deflect attention from more fundamental determinants of FDI such as market size and growth, industrial dynamism and infrastructure development.

26. Second, and as elsewhere, not only are past FDI flows in Africa likely to influence current and future flows, but their likelihood of becoming part of a self-sustaining and dynamic investment process with a positive impact on productivity performance depends upon establishing complementary interactions with domestic investment in both the private and public sectors. The failure of capital formation to make a strong recovery since the debt crisis, the limited evidence for crowding in from FDI, the incidence of capital flight and the fact that the ratio of FDI to gross fixed capital formation in Africa is close to the developing-country average all suggest that such cumulative interactions have not taken hold across most of the region during the past 20 years.

27. Thirdly, the recent surges of FDI to some countries, principally in the extractive sectors, should not be taken to suggest that opening Africa up to international business can bring about a rapid region-wide “economic renaissance”. Dependence on commodities for sustained growth has proven a mixed blessing in the past, in part because commodity booms tend to have been shorter than subsequent slumps, and because such booms, particularly when improperly managed, have had a distortionary impact on other parts of the productive economy. Accordingly, and even if commodity markets can offer African producers a more favourable future, policies are still needed to address the same kinds of market failures and structural constraints that have hindered economic diversification in the past.

28. Under current circumstances, and with the policy frameworks in place privileging external integration over internal integration, FDI will tend to reinforce enclave-type development. Moreover, simply pointing to the higher returns on FDI in Africa as indicative of missed investment opportunities is a misleading guide for policy makers. Such figures simply indicate that, from the firm’s point of view, FDI is attracted to high-risk sectors with the possibility of sizeable rents; from the country’s point of view, they mean that FDI is an expensive way of financing development which in the short run can be of benefit if it generates significant government revenues, but which over the longer run can be justified only if it creates linkages with the rest of the economy and brings with it significant technological spillovers and jobs. To date this has not been the case.

29. Accordingly, there is an urgent need to rethink the emphasis on attracting FDI and its replacement with a more balanced and more strategic approach tailored to African conditions and challenges. To do so, governments must be able to mix and sequence a broad set of policies with the aim of raising investment and diversifying into non-traditional exports. Such policies will seek to raise profits above those allowed by market competition, as well as improving the coordination of investment decisions across complementary activities, including through effective corporate governance among local firms. Accordingly, and while the term has been deleted from the conventional policy lexicon, strategic industrial policies have a key role to play in this regard.

30. The key issue for African policy makers is, from this perspective, how the gains and costs from hosting FDI can best be managed to complement wider efforts to strengthen profit–investment–export linkages, and in such a way that internal integration is deepened. Again, simply leaving this to market forces through standard policy recipes of rapid liberalization in the hope of attracting FDI will neither achieve economic development goals nor maximize any potential gains from hosting FDI. Indeed, even if the benefits from hosting were instantaneous, which they are not, and the costs minimal, which is unlikely, policy makers still need to be aware of longer-term losses that may result from giving up policy space for subsequent industrialization and diversification efforts. There are no hard and fast

rules, and policies need to be adapted to individual circumstances. Depending on those circumstances, a country may wish to limit or even exclude FDI if it is likely to threaten infant firms or distort the policy support extended by governments to help them reach the scale and technological levels needed to make them competitive. At other times it may be advisable to have an open-door policy with few restrictions, and at yet other times a country may even wish to use an array of incentives to attract FDI into preferred sectors.

31. Adopting this more strategic approach to FDI will require policy makers to have full knowledge of the policy instruments that have worked in the past and to assess their relevance to current conditions. These include entry restrictions, barriers to hostile takeovers, ownership ceilings, differential taxation, performance requirements linked to exports and local purchasers, and so forth. However, none of these measures can be used successfully in isolation, and policy makers will require a more holistic approach to determine how these instruments best link up to and complement other policies supporting development targets and tailored to local conditions. Here technical assistance programmes can play a useful role in informing policy makers of their full range of options and their likely effectiveness.

32. As was suggested earlier, some of the most pressing policy challenges from hosting FDI in Africa are in the extractive sector, where the investment–profit nexus remains strongly outwardly oriented, upgrading has been limited and the challenges of diversification have not been met. Already a number of mineral-rich countries, particularly in Latin America, that have gone through liberalization experiences, and where relaxation of ownership rules, combined with accommodating fiscal and regulatory regimes, has generated resource booms but few positive spillovers and linkages, are re-examining their mining codes in light of wider development objectives. Re-evaluation exercises are also underway in a number of African economies. The lessons from these experiences need to be carefully assessed and absorbed by other countries looking to benefit from the development of their extractive sectors.

33. Over the medium term, reversing the premature deindustrialization of the past two decades will be key to shifting resources away from traditional low-productivity activities and attracting a more dynamic type of FDI to Africa. This can only be done if a more robust domestic accumulation process is established across the region and based on a denser network of linkages between the rural and urban economies, across sectors, and among consumer, intermediate and capital-goods industries. Attracting FDI to international production networks could be one option in some circumstances, including in the context of export processing zones (EPZs). However, the poor record of such zones in Africa, including the dangers of enclavism, still means that policy makers need to carefully monitor their performance, taking full account, in particular, of the balance-of-payments impact of attracting FDI in these networks, and should from the outset devise policies that reduce the high import content of such activities. Certainly the use of differential tariffs, performance requirements and incentives will still be necessary to establish domestic capacities. In this respect, a more balanced assessment of the successful East Asian countries' experience with FDI needs to be made if appropriate lessons are to be drawn. That experience includes a good deal of diversity, but, particularly in the most successful cases, policies were designed to make TNCs conform with wider objectives related to profit remittances and balance of payments, technological upgrading, and levels of monopoly control, all of which amounted to managed integration into the global economy.

34. The effectiveness of strategic trade and investment policies to encourage diversification into non-traditional exports could be complemented with a stronger regional focus. Regional trading arrangements (RTAs) have assumed increasing importance and proliferated in recent

years despite the strengthening of the multilateral trading system. Research by the UNCTAD secretariat has shown that such arrangements are likely to be strongly trade expanding for developing regions generally, and for sub-Saharan Africa in particular, increasing both intra-regional trade and trade with third countries. In light of the importance of market size to potential foreign investors, it also seems likely that such arrangements could help attract FDI to Africa. There is, however, more to regional integration than the offer of larger markets. Regional cooperation can bring greater financial stability, better policy coordination, improved infrastructure planning and a more dynamic pattern of industrial development, all of which can contribute to a more favourable investment climate for domestic and foreign firms alike.

35. While it is unlikely that FDI will play a prominent role in the initial stages of regional integration, particularly in sub-Saharan Africa, a regional dialogue and efforts at consensus building should, from the outset, extend to related policy issues. This could cover issues concerning harmonization of codes and policies, contract enforcement, tax and other incentives, monitoring of corporate practice with respect to transfer pricing, tax avoidance, and the like. And while every country must be free to operate its system of incentives as it sees fit, it is likely to be in the interests of African countries themselves to reach some measure of agreement on the nature and extent of tax and other incentives; an agreement on a regional basis might be a particularly useful way to start, since it is here that wasteful bidding by host-country governments hoping to attract TNCs is likely to take hold.

36. To date, the international agenda on FDI has revolved around a “big push” to liberalize FDI rules, adopt national treatment and withdraw strategic support from domestic firms. Accordingly, a kind of policy coherence has evolved in the international trade and financial system around controlling the actions of sovereign States by prescribing a narrow and uniform range of acceptable policy instruments. For many countries in Africa, this approach has been pushed through conditionalities attached to multilateral lending, and, while the Poverty Reduction Strategy Paper (PRSP) process has helped broaden and nuance the policy dialogue in some areas, with respect to FDI the emphasis has remained singularly focused on promoting openness to foreign firms as a measure of good governance. Developing countries have also been advised to adhere to the objective of an open capital account, and to resort to capital controls, if at all, only under exceptional circumstances. In the context of multilateral trade negotiations, they have accepted that owners of intellectual property should be able to monopolize access through internationally enforceable rules on protection, while at the same time accepting restrictions on their own policy latitude both in pre-establishment negotiations and once investments are in operation; and, where these investment have a trade-related dimension, they have accepted that policy measures should be subject to international disciplines. Bilateral and regional trade negotiations involving African economies have often tried to push beyond agreements reached at the multilateral level, on the assumption that openness will in itself generate conditions conducive to the most efficient allocation of resources, and irrespective of whether it is reciprocated or not. The promise and the expectation are that developing countries will receive increased FDI and technology flows, although there is no recourse if these do not materialize.

37. None of this has done much to alter African countries’ terms of participation in the international division of labour in a way that could bring about significant net gains. Moreover, the uniformity of views on FDI contrasts with the growing body of opinion that the benefits and costs of FDI are country- and sector-specific and that measures aimed at attracting foreign firms should only be introduced once the full extent of externalities associated with FDI have been fully examined and assessed.

38. If, instead, it is accepted that FDI responds to success rather than creates it, then such gains are unlikely to materialize in the absence of policy space to devise effective industrial strategies that help nurture and strengthen the capabilities of domestic firms, raise the rate of domestic investment and encourage diversification into non-traditional activities. From this perspective, action at the international level should be geared to ensuring that sufficient policy space remains available to secure Africa's long-term economic future. An immediate challenge is to map out the full range of options still available to policy makers to allow them to effectively manage the costs and benefits of hosting FDI in a way that is consistent with a wider set of development goals.

39. Doing so also implies a rather different notion of policy coherence built around development ends rather than policy means. Recently the Blair Commission Report recognized that the quality of government intervention hinges on strong local state capacities and that past policies that undermined these capacities need to be avoided in favour of a more creative and flexible approach to promoting long-term growth, with the precise mix of policies tailored to country specifics.

40. In this regard, it may also be useful to recall that in an earlier Africa Report, the UNCTAD secretariat argued that an immediate requirement for Africa was to double aid and maintain it at that level for 10 years in order to raise domestic savings and investment and establish a virtuous process of growth and development, thereby attracting private capital flows and reducing aid dependency in the longer term. This call has subsequently been echoed in the Zedillo Report on Financing for Development, and more recently both the Blair Commission Report on Africa and the Sachs report on the MDGs have arrived at a similar conclusion. Combined with a debt write-off, this support should provide African countries with the necessary "big push" to break out of the vicious circle of low growth and rising poverty. The aim of this kind of push is precisely to trigger a virtuous growth circle building on mutually supportive links between rising levels of income, savings, investment and exports, and where FDI could also play a constructive role in filling resource gaps and building technological depth.