The Role of ODA in Promoting Sustainable Investment in Developing Countries

A Workshop of the Vale Columbia Center on Sustainable International Investment and the Finnish Ministry of Foreign Affairs

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Columbia University Law School

Workshop Report

Workshop Organizers

Vale Columbia Center on Sustainable International Investment
Columbia Law School/The Earth Institute

The Vale Columbia Center on Sustainable International Investment promotes learning, teaching, policy-oriented research, and practical work within the area of foreign direct investment (FDI), paying special attention to the sustainable development dimension of this investment. It is a joint center of Columbia Law School and The Earth Institute. For more information, see: www.vcc.columbia.edu.

Ministry for Foreign Affairs of Finland

Finland's Development Policy Programme and its Aid for Trade Action Plan emphasise the importance of creating economic growth as a means to meeting development goals such as poverty eradication. One of the main components of the Action Plan is assistance to the creation of an enabling business environment in developing countries. Within the Action Plan the Ministry launched this spring in cooperation with the OECD secretariat a new programme to unlock investment potential in Southern Africa by using the Policy Framework for Investment (PFI) to advance investment policy reform. For more information see: http://formin.finland.fi

The Vale Columbia Center on Sustainable International Investment and the Ministry of Foreign Affairs of Finland organized a workshop on November 4, 2009 at Columbia University in the City of New York to promote discussion about using funds legislated by donor governments for official development assistance (ODA) in ways that lead to more sustainable foreign direct investment (FDI) in aid receiving countries, particularly through support of policies and activities at the sub-national level. This is the report of that workshop.

The workshop brought together 16 experts from developed and developing country governments, international organizations, academia, the private sector, and civil society, all of whom participated in their personal capacity in a half day of intense discussion of two related themes, namely, (1) How ODA might be leveraged at national and sub-national levels so as to either directly or indirectly encourage FDI that meets essential sustainability criteria, and (2) How ODA might (and whether it should) help foster linkages between the foreign firms operating in an economy and domestic firms, thereby enhancing local employment and stimulating domestic entrepreneurship.

On attracting additional and sustainable FDI: leveraging ODA at the sub-national level

Participants in the workshop were of one mind on the positive potential of FDI to accelerate sustainable and sustained development, and that official funds from donor governments can help promote the conditions that would encourage additional FDI. There were, however, some well-known *caveats* that must not be forgotten. A central *caveat* is that some investments will be more supportive of development than others. Indeed, FDI can be detrimental to domestic private sector development if it crowds out domestic firms. Promotion of FDI needs to be coherent with national – and sub-national – development strategies. A second *caveat* is that, just as some donor countries have long used ODA to promote their exports, ODA has sometimes served to promote FDI by donor country firms. Both types of "tied aid" should end, although its persistence reflected the view of some donors that tying some of its aid to benefit their own firms was necessary to gain parliamentary support. Aid officials must strive that their assistance is aimed at development cooperation rather than commercial promotion. At the same time, a number of developing countries have found it helpful to encourage home investment by their diasporas, since when they return they are more likely to want to sink roots into the soil of their homeland and less likely to be "footloose".

There was common ground in the discussion on the priority need for investment-receiving countries to have an effective institutional and policy framework for investment, one in which legal rules and regulations for operation are clear and stable, with adequate availability of quality ancillary business services (e.g., land registries). The "PFI" (Policy Framework for Investment) of the Organization for Economic Cooperation and Development was suggested as a useful tool in this regard. The reality is that FDI is more attracted to environments that already support an effective private sector. Similarly, there is no controversy about needing to add to physical and social infrastructure (in which we would include port services, electricity, potable water, sanitation and urban transportation on the one hand, and public services, such as in health, primary and secondary education, and enforced worker safety and other labor standards on the other hand). ODA has supported development of many of these factors and should continue to do so. They are basic to private sector development, of which FDI is a part. Indeed, they are basic to development.

An additional and important dimension of policy was also emphasized in the discussion, which is that the aid receiving countries are not homogeneous wholes, but places with more and less advanced areas, with different local needs and different ability to command political attention at the center of the country. Development, after all, disrupts traditional patterns of economic activity, brings new activity to some regions and leaves other regions untouched or in declining condition. Employment opportunities will rise in some locations and fall in others; some infrastructure will be added in response to the pressure of the business sector in advancing areas, although other infrastructure in those areas may be ignored. Non-central areas may be left in increasingly backward condition.

The implication is that developing countries, as countries everywhere, need regional and urban development strategies and plans. While it is the responsibility of the national government to ensure coherence of local strategies with national priorities, the sub-national plans themselves need to be developed at the relevant level – whether cities, towns, states or provinces, as the case may be – and with the full participation of the people and firms who live in them, the local stakeholders, as they will be the most consistent and knowledgeable advocates for those spaces. But plans have to be implemented and the authorities in these sub-national spaces must have the capacity to follow through, as in seeking investors at home and abroad to undertake priority investment opportunities.

The reality, however, is that the technical capacities of government at these sub-national levels tend to be weaker than at national level, which means that one priority for development assistance is to strengthen sub-national capacity for development, especially in secondary cities or regions. This may include adopting and efficiently implementing appropriate regulatory frameworks at the local level, encouraging modalities for government/business/citizen dialogues on sustainable development, and promoting the locality to potential investors in the country and internationally. An example of the last element is the Millennium Cities Initiative which has worked with medium-size under-resourced cities in sub-Saharan Africa to develop information on commercially viable investment opportunities, to disseminate this information to the international investor community and to build local capacity to attract FDI and benefit more from it.

On leveraging ODA to strengthen foreign affiliates' contribution to domestic enterprise development

Besides the direct tax revenue, employment, supply and possibly balance-of-payments contributions to the host economy, FDI can produce additional benefits, as through increased sales to and purchases from domestic enterprises ("linkages") or general dissemination by example of international business standards ("spillovers"). Workshop participants saw these secondary benefits as of primary importance for increasing the development impact of FDI, including spreading that impact to small and medium-size enterprises. And indeed, many examples were discussed of explicit programs to strengthen such linkages, as in sourcing high-grade coffee and its processing from independent farmers for a major coffee producer in Uganda, and upgrading to 80% local sourcing for a Danish producer of wind turbines in India.

One question for development assistance policy is how directly or indirectly to use ODA to increase desirable linkages. Linkage programs, for example, may support education and training in those technological matters that increase the prospects of linkages in the priority industries the country is seeking to develop. Donors might also encourage foreign affiliates operating in a country to strengthen their linkages through practical mentoring of suppliers and enterprise customers with which they establish relationships, as by sharing the cost of trainers. Alternatively, a donor could support an information hub in an aid-receiving country that would seek to identify prospective linkages and providers of the services needed to carry out the quality enhancement. In reality, however, donors tend to eschew support for investment promotion agencies that undertake such work, as they prefer not to finance regular operations of government offices, especially when the offices engage in ongoing processes rather than produce identifiable projects.

However, there is a second question regarding direct use of ODA for promoting linkages, namely, should this be a priority use of limited aid funds? Several arguments were made in the workshop against using ODA in these ways. Firstly, donor governments have agreed in the Paris Declaration and Accra Agenda for Action on Aid Effectiveness that aid should only support projects that fit into the country's development framework and align themselves with country systems. This may or may not warrant using aid funds to support domestic enterprise development through the strengthening of linkages between foreign affiliates and domestic firms. For example, more direct support of enterprise development may be deemed a higher priority than linking aid to FDI. Indeed, the application of ODA in support of FDI linkages needs to be compared to ODA investments directly in public goods sectors, such as in the physical and social infrastructure discussed earlier, which also benefits foreign investors but which may be more employment intensive and create more new, decent and green jobs than enhanced linkages. On the other hand, local enterprise development is also widely taken to be a priority for sustainably reaching the Millennium Development Goals (MDGs), and linkage programs can be an effective technique in this regard.

Conclusion: the aid and enterprise development imperative

The hard choices for allocating aid posed in the previous paragraph are primarily a function of the tight ODA budgets that donor governments are offering in the midst of the worst global economic downturn since the 1930s. The discussion in the workshop recognized that, without building productive domestic capacity, the MDGs are not achievable on a sustainable basis. Foreign direct investment can make a contribution to building productive capacity in a country and, through linkages (and other mechanisms), can help advance enterprise development. ODA can therefore play a useful role in promoting linkages between domestic firms and foreign affiliates and in helping to attract sustainable FDI. At the same time, of course, competing claims for ODA need to be recognized. The solution to the limitation on the deployment of ODA resources as discussed in this workshop is analytically simple if politically complicated: aid must be raised to the promised levels, and then beyond.

— *Barry Herman*
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