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Introduction

1. There is a wide consensus among policy-makers in least developed countries (LDCs), international development agencies and the donor community on the need to promote both foreign investment and private investment in general in LDCs. The private sector is viewed as being both more dynamic and (in competitive markets) a more efficient user of scarce resources than the public sector. It can also mobilise finance, and other scarce resources, not available to the public sector. Foreign investment in particular can enhance access to scarce managerial skills, technology and marketing channels, and thereby provide an important channel for raising output, productivity and exports (Economic Commission for Africa, 1996, p.1).

2. Many LDCs have attempted to improve the business climate for foreign and domestic private investment by implementing broad-based economic reforms, liberalising markets and improving incentives for investors. Despite these reforms, foreign direct investment (FDI), other forms of foreign investment (such as portfolio investment) and domestic private sector investment remain at very low levels in most LDCs. This paper examines why foreign investment has remained depressed in LDCs, evaluates policy options for boosting foreign investment, and makes recommendations for policy reforms and associated technical assistance programmes. It argues that the existing thrust towards liberal economic policies should be continued, that policy should be broadly neutral between domestic and foreign investors, as the two sets of investors have the potential to complement each other, and that a range of policy initiatives, supported by donors, to strengthen the institutional base in LDCs for promoting and supporting private investment should be undertaken.

I. Current levels and trends in foreign and domestic private investment in LDCs

3. FDI inflows to all 48 LDCs averaged $1.44 billion per annum during 1991-1996. This amounted to only slightly more than 1% of the combined GDP of the LDCs, and only 1.1% of the total inflows of FDI to all developing countries.[1] Nevertheless FDI flows to LDCs have increased during the 1990s, albeit from a very low base: inflows in current dollars during 1991-1996 were almost 160% higher than during 1985-1990. Among LDCs, the major recipients of FDI in 1996 were Angola and Cambodia, which both attracted around $300 million, and Uganda, United Republic of Tanzania, Yemen, Lao People's Democractic Republic and Myanmar, which each received between $100 million and $200 million (UNCTAD, 1997, pp. 303-307). Comprehensive data on forms of foreign investment other than FDI (e.g. portfolio investment) in LDCs are not available, but it is likely that the levels were negligible.

II. Impediments to foreign investment

4. Many of the LDCs have implemented policy reforms to improve the investment climate for the private sector since the 1980s. Policy reforms include liberalisation of external trade, foreign exchange and financial markets, removal of restrictions on foreign investment,

[1] FDI inflows to all developing countries amounted to 1.8% of their combined GDP.

privatisation of state-owned enterprises, and the enactment of liberal investment codes providing, inter alia, investors with guarantees against expropriation, fiscal incentives and rationalised approval procedures. These policy reforms have not yet stimulated a major expansion in the level of foreign investment in LDCs, although, as noted above, there was a rise during the 1990s from a very low base.

5. Foreign investment has remained depressed in LDCs for several reasons. First, profitable investment opportunities, outside oil and minerals, are very limited because of the small size of domestic economies and a variety of supply-side constraints on competitive export production, such as poor infrastructure and lack of technical skills in the workforce.

6. Second, the implementation of reforms has been inconsistent or only partial in some countries: for example, some important restrictions on foreign investment remain in place, investment applications entail bureaucratic procedures, privatisation has been slow to get off the ground, and the macroeconomic environment is still very difficult, with high inflation, large government deficits, and sluggish growth rates.

7. Third, many LDCs lack an adequate institutional framework for private investment: for example, the legal framework required to enforce financial contracts is often weak, which impedes the mobilisation of finance by the private sector.

8. Fourth, many LDCs are perceived as being high-risk locations for investment, because of economic and political instability, the legacy of past policies whose consequences were often detrimental to the private sector, and, especially in Africa, the fear that even peaceful countries might in future be affected by the type of internal conflicts which afflict many countries in the region. These factors have impeded domestic private investment as well as foreign investment. The weakness of the domestic private sector itself has served to deter foreign investment.

III. Policies to enhance inflows of FDI

9. If LDCs are to attract significant levels of foreign investment, a range of policy reforms will be needed. Policy reforms should aim to stimulate both foreign and domestic private investment, as there are likely to be important complementarities between the two (Lall, 1997). Investments often have positive externalities: one firm's investment can provide a market for the output of an another firm or can provide it with production inputs. A flourishing domestic private sector provides opportunities for foreign portfolio investment. In addition, foreign companies are reluctant to invest in countries where the domestic private sector itself is unwilling to invest, as this sends negative signals about the attractiveness of the business climate. Policies which benefit domestic private investment are therefore also likely to stimulate foreign investment.

10. Probably the single most important prerequisite for boosting private investment is to sustain robust economic growth rates over a prolonged period. Most empirical work on the determinants of private investment indicates that the main determinant, at the aggregate level, is growth in output, often referred to as the accelerator theory of investment (Greene and Villanueva, 1991; Oshikoya, 1994). Growth-enhancing policies will include, inter alia, low inflation, low fiscal deficits and competitive exchange rates, an open trade policy with

minimum barriers to imports, the avoidance of policy-induced distortions, restrictions and disincentives to production (especially in agriculture and the export sectors), and increased public savings mobilisation (Hadjimichael et al, 1996; Goldsbrough et al, 1996). Sustaining economic growth in LDCs will also require enhanced financial support from donors, in particular to enable countries to maintain expenditure and import levels in the face of negative external shocks.

IV. Regional integration

11. Given the very small size of most LDCs' domestic markets, enhancing regional integration among LDCs and their non-LDC neighbours would greatly expand the range of profitable opportunities available for investors, allowing them to realise economies of scale which would not be possible were they to produce only for a single country market. A number of regional trading arrangements involve LDCs (e.g. ECOWAS, SADCC), but both institutional and physical barriers impede trade flows between the members of these groupings. Effective regional economic integration requires the full implementation of regional accords to dismantle non-tariff barriers and reduce tariffs between members, to introduce more efficient customs procedures at borders, and to improve the transport infrastructure. In addition, regional agreements can improve conditions for foreign investment by harmonising investment regulations between different member countries.

V. Reducing the risks of investment

12. There has been a growing awareness among academic economists of the sensitivity of private investment decisions to risk and uncertainty (Rodrik, 1991). To compensate for risk, investors will demand much higher expected rates of return, and many feasible investment projects will not be undertaken in a risky business environment. The risk premiums demanded by investors are likely to be so high in many cases that Governments cannot easily offset their impact by offering investment incentives such as fiscal concessions. What is needed is the creation of a business environment in which avoidable risks are minimised.

13. Many business risks are outside the control of policy-makers (such as the terms of trade), but there are some strategies which Governments can adopt to reduce risks for investors. These include pursuing macroeconomic stability, preventing key prices, such as interest rates and exchange rates, from becoming seriously misaligned (which would create the risk of sharp corrections in the future), and the avoiding frequent changes in policies, and in particular policy reversals.

14. Risks can also be reduced through the enactment of appropriate regulations. Investment codes which provide guarantees against expropriation, guaranteed rights to repatriate profits, etc, can give foreign investors some degree of assurance against future changes in policy which would be detrimental to their interests (see below).

VI. Investment insurance

15. To enhance their credibility, LDCs should aim to join multilateral bodies which offer investors insurance against certain types of risk and to enter bilateral investment agreements

with potential source countries for foreign investment. In addition, multilateral and bilateral investment insurance agencies should be prepared to offer concessional insurance rates to investors in LDCs in order to encourage investment in these countries, provided that the LDC Governments meet certain criteria with regard to policy and legislation.

VII. Regulatory issues and investment incentives

16. Business confidence can be enhanced by the enactment of a regime of investment regulations which is transparent, does not discriminate against foreign investors or particular categories of investors, does not impose restrictions on legitimate business activities, is administratively simple and minimizes the scope for arbitrary application by public officials. Liberal rules on profit repatriation, capital outflows and the servicing of external debt are essential to attract foreign investment. Foreign investment, however, does not necessarily require generous fiscal concessions (e.g. tax holidays, accelerated depreciation allowances, duty exemptions). There is little evidence that fiscal incentives achieve their objectives of promoting investment in the targeted sectors, while the negative affects of selective fiscal incentives are well established: these include the distortion of incentives between different sectors of the economy and between the use of different assets, often in complex and unpredictable ways, and the loss of tax revenue. A fiscal policy comprising uniform but relatively low corporate tax rates with a minimum of exemptions and concessions would provide a conducive fiscal regime for foreign investors without jeopardising government revenue. Regional co-operation is needed to ensure that LDCs do not compete with each other to offer increasingly generous concessions to foreign investors at the expense of their taxpayers (Lall, 1997, p.21).

VIII. Financial market development and regulation

17. The depth and efficiency of domestic financial markets are important factors in attracting foreign investors. Portfolio investment is clearly dependent upon domestic capital markets, while most direct foreign investors will use the domestic banking system and some may need to raise finance on domestic capital markets. Foreign investors need liquid markets, a diversity of instruments, and a sound banking system. The role of policy will mainly be to ensure that the appropriate institutional structures and regulations are put in place. If domestic stock markets are to attract foreign capital, liberalised entry and exit regulations, including the ability to repatriate capital, good-quality information on listed companies, transparent and rigorous application of rules to prevent fraud and other abuses, and efficient trading and settlement procedures are necessary (Economic Commission for Africa, 1996, pp.17-18).

IX. Investment promotion

18. With strong competition from countries throughout the world to attract foreign investment, LDC Governments need to greatly improve the marketing of their countries as suitable locations for foreign investment, with investment promotion agencies in LDCs taking a more proactive marketing and promotional role. Promotional strategies should go beyond general marketing (e.g. at trade fairs) to selective targeting of potential foreign investors. Investment promotion agencies in LDCs should identify the main strengths of their own countries as locations for foreign investment, and then target specific foreign investors which

are most likely to be attracted by these strengths. The strategies adopted by some of the most successful investment promotion agencies in the world (e.g. the Malaysian Industrial Development Agency) provide potentially important lessons for LDCs (Tillet, 1996). As with many other components of the institutional structure in LDCs, however, investment promotion agencies face severe constraints in terms of human and financial resources.

X. Recommendations, including elements of international best practice in attracting foreign investment to LDCs

19. The following summarises the recommendations for policy reforms and technical assistance programmes to strengthen the institutional, policy and legislative frameworks for foreign investment in LDCs.

(i) LDCs should establish clear, straightforward, administratively simple and "investor friendly" investment codes. These should not discriminate between different categories of investors (e.g. foreign and domestic), should minimize government interference in legitimate business decisions and provide a set of basic guarantees to investors in respect of property rights, foreign exchange transactions, etc. Donors and international agencies should provide technical assistance where necessary.

(ii) LDCs should enact comprehensive legislation and establish supervisory frameworks for capital, money and banking markets. The regulatory framework should focus on prudential rather than economic regulation; i.e. promoting prudent management of funds, proper accounting standards, transparency in financial transactions, prevention of fraud and insider abuses, and competition in financial markets. Technical assistance to strengthen financial system regulation and supervision will be needed. International agencies should assist LDCs without national stock exchanges to undertake research on the viability of establishing their own stock exchanges, or alternatively of establishing exchanges on a regional basis or joining an already established stock exchange in the region.

(iii) LDCs should set up investment promotion agencies (IPAs), adopting the "best practices" of successful IPAs around the world, to formulate investment promotion strategies, market the country as an investment location, and target specific foreign investors. International agencies such as UNCTAD, UNIDO, MIGA and the World Association of Investment Promotion Agencies (WAIPA), should collaborate to facilitate the exchange of national experiences in investment promotion and to encourage the adoption of "best practices" by LDCs.

(iv) LDCs should seek to strengthen regional integration in order to expand the size of the potential market available to foreign investors. This should entail the full implementation of existing agreements to remove trade barriers among neighbouring countries and further liberalisation of trade and investment within regional groupings.

(v) LDCs should provide all investors with low but uniform tax rates with a minimum of selective tax exemptions and concessions and other incentives. LDCs should seek to harmonise investment incentives within the regional groupings of which they are members in order to avoid pressure to compete against their neighbours by offering generous fiscal incentives. LDCs should sign "double taxation" agreements with all countries from which foreign investors are likely to be based. Donors and international agencies should provide technical assistance to LDCs to assist them to evaluate and rationalise investment incentive schemes.

(vi) Donors and international agencies should provide comprehensive capacity building programmes for the agencies within LDCs responsible for investment promotion and regulation and for financial system development and regulation. Capacity-building should include training of staff, study visits to more established IPAs, stock exchanges, regulatory bodies, etc, and provision of technical advisors.

(vii) Multilateral and bilateral investment insurance should be extended to foreign investors in LDCs at preferential rates, provided that LDC Governments meet specified minimum conditions related to the policy and legislative framework.

(viii) Donors and international agencies should establish programmes to enhance the technical and managerial skills of domestic private sector investors; e.g. by strengthening technical training institutions and providing technical assistance to train key personnel in domestic firms.

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