

Responsible enterprise, foreign direct investment and investment promotion

Key issues in attracting
investment for sustainable
development



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Abbreviations and acronyms

AAITPC	Asia–Africa Investment and Technology Promotion Centre
ABS	Academy of Business Studies
ADM	Archer Daniels Midland
APEX–Brasil	Brazilian Export and Investment Promotion Agency
APIX	Agence Nationale Chargée de la Promotion de l’Investissement et des Grands Travaux
BKPM	Indonesian Investment Coordinating Board
BP	British Petroleum
CAFTA	Central American Free Trade Agreement
CBI	Caribbean Basin Initiative
CDCFC	Community Development Carbon Fund
CD4CDM	Capacity Development for the Clean Development Mechanism
CDM	Clean Development Mechanism
CEI	Center for Exports and Investment
CER	Certified Emission Reduction
CINDE	Coalición Costarricense de Iniciativas para el Desarrollo
CM	Contract Manager
CNZF	The National Free Zone Corporation, Nicaragua
CPI	Centro de Promoção de Investimentos
CSR	Corporate Social Responsibility
CZF	The Free Zone Commission, Nicaragua
DANIDA	Royal Ministry of Foreign Affairs of Denmark
DBSA	Development Bank of South Africa
DEAT	Department of Environmental Affairs and Tourism, South Africa
DGIS	Dutch Ministry of Foreign Affairs
DOE	Designated Operational Entities
DNA	Designated National Authority

DR-CAFTA	Central American Free Trade Agreement with the USA
EIA	Environmental Impact Assessment
EMS	Electronic Manufacturing Services
EPA	Economic Partnership Agreement
US EPA	United States Environment Protection Agency
ERA	Electricity Regulatory Authority
ERP	Economic Recovery Programme
ERPA	Emissions Reduction Purchase Agreements
ETS	Emissions Trading Scheme
EUA	European Amount Unit (on the EU ETS)
FDI	Foreign Direct Investment
FDI-T	Foreign Direct Investment in Tourism
FELDA	Malaysia's Federal Land Development Authority
FFV	Flexi Fuel Vehicle
FIC	Foreign Investment Committee
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GHG	Greenhouse Gas
GPN	Global Production Network
GRI	Global Reporting Initiative
GWP	Global Warming Potential
HFO	Heavy Fuel Oil
HIPC	Heavily Indebted Poor Countries Initiative
IADB	Inter-American Development Bank
ICRIER	Indian Council for Research on International Economic Relations
ICT	Information and Communications Technology
IEA	Industrial Ecology Agreement
IIC	Indian Investment Centre
IIED	International Institute for Environment and Development
IMD	Institute for Management Development
IMF	International Monetary Fund
INAFOR	The National Forestry Institute, Nicaragua
INTUR	The Nicaraguan Tourism Board
IPA	Investment Promotion Agency
IPP	Independent Power Producer
ISI	Import Substitution Industrialisation
ITA	Investment Tax Allowance
ITSP	International Trade and Services Policy
LDC	Least Developed Country
M&A	Merger and Acquisition
MARENA	The Ministry of the Environment and Natural Resources, Nicaragua
MDC	Most Developed Country

MFN	Most Favoured Nation
MIDA	Malaysian Industrial Development Authority
MIIFIC	Ministry of Industry, Trade and Development's Private Sector Development Division (Dirección de Fomento Empresarial), Nicaragua
MIGA	Multilateral Investment Guarantee Agency of the World Bank
MNC	Multinational Corporation
MOST	Ministry of Science and Technology
MRI	Mitsubishi Research Institute
NAFTA	North American Free Trade Agreement
NEMA	National Environmental Management Authority
NGO	Non Governmental Organization
NKG	Neumann Kaffee Gruppe
NTA	National Tourism Administrations
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PC	Personal Computer
PCF	Prototype Carbon Fund
PIRT	Presidential Investors' Roundtable
R&D	Research and Development
REDIEX	Red de Inversiones y Exportaciones
RIBEC	Roshini International Bio Energy Corporation Ltd
RoHS	Restriction on Hazardous Substances
SAPCO	Société d'Aménagement et de Promotion des Côtes et Zones Touristiques du Sénégal
SME	Small and medium-sized enterprise
TIC	Tanzania Investment Centre
TNC	Transnational Corporation
TRIM	Trade-Related Investment Measure
UIA	Uganda Investment Authority
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNESCO	United Nations Educational, Scientific and Cultural Organizations
UNFCCC	UN Framework Convention on Climate Change
UNICA	Sao Paulo Sugarcane Agroindustry Union
UNWTO	United Nations World Tourism Organization
VAT	Value Added Tax
VER	Vehicle Emission Reduction
WAIPA	World Association of Investment Promotion Agencies
WEEE	Directive on Waste from Electrical and Electronic Equipment
WERECO	West Nile Electrification Company
WTO	World Trade Organization
ZIC	Zambia Investment Centre

Foreword

Foreign direct investment (FDI) is widely considered to be an important factor in generating faster and broader patterns of economic development. Yet it is also recognised that the development potential of FDI will be influenced by existing government policy and institutions. An automatic contribution by FDI to economic progress in the host country cannot be taken for granted. Moreover, in some cases, sustained delivery of economic benefits from FDI may be undermined by adverse social and environmental impacts. Good governance, effective institutions, coherent economic policies and well-targeted social and infrastructure investment will increase the benefits of FDI.

The mixed experience from foreign investment is driving many investment promotion agencies (IPAs) to broaden their ambition and mandate. Increased efforts are being made in the field of policy advocacy. Also, IPAs are moving away from focusing on the total volume of investment they can generate to identifying investors that may match with the domestic corporate and human capital resources available in the host country or region. In this way they can reduce negative effects and increase positive development impacts of investment.

Over the last ten or 15 years, global flows of FDI have increased considerably in volume and economic importance. As a result, competition amongst countries for attracting FDI has also increased. Investment promotion has become a business in its own right and the IPAs have had to become ever more professional in their approach to attracting investment.

This challenging context provides the background for this publication. IPAs are now taking a range of new ideas and tools on board to attract investors associated with greater corporate responsibility. But more needs to be done. *Responsible enterprise, foreign direct investment and investment promotion – Key issues in attracting investment for sustainable development* aims to contribute to this debate. It brings together think-pieces from different sectoral experts on how IPAs from developing countries can enhance their

efforts in attracting FDI that maximises overall benefits, broadly defined, for the host country.

We would like to acknowledge the contributions of Reinalina Chavarri, Lorenzo Cotula, Annie Dufey, Johanna Edlund, Maryanne Grieg-Gran, Moustapha Kamal Gueye, Davina Hayles, Kate Lee, Carlos Mena, Issa Mukasa, Juan Carlos Pereira, Gregor Pfeifer, Frances Reynolds, Geoff Stiles, Camilla Toulmin, Bill Vorley, Halina Ward, Eugenio Yunis and Lyuba Zarsky. We would also like to thank the Dutch Ministry of Foreign Affairs (DGIS), the Royal Danish Ministry of Foreign Affairs (Danida) and the Norwegian Agency for Development Cooperation (Norad) who made the funds available for this publication.

We hope this book published by the International Institute for Environment and Development (IIED) will constitute one of the many efforts towards enriching the available knowledge on the issue and highlight the capacity of IPAs for policy advocacy in order to increase the overall benefits of FDI to the host country.

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Kai Hammerich, President, WAIPA, Geneva

Overview

Halina Ward

Introduction

Foreign direct investment (FDI) is widely considered to be a key factor in economic development in middle- and low-income countries. Positively, it can be associated with the introduction of new technologies, job creation, access to new markets and improvements in the competitiveness of host countries. But too often, FDI has been associated with environmental degradation, increased inequality, and lack of integration with the local economy.

A number of host country government agencies and departments have a role in influencing the overall investment climate. Among them, investment promotion agencies (IPAs) are often key players. They are in the front line of targeting investors and marketing the country as a whole. The increasingly competitive environment between countries for attracting foreign investors coupled with enormous pressure on IPAs to enhance the quality and the national development contributions of FDI, are today prompting a rethink of investment promotion strategies. This creates an opportunity for IPAs to consider the relevance of corporate social responsibility (CSR)¹ and sustainable development to their work.

This book is about the work of investment promotion and its relationship with sustainable development and CSR. Sustainable development for these purposes can be

1. CSR for the purposes of this book is more ambitious than the commonly understood “beyond compliance” and involves corporate practices that minimises environmental and/or social costs and impacts while at the same time maintaining or maximising economic gains.

understood quite simply as the policy and business imperative to ensure that economic, social and environmental dimensions of human and business endeavour are addressed in an integrated way. The book brings together a series of papers identifying opportunities for IPAs to attract FDI that is associated with good CSR practices and makes a contribution to sustainable development in the host country. The papers are written by IIED researchers and other sectoral experts, representatives of IPAs and of multilateral organisations working closely with IPAs in attracting FDI. The book examines the advantages and risks involved for IPAs in attracting FDI with good CSR practices, highlighting key leverage points and practical tools to achieve this.

Sustainable development is often linked to questions of corporate responsibility. When this association is made, the various practices of corporate responsibility also referred to as “corporate social responsibility (CSR)”, can be understood as expressions of businesses’ contribution to sustainable development. But market-based CSR doesn’t happen alone. It needs to be “enabled” – so that the best possible drivers and incentives, standards and tools, and human skills and institutions are in place to encourage the best solutions and business contributions to sustainable development.² A key question for the authors of this book, then, is this: “to what extent can the work of IPAs around the world contribute to creating the right “enabling environment” for maximising the positive contribution of business to sustainable development?”

This is not an easy question to answer in generic terms, since the institutional settings and mandates of IPAs vary considerably in different investment locations. And the task of attracting investment to many economic sectors that are vital from a sustainable development perspective – for example oil and gas, or mining – often falls within the remit of specialist agencies or government divisions, not multi-sectoral IPAs. Nevertheless, because almost any kind of business endeavour carries implications for sustainable development, IPAs will always have potential to make a contribution to sustainable development.

The public policy dimensions of the work of IPAs are increasingly well understood; particularly through an emphasis in the work of the UN Conference on Trade and Development (UNCTAD), and the World Association of Investment Promotion Agencies (WAIPA), on the potential and boundaries of policy advocacy by IPAs, and “good governance” of investment promotion.³ But the work of IPAs has rarely been considered from either the broad public policy lens of sustainable development or the public and private lens of CSR.

In the chapters that follow, the authors explore the dimensions of a long-established area of analysis and policy concern: the implications of FDI for sustainable development. They go further, too, seeking to identify whether there are any distinctive roles that could be played by IPAs in channelling investment towards

2. See further Halina Ward, 2004.

3. See e.g. UNCTAD’s Programme on Good Governance in Investment Promotion and Facilitation; UNCTAD, 2004; UNCTAD, 2006.

sustainable development, or filtering out investment that may not be supportive of public policy goals related to sustainable development.

As noted by UNCTAD Secretary-General Supachai Panitchpakdi,⁴ IPAs need to find a balance between public and private sector interests in their work. In their role as a bridge between public and private interests, IPAs ought, at first glance, to be able to play valuable government and business-facing roles for sustainable development; by helping, through policy advocacy, to optimise the enabling role of public policy in corporate responsibility, and by raising awareness among foreign investors of host country expectations and policy commitments to sustainable development. Understanding the processes of investment promotion; hearing the concerns of investors; representing the policies of their governments – these are all common features of IPA work, which offer real potential for these agencies to play a valuable role in getting the best sustainable development contributions from investors.

Setting the scene: IPAs' current practices

There are already many examples of good practice around the world. In their scene-setting chapter, IIED's Maryanne Grieg-Gran and Johanna Edlund report on the results of a review of the websites of 53 IPAs in middle- and low-income countries. They set out to identify the extent to which, based on these websites, IPAs are already presenting their countries as concerned about sustainable development. They offer incentives to inward investors to promote inward investment with economic, social and environmental benefits, targeting investors committed to sustainable development or CSR, or specifically targeting investment in activities associated with positive contributions to environmentally sustainable development such as solar energy or biomass.

An impressive 47 of the 53 English language IPA websites surveyed contain information on one or more of these approaches. If this overall coverage is impressive, however, it is striking that only one IPA, PIPA in Peru, in stating its responsibilities, highlights all three dimensions of sustainable development – the social, the environmental and the economic. And only a handful – with the Solomon Islands among them – specifically state that they are aiming to attract investors who bring benefits that are social as well as economic (though even in that case, without mentioning the environmental dimension of sustainable development).

Sectoral case studies/investment promotion in selected sectors

In the first of a series of sectorally focused chapters, Lyuba Zarsky turns to one of the world's most rapidly growing sectors, information and communication technology (ICT), and assesses the implications for sustainable development and IPAs specifically.

4. *Ibid.*, last visited 5th February 2008.

ICT, she notes, is often considered to be a clean and green sector – and, moreover, one that has the potential to bring substantial spillover benefits to local economies in terms of growth of dynamic local industry clusters. But barriers to attracting ICT investment, not to mention environmental and health risks, mean that IPAs need to be highly strategic. Once more, the importance of clearly addressing the sector within an overarching development strategy is identified as a prerequisite for effective IPA activity, with IPAs working alongside other stakeholders to identify the desired social, environmental and economic outcomes of investment in the sector.

Ms Zarsky analyses the structure of the global ICT sector, noting its tendency to concentrate marketing and software development in a handful of countries – particularly in Asia and the US – with geographical clustering of firms, particularly in regions close to the most significant markets. Availability of local capacities at the enterprise and human level is also key – and public policy has played an important role in creating and sustaining this. Policies requiring transfers of technologies and formation of joint ventures with local partners have been catalytic in China, for example.

Ms Zarsky offers a definition of “sustainable industrial development” that many IPAs will find helpful as they address their roles. She suggests that it is characterised by simultaneous evolution along three axes: industry upgrading – particularly through creation of local capacities for commercially viable production and innovation; positive environmental spillovers through approaches that reduce the environmental costs of industrialisation, and equity-enhancing growth based on broad-based creation of jobs, particularly for poor people. Understanding how to deliver these benefits calls, as Ms Zarsky demonstrates, for a sophisticated knowledge of the sector and the potential trajectories of its evolution. Without that understanding, there are significant risks of getting stuck in development models that generate jobs and income, but not dynamic, sustainable, local industry clusters. Yet for some countries, it may be pointless to try to catch up with competitors by offering expensive incentives to new investors.

On the environment side, a range of toxic materials are used in ICT-related manufacturing processes and rising environmental standards in some key markets have raised the costs of market entry. A lack of consistent convergence in environmental standards, however, will mean that producers will need to link environmental management approaches with their export markets.

Some industry analysts suggest that the greatest potential for developing countries lies with development of software and internet content suitable for local settings. Consequently, an important priority may be to develop the “soft” infrastructure of the knowledge economy in terms of local knowledge workers and information networks.

Case studies address the particular circumstances of Costa Rica, Malaysia and China. Each has a distinct story to tell, from China’s efforts to base ICT expansion on a strategy of “access to [our] market in return for technology transfer”, to Costa Rica’s efforts to woo Intel. One overarching message concerns the need to match

aggressive efforts to attract FDI to post-investment aftercare and policy focus so that local skills continually evolve, and high environmental standards are maintained or developed and enforced. CSR has a role to play here – but it needs to be integrated within a conscious overall public policy approach.

In short, Ms Zarsky concludes, capturing benefits from FDI is even more challenging than attracting it. She identifies four lessons for IPAs in developing countries. First, investment promotion policies must be integrated with domestic policies for creating linkages to local firms and institutions. Second, that if ICT is to bring equitable growth that benefits poor people, targeted pro-poor policies are needed – for example, providing incentives for investment away from cities, or helping investors to identify social investment opportunities. The clear pointers here are towards the policy advocacy role of IPAs. Third, that environmental monitoring and enforcement have to be taken seriously – with IPAs playing a role (as Grieg-Gran and Edlund’s survey suggests some already do) in attracting those investors with a demonstrated commitment to environmental performance. Fourth, given the need for post-investment aftercare, IPAs should continue to provide communication channels between government and investors long beyond foreign investment contract signature.

Bill Vorley’s chapter focuses on the food retail sector; highly competitive and concentrated in industrialised countries, with supermarkets now rapidly increasing their presence in emerging and developing economies. The development implications for those countries with large informal trading and retail structures, and large numbers of people engaged in agriculture are very significant. With liberalisation of trade in services, FDI in the food sector is increasing – making it important that IPAs be aware of the sustainable development implications of their efforts to target the sector.

As with ICT, the challenge is to attract food retail that contributes to broad-based, not exclusive, development. As with tourism, concentration is a major concern. Dr Vorley points to the implications of what he calls “supermarketisation” – essentially associated with market concentration – for restructuring of food markets and impacts on lower income people. One of the side effects is that smaller and independent retailers organise international buying alliances in order to remain competitive. And market concentration need not mean that local suppliers are left in the cold; Dr Vorley points to statistics that indicate that local supermarket subsidiaries usually purchase over 80 per cent of their merchandise from local suppliers. As his chapter shows, there are also other kinds of development benefits from the “supermarket revolution” in terms, for example, of stable prices and access to credit. Nonetheless, in this concentrated structure, most of the power rests at the retail end of supply chains. Consumers and shareholders, not primary producers, are the main beneficiaries.

Whilst eight out of ten of the world’s largest grocery chains are European headquartered (with the other two US-headquartered), powerful regional players are now emerging and adapting the modern grocery format to local markets.

Whilst the food retail and wholesale sectors have been identified as a major prospect for FDI, along with other service sectors, it is striking that to date, few IPAs

have as yet strongly targeted these sectors. Policy approaches to food retail FDI are also mixed around the world – with backlashes against foreign-owned supermarkets in countries as wide apart as India and Poland.

In a few examples in the Balkans, IPAs appear not to be playing a role in making connections between choices related to attraction of retail investment, and the wider development implications of food retail for urban and rural poverty reduction, working instead simply as information resources and to provide permits. That this should be so is perhaps not surprising, since as Dr Vorley points out later, impact assessment processes for new retail developments rarely go so far as to consider implications for agricultural production in the countries concerned or traditional distribution sectors. In contrast, in China, local government-based IPAs work not only to provide information, but also to align the interests of investors and public policy-makers. In other words, they appear to be better at viewing businesses as development actors. At the same time, local governments themselves have become stakeholders in some local retail enterprises.

Looking more widely to the role of IPAs in retail and wholesale FDI promotion, there are some real potential benefits, which could more effectively be captured with IPAs playing a more strategic role. These include upgrading of supplier competencies and potential for beneficial spillover effects in terms of quality and food safety. But “there is a potential large trade-off between attracting FDI in retail services and the livelihoods of primary producers and the informal retail sector.” Calling for better public policy is no silver bullet, either – public policy is currently poorly equipped to intervene in private sector governance of food chains. Nonetheless, IPAs can get better at providing information about local suppliers, and encouraging retail and wholesale investors with a demonstrated commitment to CSR. As with ICT, post-investment “aftercare” services provided by IPAs also need to be stepped up, so as to better align ongoing practices of investors with national development priorities.

Annie Dufey focuses on issues relating to a rapidly developing “new sector” – biofuels. Biofuels are fuels produced from biomass for purposes such as transport (their main use), heating, electricity generation and cooking. Their production, processing and distribution can be associated by host countries with a variety of sustainable development-related policy goals, including energy security, agricultural development and climate change mitigation. Herein lies the nub of the controversy surrounding biofuels: the mix of social, environmental and economic pluses and minuses of biofuels production mean that conscious public policy approaches to the sector entail difficult choices and potentially tradeoffs. Food security, sustainable rural livelihoods and energy security all have the potential to compete when governments consider the role of biofuels in the overall economic mix. And, as with other sectors, attracting investment for production but not processing can mean that potential economic benefits do not all accrue to host countries.

Whilst data is scant, it seems clear that governments are increasingly offering foreign investors a major role in the development of the biofuels sector, and that the

US is currently the source of most FDI into this sector. But biofuels investment also has an increasingly important “South-South” dimension, with players from leading developing countries such as China and India also looking to enter other countries. Ernst and Young have already developed specific “Biofuels Country Attractiveness Indices”, with five developing countries, Brazil, Thailand, China, Indonesia and India, included amongst the top fifteen worldwide. Ms Dufey explores the key motivations that guide investors’ decisions to invest – including natural resource availability (for feedstock) and the potential size of markets in host countries themselves. Preferential trade arrangements for access to key international markets also seem to matter in the overall mix.

As a new sector, biofuels present a number of policy and strategy choices for host country governments and their IPAs. Even in the most advanced countries, the development of national biofuels programmes are in their infancy. First, investors are themselves drawn from a number of different sectors, including agribusiness, energy, and financial services. Second is a choice whether to consciously recognise biofuels as a distinct sector for investment promotion purposes – or to view it as a subset of an existing sectoral categorisation (e.g. renewable energy). Some IPAs – for example in India and Argentina – are beginning to address biofuels as an individual sector. The use of fiscal incentives and legislative incentives is gathering pace, and wider information dissemination and facilitation initiatives (for example in the form of Peruvian ProInversion’s technical assistance to a bioethanol project) are also gathering pace.

In this, as in any other “new” sector where public policy lags behind economic market potential, the communication role of IPAs can be particularly valuable, in bringing together and guiding investors through policy and market information on sectoral opportunities and relevant public policy frameworks. More cautiously, Ms Dufey suggests that the potential downsides of biofuels investment may make it advisable for IPAs to wait for host governments to design and implement legal frameworks to increase benefits and minimise risks before starting to attract FDI. Yet she also indicates that the hot politics of biofuels development can mean that large-scale projects are approved through high level political decision-making rather than through standard investment processes. For IPAs in those countries with significant biofuels potential but without dedicated policy frameworks for this purpose, attracting investment in the biofuels sector will be a test case for their approaches to policy advocacy. Clearly, IPAs need to be aware of relevant public policy frameworks. And in those countries that do not have dedicated sectoral biofuels frameworks, IPA’s may need to be active in guiding investors to address a wide range of social, economic and environmental policy goals. In their public policy advocacy, IPAs have a potentially valuable role in advocating integrated approaches.

In his chapter, Eugenio Yunis, of the World Tourism Organization (UNWTO) explores links between attraction of FDI in tourism and sustainable development. Taking the 2006 foreign exchange earnings figure of US\$730 billion as a baseline, Mr Yunis points out that international tourism is today the world’s largest sector for trade in

services, and the third largest sector overall in international trade terms. With a high contribution to domestic GDP in many countries, rapid projected growth, and increasingly broad geographical spread, the implications for IPAs and the competition to attract foreign investment are clear. Equally, low barriers to entry in most countries make the “sustainable development gatekeeper” role of IPAs a significant one. Mr Yunis outlines the opportunities for developing countries, and also the nature of the imperative to ensure that direct investment in the tourism sector is supportive of sustainable development. Some countries, he notes, such as Vietnam, have already adopted specific policies for attracting FDI in the tourism sector. And bilateral investment agreements have also in some cases stimulated increases in tourism investment (for example between Spain and Mexico). Equally, promotion of tourism investment opportunities has already been part of the practice of a number of countries wishing to attract foreign investment in the sector – Mexico again among them.

Mr Yunis goes on to review the kinds of commitments and approaches on the part of public sector actors and businesses alike to ensure that tourism investment is “responsible”. Many point to possible roles for IPAs. Quite specifically, Mr Yunis suggests that IPAs need to work closely with national tourism authorities to establish specific guidelines for promotion of FDI in tourism and agree sustainable development-related limits to overall carrying capacities and to foreign ownership. He suggests in addition that IPAs be involved in careful screening and selection of foreign investors in the tourism sector; checking in particular for any mismatch between what companies say about their commitment to social and environmental issues and their practices in other countries and for evidence of monopolistic practices which, as Mr Yunis points out, can lead to dangerous dependencies – but could also undermine efforts to promote local economic development benefits from international tourism.

Finally, where IPAs are involved in assessing the merits of particular investments in tourism, Mr Yunis suggests that they should ensure they have prior sight of proposed contracts between investors and developers and hotel management companies, because the terms of such contracts can have significant implications for market concentration. A similar rationale might hold for food retail – and indeed, Dr Vorley’s chapter, too, hints, given the backlash against “supermarketisation” in some countries, that this kind of role might be valuable in that sector, too.

Cross sectoral issues: land and carbon

Two chapters address issues that cut across a number of sectors: access to land, often seen as an obstacle to investment, and the emerging investment opportunities afforded by the Clean Development Mechanism (CDM) in reduction of greenhouse gas emissions.

The importance of land in the investment promotion process is addressed by IIED’s Lorenzo Cotula and Camilla Toulmin who focus on local land issues in Africa

and their implications for foreign investment. Securing access to land is a key stage in implementation of most investment projects – with ease of access to land a key factor in investment decision-making in Africa and a key obstacle cited by investors in many countries. Yet land is also a major source of livelihoods in much of rural Africa, with increasing competition for land in many areas. The potential tensions are clearly apparent. The challenge for IPAs is to play an optimal role in ensuring not only that investors gain access to land, but also that local land users benefit from any investment.

Based on a review of IPA websites and legislation in a number of African countries, Mr Cotula and Dr Toulmin also consider the significant role played by customary resource tenure systems in Africa in determining how land is managed at local level. Yet these “customary” systems often enjoy little formal legal protection. The local reality is often based on an evolving continuum between statutory and customary rules. Against this background, the role of IPAs varies from facilitating dealings with government land agencies, to a more direct role in allocating land to investors – either through a role as facilitators, as with Senegal, Ghana and Mozambique’s “one-stop-shop” agencies, or more directly in directing land to investors, as with Tanzania’s Investment Centre. Mr Cotula and Dr Toulmin highlight the role played by legislation on community consultation requirements linked to decision-making on allocation of land to investment projects in a number of countries – as well as its shortcomings.

As one would expect given the huge development significance of access to land in African countries, there are wide variations between countries in terms of the nature, scope, duration and content of the land rights that investors are vested with – including legislation in some countries that restricts foreign ownership of land.

Much more work is needed to clearly identify realities on the ground. However, based on their scoping study, Mr Cotula and Dr Toulmin identify three possible insights for IPAs. First, IPAs need to be more visible in explaining their role in dealing with land access issues. Second, that there would be value in exchanges of information between IPAs – and between IPAs and other stakeholders – on the range of approaches taken. And third, IPAs should develop the skills, capacities, and mandates to take account of the long-term impacts of investment projects on land claims of other stakeholders, including local groups.

Like Ms Dufey, Gregor Pfeifer of AfricaPractice considers an emerging sector for FDI – that associated with “carbon finance”, i.e. finance that allows the purchase of greenhouse gas emission reductions, driven by the range of voluntary and legally mandated approaches that quantify and limit the emissions of greenhouse gases into the atmosphere. Among the key drivers are the European Emissions Trading Scheme and the Kyoto Protocol of the UN Framework Convention on Climate Change (UNFCCC), particularly carbon emission reductions generated within its CDM. Carbon finance allows organisations to buy and sell emissions reduction “credits”.

The CDM is designed to promote investment in projects that reduce or sequester emissions of greenhouse gases in developing countries functioning, in

essence, as an artificially created international commodity market overseen from structures within the UNFCCC. Projects meeting stringent screening and approval processes are issued with “certified emissions reductions” (CERs).

The size of the carbon market that is generated by this framework is significant: expected to reach a total volume of US\$200 billion by 2010, according to statistics cited by Mr Pfeifer. But private carbon finance for CDM projects is typically not available until close to the delivery of the CERs. Public finance providers, in contrast, are generally more willing to accept risks of non-delivery, providing finance for the project capital needed.

Mr Pfeifer notes that as of 18 July 2007, the CDM Pipeline contained 2,260 CDM projects, including 738 registered with the Executive Board of the UNFCCC for the issuance of CERs. But the market is grossly geographically imbalanced: China, India and Brazil account for more than two thirds of the pipeline projects. Africa accounts for only 2 per cent, despite the potential sustainable development benefits of CDM investment. These include transfer of environmentally sound technologies, the partnerships fostered by CDM project implementation, and achievement of domestic sustainable development objectives. For investors, the current limited geographical spread of CDM projects allows for portfolio diversification through investments in Africa, alongside a range of other commercial and development benefits.

IPAs potentially have a significant role to play in reaping the potential benefits of CDM investments in Africa – and some, including the Development Bank of South Africa and the Ugandan Investment Authority, are already doing so. Mr Pfeifer identifies seven distinct roles, ranging from linking CDM to national investment policies, promoting CDM investment through IPAs’ promotional activities, policy advocacy for reduced taxes on CDM-related revenues, and requiring prospective investors in new projects specifically to identify their CDM potential. For these roles to be effective, it will be important to build capacity within IPAs, and strengthen linkages between IPAs and CDM developers, including commercial financial institutions with an interest in CDM projects. The challenge, as Mr Pfeifer concludes, is for African countries and their IPAs to promote the carbon potential of their country to attract additional foreign investments.

Attracting foreign direct investors with good CSR practices: insights from IPAs

Uganda

The first of a series of contributions from IPAs based in middle- and low-income countries comes from Issa Mukasa of the Uganda Investment Authority (UIA). Uganda, an East African country of 30 million inhabitants with one of the world’s fastest growing populations, lies at the heart of sub-Saharan Africa. The UIA was

established in 1991 as a government agency with a mandate primarily to promote and facilitate private sector investment. An important task was image building for the country as a whole. The Authority began with Ugandans themselves and with the wider diaspora – working to build confidence among Ugandans nationally, but also reaching out to departed Asians and to the diaspora more widely. The priority countries from those efforts – among them the UK, India, Kenya and the US, remain Uganda’s top source countries for FDI.

Mr Mukasa stresses the UIA’s role as part of a much wider network of investment promotion activity, including the role played by the presidency and a Presidential Investors’ Roundtable. He goes on to identify the range of tools used in investment promotion activities, admitting that the approach of specifically targeting companies with a commitment to CSR has not yet been taken. Reflecting on what is already done, however, Mr Mukasa points to the Authority’s existing close relationship with aspects of public policy for CSR through its role in promoting respect for Uganda’s social and environmental norms and laws. And he notes that through its work on priority sectors – including agriprocessing, mining, services and ICT, the UIA aims to achieve maximum visible impact with regard to employment, poverty reduction and foreign exchange/savings. Some international companies in these sectors have in fact practised community investment, even though CSR requirements did not feature in selection of priority sectors. The UIA has also worked to promote inward investment under the CDM, with one project, the West Nile Electrification Project already registered to benefit from sale of carbon credits (the first in East and Central Africa to reach this stage).

The implication of Mr Mukasa’s chapter is that there is potential to make stronger links to CSR for the benefit both of the UIA and the public policy goals that its work is closest to, and of the wider investment community. As he says, reflecting the wider challenge of this book, “the challenge now is to design an appropriate incentive package for those who provide and implement project proposals with ingrained CSR programmes.” Promotion of renewable energy investment opportunities appears to be one promising avenue for the future. However, Mr Mukasa rejects an approach in which CSR practices become a “negative screen” for investment: efforts to address wider investment climate considerations remain a priority.

Nicaragua

Turning to Central America, Juan Carlos Pereira focuses on Nicaragua – and specifically the country’s IPA, ProNicaragua, founded in 2002. Like Uganda, Nicaragua has to deal with the investment promotion impacts of the legacy left by the violent conflict of the 1980s.

Mr Pereira describes the process of 1990s free market reform as leading to a “pro-business climate”. A burgeoning export-oriented services sector in areas such as

contact centres is also providing much-needed job opportunities. And its phenomenal natural features make Nicaragua one of the last “untouched” tourist attractions in the Americas – and in turn make this the country’s third-largest source of foreign currency earnings.

But there remain huge needs. As a small country, roughly the size of Greece, the country is heavily reliant on FDI for its future success. Mr Pereira illustrates the scale of the challenge forcefully: with annual per capita income of just US\$971, and 33 per cent of the economically active population considered “underemployed”, the equivalent of 20 per cent of GDP should be mobilised annually to provide jobs for the 100,000 Nicaraguans entering the workforce each year.

In the face of this reality, responsible investment has the potential to become a core element in the country’s efforts to build competitive advantage: “In an effort to mobilize this critical investment, Nicaragua is making efforts to upgrade its image and find its place in the global economy as a competitive platform for sustainable and socially responsible investment in the manufacturing, agricultural, and services industries.” However, Mr Pereira hints that much more needs to be done if this sentiment is to accurately reflect a national consensus; one in which investment promotion is recognised as playing a central role in breaking the cycle of poverty and inequity.

Mr Pereira outlines the country’s institutional architecture for foreign investment promotion, spelling out his agency’s achievements in terms of jobs created (21,000) and value of investment supported (US\$250 million) – common enough measures but not, of themselves, indicators of “pro sustainable development investment promotion”. However, Mr Pereira stresses that the agency “seeks to attract innovative projects that generate increasing amounts of value added, provide better working and environmental conditions, and help improve the image of the country.” Among the approaches highlighted are efforts to target companies for investment road shows on a range of factors including those related to CSR, a series of tax and non tax-related incentives for sectors that the country believes could bring positive social or environmental spillovers, and development of strong working relations with NGOs that can bring matching donor agency-backed funds to companies’ social investment projects. In this area, the agency acts as a broker, making links between NGOs and investors with a view to securing high-quality social investment programmes.

The legislative framework also incorporates a range of incentive laws to stimulate investment in sectors bringing “win-win” social, environmental and economic benefits – such as ecotourism and renewable energy.

A case study focuses on ProNicaragua’s engagement with a German-run sustainable forestry enterprise, following a decision to target potential investors with existing operations in Central America and a potential interest in expanding into Nicaragua. The company’s approach to responsible behaviour made it possible for ProNicaragua to expend political capital to secure sign-off on a forestry incentive law which was a prerequisite for the project, but which had not yet entered into force.

The investment went ahead, giving Nicaragua one of the three largest forestry plantation projects in the Americas.

This, then, is a “success story” from an extractive natural resource sector. But what of other sectors? Here, the agency’s basic approach is reflected in Mr Pereira’s assertion that “companies from higher value added sectors and high-end segments will be favourably impressed by a country with high CSR expectations, and will be more inclined to invest there all other things being equal.” Mr Pereira gives another example – this time highlighting the CSR policies and practices of a US-based apparel manufacturer.

Like Mr Mukasa, however, Mr Pereira sounds a note of caution. He sees little risk in a strategy of attracting FDI with good CSR practices, but remarks that “the risk of an overly zealous policy to limit investment to those that policymakers deem to be “socially responsible”, must not be overlooked, as it could be highly detrimental to the welfare of the neediest.” CSR standards and norms need to be judged, he suggests, through the eyes of the needy unemployed worker, not the eyes of “often well-off policy-makers”. For government, the first “responsibility” should be to create an attractive overall business climate.

For IPAs conducting proactive promotional efforts, Mr Pereira concludes, “CSR should be a key factor in choosing its targets and in allocating precious incentives and the precious time of top government officials. Attracting highly-regarded companies will attract other like-minded companies, and will go a long way towards the creation of a virtuous circle of CSR-centric FDI promotion efforts.”

Chile

From Chile, authors Carlos Mena and Reinalina Chavarri report that the Foreign Investment Committee (FIC) has begun to integrate CSR into its activities as a strategic priority. The FIC is one of a suite of agencies working to promote Chile as an investment location. The agency reports to the Ministry of Economy, Development and Reconstruction, and was established to represent the state in its relations with those investors who choose to use Chile’s Foreign Investment Statute. Among other key strategic objectives, the issue of corporate business ethics is integrated within the Action Plan for 2006-9.

Building on Chile’s positive overall investment climate, and a history of success in attracting foreign investment, the authors explain that CSR has now become a vital component of policy design and decision-making in both public and private sectors. The role of the FIC in this contemporary competitive environment is to “encourage and promote good corporate practice.” Outlining the priority social policy agenda under President Bachelet, they stress the integration of economic growth and high levels of social protection. By any standards, these factors must play a key part in determining Chile’s overall approach to setting the “enabling environment” for investment by responsible enterprises. The challenge for the FIC, in turn, as the

authors see it, is to “strengthen its work with those sectors attracting the highest investment levels in order to obtain the best public-private cooperation indexes.”

The authors highlight public access to information – both by the FIC itself (e.g. in relation to the country’s Free Trade and Political Cooperation Treaties), and investors (in the form of company reports) as key features of CSR (or, by implication, its “enabling environment”). Companies have begun to submit CSR reports alongside their annual submissions of financial information to the FIC. And in turn, the FIC has carried out a number of promotional activities with foreign investors and their home countries’ representations in Chile, stressing the importance of CSR and business ethics. In particular, the FIC has stressed the high value placed in business and investment plans on CSR-relevant intangible assets, such as trust, transparency, consistency and dialogue with stakeholders. The implication is that in a context of increasing competition for FDI, such assets constitute lasting competitive advantage for countries like Chile.

Concluding comments

The links between investment promotion, sustainable development and CSR affect almost every area of IPA activity. IPAs can act as “gatekeepers” for expressions of public policy commitment to sustainable development in their countries. For example, a number of agencies (as Ms Grieg-Gran and Ms Edlund point out) expressly communicate details of their host countries’ tough environmental legislation and severe penalties. Through ongoing engagement with the investment community, IPAs can raise awareness among investors on links between investment, corporate responsibility and sustainable development.

Linkages between investment, CSR and sustainable development also point to the value of strategic approaches to defining new investment sectors (as with biofuels and carbon markets); the potential to carve out new incentives for investment/sustainable development “win-wins”; and to the role of IPAs as facilitators in understanding and providing guidance for investors on potentially competing policy priorities across economic, social and environmental spheres.

The chapters in this book show that there are some potential benefits to be reaped from more “conscious” efforts to integrate consideration of sustainable development and CSR within the investment promotion community. There is already wide-ranging experimentation underway across a wide range of IPA functions, from brand-building (Nicaragua) to wider advocacy with private sector actors (Chile), and fiscal incentives (a wide range of countries). It is clear, too, that CSR and sustainable development competences exist within a number of agencies and that a number have seen real market potential, across a variety of sectors, in “pro sustainable development” responsible investment.

Other kinds of approaches appear less likely to provide part of the overall mix of IPAs’ practice for a little while at least. For example, corporate responsibility “negative investment screens” beyond compliance with host country legislation seem unlikely

to emerge for the foreseeable future, if the notes of caution on their desirability from Nicaragua and Uganda are anything to go by. And comprehensive approaches that range from public policy advocacy to “passive” information dissemination also currently appear rare.

There is clearly more to be done to raise awareness of sustainable development and CSR among IPAs – and to ensure that they are aware of their own countries’ policy commitments in relation to sustainable development, including for example the content of national sustainable development strategies. There is also more to be done to raise awareness, or convince IPAs, of the potential national competitiveness benefits of promoting responsible business practices – at least in some sectors and countries some of the time. Happily, this latter area is a vibrant theme of analysis and advocacy within the CSR community.⁵ And it is also an area of public policy experimentation, as demonstrated by the work of the World Bank Group’s CSR Practice. The challenge is to link that body of work to the wider IPAs community.

For IPAs to optimise their potential positive contribution to sustainable development-friendly FDI, they need to be institutionally equipped with the right expertise. That means understanding the wider debate about business and sustainable development and the overall shape of the international CSR agenda. It means an ability to push right to the limits of the positive national competitiveness arguments in favour of promoting CSR – whether there is a wider government commitment in this area or not. And it means personal and institutional commitments to pursuing quality investment that works for sustainable development.

Whilst IPAs are to some extent creatures of the government bodies or forces that led to their creation, they should make the most of whatever positive opportunities exist to promote “win-win” investment. And at the same time they should wherever possible lead by example, seeking to play a part in ensuring that projects which themselves directly generate tensions or conflicts with clearly established social or environmental policy priorities are not approved without due deliberation.

These are not pipe-dreams for reform of IPAs – indeed they build incrementally on current “good practice” thinking. But they will require more concerted effort from within the investment promotion community if the benefits of “responsible” direct investment are to be realised across all the countries and sectors where they have potential to accrue.

The investment community as a whole needs to work to build relevant capacity and skills within IPAs; to develop appropriate performance metrics; to provide ready access to the best sources of information on CSR and sustainable development and their links to investment; and to equip IPAs to view the impacts of the investment that they attract in the broader context of sustainable development.

5. See, for example, work led by the UK-based NGO AccountAbility on “responsible competitiveness” or the work of the World Bank Group’s CSR Practice.

6. See e.g. OECD Secretariat, *Policy Framework for Investment: A Review of Good Practices*, at pp 33–48, OECD, Paris, 2006.

We hope that this book and the analysis and experience reflected in its pages will inspire further innovation by pointing to the real opportunities that exist; and the wealth of knowledge and experimentation that has already begun to evolve.

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Chapter 2

Attracting FDI that contributes to sustainable development: A review of current IPA practice

Maryanne Grieg-Gran and Johanna Edlund

Introduction

It is widely recognised that foreign direct investment (FDI) can be an important stimulus for economic growth. This has motivated governments in many developing countries to establish investment promotion agencies (IPAs) to attract inward investment. As competition for investment has increased, the approach to attracting investment has become more professional. There are well-established approaches for targeting investors and numerous toolkits and guidance on achieving success in investment promotion.¹ A number of empirical studies have provided evidence that

1. Foreign Direct Investment Promotion Center, 2008.

government investment promotion efforts are successful in increasing the volume of FDI.²

There is less knowledge about the practices necessary to attract FDI that makes a more lasting contribution to development in the host country. The aim of this chapter is to examine what IPAs are currently doing to attract FDI that contributes to sustainable development. This is based on a survey of information provided on the websites of IPAs.

While the nature and scope of activities of IPAs varies from country to country, their functions can be summarised³ as:

- image-building to create positive perceptions about the country as a site for international investment;
- investment generation, involving targeting of specific sectors and companies to create investment leads;
- provision of pre- and post-investment services to facilitate the investor's entry and operation in the economy through provision of information, assistance with obtaining necessary permits etc; and
- policy advocacy to improve the investment climate.

The relative importance of these functions depends on the lifecycle of the IPA. The Organisation for Economic Cooperation and Development (OECD) in its Policy Framework for Investment⁴ stresses that: "the principal aim of an IPA, at least in its early stages, is to draw attention to profitable investment opportunities in the host economy." As the level of foreign investment in a country increases, the efforts of the IPA will shift more to promotion of linkages between multinational enterprises and the local business sector.

Our survey focuses on the functions of image-building and investment generation as the approach to these will be reflected in information provided on the IPAs' websites. This chapter presents results from a survey carried out at the end of 2006 of IPAs websites in 53 low- and middle-income countries in Africa, South and East Asia including the Pacific, and Latin America and Caribbean (see list in Annex 1)⁵. The sample was drawn from the IPAs listed on the website of the World Association of Investment Promotion Agencies (WAIPA) and was restricted to websites presented in English, and also excluded Middle East, Central Asia and Eastern Europe. The sample represents 64 per cent of the 83 low- and middle-income countries in the regions targeted in the WAIPA list.⁶

2. Charlton and Davis, 2007; Morisset, 2003.

3. Piontkivska and Segura, 2003; Wells and Wint, 2000.

4. OECD, 2006.

5. Where a country has more than one IPA, it is counted as one.

6. The OECD's Development Assistance Committee list of ODA recipients as at 1 January 2005 was used to classify countries in the WAIPA list. Excluding overseas territories, Middle East, Central Asia and Eastern Europe, there are 83 low and middle income countries in the WAIPA list. <http://www.oecd.org/dataoecd/43/51/35832713.pdf> viewed on 29-12-07.

Our approach was to examine the websites of the IPAs for each of these 53 countries to identify information presented about the following issues:

- Image building – Efforts to present the country as concerned about sustainable development or specific dimensions of it such as environmental protection.
- Investment generation –
 - Incentives offered to investors to promote inward investment with economic, social and environmental benefits.
 - Targeting of specific types of investors committed to corporate social responsibility (CSR) and sustainable development.
 - Targeting of investment in sustainable activities.

Our concern was to note the existence of such information on the websites. We made no attempt to assess the amount of space allocated to these issues relative to other more general aspects of investment.

There are clearly some limitations to this approach. Our sample is based on what IPAs communicate in their website about their practices and assumes that this is representative of actual practice in the countries concerned. It may be that some countries are adopting some of the approaches listed above but for various reasons this is not publicised in the IPA website. The survey also tells us little about whether these activities are successful in terms of volume of investment attracted or the sustainable development contribution of the investment. It also leaves out non-English language websites. Nevertheless, the content survey gives an idea of the importance attached to sustainable development by the IPAs and the information that they consider relevant for investors. Subsequent chapters in this volume on specific sectors and specific countries go into more detail on how these approaches are implemented in practice.

Survey findings

We found that for 47 of these 53 countries, the IPA websites present some information on one or more of these aspects.⁷ Table 1 summarises the findings. Further details are given in the sections that follow.

Linking the country brand with sustainable development

IPAs have traditionally emphasised the purely economic aspects of their investment potential, highlighting trade preferences, natural resources, labour force, location and stability of governance. We examined whether any IPAs mention aspects of the country's investment climate that can be considered to go beyond this, such as the country's sustainable development objectives or its approach to environmental and social policy. A notable example is the IPA of Belize, which emphasises the country's commitment to long-term sustainability:

7. Except where otherwise stated, the sources for the information given are the websites of the IPAs listed in Annex 1.

Table 1: Different strategies for targeting sustainable FDI	
TYPE OF STRATEGY	IPA/COUNTRY
Branding of the country	
Serious about environmental protection	Nigeria, Senegal, Seychelles, South Africa, Belize, Mexico, Sri Lanka, Indonesia, Thailand
Strict labour standards	Vietnam
Consultation with communities	Philippines
Technology transfer in policy or legislation	The Gambia, Nigeria, El Salvador, Peru, Philippines, India
Sustainable forest management	Kenya, Uganda
Advantages for CDM projects	Peru, Brazil
Incentives for FDI with economic benefits	
Investment in high technology to promote technology transfer	Libya, Tunisia, Angola, South Africa, Costa Rica, Sri Lanka, Fiji, Cambodia, Malaysia, Vietnam
Linkages between foreign and local enterprises	Angola, Trinidad Tobago, Solomon Islands, Malaysia (MIDA)
Incentives for FDI with social benefits	
Social benefits as one eligibility criterion for general incentive programme	Social/cultural wellbeing (Angola), Investment in areas with difficult socioeconomic conditions (Vietnam) Training (Solomon Islands, Gambia, Tunisia)
Tax concessions and grants for training	Libya, Botswana, Moçambique, Namibia, Nigeria, South Africa, Uganda, Chile, Sri Lanka, Trinidad Tobago, Malaysia
Incentives for FDI with environmental benefits	
Environmental protection as one eligibility criterion for general incentive programme	Egypt, Lesotho
Incentives specifically for environmental protection	Tunisia, Argentina (ADI), Cambodia, Malaysia, Vietnam
Clean technology/production	Algeria, China
Renewable energies	Algeria, the Gambia, Ghana, Argentina, Nicaragua, Malaysia
Waste management	Ghana (GIPC), Malaysia (MIDA)
Targeting investors committed to sustainable development	
Interested in companies with CSR policies	Solomon Islands (Commerce), Peru (PIPA)
Targeting sustainable sectors	
Geothermal energy	Djibouti, Tanzania, Uganda, Mexico, Nicaragua, India
Wind energy	Namibia, Tanzania, Uganda, Brazil, Mexico, Nicaragua, India
Solar energy	Tanzania, Uganda, Brazil, Mexico, India
Biomass	Brazil
Waste management	Lesotho, South Africa, India

“Belize’s government is proud to be viewed as a model of a developing country able to protect its environment and resources, while simultaneously welcoming foreign business and trade.”

The most common approach of the IPAs in our sample is to emphasise the importance of environmental policies and management. Ten of the IPAs in our survey refer either to environmental policy or to specific environmental legislation to demonstrate that the country takes the environment seriously. In seven cases (Nigeria, Senegal, South Africa, Mexico, Sri Lanka, Indonesia and Thailand) the IPAs give information about environmental legislation in the country and in some of these cases go further to indicate how seriously it is taken. For example, in Mexico, the basic legal guide for investors states that the environmental legal framework is comparable to those of developed countries and that it is increasing enforcement of its law. The Sri Lanka IPA explains that it has an environmental protection programme and that investors have to apply for an environmental licence, renewable on a yearly basis. The Board of Investment in Thailand states that for projects with a potential environmental threat, it will prescribe special conditions for both the location of the project and the manner of pollution treatment. The South African IPA mentions severe penalties under discussion in a proposed Environment Bill for those found guilty of damaging the environment, which could extend even to directors of the company concerned.

The Seychelles, perhaps reflecting this country’s heavy reliance on tourism, makes a business case for environmental policies arguing that it is important for a stable investment climate:

“The Seychelles recognises the importance of sustainable environmental policies both for the benefit of its population and as a stable investment climate for the business community.”⁸

The Kenyan and Ugandan IPAs emphasise the measures being taken to ensure sustainable forest management and conservation, while those of Peru and Brazil highlight the particular advantages of these countries for Clean Development Mechanism (CDM) projects.

Social aspects of sustainable development are less frequently mentioned. Vietnam makes specific reference to its regulation on labour standards requiring that investors apply good labour standards but was the only IPA in our sample to do this explicitly: “The rights, interests and duties of employees working in Enterprises with Foreign Capital Investment shall be ensured by means of labour contract, collective labour agreement and the provisions of labour law.” Apart from this, the only specific reference to social issues is from the Board of Investment in the Philippines, which emphasises the need for consultation with affected communities.

Six IPAs (El Salvador, the Gambia, India, Peru, Philippines and Thailand), make specific reference to arrangements for promoting technology transfer and two of

8. Seychelles Investment Bureau, 2006.

these go further to set out specific expectations on investors for promoting technology transfer and local involvement more generally.

- The Board of Investment of Thailand states that: “The country’s well-defined investment policies focus on liberalization and encourage free trade. Foreign investments, especially those that contribute to the development of skills, technology and innovation are actively promoted by the government.”
- In the Philippines there is an act to promote foreign investors, which states: “Foreign owned firms catering mainly to the domestic market shall be encouraged to undertake measures that will gradually increase Filipino participation in their businesses by taking in Filipino partners, electing Filipinos to the board of directors, implementing transfer of technology to Filipinos, generating more employment for the economy and enhancing skills of Filipino worker.”

Promoting sustainable FDI with incentives

Promoting inward investment through the provision of incentives such as tax concessions is a standard approach in investment promotion and has been employed often to secure economic benefits such as technology transfer. The use of incentives to promote good environmental and social performance is more recent but is increasingly important. This is reflected in our sample as a high proportion of the IPAs are offering these types of incentive. Some of the IPAs have multiple kinds of incentives in varied sectors. Malaysia for example has the highest number with eight different tax incentives.

Incentives for FDI with economic benefits

It is common for IPAs to promote investment in high technology industries as a way of encouraging technology transfer. Eight IPAs are offering tax concessions on income tax (Cambodia, Costa Rica, Fiji, Malaysia, Sri Lanka and Vietnam), on import duty (Angola) or a combination of these (Libya). In addition, two IPAs have a different approach. Tunisia is offering to cover part of the employer’s share of social security contributions for recruitment of recent graduates for investments that control or develop technology. South Africa has an innovation fund offering grants to promote technological innovation in IT, biotechnology and value added processing.

Four IPAs mention efforts to foster linkages of inward investing transnational corporations (TNCs) and local companies, through the promotion of partnerships or of use of locally-produced materials and services. Malaysia has a particularly extensive programme to promote linkages. Investment projects meeting, amongst other conditions, the generation of extensive linkages and significant impact on the economy qualify for pioneer status with a tax exemption of 100 per cent on income for ten years. Angola, Solomon Islands and Trinidad and Tobago also include the use of local raw materials and supplies as one of a number of eligibility conditions for their incentive programmes.

Incentives for FDI with environmental benefits

Thirteen of the IPAs have incentives for investors that are directly or indirectly oriented to environmental improvement. In two cases, Egypt and Lesotho,⁹ environmental requirements are just one of a number of criteria necessary for the investors to access a general incentive programme. More commonly, though, the incentives are specifically aimed at environmental protection. In five cases (Tunisia, Argentina, Cambodia, Malaysia and Vietnam), the incentives are awarded for general environmental protection activities. For example the Tunisian IPA states: “Regulations governing investments made by companies relating to environmental protection and processing of waste confer the following incentives: 50 per cent tax reduction on reinvested income or profits, income and profits taxed at a reduced 10 per cent rate, 20 per cent premium on the value of investments and suspension of VAT due on specific capital goods.” In two further cases, Algeria and China, incentives are offered for clean technology and clean production respectively.

In some cases, IPAs give information about incentives for specific aspects of the environment, principally, renewable energy and waste management. Six IPAs, (Algeria, The Gambia, Ghana, Argentina, Nicaragua and Malaysia), offer incentives for investors in the renewable energy sector. These mostly entail reductions on import duties and VAT for machinery/capital equipment. For example, the Gambia offers the following exemptions for solar, wind, and hydro energy: “Exemption from customs duties on the following items: approved capital equipment, machinery, appliances, furniture and fittings imported to be used by the project or business.” Ghana offers a reduction from 20 per cent to 5 per cent in import duty and 0 per cent VAT for investors in the solar, wind, and thermal energy sector with 5 per cent (standard is 20 per cent) import duty and 0 per cent VAT. Nicaragua combines import duty and VAT exemptions on capital goods for renewable energy with exemption on income tax and profits from the sale of carbon dioxide bonds for a seven-year period.

Malaysia takes a different approach, offering an income tax reduction. Companies undertaking energy generation using biomass, hydropower (not exceeding 10 megawatts) and solar power are eligible for Pioneer Status with a tax exemption of 100 per cent on statutory income for ten years.

Income tax concessions (70 per cent exemption) and pioneer status for five years are also offered by Malaysia for companies directly involved in toxic or hazardous waste management. Similarly, in Ghana investors involved in waste processing (including plastics and polythene) – are eligible for a tax holiday lasting seven years.

Incentives for FDI with social benefits

Five IPAs mention promotion of social benefits as one of a number of eligibility criteria for accessing an incentives programme. For example, according to the Angolan IPA, for investments to be granted incentives they must be capable of

9. LNDC, 2006.

achieving some stated economic and social goals such as promoting “the economic, social and cultural wellbeing of people, in particular, that of youth, the elderly, women and children”, or “promote less-favoured regions, mainly in the country’s hinterland.” Vietnam offers special incentives to companies investing in “geographical areas with difficult socioeconomic conditions. The Solomon Islands stipulates that for access to incentives, the enterprise must provide training to citizens at technical, skilled and managerial levels. The Gambia and Tunisia identifies skills development/training as one of a number of priority sectors qualifying for special incentives.

The main specific incentive that can be considered to be linked with social benefits is aimed at promoting training. A further eleven IPAs in our sample publicise information about such incentives. These are in most cases, income tax concessions. Two IPAs which have a different approach are South Africa and Chile. South Africa has a grants programme which covers up to 50 per cent of the training costs and up to 30 per cent of the total salaries payable for up to three years for companies with approved training programmes. Chile in addition to income tax rebates, has a grants scheme. Firms with annual sales of less than approximately US\$8 million are eligible to apply for training grants from a fund operated by SENCE (the national training and employment service).

Targeting investors committed to sustainable development

Only a few IPAs in our sample give explicit indication that they are looking for investors that will bring more than traditionally expected (i.e. capital and technology) and who are committed to sustainable development. It can be argued though that this can be inferred from other information given in the website e.g. environmental policy and enforcement. The IPA of the Solomon Islands is one of the exceptions in clearly stating that it is looking for investors who will bring economic and social benefits although it does not mention the environmental dimension:

“Consideration will be given to genuine investors that are willing to transfer skills and technology, have financial resources, commit to export and also provide for import substitution, employment opportunities and training.”

Only one IPA mentions all three dimensions of sustainable development, In Peru, PIPA’s main responsibility is amongst others: “ To attract investors able to transfer state-of-the-art technology and to take responsibilities in respect to the development of their social environment and to assist in the disclosure, among potential investors, of the role and social commitment they have with the environment and people.”

Targeting sustainable activities

A small proportion of the IPAs in our sample are promoting environmentally-friendly activities by providing information about the specific advantages of the

country for these industries and the opportunities available. Most commonly, the IPAs address different types of renewable or alternative energy. Tanzania, for example, stresses the advantages of solar, wind and geothermal sources of energy in requiring low investment capital relative to hydroelectricity generation. The Ugandan IPA highlights how, in addition to power generation, geothermal energy could be used in Uganda to substitute for increasingly scarce wood to dry fish, tea, and crops, cure tobacco and process sugar, and points to the evidence of the potential for geothermal power from the hot springs found in the western region of the country. It provides details also about the country's potential for wind energy and solar energy. Two other IPAs (Djibouti and Nicaragua) provide quite detailed information about the potential for geothermal energy generation potential. The latter also gives details on wind energy: "a wind energy potential over 200 MW has been identified in the country. The most potential is in the Rivas Isthmus at the southwest of the country, and in Chontales, central highlands." Brazil gives information on opportunities regarding biodiesel and ethanol, highlighting the possibility to benefit from carbon credits.

More rarely, IPAs give information about sustainable activities in the waste management sector. Lesotho highlights opportunities in waste recycling, India in energy generation based on industrial wastes, while South Africa emphasises the potential of recycling in the chemical industry:

"A major thrust is to find opportunities for Industrial Ecology Agreements (IEAs) in which the waste stream of one company becomes the feedstock of another.

Strategies being investigated include organic wastes, the refinement of chemical by-products, the creation of Fundafilters, Mintek Pyrometallurgy, the utilisation of spent brewery grains to produce a high-protein animal feed and tyre recycling.

There are opportunities for new and small business development in waste recycling, including the production of fertilisers from waste streams of chemical plants, and glass manufacturing from bottle recycling."

Conclusions

Image building and investment targeting are the two main approaches by which IPAs aim to attract investment. The websites of IPAs play an important role in these two approaches in communicating information about the country and investment opportunities in different sectors and activities. Very few of the IPAs in our sample explicitly use the terms sustainable development, sustainability or corporate responsibility in their websites. Yet our survey shows that a high proportion of IPAs are including information about broader aspects of development such as environmental protection, social benefits, economic linkages and capacity building.

Just under half of the IPAs in the sample are including some aspect of the country's stance on environmental or social issues or economic linkages in their national image-building. In particular, a number of the IPAs are explicitly

communicating details of tough environmental legislation and severe penalties, aspects which perhaps might deter less responsible investors.

Investment targeting in IPA websites is also addressing environmental and social issues. The main information provided is on general and specific incentive programmes designed to promote inward investment with environmental, social or economic benefits. Twenty-six IPAs (49 per cent of the sample) provide information on such programmes. A smaller number of IPAs are targeting investment in environmentally sustainable activities, by communicating their country's advantages for such activities, in particular, renewable and alternative energy.

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Chapter 3

FDI and sustainable development: Challenges and opportunities in the ICT sector¹

Lyuba Zarsky

Introduction

Foreign direct investment (FDI) in the information and communications technology (ICT) sector is highly attractive to developing countries. Beyond benefits common to all FDI, such as jobs and foreign exchange, FDI in the ICT sector offers the promise of spillovers that promote the growth of dynamic local industry clusters: new technology, new skills, and a link with the world's fastest-growing industry. Moreover, ICT is often considered a "clean and green" alternative compared to traditional smokestack industries.

1. Parts of this paper draw on Kevin Gallagher and Lyuba Zarsky, 2007, *Enclave Economy: Foreign Investment and Sustainable Development in Mexico's Silicon Valley*, MIT Press.

There are formidable barriers, however, to attracting FDI in the ICT sector, and even greater barriers to capturing spillovers that promote the broad-based upgrading of local industry. There are also significant health and environmental risks associated with the ICT sector, risks that developing countries are often ill-equipped to address.

In this context, investment promotion agencies (IPAs) must be highly strategic in the ways they target and interact with ICT multinationals, as well as government ministries. Being clear about the role of ICT growth in an overarching development strategy – in terms of both production and dissemination of ICT products – is essential. With that clarity, IPAs must then work with government ministries and other stakeholders to identify the desired economic, environmental and social contributions of FDI. Once goals are clear, policies can be designed to secure multinational corporation (MNC) partners most likely to deliver the desired benefits.

This paper is in four sections. The first section provides an overview of the global ICT industry, including FDI trends in developing countries. The second section defines the concept of “sustainable industrial development” and evaluates the opportunities and risks for developing countries posed by FDI in the ICT sector in achieving it. The third section presents three country case studies of FDI in the ICT sector: Costa Rica, Malaysia and China. The fourth section provides recommendations for IPAs to enlarge the sustainable development benefits of FDI in the ICT sector.

1. FDI trends in the global ICT industry

The ICT industry is the fastest growing part of the electronics industry, which is the highest traded industry in the world. While definitions vary, the hardware portion of ICT is generally considered to encompass an “integrated complex” of electronics, computers and peripherals, servers, and monitors.² Software and services includes the design and production of internet content and business processing outsourcing (call centres).

According to the Organisation for Economic Cooperation (OECD) biennial *Information Technology Outlook*, the worldwide ICT sector was expected to grow by 6 per cent in 2006.³ While down from the heady days of the 1990s, when the industry grew by 20 to 30 per cent per year, future growth is expected to be moderate but steady. The highest growth areas are expected to be in internet-related investments, Linux servers, digital storage, personal digital assistants, and new portable consumer products. Furthermore, the OECD expects that market growth will be more of a truly global phenomenon over the coming years, as opposed to 2004 when growth reflected a surge in industry growth in the US. Growth in China is expected to be especially strong.

2. Luthje, 2006, p.27.

3. OECD, 2006.

Industry structure: global production networks

The global ICT industry is characterised by a high level of vertical specialisation and horizontal networking. In any industry, there are three parts to a value chain⁴: 1) product innovation (research and development, design, market research and new product introduction); 2) operations (process engineering, manufacturing, logistics, finance and human resources); and 3) customer relations (marketing, sales, advertising, distribution, customer service, and technical support).

In the traditional, vertical model of industrial organisation, all three functions are undertaken within a single firm. From the 1960s to 1980s, ICT giants such as IBM and Hewlett Packard were, for the most part, structured vertically. Offshore assembly and components manufacturing, undertaken by MNC affiliates, grew rapidly, especially in South East Asia.

Starting in the late 1980s, large ICT firms began outsourcing their manufacturing functions and, increasingly, offshoring them. Today, the ICT industry is organised into “global production networks” (GPNs): independent firms located in different parts of the world undertake productive functions linked together through external contractual transactions. Also referred to as a “global value chain,” a GPN has three tiers:

- 1) *Global flagship* or GPN leader: mostly US multinationals, along with companies from Europe and Japan;
- 2) *Contract manufacturers*: a small number of large multinational companies who assemble and/or manufacture products under contract to GPN clients (also called suppliers of electronic manufacturing services or EMS). Contract manufacturers are also increasingly providing design services;
- 3) *Suppliers*: a large number of suppliers of components and other goods and services, ranging from large to small and medium-sized firms (SMEs).

Some semiconductor companies, including large firms like Intel and Texas Instruments (TI), continue to produce silicon chips within their own companies in large manufacturing facilities called “fabs”. However, there are also “fables” semiconductor companies who outsource production.

Globalisation of the ICT industry has propelled global dispersion of both marketing and manufacturing, and increasingly research and design functions as well. Hewlett Packard, for example, serves more than a billion customers in 178 countries on five continents and its supply chain encompasses about 7000 suppliers in 26 countries.⁵ The company’s research and development (R&D) arm, HP Labs, operates in six sites around the globe, including its headquarters in Palo Alto, a substantial research facility in Bristol, and labs in Bangalore, Cambridge (Massachusetts), Haifa, and Tokyo.

4. Dedrick and Kraemer, 2002a.

5. HP, 2006.

Geographical concentration

Despite growing global dispersion, the primary feature of the global ICT industry is its tendency to concentrate manufacturing and, increasingly, software development, in a handful of countries. For example, the US accounts for about a quarter of global computer hardware production, while East Asia accounts for another 45 per cent. While East Asian production is most concentrated in Japan, Taiwan and South Korea, production is growing fast in China, rising from under 2 per cent to nearly 7 per cent of global production in the five years between 1995 and 2000 (Table 1). In 2005, ICT-related FDI inflows into China totalled about US\$21 billion.⁶ Other developing countries in Asia with computer manufacturing clusters include Malaysia and Thailand.

Suppliers to the global ICT industry are also highly concentrated in East Asia. Hewlett Packard, for example, sources more 75 per cent of its product materials, components and services from ten countries in East Asia.⁷

Developing countries in Asia also account for about 30 per cent of global semiconductor manufacturing.⁸ That proportion is likely to increase in the coming years with the announcement in 2007 by Texas-based semiconductor manufacturer Texas Instruments (TI) that it will invest US\$1 billion in a new semiconductor manufacturing facility in the Philippines.⁹ Outside of Asia, Costa Rica has emerged as a semiconductor site with an investment of nearly US\$1 billion by Intel (see below). Software production is also increasingly concentrated in Asia, with India emerging as a major site for both software development and production.¹⁰

Asia is emerging as a site for global R&D activities. For example, the *Financial Times* reported in June, 2007 that the California-based search and online advertising company Google will establish an engineering centre for research and development to provide local online content for the South East Asian market.¹¹ A United Nations Conference on Trade and Development (UNCTAD) survey of MNC managers from a variety of industries found that six Asian countries were among the 17 “most attractive prospective R&D locations” for expansion between 2005 and 2009. China was the most attractive, favoured by nearly 62 per cent of respondents, while India was third with 29 per cent following the United States. No non-Asian developing countries were among the 17.¹²

Like hardware and software production, global electronics markets are also highly concentrated, with 16 countries in North America, Europe and East Asia accounting for nearly 65 per cent of the total. Valued at US\$362 billion in 2003, the United

6. OECD, 2006.

7. Hewlett Packard, 2006.

8. UNCTAD, 2005.

9. FT, 2007.

10. OECD, 2006.

11. FT, 2007.

12. UNCTAD, 2005.

	1995		2000	
	Share	Global rank	Share	Global rank
Americas				
US	26.5%	1	26.2%	1
Brazil	2.3%	10	2.7%	11
Mexico	1.1%	15	3.0%	9
East Asia				
Japan	25.2%	2	16.3%	2
Singapore	7.3%	3	7.6%	3
Taiwan	5.6%	4	6.5%	5
China	1.9%	12	6.8%	4
Malaysia	1.8%	14	3.1%	8
Thailand	1.9%	13	2.6%	12
South Korea	2.4%	8	2.3%	13
(Total East Asia)	46.1%		45.2%	
Europe				
UK	4.7%	5	4.8%	6
Germany	2.8%	6	3.5%	7
Ireland	2.2%	11	3.0%	10
France	2.7%	7	2.1%	14
Italy	2.3%	9	1.7%	15

Source: Dedrick and Kraemer (2002a)

States is by far the largest market. But the Chinese market is growing rapidly: China was the world's sixth largest ICT market in 2005.¹³

Outside of East Asia, ICT manufacturing tends to be sited in local geographical clusters which serve a regional market. In Europe, for example, there are manufacturing clusters in Ireland and in Eastern Europe. Along with China and India, the OECD predicts that a number of Eastern European countries will emerge as major ICT manufacturing platforms. In Mexico, the city of Guadalajara serves as a contract manufacturing cluster for electronics exports to the US.

FDI location decisions

Investment decisions by ICT multinationals are driven by many of the same factors that influence FDI locations more generally: political stability; rule of law, including transparency and a functioning judiciary; and investment incentives, including tax exemptions. Another important factor for the ICT industry is adequate infrastructure,

13. OECD, 2006.

especially cheap and reliable sources of energy and water, as well as communications networks. There are three additional factors of particular importance in the location decisions of ICT multinationals.

The first is proximity to major markets. In an industry where products are rapidly evolving, speed to market is a key component of competitiveness. Loss of market share not only cuts into profit margins but also, more importantly, undermines R&D and product innovation capacities. Hardware manufacturing operations are thus established close to major export and/or domestic markets. Shipments from assembly plants in Guadalajara, Mexico to the port of Long Beach, California, for example, take less than one day. Shipments from China, Japan, and Malaysia take 15, 12, and 23 days respectively.¹⁴

The second factor is the availability of local manufacturing, engineering, and/or research capabilities that provide or have the potential to develop into a local supply base. While flagships and contract manufacturers source components globally, transport and time costs are reduced when local suppliers are available. Moreover, the geographical clustering of firms generates “economies of agglomeration”, whereby firms reap benefits by co-locating with firms who provide specialised skills and services. Clustering promotes learning and sharing of ideas, which can promote innovation. Clustering also occurs when product engineering, development, and ramp-up require close interaction between engineers in assembly and supplier firms. Innovative industry segments that benefit from specialised skills, such as disk drives and flat-panel displays, tend to cluster.¹⁵

The third factor drawing FDI in the ICT sector is the availability of an educated and skilled labour force. Some parts of the global ICT industry, such as sub-assembly and assembly of hardware, require only minimal skills. However, literacy and job discipline are required. Moreover, adding value requires higher levels of skills and training, including the availability of engineering and other science and technology capacities.

Government policy has played a decisive role in influencing all three factors and goes a long way towards explaining why the ICT industry is concentrated in Asia. While proximity to export markets is geographically determined, government policy can help to boost domestic market diffusion of ICT products. Domestic market opportunities, especially in larger population and/or higher income countries, can attract ICT companies. Both China and India, have adopted policies to increase domestic diffusion of ICT products.

The most decisive, however, were industry policies that generated “virtuous circles” of ever-growing local manufacturing capacities – which in turn spawned new domestic firms and attracted foreign investment. In the 1960s and 1970s, Taiwan and South Korea were early leaders in targeting electronics in their domestic industry policies, followed in the 1980s and 1990s by Singapore, Malaysia, India, and China.

14. CANIETI, 2003.

15. Dedrick and Kraemer, 2002a.

Both China and India have implemented a host of proactive industry policies to garner benefits from FDI for domestic firms. China required foreign flagship computer companies to form joint ventures with local firms and to transfer specific technologies, establish R&D centres, source to local firms, and train Chinese employees.¹⁶ By the 1990s, all of the major contract manufacturing firms also came to China under similar arrangements. “By carefully nurturing its domestic computing industry through tightly controlled partnerships with foreign manufacturers, China has become the fourth-largest computer maker in the world.”¹⁷

2. Opportunities and risks for sustainable industrial development

Growth of an FDI-driven ICT cluster is a highly attractive prospect for developing countries, offering the promise of connection to a dynamic, cutting edge global industry with associated benefits for domestic employment and income. More broadly, the goals associated with FDI are not just to provide income but also to promote the sustainable development of a local ICT industry, and to diffuse ICT products widely into domestic production processes and consumption.

Sustainable industrial development can be defined as simultaneous evolution along three axes:

- 1) *Industry upgrading*: the creation of new local capacities for commercially viable production and innovation. This means that FDI should generate knowledge spillovers that help developing countries to move up the global value chain;
- 2) *Environmental spillovers*: the reduction of the ecological costs of industrialisation. This means that FDI should transfer clean technology and disseminate state-of-the-art environmental management practices to both subsidiaries and suppliers;
- 3) *Equity-enhancing growth*: the broad-based creation of jobs, especially for the poor. This means that FDI should help to stimulate employment, both directly and indirectly.

This section examines the opportunities and risks associated with FDI in ICT manufacturing in developing countries, first in attracting FDI and then in gaining benefits from FDI for the three aspects of sustainable industrial development. It then considers opportunities for growth in the software and services parts of the ICT industry.

Attracting FDI in ICT manufacturing

The primary objective of FDI promotion strategies in the ICT sector has been to build low-wage export platforms for low and semi-skilled hardware manufacturing and assembly operations. The plants are owned and operated by foreign flagships,

16. USDOC, 2006.

17. Dedrick and Kraemer, 2002b, p 28.

contract manufacturers, or higher tier suppliers and, mostly, products are exported to markets in the US, Europe or Japan. Production is highly standardised but the hope is that knowledge spillovers and MNC procurements will nurture the emergence of a local supply base. A domestic industry can also help to locally diffuse ICT products, with large benefits for productivity and poverty alleviation

While the promise is palpable, there are four obstacles in attracting – and sustaining – FDI in ICT manufacturing. First, competition is intense, both among developing and developed countries. Many developing countries do not have the requisite infrastructure, skills, and proximity to export markets or large domestic markets to successfully attract ICT investment.

Second, the global ICT industry is highly concentrated, creating barriers to entry for would-be flagships, contract manufacturers, larger suppliers, and even smaller suppliers. “The domination of the United States and Asia in electronics,” concludes industry analyst Alice Amsden, “makes it very difficult for newcomers to enter this field”.¹⁸

Third, intense cost pressures inside the industry undermine the sustainability of low-wage, assembly operations. Even if a developing country attracts FDI, success may be short-lived as contract manufacturers tend to rapidly relocate assembly operations to lower-cost locations when global conditions change. Moreover, the cost advantages of basing manufacturing operations in China may increasingly overwhelm location-specific assets in other developing countries. Even important producers like Malaysia and Singapore may not be able to meet the challenge of new competition from China and India, as well as continuous upgrading in the face of the intense competitive dynamics of the industry itself.¹⁹

Fourth, greater standardisation is reducing both the need for specialised skills provided by a particular industry cluster and the need to be located near export markets. Industry analysts Dedrick and Kraemer (2002) argue that the personal computer (PC), for example, is a “mature industry” with virtually no innovation and no need for specialised skills. They predict that the need to locate near a national or regional market will become much less important in the future. PC manufacturing, they suggest, will shift from regional production to production in Asia – basically China – for global markets. “The result could be a two-tier production network, with complex build-to-order products being produced near the end customer and standardised products being produced in one or two locations to supply worldwide demand”.²⁰

Challenges for industry upgrading

FDI in ICT manufacturing offers the opportunity for developing country workers and firms to capture productivity-enhancing “knowledge spillovers” from MNCs. Spillovers are generated through technology transfer, on-the-job training, and

18. Amsden, 2004.

19. Ernst, 2003; Wong, 2003.

20. Dedrick and Kraemer, 2002a, p. 29.

requirements for affiliates and local suppliers to meet best practice quality and management standards. Spillovers can be captured by affiliates and supplier firms, as well as competitor firms through demonstration effects. Spillovers promote industry upgrading, allowing developing country firms to move up the global ICT value chain. The capture of spillovers, however, is not automatic. Without proactive government policy (see section 4), there is a risk that few spillovers will be generated or captured.

One problem is that there is little skill acquisition and hence few human capital spillovers in assembly work. Because an initial level of training is required, assembly workers have been called “semi-skilled”. But there is no chance to get further training and little opportunity for workers to innovate on-the-job. Organised into work groups, workers undertake highly standardised and repetitive tasks. Indeed, global standardisation and uniformity of work procedures is a defining feature of contract managers (CMs), who “offer a uniform interface for flagships seeking global one-stop-shopping for manufacturing services”.²¹

Another problem is that foreign ICT firms may not have many linkages with local firms. Besides training, spillovers are indirectly captured through backward and forward linkages. But CMs draw inputs from a global supply chain and may have few backward linkages to local firms. Moreover, many developing countries have adopted a “hands-off” policy framework that inhibits governments from helping local firms develop the technical and business management capacities to become suppliers.

Spillovers will also be scarce if forward linkages – that is, to upstream markets – are weak. But many developing countries have adopted a single-minded focus on production-for-export that inhibits the growth of a domestic market for ICT goods and the benefits of ICT domestic diffusion, including the spur to product innovation. The number of personal computers per 1,000 people in Mexico, for example, fell well below the Latin American average in 2001, despite the ICT assembly operations in Guadalajara.²² The lack of a strong domestic market, in turn, makes it more likely that flagships and CMs will be footloose, and less likely that they will be willing to partner with local governments and firms to transfer technology and know-how.

Lack of funds for investment is another obstacle to technological upgrading by local firms. Small and medium-sized supplier firms operate with very thin margins and, in many developing countries, have little or no access to credit. Without investment, smaller firms cannot ramp up to the economies of scale that would enable them to win more stable supply contracts with CMs or global flagships. As industry analysts Gereffi and Sturgeon (2004, p.12) argue: “... profits are driven down at the base of global value chains because of intense competition, leaving little money for reinvestment, innovation, or wage increases.”

Overall, there is a risk that countries that attract FDI in ICT manufacturing will remain stuck at the lower ends of the global value chain. While FDI may generate

21. Luthje, 2003 p. 9.

22. World Bank, 2005.

local benefits in terms of direct employment and income, the even larger potential development benefits of a sustainable, dynamic local industry cluster will not materialise. Moreover, the standardised, low skill, low wage production that characterises the lower ends of the global value chain is vulnerable to relocation. Finally, there are often costs associated with attracting FDI. “Some countries are offering expensive incentives to attract foreign investment in hardware production,” conclude Kraemer and Dedrick (2002, pp. 40–41), “but it is questionable whether they can catch up at this point. And even if they are successful in attracting foreign investment, the resulting industry is likely to have limited value added and few opportunities for local companies to participate.”

Environmental challenges of ICT manufacturing

The ICT sector has a “clean and green” image, making it a low priority for regulation and monitoring in developing countries. However, the sector carries two sets of environmental risks: 1) significant and long-lived health and environmental problems associated with ICT manufacturing and assembly; 2) rising and potentially bifurcated global environmental standards for ICT products.

At the centre of all ICT products is a microchip – a highly manufactured silicon wafer on which hundreds or even thousands of transistors have been etched. Beyond water and energy, microchip fabrication requires an intensive use of a wide variety of solvents, acid solutions and alcohol. A survey by the US Environmental Protection Agency (EPA) in 1995 listed 31 categories of chemicals used in photolithography alone, one of the last stages of manufacturing.²³

While somewhat less chemical-intensive, the component manufacturing and assembly parts of the ICT global production network expose workers to some of the same hazardous substances, including solvents, as well as exposure to lead and formaldehyde. Assembly involves plating copper and soldering components to the plates with lead and tin. The copper plating process emits formaldehyde while the soldering process produces lead “solder drass” which is highly contaminating, especially if it ends up in local waterways.²⁴

A newer but possibly even greater hazard is the widespread use of brominated flame retardants. Workers routinely add brominated flame retardants to a wide variety of ICT goods, including circuit boards and plastics in computer cabinets, to reduce flammability. The compounds are bio-accumulative and are rapidly rising in human breast milk in North America. While toxicology studies are still being undertaken, there is evidence that exposure is linked to thyroid hormone disruption, neuro-developmental deficits, and possibly cancer.²⁵

23. Mazurek, 1999, p. 52.

24. Kuehr and Williams, 2003.

25. Kuehr and Williams, 2003.

The toxic materials used in the production of ICT products create hazards for end-of-life product management. In landfills, chemicals and other hazardous substances inside a computer – lead, arsenic, selenium, brominated flame retardants, antimony trioxide, cadmium, chromium, cobalt, mercury – leach into land and water. In the US, about 70 per cent of the heavy metals found in landfills, including mercury and cadmium, comes from electronic products. In 2001, California and Massachusetts banned cathode ray tubes (CRTs) from municipal landfills.²⁶

In developing countries, the lack of waste management infrastructure and regulatory oversight makes ICT manufacturing even more hazardous than in developed countries. Occupational health standards in particular tend to be sketchy or non-existent in developing countries. In Thailand in the early 1990s, for example, four workers at a Seagate disk drive facility died after a pattern of fatigue and fainting. A study by the country's most prominent occupational health doctor found that some 200 plant employees had blood levels that suggested chronic lead poisoning, perhaps aggravated by exposure to solvents.²⁷

Even a relatively well-off industrialising country like Taiwan has suffered the effects of toxic chemical use by the ICT industry. In a study of the Hsinchu Science-Based Industrial Park, the heart of Taiwan's high-tech industry, the Taiwan Environmental Action Network found a shocking pattern of neglect of human health and the environment, starting from the 1960s and continuing through to 2001. The legacy of Taiwan's spectacularly successful high-tech development is a cohort of former employees with a high rate of rare cancers, and a severe and widespread problem of freshwater and coastal chemical pollution.²⁸

Another environmental risk of the ICT industry stems from the fact that manufacturing is highly energy-intensive. As concern about global warming mounts, prices of fossil fuels are likely to increase dramatically. Countries seeking to expand ICT production will need to plan for climate change constrained development.

The second environment-related risk of FDI in ICT is the bifurcation of global standards. With public concern mounting, national and municipal authorities in Europe, Japan and the United States, as well as companies themselves, are undertaking a wide range of regulatory and voluntary initiatives to reduce chemical hazards and electronic waste and to improve energy and resource efficiency. The European Union, however, has gone the farthest towards "raising the bar" in terms of environmental regulation of the ICT industry, as well as hazardous chemicals in general. As a signatory to Annex One of the Basel Convention, which prohibits the export of hazardous waste from developed countries, its regulation is focused on reducing the amount of waste entering, produced, and stored in Europe.

Along with new sweeping regulation of chemicals, two EU directives have changed the rules for ICT market access in Europe:

26. BAN and SVTC, 2002.

27. Foran, 2001.

28. Shang *et al*, 2001.

Restriction on Hazardous Substances (RoHS) The RoHS Directive, which came into effect on July 1, 2006, bans the placing on the EU market of new electrical and electronic equipment containing more than the agreed levels of lead, cadmium, mercury, hexavalent chromium, and two flame retardants;

Directive on Waste from Electrical and Electronic Equipment (WEEE). Adopted in the Spring of 2003, WEEE sets criteria for the collection, treatment, recycling and recovery of waste electrical and electronic equipment and makes producers responsible for financing most of these activities (producer responsibility).

Other large electronic markets, notably the United States and Japan, have not adopted such laws, at least not yet, giving rise to the possibility that global standards will bifurcate by end market. While there is mounting concern about landfill contamination from e-waste, the United States is not a signatory to Annex One of the Basel Convention. Indeed, the US EPA views the export of e-waste to Asia as part of its industrial waste management strategy.²⁹

On the other hand, MNCs may find ICT too costly to design products and processes around multiple standards, suggesting that globally harmonised standards might be in the making. The state of California, for example, has enacted IT's own version of RoHS, and the US EPA is working with chemical manufacturers to phase out the most toxic of the brominated flame retardants.³⁰

Full global harmonisation may be on the cards in the future. In the short to medium term, however, ICT markets will bifurcate along the lines of higher EU versus lower US environmental and health standards. Japan, which was the first country to pass a law requiring recycling of domestic e-products, is likely to be in-between. Developing countries – and the MNCs that invest in them – will need to strategically align their environmental management policies with their export markets. If they choose markets with lower standards, they may be at risk of being squeezed out if and when standards are globally harmonised.

Challenges for equity-enhancing growth

The growth of ICT manufacturing offers the potential for broad-based growth with significant employment potential if there are substantial linkages between foreign and domestic firms. Without local linkages, however, there is a risk that ICT clusters will become enclaves dominated by foreign firms who rely on imported components for assembly. Such enclaves provide limited potential for employment growth, especially jobs for the poorer segments of the population.

Moreover, without proactive government policy, foreign ICT manufacturing operations tend to locate and agglomerate in capital cities or other major urban areas. In most developing countries, the poorest segments of the population live in non-capital cities and/or rural areas. India's rapidly growing ICT sector, for example, is

29. BAN and SVTC, 2002.

30. Pohl, 2004.

highly concentrated in selected urban clusters in the south and west of India, while the poor overwhelmingly live in rural areas. Moreover, the ICT sector utilises skilled labour, while the poor are unskilled. The electronic products of the ICT sector likewise do not reach the poor but are exported or shipped to other urban middle class clusters in India.³¹

New opportunities: software and services?

According to the OECD, technological change has reduced the need for face-to-face contact in the provision of ICT services and made them more tradable.³² As a result, there are new opportunities for developing countries to attract FDI in software. As the OECD argues:

“The widespread development of ICT infrastructure and enabling business frameworks makes it clear there is great scope for increasing the supply of services from and to developing countries. This is a two-way process. Services from these countries, especially India, are adopting global business models and services operations, establishing a presence in OECD countries, and increasingly competing with firms from OECD countries. But *as these countries’ domestic demand* grows and they open their markets to international competition, services firms from OECD countries are also activities in their markets.” (emphasis added).

The importance of domestic demand for ICT products and services needs to be underscored for three reasons. First, greater domestic demand makes developing countries more likely to attract FDI. Second, greater domestic diffusion of ICT products and services makes it more likely that FDI in both ICT hardware and services will generate spillovers for industry upgrading. Third, the diffusion of ICT products and services throughout the economy can bring substantial benefits in terms of greater efficiency and productivity.

Indeed, industry analysts Kraemer and Dedrick (2002) argue that the benefits of ICT use substantially outweigh the benefits of ICT production. They suggest that the greatest opportunity for developing countries – including in South East Asia – lies in the development of software and the design of internet content suitable to local cultures and business environments. They call such opportunities “production close to use” because providers and end-users are in close interaction (*ibid* p. 41).

The diffusion of ICT products and services will help to bridge the “digital divide” between OECD and developing countries. It will also help make developing countries more able to absorb spillovers from FDI in all industries. An FDI promotion strategy aimed at increasing the benefits of ICT *use* would target not just the ICT industry but on what multinationals in all sectors can bring in terms of advanced information systems. “In order to benefit from globalisation and from foreign competition in the domestic market,” conclude Kraemer and Dedrick (*ibid* p 38),

31. Tiwari, 2006.

32. OECD, 2006.

“countries need to establish competitive capabilities beyond cheap labour...[including] educated workers, high-quality infrastructure, local R&D capabilities, and strong entrepreneurial skills. Information networks along with skilled knowledge workers make up the “soft” infrastructure that [is becoming] at least as important as physical infrastructure. The key payoff from developing this soft infrastructure will be the ability to use IT productively.”

3. Case studies: FDI and sustainable industrial development

Developing countries that have successfully attracted FDI in the ICT sector have had a mixed experience in terms of its impact on sustainable industrial development. This section examines the experience of three countries: Costa Rica, Malaysia, and China.³³ For each country (as far as available information permits), it seeks to answer three key questions:

- 1) How and why was FDI attracted? What role was played by IPAs?
- 2) Has FDI generated spillovers that promote industry upgrading and a sustainable local industry cluster? If so, what are the impacts on pro-poor employment?
- 3) What are the environmental and health impacts? Has FDI transferred “best practice” in environmental and occupational health and safety management?

Costa Rica

In 1996, Intel Corporation, the world’s largest maker of silicon chips and semiconductors, announced that it would build a US\$300 million semiconductor assembly and testing plant in Costa Rica. By 2005, the accumulated investment in Intel’s Costa Rica campus amounted to US\$770 million and employed 2,900 workers directly and 2,000 indirectly.³⁴ Likened to “putting a whale in a swimming pool”, the Intel’s operations accounted for some 8 per cent of Costa Rica’s GDP in 2000 and over a quarter of its exports.³⁵

Competition for the investment was intense. In addition to Costa Rica, Intel considered Indonesia, Thailand, Brazil, Argentina, Chile, and Mexico. Spurred by the acumen of its IPA, Costa Rica was selected because it offered a number of location-specific advantages, including:

- incentives to attract FDI under the free zone scheme (see Table 2);
- the high educational level of the labour force;
- political and macro-economic stability; and
- a relatively corruption-free environment.³⁶

33. For an in-depth case study of FDI in the ICT sector in Guadalajara, see Gallagher and Zarsky, 2007.

34. MIGA, 2006.

35. Larrain *et al*, 2000; UNCTAD, 2002.

36. Paus and Gallagher, 2006; Larrain *et al*, 2000.

Table 2: Costa Rica's free zone investment incentives

- 100 per cent exemption on import duties on raw materials, components, and capital goods
- 100 per cent exemption on taxes on profits for eight years and 50 per cent on following four years
- 100 per cent exemption on export taxes, local sales and excise taxes, and taxes on profit repatriation
- 100 per cent exemption on municipal and capital taxes
- No restrictions on capital repatriation or foreign currency management
- Fully expedited on-site customs clearance
- Ability to sell to exporters within Costa Rica
- Ability to sell up to 40 per cent in the local market with exemption from sales tax

Source: FIAS Occasional Paper 11, 1998

Intel's decision, which took more than one year to make, involved four phases: pre-qualification, site research, contingent announcement and delivery, and start-up. Seven institutions were directly involved in the process on the side of the Costa Rican government, all under the direction of the Presidency and the Ministry of Foreign Trade, and with the coordination and support of CINDE (Coalición Costarricense de Iniciativas para el Desarrollo), a USAID-funded institution whose main responsibility is investment promotion.

Costa Rica's targeted effort to attract Intel was part of a larger national development strategy focused on building a high technology cluster with the aid of FDI. In the mid 1990s, Costa Rica was losing its advantage in apparel manufacturing and the prices of two key exports, coffee and bananas, were falling. The development of high technology was central to the country's economic future. Besides its direct benefits, Intel's decision worked to "signal" the attractiveness of Costa Rica to other investors. In addition, Intel managers spoke publicly about the benefits of Costa Rica. Investors that followed included Motorola in the ICT sector, as well as Conair in electronics and Baxter Healthcare. After 1998, CINDE focused on reinforcing the emerging electronics cluster by seeking to bring in suppliers, not just for Intel but other investors.³⁷

As important as the effort to attract Intel initially was Costa Rica's follow-through on commitments made to Intel. The government's "post-investment care and policy advocacy" built the company's confidence, leading to further investments, not only by Intel but also by other foreign companies. Besides a steering committee for policy advocacy and implementation, CINDE and the government created a private-public sector committee, led by the President, to channel feedback from existing investors. CINDE also created a Post-Establishment Coordinator to oversee and augment the efforts of its staff. "A country and its IPA cannot just attract a foreign investor and leave it alone," said Julio Acosta, CINDE's Managing Director. "They

37. MIGA, 2006.

have to provide aftercare in order for investors to prosper and become spokespeople in favor of the country”.³⁸

While CINDE’s efforts have paid off in terms of attracting FDI, the technology cluster strategy has had limited results in terms of local industry upgrading and supplier development. The share of exports of electrical machinery jumped from 1.4 to 24.6 per cent between 1997 and 2003. However, recent studies have found that “this seeming transformation has not been mirrored by a transformation of indigenous technological capabilities, not least because FDI spillovers have been limited.”³⁹

A number of global supplier firms established satellite offices in Costa Rica to provide technical support to Intel. CINDE helped them to find additional clients within the country. Some local firms were able to capture spillovers and upgrade their operations to supply the global suppliers. More generally, however, potential domestic input suppliers do not have the requisite technological know-how and business management skills to upgrade to the scale and standard needed to become TNC input suppliers. Moreover, their access to credit is constrained by high interest rates. Investing in the capacities to become suppliers is a high-risk operation, especially given that MNCs are often unwilling to commit to a contract, in part because of their uncertainty that Costa Rican suppliers are reliable (*ibid*).

In an in-depth study, Paus and Gallagher (2006) find that, to date, Costa Rica’s FDI-driven high technology growth has created more of an import-dependent enclave than a cluster. They argue that the “missing links” between FDI and development stem largely from the failure of the government to develop a coordinated, proactive national development strategy aimed squarely at building local suppliers. Individual initiatives to do so were not institutionalised nor coordinated with other agencies. “The creation of local linkage capability has to be taken as seriously as the attraction of FDI,” they conclude, “and both goals have to be pursued in tandem.”⁴⁰

A study by the World Bank’s Multilateral Investment Guarantee Agency (MIGA) argues that Costa Rica has “real potential” to move up the value chain. Given the “dramatic consolidation of operations in South East Asia and China,” it is urgent that Costa Rica – which has higher labour costs than its Asian counterparts – realise the potential through active linkage policies and the development of new product capabilities.⁴¹

In the area of environment and worker health and safety, Intel has brought real benefits to Costa Rica. Following Intel’s example, the government created the country’s first national job safety and health standard. Intel also set strict worker safety standards for suppliers and subcontractors.⁴² Moreover, following initial community protest of the Intel investment due to fears of groundwater contamination, Intel

38. Quoted in MIGA, 2006, p.11.

39. Paus and Gallagher, 2006, p.11.

40. Paus and Gallagher, 2006.

41. MIGA, 2006.

42. MIGA, 2006.

worked with the Environment Ministry and local NGOs to provide environmental assurances. The plant operates with the highest existing environmental standards (at minimum, California standards), provides funds for a regular environmental audit, and has an onsite treatment plant for conventional wastes.⁴³

Malaysia

Few developing countries have been as successful in attracting FDI overall and in the ICT sector in particular as Malaysia. Led by the Malaysian Industrial Development Agency (MIDA), the country's investment promotion agency, Malaysia has aggressively pursued FDI since 1980 in sectors targeted in five-year national development plans. High-tech electronics industries have been a high priority.

In the 1980s and 1990s, Malaysia was transformed from a primarily agricultural and resource-based economy to a manufacturing economy. At the centre was electronics. From less than 1 per cent in 1968, electrical and electronic products rose to 71 per cent of Malaysia's manufactured exports in 1997.⁴⁴ By the mid-1990s, Malaysia was a major player in global electronics and IT markets. By 2004, Malaysia's shares in OECD imports of computers and telecommunications had surpassed that of Taiwan and Korea respectively.

Malaysia's industrial policies in the 1980s were based on import substitution industrialisation (ISI) and investment incentives were based on the investment project. Following liberalisation in the mid-1990s, incentives have been tailored to the specific industries targeted in the development plans, including high technology industries (Table 2). In addition to incentives and aggressive promotion, Malaysia's success in attracting FDI in the ICT sector was based on the availability of skilled labour, proximity to growing Asian markets, and the creation of special zones, such as the Multi Media Corridor in Penang, which provides cheap and reliable sources of energy and water, as well as a comfortable lifestyle.

While its pursuit of FDI was aggressive, Malaysia's after-investment policies towards MNCs have been relatively passive. Indeed, with the exception of Singapore, Malaysia is far more exposed to and integrated in the global production networks of the global ICT industry than other East Asian producers. According to Ernst (2003, p. 13), "Malaysia's electronics industry continues to be shaped by strategic decisions of global flagships (both flagships and major American CMs)."

Until the mid-1990s, the strategy generated significant employment and productivity growth in the electronics industry. Since the mid-1990s, however, productivity growth has slowed and redundancies have increased. While Malaysian firms are adept at changing product lines, they have not moved much beyond generic manufacturing capacities into higher value-added activities. "Structural change in products," concludes Rasiah (2003), "has not been matched by a similar upgrading in

43. Zarsky *et al*, 2002.

44. Rasiah 2003, p 309.

functions” and Malaysia’s FDI-driven economy “remains specialised in low value-added functions within high-tech activities” (emphasis in original, p. 312). As a result, Malaysia’s electronics sector is vulnerable to the relocation of flagships and CMs to countries with lower labour costs, especially China.

What accounts for Malaysia’s failure to date to upgrade its production capabilities in the ICT industry? Recent studies point to two shortcomings. First, there is a serious shortage of specialised skilled labour in Malaysia, including managerial, scientific and engineering. Despite a variety of Government incentives to MNCs to stay or locate in Malaysia, especially Penang, lack of sufficient investment in education and training has created a “human resource bottleneck”.⁴⁵ As a result, “growing deficits in skill and innovation are weakening the foundations of long-term growth.”⁴⁶

Second, despite a vendor development programme, Malaysia’s export-oriented electronics sector is highly import-dependent: some 43 per cent of intermediate goods are imported. Unlike Taiwan, Korea and Singapore, Malaysia “failed to develop a broad and multi-tier base of support industries”.⁴⁷ One reason may be the large role of CMs, who tend to keep their design functions in the US and Europe and thus create “only limited upgrading opportunities, insufficient for a major push into more knowledge-intensive activities.”⁴⁸

The growth of the ICT sector has not been accompanied by adequate environmental regulation or infrastructure. Until the privately-owned Kualiti Alam facility was built in the mid 1990s, there was no national or regional capacity to dispose of hazardous electronic waste. The waste was stored on site and companies often contracted with haulers whose methods of disposal were unknown. Moreover, a 2002 study found that the Kualiti Alam facility was not able to keep up with the production of waste: the incineration capacity was 100 tons per day while up to 300 tons per day was arriving at the site.⁴⁹ In 2006, the electronics sector was the largest industrial source of hazardous waste, accounting for nearly 24 per cent of the total.⁵⁰

Environmental regulation of the ICT industry is either non-existent or poorly enforced, leaving companies to self-regulate. Many foreign companies have implemented environmental management systems, either at their own initiative or at the directive of company headquarters.⁵¹

China

Twenty years ago, China had little to nothing of an IT sector. Today, China is at the centre of MNC global production networks and has launched its own, globally

45. Ernst, 2003, p. 17.

46. Rasiah, 2003.

47. Ernst, 2003, p. 14.

48. Ernst, 2003.

49. Zarsky *et al*, 2002.

50. The Star, 2007.

51. Zarsky *et al*, 2002.

competitive IT firms. Beyond low wages and *in situ* capabilities for standardised manufacturing, China's success stems from deliberate government policy.

In 1986, four Chinese scientists recommended to the Ministry of Science and Technology (MOST) that ICT become a strategic sector. The request was approved. In 1988, MOST dubbed ICT as a “pillar” strategic sector and launched the National High Tech R&D or 863 Program to foster a vibrant, globally competitive domestic high-tech sector, including flagship firms, contract manufacturers and suppliers. The two-pronged strategy involved inviting foreign firms to China to partner with domestic firms and building the capacity of domestic firms to produce components and peripherals for personal computers.⁵² A third prong – expanding the domestic IT market – was added in the 1990s.

The government invited foreign ICT firms to form joint ventures with Chinese firms and required that they transfer technology, establish R&D centres, procure inputs from local firms, and train Chinese employees.⁵³ By the 1990s, all of the major contract manufacturing firms also came to China under similar arrangements. “By carefully nurturing its domestic computing industry through tightly controlled partnerships with foreign manufacturers, China has become the fourth-largest computer maker in the world.”⁵⁴

The foreign firms invested in China and accepted these requirements because of China's compelling location-specific assets, including a low-wage, relatively skilled export platform and a large and growing domestic market. In essence, foreign firms traded market access for technology transfer.

China's rapidly growing domestic IT market is propelled not only by a rise in personal income but also by active Government promotion strategies. In 1990, there were only 500,000 PCs in China. By 2000, 7 million PCs were sold in China in just one year and by 2003, annual sales had risen to 13.3 million.⁵⁵ While the US remains the world's largest market, access to China's domestic market has become essential to the future global competitiveness of all major IT companies.

Crucial to China's success are incentives to domestic firms. A key programme has been the establishment of high-tech industrial parks.⁵⁶ There are now 25 high-tech parks in five cities that attract foreign firms through land and infrastructure subsidies. Foreign firms are matched with domestic firms who receive government assistance, including access to credit.⁵⁷

The government also invests substantially in both education and research and development. China spends about 1.23 per cent of its GDP on R&D, a large part related to ICT. Local governments often match national government funding. In tandem with R&D policies, China supports science and technology in tertiary

52. Dussell, 2005.

53. USDOC, 2006.

54. Dedrick 2002, p 28.

55. CalTrade Report, 2004, www.caltradereport.com

56. Dussell, 2005.

57. Dussell, 2005.

education: each year, over 20,000 newly-graduated scientists and engineers find work in local firms, foreign firms, and R&D centres.⁵⁸

China's large and growing manufacturing capacities, in tandem with its large and growing domestic market, have made China the centre of global ICT manufacturing. According to Gereffi and Sturgeon, "China has established a critical mass of infrastructure and factory capacity that makes ICT the world's most important global outsourcing platform for manufacturing. ICT has an unparalleled mix of economies of scale, industrial diversification, and domestically funded infrastructure, buttressed by the world's largest inflows of foreign direct investment".⁵⁹

China's preeminent manufacturing position is matched, regrettably, by its increasing role as the world's electronic waste dump. A 2002 study found that about over 70 per cent of recycled electronics from the US are exported to China, where computers are pulled apart by hand, useful components sold, and the rest thrown into landfills, waste dumps or the nearest piece of empty land.⁶⁰ The US is not the only source. Indeed, according to one estimate, about 70 per cent of the all the electronic waste in the world is exported to China.⁶¹

A 2007 report by China's State Environmental Protection Administration found that coastal plants, which use outdated techniques to melt metals from circuit boards and to separate electronic components, discharge untreated toxic liquids into the environment. Moreover, e-waste is shipped to the interior, where there are no processing plants.⁶²

The e-waste problem is not only driven by imports but also by domestic manufacturing and consumption, a problem increasingly recognised by the Chinese government. "As China emerges as a major global manufacturing and consumer powerhouse," advises the government's newspaper *China Daily* (2005), "discarded electronics products and household appliances, many filled with toxic chemicals, are piling up, posing a severe threat to the environment and sustainable economic growth."

Prompted by concerns about the WEEE and RoHS requirements in the EU, China adopted its first regulation to deal with e-waste in 2005. The regulation requires that all electronics manufacturers replace the products that are banned in the EU with environmentally friendly materials, and that producers be responsible for collecting, recycling and reusing their products. "We are trying our best to catch up with the EU in drawing up rules related to electronic waste by adopting the same, or at least similar, standards," said Huang Jianzhong of the Ministry of Information Industry so that "Chinese companies will not be squeezed out of the market."⁶³ Initial estimates suggested that Chinese exports in products affected by the two EU directives would fall by 30-50 per cent.

58. MOST, 2006.

59. Gereffi and Sturgeon, 2004, p.12.

60. BAN and SVTC, 2002.

61. ChinaTechNews, 2006.

62. UPI, 2007.

63. China Daily, 2005.

4. Recommendations for IPAs

Garnering benefits for sustainable development of FDI in the ICT sector requires targeted, strategic proactive policies to capture spillovers for industry upgrading, environmental management and employment creation. In the first instance, aggressive and strategic efforts are needed to attract FDI given intense competition and an already crowded field. Moreover, it is important to target particular parts of the industry where there is an opportunity to develop a market niche. Generally, there may be more opportunity in software and services than in ICT manufacturing.

The analysis above suggests that capturing benefits from FDI is even more challenging than attracting it and points towards four lessons for IPAs in developing countries.

1. Promotion policies must be integrated with coordinated, proactive domestic linkage policies

The benefits of FDI both for industry upgrading and for employment creation depend on building linkages between MNCs and local firms, as well as local universities. Greater linkage capacities, in turn, help to attract FDI. The experience of successful developing countries shows that such linkages must be nurtured by government policies. To develop a local supplier base, three types of policies are useful.

First are policies that directly help to build capacities of local firms to be suppliers, including *inter alia* technical and business management training and provision of credit for retooling and expansion. Second are policies that build larger engineering capacities, including investment in education and R&D. Third are policies that help diffuse ICT products domestically, creating market niches for both domestic and foreign companies.

IPAs have key roles to play in *coordinating* linkage policies among government agencies and in *communicating* key information to – and from – foreign companies. This might include, for example, making sure that foreign companies are aware of available trained (or training) human resources, and existing incentives for technology transfer. In the other direction, IPAs can alert other government agencies about the differential willingness of and conditions for MNCs to enter into partnerships to promote local supply linkages. Indeed, IPAs can even take a proactive stance in designing the scope and content of partnerships.

2. Targeted pro-poor policies are needed to enhance benefits of ICT

With effective linkage policies in place, FDI can help to generate broad-based domestic employment opportunities as well as diffuse ICT products. However, to ensure that such benefits are not confined to particular geographic and/or income enclaves, employment and diffusion policies need to target the poor. For example,

incentives can be directed towards MNCs to locate production outside of capital cities; and governments can work with international NGOs and aid agencies to make ICT training and products available.

Here again, IPAs can play key coordinating and communication roles, letting foreign investors know of government policies and priorities. In searching for potential investors, IPAs can seek to identify companies searching for “social investment” opportunities.

3. Environmental regulation and monitoring must be in place

There are large environmental risks associated with ICT manufacturing. Beyond the human costs imposed on workers and communities, the hazardous materials used in ICT production threaten water systems, which are inputs to both agriculture and industry. Moreover, global environmental standards are rising, particularly in the EU. Developing countries must be able to produce using global “best practice” technology and management or risk being squeezed out of global markets.

To achieve both objectives, environmental standards and monitoring capabilities must be in place before production commences. Attracting companies with strong demonstrated environmental commitments – and partnering with them to build skills – is also a good way to help build domestic capacities.

IPAs have an important role to play in identifying and seeking to attract companies with a demonstrated commitment to good environmental performance. In the ICT industry – like other industries – there are “leaders” and “laggards” when it comes to corporate social responsibility in general and environmental management in particular. Capturing environmental spillovers from FDI is much more likely if foreign investors already have “best practice” systems in place and come with expectations to help raise local capabilities.

4. Post-care investment services are needed

In the highly dynamic global ICT industry, few investment decisions are final. The economics of even a large “sunk cost” in a particular locale can be undone by a new cost-benefit calculus that favours relocation to a cheaper site or one closer to growing markets. It is essential that after-care services are in place for foreign investors. Chief among them is a growing local knowledge and capability base that is in tune with the global business plan of the company. Other services include ensuring that foreign investors are aware of changes to government policy and regulation.

The work of IPAs should not be considered complete once a foreign investment contract has been signed. IPAs need to continue to liaise with foreign investors, providing regular communication channels with the government overall, and be up-to-date with the latest developments in the global ICT industry. After-care services are an important part of laying the groundwork for additional investment.

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Chapter 4

Risks and opportunities in attracting foreign direct investment in the agrifood sector: The case of supermarkets

Bill Vorley

1. Introduction

The subject of foreign direct investment (FDI) in the food retail sector brings the challenges of trade, investment and sustainable development into sharp relief.

The liberalisation and deregulation of trade in retail services is promoted in the name of market efficiency and consumer welfare, freeing up wealth for spending on non-food items.¹ It is also a bargaining chip in World Trade Organization (WTO) negotiations, where industrialised countries are demanding liberalisation of services in

1. Hagen, 2003.

developing countries in return for reductions in support for domestic agriculture.² But grocery retail is a link between consumers and millions of – often poor – rural producers, and is itself one of the most important sources of livelihoods for low-income households in the urban informal sector.

Retail tends to be highly concentrated and competitive in industrialised countries, and since the early 1990s the giants of modern grocery retail have been transferring the “supermarket revolution” to emerging and developing economies, where the retail segment tends to be highly fragmented and barriers to market access remain common.³ The way that retail organises its procurement can have a profound impact on rural development, and also on the prospects for small and medium-sized enterprises (SMEs), especially in food processing.

When modern retail moves into countries with high proportions of the population engaged in agriculture, and also large informal trading and retail sectors, the numbers of potentially affected people are enormous. In India, where fierce debate currently surrounds the liberalisation of retail FDI, there is a total agricultural labour force of over 300 million. And the Indian retail sector, dominated by very small independent *kirana* stores, is the second biggest employer after agriculture, with around 42 million jobs that account for 14 per cent of GDP. The traditional retail and informal trade sector are the first to feel the effect of “supermarketisation”. So any policy changes that affect the structure of grocery retail in India are inextricably linked to development and poverty reduction.

Investment Promotion Agencies (IPAs) use a combination of policy and investment promotion tools to compete for and attract FDI.⁴ FDI in the sector is on the rise because of strong pressure to liberalise under the WTO services agreement (GATS) and other trade agreements such as the EU Economic Partnership Agreements (EPAs). It is therefore very important that IPAs have full knowledge of the wider development implications of attracting investment in the sector. Developing countries and their IPAs need to take stock of the implications of retail FDI, and the conditions under which it can work for poverty reduction, especially if IPAs seek to pursue a more aggressive targeting of the sector in the future.

This chapter tracks the expansion of modern grocery retail into emerging and developing countries, and explores the links between retail and poverty reduction. It then describes some policy options available to governments and IPAs in attracting retail FDI for broad-based rather than exclusive development. The focus is on grocery retail, which dominates global retail sales, though much available data and analysis on retail investment applies to the sector as a whole, including non-food: home products, apparel and department stores.

2. IATP and Polaris Institute, 2006.

3. World Bank, 2005; ITSP, 2005.

4. UNCTAD, 2004a.

2. Internationalisation and FDI in grocery retail

The modernisation of retail and the “supermarket revolution”

At its simplest, the supermarket model is distinguished by self-service shopping with separate departments for produce, meat, bread and other grocery items under one roof, discount pricing, large-volume procurement and a centralised distribution system. Different supermarket companies have targeted specific market segments and concentrated on a preferred format, from the convenience segments to full range one-stop formats. Some of these distinctions are being eroded, as companies track the trend to convenience, or diversify out of saturated or heavily regulated areas. Furthermore, the distinctions between grocery, other retailing and food service are becoming blurred as the large supermarkets move aggressively into non-food, such as electronic items and clothing, and into home meal replacements and meals on the go – a trend known as “channel blurring”.

What is especially important to understand is that supermarket companies have long since moved out of the strategy of serving only the middle classes and expatriate populations. Different formats are used to develop the lower income market segments. There are still limits; it is reported from Vietnam that the poor as consumers have little access to supermarkets, relying instead on informal markets and street vendors.⁵ In the majority of countries it is still cheaper to buy fresh food from traditional retail outlets, mainly fresh markets, while preserved food is cheaper in modern retail outlets. But the indirect reach of “supermarketisation” into low-income communities goes much further, through restructuring of wholesale, with global and regional cash-and-carry giants such as Metro and Makro serving food service, convenience retail and street vendors.

Market share is the traditional measure of success in the marketplace. Larger market share allows economies of scale and the extraction of better terms from their suppliers. Increased market share and sales density deliver lower unit costs and higher net margins, potentially leading to a “spiral of supermarket growth”.⁶ Features of this spiral are that (a) absolute costs and barriers to entry for competitors are raised, and (b) growth becomes dominated by one or two organisations – this is why the global retailers such as Tesco and Carrefour aim at market leadership. Smaller and independent retailers organise to stay competitive with the buying power of the retail giants through international buying alliances.

Another key feature of the modern supermarket model is supply chain management with marketing strategies built around trust and the defence of quality, through traceability systems, especially in support of supermarkets’ private labels (“own label”). Thus supermarkets can pick up custom with every food scare and animal health crisis, with customers placing trust in the safety of the supermarkets’ produce, as seen in China with the SARS outbreak.

5. Malica and M4P, 2005.

6. Burt and Spark, 2003.

Own-label has been “one of the competitive forces which shifted strongly in favour of retailers”.⁷ Own-brands return the highest contribution margin or gross profit. The market share of own-brand in the UK, at around 40 per cent, is the highest in Europe. Retailers’ brands now compete head on with manufacturers’ brands through shelf placement and packaging. Own-label is not only a huge revenue generator, but also key in enhancing corporate image and customer loyalty.

Much has been made of “global sourcing” and the ability of large retail players to procure supplies from wherever they are cheapest or legislation is weakest etc. So far, it is estimated that, although the global players have increasingly global relationships with major food manufacturers, local subsidiaries usually purchase over 80 per cent of their merchandise from local suppliers.⁸

Another feature of the modern supermarket model is buyer-driven chains, ie vertical coordination of agrifood chains with associative (rather than arms-length) supply relationships using preferred suppliers. Supply chain management – achieving the right mix of products for maximum profit and minimum wastage – is being outsourced to produce suppliers. While the retailer sets the “rules of the game” for participating in the chains, a key supplier may take responsibility for developing a product category’s profile to give maximum returns, for example by devising new packaging strategies, or taking more responsibility for unsold produce.

Retailers are close to end consumers and many have developed sophisticated information systems that can facilitate supply chain management. Information on consumers from point-of-sale scanners (EPOS data) is a source of competitive advantage to retailers and the chain “insiders” – the category managers – with whom it is shared.

In summary, the modern supermarket model is accelerating towards a highly concentrated structure, in which most power and leverage resides at the retail end of supply chains.

Trends in retail FDI: towards retail internationalisation

Supermarket dominance of agrifood is no longer an industrialised-world phenomenon. After lagging behind manufacturing in internationalisation, FDI in grocery retail rapidly gained momentum in the mid-1990s. Groundbreaking work in Latin America⁹ showed that penetration of transnational retail firms is proceeding at a rapid pace even in rural areas of the developing world, and this is having a marked impact on market structure.¹⁰ Just about all population growth over the next 25 years is predicted to take place in urban centres in low- and middle-income countries, and more than half of the growth in global food retail markets is expected to come from emerging markets.

7. Wrigley and Lowe, 2002.

8. Deloitte Research, 2004.

9. Reardon and Berdegúe, 2002.

10. Vorley *et al.*, 2007.

Table 1: Global top ten grocery sales and internationalisation

Rank	Company	Grocery Retail Banner Sales (US\$ mn) 2006	Global Market share of modern grocery distribution (%)	Number of countries of operation, 2007	Home country
1	Wal-Mart	166,504	3.8	14	US
2	Carrefour	90,285	2.1	27	France
3	Ahold	65,713	1.5	9	Netherlands
4	Tesco	63,452	1.5	13	UK
5	Kroger	49,323	1.1	1	US
6	Schwarz Group	47,223	1.1	23	Germany
7	Seven & I	45,749	1.1	8	Japan
8	Aldi	45,247	1.0	17	Germany
9	Rewe	43,400	1.0	14	Germany
10	Metro Group	41,636	1.0	31	Germany
	Total top 10	660,538	15.2		
	Total top 100	1,660,582	38.3		

Source: Planet Retail

Retailers assess the attractiveness of new markets based on factors such as consumer expenditure, economic and political risk, infrastructure, competition, and market saturation. First-mover retailers such as the Metro Group will assess risks and benefits in a different way than more cautious players such as Wal-Mart. But what is clear from global indices of market attractiveness is that so far, sub-Saharan Africa barely registers. India and China are among the five most attractive countries for expansion of “modern” food systems. The 2007 World Investment Report points to the importance of retail in China as a FDI recipient, with accumulated flows of US\$5 billion, as the global players vie for first-mover advantage.¹¹ Global retailers are structuring their organisations to follow this location of demand.

With the exception of US retailer Kroger, all the leading retailers and cash-and-carry operators led by food retailers have over the last decade invested heavily outside of their home markets (Table 1). Eight of the top ten grocers are European in origin.

Carrefour operates in 38 countries and French overseas departments, Metro in 31 countries, and Tesco – the most rapidly accelerating transnational retailer – in 13 countries. The big retailers also have buying offices in India and China. Global market share of the top grocery players is low – between one and 4 per cent – though the global giants dominate some national markets; for instance, Wal-Mart is dominant market leader in Mexico, supported by its global buying power.

11. UNCTAD, 2007.

Table 2. Top South African non-financial TNCs, ranked by sales, 2004

Company	Sales (\$ billion)	Industry	Degree of internationalisation	
			Foreign to total sales(%)	Foreign to total assets(%)
Sasol	10.7	Industrial chemicals	38	38
Metro Cash & Carry	9.1	Retail	–	–
Bidvest	9.0	Trading activities	35	44
Transnet	8.2	Transportation	–	–
Telkom	7.6	Telecommunications	2	3
Eskom	7.6	Electricity	54	51
Barloworld	6.5	Diversified	54	51
Imperial Holdings	6.2	Automotives	–	–
MTN Group	5.1	Telecommunications	37	57
Shoprite Holdings	4.8	Retail	10	16
Sappi	4.7	Paper	74	68
Tiger Brands	4.5	Agroindustry	–	–
Massmart Holdings	4.2	Retail	5	6
Nampak	3.1	Packaging	74	68
Anglogold Ashanti	2.9	Mining	67	50

Source: UNCTAD, 2006

There are also powerful regional players who are adapting the modern grocery format to local markets. These include Pick 'n Pay and Shoprite in South Africa – who are the main sources of retail FDI in sub-Saharan Africa (Table 2); Maxima (formerly VP Market) in the Baltic, and Cencosud in Chile and Argentina. Local and regional players, such as Shop-Rite in southern Africa, Reliance in India, Hualian and Lianhua in China and Ramayana and Matahari in Indonesia, may also have more experience of working in risky environments with low-income consumer segments. And they will play an increasingly important role and are likely to prevent the transnationals (TNCs) from gaining significantly in global market share of modern grocery distribution.

The attractiveness of Central and Eastern Europe for retail (including grocery) FDI after the opening up of centrally-planned economies and in some cases in the wake of EU accession is shown in Table 3. Turkey, Croatia, Ukraine, Czech Republic, Slovakia and Poland are all in the global top ten growth rates.

12. Gulati and Reardon, 2007.

Table 3. Growth rates of retail and wholesale FDI in selected countries

Country	Inward Flow (US\$ million)	Year	Inward stock (US\$ million)	Year	Annual growth since 2002 (%)
Turkey	68.0	05	5,865.0	05	60.7
Croatia	366.6	05	1,116.5	05	33.9
Ukraine	423.0	04	1,569.4	04	28.5
Czech Republic	630.8	05	7,395.3	04	26.8
Slovakia	127.3	05	1,699.6	05	26.7
Poland	2,563.9	05	16,548.4	05	26.4
Hungary	737.4	05	6,442.7	05	21.1
Estonia	82.2	05	974.4	05	19.6

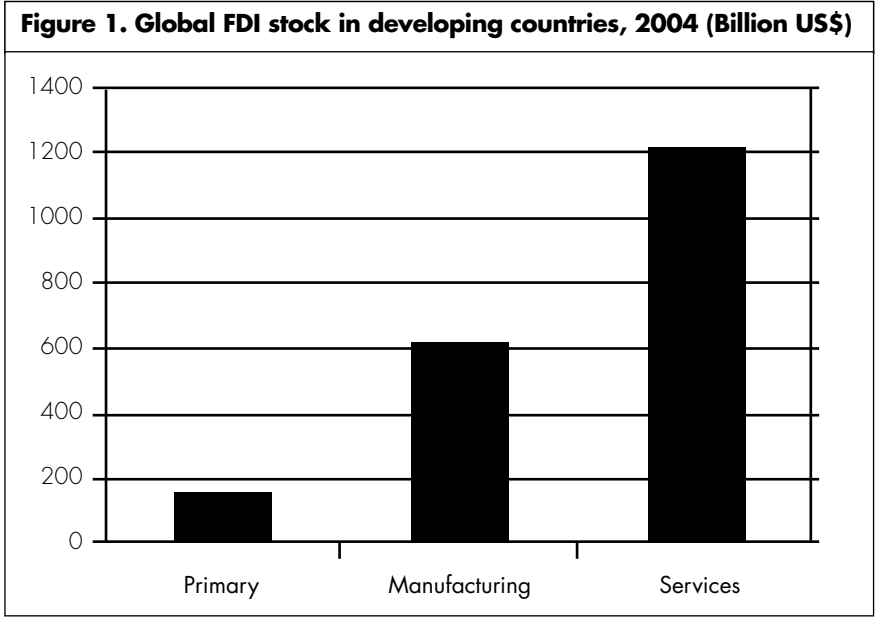
Source: www.investmentmap.org

The development and penetration of supermarkets accords with the pattern expected from the general model of “waves of diffusion”¹² over countries and products that appears to hold generally for both developed and developing countries. Restructuring is fastest in dairy and meats, slower in fruit, and slowest in fresh vegetables, and most advanced in the countries where the retail revolution is itself most advanced.

The inevitability of supermarket dominance of agrifood chains can be exaggerated and the eventual dominance of retail by “modern” supermarket formats is not a foregone conclusion. It is clear that the traditional agrifood actors do not stand still, but learn from and respond to these changes, leading to forms of co-existence. Even in China, the proportion of total retail sales accounted for by the modern grocery distribution sector has made little headway over the past five years, suggesting that traditional retail channels are also booming in the climate of buoyant retail sales.

2.3 Drivers of retail FDI

The drivers of expansion overseas are varied. Home markets in Europe and North America are saturated and highly price-competitive, and the more fragmented markets of Central and Eastern Europe and East and South East Asia offer chances for continued growth and sustained profitability. Shareholder pressure for higher dividends can lead to pressure for increased turnover. Financial crises in Latin America and South East Asia in the 1990s made for cheap acquisitions of national chains. EU accession and WTO accession reduced the barriers to market entry (see Box 1). The quest for first-mover advantages in the largest emerging markets is also a powerful incentive for early entry to emerging markets. Companies also seek greater efficiency from economies of scale, including using distribution systems for global



Source: UNCTAD, 2006

procurement. There is also a pull from emerging economies. For example, Russian authorities are said to be promoting retail FDI in order to formalise the retail economy and increase the VAT income for the government.

Unlike investment in the primary natural resource sectors, FDI in retail is market-seeking, allowing fixed costs to be spread over more markets and increasing returns to scale. Larger economies such as Brazil and Mexico or countries with consolidated economic growth such as Chile have been the major recipients of market-seeking FDI in both goods and services. Services FDI now comprises 60 per cent of global stock, up from 25 per cent in 1970 (see Figure 1), and services industries account for a high and increasing share of FDI in developing countries.

IPAs ranked the retail and wholesale sectors in the period 2004–7 as a top-ranking industry in terms of prospects for FDI, along with other service sectors – hotels and restaurants, tourism, computers/information and communication technologies (ICT).¹³ This ranking was especially high in Africa, Asia and Latin America–Caribbean.

But in recent years the increase in FDI inflows directed to the services sector has been surpassed by the growth in FDI in the primary sector, linked to high commodity prices, driven in part by Chinese demand. Within the service sector, there has been a shift from finance and trade (distribution) to telecom, energy, and business services.¹⁴

13. UNCTAD, 2004a.

14. UNCTAD, 2006.

Box 1. The trade policy context

Trade in retail services is covered in WTO negotiations within the General Agreement of Trade in Services (GATS), which was negotiated during the Uruguay Round. It entered into force at the beginning of 1995, and was intended to achieve further liberalisation in the services sector. Under the GATS, member countries negotiate schedules in which they commit to limit tariff levels and agree to apply certain principles of free trade to specific sectors. These include the right of foreign enterprises to engage in commercial activities in a country's market (the right of establishment); equal treatment of foreign and national enterprises under domestic law (national treatment); and non-discrimination in the treatment of enterprises from all WTO member nations (most-favoured nation or MFN treatment).

The GATS agreement covers four modes of supply for the delivery of services in cross-border trade. International trade in distribution services is mainly conducted through FDI in foreign affiliates (i.e. GATS Mode 3).

High-income countries, where retail liberalisation is well advanced and strong domestic retailers have an interest to expand abroad, are eager to see further progress. The industry groups EuroCommerce and European Services Forum lobby strongly at the EU level for market opening in developing countries under GATS. The EU has requested full market access and national treatment for its wholesale and retail companies in 36 developing countries, and requested another 16 countries to consider making commitments.¹⁵ Because GATS negotiations set out to liberalise market access and seek the granting of national treatment for foreign affiliates, the role of domestic regulation becomes paramount. The "national treatment" rule (GATS Article XVII) prohibits treating foreign firms differently than domestic firms, and also prohibits the modification of the "conditions of competition" in favour of local service suppliers. Regulations that would oblige retail companies to positively discriminate in favour of SMEs for example (as currently proposed as part of pricing law reforms in France) could be challenged through the WTO dispute settlement process as a trade-distorting domestic regulation. However, governments have a great deal of room for manoeuvre to regulate in support of national policy.

Retail TNCs have successfully dealt with quite restrictive controls on inward investment, such as in Malaysia, where markets have been attractive and stable enough for their investments to be safeguarded.¹⁶

In the GATS negotiations to date, low and middle-income countries have been very reluctant to make commitments. By 2005, only 33 WTO members had made binding commitments to liberalise the distribution sector under the GATS – one of the lowest figures of all sectors.¹⁷ China removed restrictions on wholesale and retail FDI over the period 2001-2004, in accordance with its schedule of commitments under its WTO accession agreement. Similarly, Vietnam removed restrictions in 2005 for wholesale and retail as part of its Commercial Law.

At the EU level, attention has moved from the WTO to the EPA process, where the EU has established a more aggressive strategy for service sector liberalisation, linked to EU development assistance.¹⁸

15. IATP and Polaris, 2005.

16. ITSP, 2005.

17. World Bank, 2005.

18. Oxfam International, 2006.

2.4 The role of IPAs in attracting retail FDI

Retail has so far not been a sector strongly targeted by IPAs. The role that IPAs have taken to date appears to focus on help with red tape, and assistance with licences and permits. Two examples of this role from the Balkans follow.

The Bulgarian Executive Investment Agency¹⁹

The easing of market access restrictions to Eastern European countries, often in the lead up to admission into the EU, has greatly facilitated retail FDI into markets which have been highly fragmented and informal. A gold rush of retailers into Central and Eastern European countries took place between 1997 and 2004 in Poland, the Czech Republic and others of the ten countries that acceded into 2004, and from 2005 in Romania and Bulgaria. Foreign companies dominate the top field throughout the region except in Russia.

German retailer Rewe has staked its future on expansion in Russia, Bulgaria and Romania. In August 2004, the Bulgarian Executive Investment Agency introduced the Investment Promotion Act, ahead of Bulgaria's EU accession in 2007. This simplified the process of obtaining licences and permits and aimed to increase the number of foreign investors. Ranked fourth in Europe, the retailer Rewe responded fast, announcing in 2005 plans to invest around €220 million into Bulgaria over the subsequent three years. Rewe received a promise from the Bulgarian government that it would support the retailer in the acquisition of land plots as well as on issues regarding infrastructure. The group planned to expand in smaller towns nationwide, targeting towns with a population of up to 30,000 inhabitants, with its two banners Penny Discount and Billa supermarkets. By 2007, Rewe had 28 Billa and five Penny stores in the country. Despite the pro-FDI legislative environment, corruption and bureaucracy has been a factor in delaying the market entry of a number of retail TNCs into these markets.

The Lunov IPA in Macedonia and Serbia

The Balkan markets are also fragmented and slowly orientating themselves towards EU VAT systems. Macedonia has concluded a free trade agreement with the EU. The Lunov regional IPA is enthusiastic in describing the attractiveness of the region for retail FDI, though FDI is currently mainly regional and cautious. The Lunov website contains very positive testimonials from the Greek supermarket Veropoulos, which has invested in Macedonia and Serbia. But Planet Retail reports that Veropoulos' operations continue to be quite small, and in fact, company officials are complaining of bureaucracy and lack of government support in Macedonia, so expansion continues quite slowly. Regional FDI is building up steam, however: Slovenian

19. Sources: Food and Drink Europe; Planet Retail.

retailers TUS Trgovine and Mercator are preparing their market entry into Macedonia. Corruption clearly is a major problem for foreign investors and is capable of considerably delaying investment plans.

These cases show the typical role of IPAs as facilitators of supermarket investment as for any other service sector. The connection to the more fundamental policy challenges of urban and rural development is not acknowledged. As will be discussed in Section 3, the future structure of retailing is inextricably linked to much wider development agenda – touching primary producers, SMEs and small traders, and traditional retailers. But there is no evidence that IPAs are even beginning to take a more holistic view of retailers as development actors.

China: local government IPAs

In China, the role of local government IPAs is of critical importance in understanding the uneven success of FDI in the country post devolution of economic decision-making. IPAs are situated at the nexus of local government-investor interaction within what has been described as “local state corporatism”.²⁰ Hampton (2006) notes how China’s IPAs operate not only to provide information to facilitate the transaction, but also to align the interests of local government and the investor. Local governments became entrepreneurs and major stakeholders in local retail enterprises, and there were contradictory incentives of attracting retail FDI but also of protecting their own investments. Since late 2004, restrictions on foreign participation in China have been lifted in accordance with WTO rules, but even by the mid-1990s, Williams (2006) reports that local governments were flouting national FDI regulations and were encouraging international grocery firms to establish grocery hypermarkets. There is some saturation and consolidation in the prime markets, but local government IPAs are continuing to attract FDI in the supermarket sector. A quick trawl of the internet shows local IPAs especially active in second-tier cities such Ningbo, Changzhou and Wuhan,²¹ and third tier cities such as Huzhou.²²

3. Implications of retail FDI for development

Services are seen as a factor allowing an economy to operate more efficiently, producing greater output with the same people and resources. Thus the economic rationale for liberalising trade in distribution services of enhancing consumer welfare through reducing the distribution margin in product prices and widening consumer choice,²³ helps to transform and improve productivity.

The EU’s position on liberalising retail services is based on a belief that “Cross-border liberalisation of distribution services brings greater competition, substantial

20. Oi, in Hampton, 2006.

21. www.nbinv.gov.cn, www.nbfet.gov.cn www.jiangan.gov.cn, www.henaninvest.gov.cn

22. www.hzbiz.gov.cn

23. Mukherjee, 2002.

investments, and market consolidation – all developments that enhance economic efficiency.”²⁴

But where high proportions of the population are engaged in agriculture or petty trading, it is of utmost importance to look beyond net economic benefits and consumer welfare to the impacts on these two sectors – agriculture and traditional retail.

3.1 Retail modernisation and restructuring of agriculture

Modern retail is a major force in the “private re-regulation” of agriculture and the transition to buyer-driven chains,²⁵ along with trade liberalisation, deregulation, and privatisation, in which imports set price and quality. It means that primary producers and processors face domestic markets that start to take on the characteristics of export markets, in terms of standards, management, technology and capital requirements. Domestic markets under these circumstances are no longer a refuge for producers. While many questions remain about scale and the impacts on primary producers, there are now some concerted research and policy initiatives to track, understand and bring trends to the attention of policy makers, the private sector and producers. The largest research and policy programme to date – Regoverning Markets (www.regoverningmarkets.org) – has conducted empirical research in eight countries and has documented around 40 case studies of connections between smaller-scale producers and modern markets.

There are positive elements to the supermarket revolution. Supermarkets generally offer stable prices and a guarantee to buy large quantities provided that they meet their quality standards. Thus, they can contribute to securing and stabilising farmers’ incomes. In addition, farmers sometimes receive targeted technical support from buyers, as part of a preferred supplier scheme, or from government or NGOs, to meet supermarket requirements. Selling to supermarkets may also give farmers access to credit since it provides them with a contract and guaranteed payment, which serves to reduce the risk of default on loan payments. Traditional markets may be controlled by powerful cartels, which also work against the interests of primary producers.

But in line with much of globalisation, consumers and shareholders rather than primary producers are the main beneficiaries. “Insiders” in these chains may be able to prosper through investing in “relationship” marketing, product quality, and brand reputation. But from a macro perspective, there is little residual value to be shared with other actors in the chain. The fierce price wars that broke out between UK supermarkets in 2005 saved consumers £3 billion²⁶ but put a major squeeze on suppliers’ profitability, which was already under strain from rising fuel and commodity costs through oil price hikes. The dairy sector was particularly hard hit during this period, when farm-retail price spreads also widened considerably.

24. http://trade.ec.europa.eu/doclib/docs/2005/july/tradoc_124235.pdf

25. Vorley *et al*, 2007.

26. Food&DrinkEurope.com 30/11/2005.

3.2 Retail modernisation and traditional retail

The retail trade is a major informal-sector employer.²⁷ Small-scale retail, including small supermarkets, can be highly resilient in the face of hypermarket competition. In some countries that are considered quite mature in terms of modern supermarket growth, such as Mexico, traditional stores may retain a remarkably strong presence. They offer convenience, proximity, and sometimes the availability of short-term credit. Informal (grey) markets may be an important part of the food economy and also offer a refuge for small farmers who are insufficiently capitalised to deal with the demands of modern retail procurement. For fresh produce, wet markets are still favoured by emerging consumers because of the high quality, the variety and the low prices of their fresh fruits and vegetables and meats, and the ability to buy the quantity desired. In these markets the quality of fresh produce in large supermarkets is not considered to be high.

Local players don't stand still. Innovation at the supermarket level can drive innovation in the independent retail level to improve their efficiency, including management, customer satisfaction, and prices. An example is the formation of purchasing groups to aggregate buyer power (with consequent impact on suppliers and primary producers). Locally-owned stores have upgraded their premises with air conditioning, and better lighting and display.

With the growth of supermarkets comes the establishment of centralised buying and distribution centres. As a result there have been significant shifts away from traditional brokers towards new, specialised or dedicated wholesalers. These are generally more in tune with the quality, safety and consistency required by supermarkets than are traditional wholesalers. In the traditional system, a wholesaler aggregates products from many producers and there is little segregation according to quality.

But the impacts of supermarketisation can be dramatic, and force considerable intra-industry adjustment. For example in Thailand, research by JP Morgan Chase, cited by the ILO, indicated that 200,000 of the country's 500,000 locally-owned retail stores were pushed out of business by foreign-led competition.²⁸ In Vietnam, it has been confirmed that supermarkets create less employment per unit of area and volume than markets and street vendors.²⁹

It is the restructuring of cash-and-carry and wholesale that is often at the vanguard of changes in agrifood, such as the establishment of Makro, soon to be followed by Metro, in Pakistan. Wholesalers and cash-and-carry operators supply market traders and hawkers, restaurants and food service, and smaller-scale retailers. Thus the middle of agrifood chains is restructured without much change in retail or consumer behaviour.

27. Marcouiller *et al.*

28. ILO, 2003.

29. M4P, 2006.

The case for attracting FDI in wholesale distribution has been made in Thailand (Tokrisna 2005) and India because it is supposed that economies of scale in wholesale are large and repercussions on small shopkeepers are small. In fact, cash-and-carry in Thailand presents itself as the ally of small retailers in taking on the giant companies such as 7-Eleven, Big C, and Central Retail Corp. About 350,000 of Siam Makro's 1.8 million members are small, traditional retailers.³⁰ And in the Indian state of Bangalore, 73 per cent of Metro's clientele are small retailers.³¹

While growth in wholesale FDI may have minor or even positive impacts on small-scale retailing, it can have dramatic impacts for suppliers and primary producers.

4. Policy responses

In many countries, supermarkets are viewed by governments as positive economic actors, delivering on the economic ambitions of governments (low inflation and high employment) and consumers (more choice, higher quality and lower cost). As a result, IPAs see FDI in the sector as supportive of wider development goals, and the political scrutiny of the sector is relatively light. The drive to a more competitive regulatory environment in many countries has handed regulatory responsibility for important areas of the food system, most notably food safety and quality standards, to supermarkets themselves.

Moreover, where there are strong vested local government interests in retail, as in China, supermarkets can work in a very favourable policy environment with access to cheaper credit, preferential sites, and preferential rents. Thus, they can ensure that there is a policy “push” (as well as a consumer “pull”) towards their establishment and growth. In Vietnam, where the growth of supermarkets has been particularly rapid, with three leaders – Coopmart, Metro and Big C out in front, policies have favoured retail concentration, through eviction of informal markets and street vending, and support to supermarket investment.³²

Nevertheless, in a number of countries services FDI has been regarded as entailing more risks and social costs than manufacturing FDI. Many countries maintain relatively stringent market access restrictions for foreign retailers.³³ These countries regard the disruption caused by new retail practices as socially undesirable, especially if this displaces small service providers.³⁴ The independent retail federations have quite a powerful voice in domestic policy. This gives rise to a wide range of policies to limit or manage FDI and growth of supermarkets, beyond the more common requirements such as minimum level of capitalisation.

30. *The Nation*, 2007.

31. Mukherjee and Patel, 2005.

32. M4P, 2005.

33. World Bank, 2005.

34. UNCTAD, 2004.

In Thailand, where foreign supermarkets have been a very dominant force in retail since the economic crisis of 1996-7, this reaction has taken the form of a rearguard action tinged with nationalism. Tough new laws have been introduced ostensibly to protect small and medium-sized, often family-owned, local stores from competition from foreign retailers. The draft Retail Business Law going through parliament aims to control the rapid growth of foreign operators, authorising local communities to regulate retail businesses and introducing proposals for fair competition. This puts the large global retailers, especially Tesco and Carrefour and in a policy dilemma, and they have massive investments in the country.

In India, where organised retailing accounts for only 4 per cent of the US\$ 270 billion retail market, but is expected to grow at around 40 per cent in 2007 and 2008, the liberalisation of retail FDI is a political hot potato. The domestic political climate is adverse to retail FDI. The sector is still dominated by traditional retailers with single outlet businesses mainly using family labour. Only eight companies have a turnover higher than US\$100 million – about the average sales generated by a single Carrefour hypermarket in France. The big retailers including Tesco and Wal-Mart have been lobbying the Indian government to open its domestic market to overseas supermarket groups.³⁵ Policy priorities are “not to disturb small and tiny retailers who dominate the industry.”³⁶

A three-year survey by the Academy of Business Studies (ABS) commissioned by the Department of Commerce on the impact of FDI concluded that opening the retail business to foreign players on a regional basis would help India's exports, and suggested that the best strategy for foreign investors in Indian retail would be to develop the supply chain by training primary producers.³⁷ Similarly, an interim Indian Council for Research on International Economic Relations (ICRIER) report concluded that organised retail was not harming the country's farmers and was unlikely to adversely impact small neighbourhood stores.³⁸

These positive outlooks contradict some political lobbyists who predict that opening the retail sector to global retailers and large domestic houses like Reliance and Bharti would severely impact the livelihoods of small retailers and farmers.

In Poland nationalist sentiment against the dominance of foreign-owned retail continues to be part of the policy landscape, long after the demise of the finance minister Teresa Lubinska who in 2005 said that retailers opening up hypermarkets in the country are not welcome, because they were “non-productive investments” that were not needed in Poland. A new law restricting the growth of large stores in the country was introduced in July 2007, apparently in breach of EU law. The measure

35. *The Independent*, 2005.

36. Commerce Minister Kamal Nath, September 05.

37. http://content1.msn.co.in/News/Business/BusinessBS_060807_1207.htm

38. http://content.msn.co.in/News/Business/BusinessBS_030807_1110.htm

requires retailers to undergo a several-stage approvals process to open any store with an area larger than 400 square metres.³⁹

In summary, retail has so far not been a sector strongly targeted by IPAs. And when it has been, the evidence suggests that their role has been narrowly focused, on issuing permits and as information resources. The economic and social impact analysis of the retail investment projects has also been narrow, with no link to impacts on the agricultural sector and little reference to impacts on the traditional distribution sector. It is this context that led ITSP (2005) to recommend that governments of developing countries should promote retail FDI “in accordance with their social and economic priorities, and the quality of their governance and regulatory capacity” and mitigate adverse effects through training in the affected sectors.

5. Ways forward for governments and IPAs

There are genuine potential benefits for IPAs to attract retail FDI. These include the upgrading of supplier competencies (also towards export competencies), and spillover into traditional markets, in terms of quality, food safety, and closer links between producers and consumers.

However, one of the biggest challenges that results from the transition from traditional markets to supermarkets is that one source of market power is replaced by another, altogether more extensive and sophisticated. The risks and opportunities of attracting supermarket retail FDI from a development perspective are both compelling and uncertain, and it is legitimate for countries to seek to retain some policy space to manage these investments. Retail investments are not necessarily a win-win-win for producers, consumers, and broader economic growth. Investment in services is not like other natural resource-based primary sector industries. There is a potential large trade-off between attracting FDI in retail services and the livelihoods of primary producers and the informal retail sector, which raises the stakes of such a move where a high percentage of the population is dependent on agriculture and the informal sector.

It is almost impossible to reverse market exclusion once it has happened. Policy – linking investment promotion and departments of commerce and rural development – must be anticipatory, in order to secure inclusive market development. To achieve the intended benefits of many aspects of FDI in retail and avoid adverse social and environmental impacts, appropriate understanding of the impacts of the sector is required before policy and regulatory frameworks are put in place.

Public-policy leverage over private-sector governance of food chains is weak and poorly defined. Supermarkets and food companies, in turn, appear all too frequently to lack either an understanding of the impact they are having on local markets or a clear strategy for the wider inclusion of small-scale producers therein. As a result, they are often accused of not caring about “development” and growing their margins at

39. Planet Retail, 19 July 2007.

the expense of local food producers. In some instances this is doubtless the case, but in the majority of cases, supermarkets have a vested interest in working with local producers, large and small. IPAs can help by making this kind of information available for potential future investments, so that retail investors can connect to local suppliers and be partners in their upgrading and expansion. IPAs could also try to identify and target those investors with best corporate responsibility practices, especially those retailers who understand their role as development actors and are committed to pro-poor procurement.

Before implementing aggressive policies for attracting FDI in the sector, governments and IPAs need to have a deeper understanding of the strong links between agriculture and the distribution services sectors, and retain policy space to avoid trading one sector off against the other,⁴⁰ and to maximise the benefits and minimise risks of attracting retail FDI. One way of achieving this is through “post care investment services”. IPAs could offer services to help with ex-post investment impact assessment and advise foreign investors how to align their policies with national development goals.

More widely, a supporting policy framework would include:

- National policies that are better able to define the right incentives and strengthen the capacity of small-scale producers
- Improved incentives that allow the private sector to be more responsive to small-scale producers
- Policies and actions of development agencies that are more coherent with and responsive to trends

It is a joint responsibility of IPAs, public policy makers, and the retailers themselves to ensure that the economic goals of government and consumers are not pursued in isolation from the broader goals of sustainable growth and agrarian development. Retaining policy space, and preserving diversity in supply chains, are as important as attracting retail investment.

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Chapter 5

Exploring new sectors for attracting FDI: The case of biofuels¹

Annie Dufey

1. Introduction

The last five years has seen the emergence and growth of the biofuels sector. The global impetus for the development of biofuels has come about because governments see biofuels as a way of addressing different policy goals, such as greater energy security, agricultural development and climate change mitigation.

Likewise, foreign direct investment (FDI) in biofuels is also a fairly new phenomenon. The development of the biofuels sector involves channelling investment into feedstock production, biofuels processing and distribution. This explains why many countries, especially developing countries with appropriate natural conditions for sector development, are implementing active policies to

1. The author wishes to thank Moustapha Kamal Gueye of ICTSD for his comments and contributions to this document.

attract FDI in their search for financial resources and knowledge for sector development.

FDI can certainly offer host countries opportunities in terms of the financial resources, technology transfer and knowledge to achieve the different policy goals associated with biofuels. However, FDI can also create risks. These include: greater environmental pressure or small-farmer exclusion due to the generally larger size of the operations; the potential value added of biofuels not materialising when FDI is only focused on the production of raw materials; problems that arise when host governments attract investment before having adequate regulatory frameworks in place; and when governments offer generous economic incentives to attract foreign investors when the benefits of such investment are by no means assured.

Investment promotion agencies (IPAs) are the government bodies that are usually at the forefront in attracting the required investment to implement national biofuels programmes. IPAs, as well as other relevant government bodies, need to be aware of the desired policy goals behind biofuels development as well as the benefits and risks of FDI in the biofuels sector before designing their strategies for investment promotion. Only such an approach will allow them to design the right strategy to target foreign investment in a way that maximises its sustainable development contribution to the host country.

In this context, this paper aims to identify a suitable role for IPAs from developing countries to attract FDI in the biofuels sector so as to increase the overall sustainable development benefits. To achieve this, the paper is organised as follows:

- section 2 provides a brief overview of the recent emergence of the global biofuels sector;
- section 3 explores FDI trends in biofuels in developing countries;
- section 4 discusses the key sustainable development impacts of FDI in biofuels;
- section 5 reviews the IPAs' experience in attracting FDI in the biofuels sector; and
- section 6 provides recommendations for IPAs to increase the overall benefits of FDI in the biofuels sector.

2. Biofuels: an emerging sector

Liquid biofuels are fuels that are produced from biomass for the purposes of transport, heating, electricity generation and cooking. They can be produced from agricultural and forest products and the biodegradable part of industrial and municipal waste. The main usage of liquid biofuels is in the transport sector, but they can also be used for such purposes as domestic lighting, cooking and heating, especially in poor rural communities in remote or land-locked developing countries where the costs of fossil fuel transportation is prohibitive.

Although the first large-scale schemes for biofuel production began in the early 1970s (e.g. Brazil), it is only over the last five years or so that biofuels have been considered as a serious alternative to fossil fuels, especially in the transport sector.

Box 1: Market trends in biofuel development

Global biofuel production in 2006 was estimated at over 55 billion litres. However, this figure is very small considering that some 1,200 billion litres of gasoline are produced annually worldwide.

Bioethanol: 93 per cent of the global biofuel production in 2006 was bioethanol while the remaining 7 per cent was biodiesel. Bioethanol is by far the most widely used biofuel for transportation worldwide. Global production reached 51 million litres in 2006, with an average annual growth of 20 per cent since the year 2000. Bioethanol accounted for about 3 per cent of global gasoline use in 2005. Brazil and the US together account for more than 70 per cent of global production, but other countries also have significant and growing industries (See Figure 1). About 40 per cent of global bioethanol production comes from sugarcane (notably from Brazil and India) and 40 per cent from maize (from the US and China). The remaining 20 per cent comes from other crops. In temperate countries such as the EU the latter includes beet, barley, wheat and wine residues. Tropical and semi-tropical countries in Africa, Latin America and East Asia are also experimenting with other high sugar content crops such as cassava and sweet sorghum.

Biodiesel: Large-scale production of biodiesel only began in the 1990s. Since then production has increased steadily, reaching a record 3.7 billion litres in 2005, with an average annual growth of 33 per cent since 2000. Biodiesel production, however, is still fairly small compared to bioethanol and accounts for less than 0.2 per cent of the diesel consumed for transport. Of the biodiesel produced in 2005, 90 per cent was produced in the EU, with Germany alone accounting for 53 per cent of global production. Other biodiesel producers include the US, Brazil and several other countries in Latin America, Africa and East Asia with biodiesel programmes in early commercial or research phases.

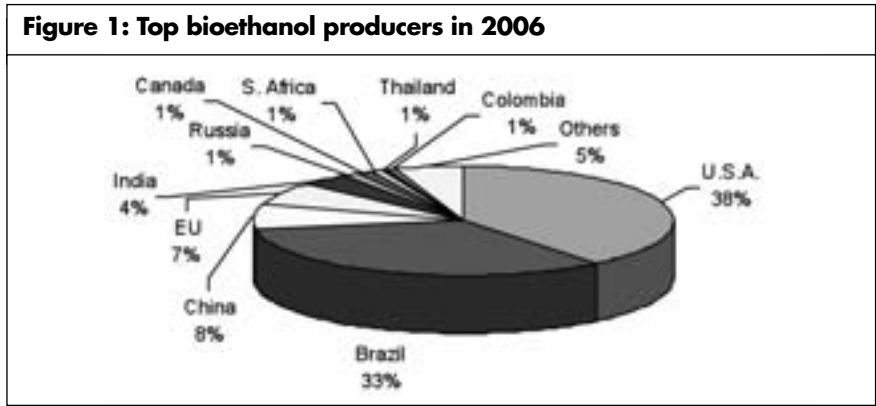
Between 80 and 85 per cent of EU production comes from rapeseed oil, which is equivalent to 20 per cent of the total EU rapeseed production. However, it has begun to be replaced by soy, sunflower and palm oil, although in small quantities. Elsewhere, soy is gaining preference in the US, Argentina and Brazil. Palm oil has the highest energy content of current biodiesel feedstocks and is the preferred choice for biodiesel in some Asian and Latin American countries. There are a few early experiences with coconut oil in Southeast Asia (the Philippines and other Pacific islands). Several dry tropical countries are experimenting with *Jatropha* (some of them with plantations at a commercial level) and *Pongamia* (India).

Source: adapted from Dufey, Vermeulen and Vorley, 2007.

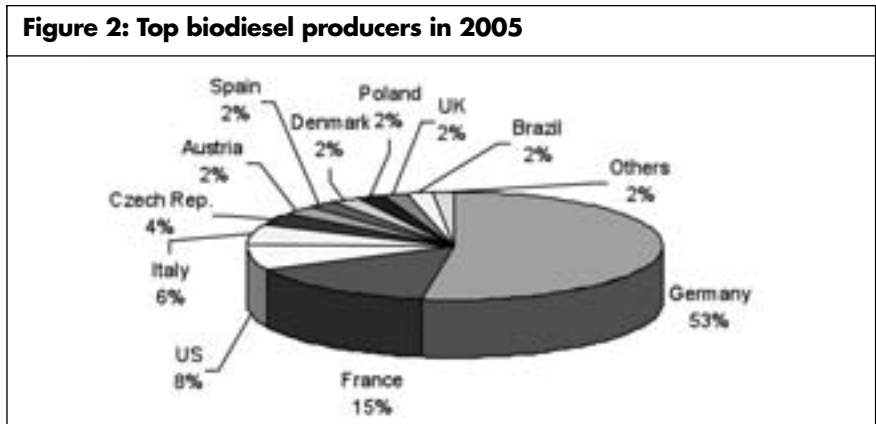
The current high oil prices mean that energy security and a reduced oil imports bill are at the heart of the policy agendas behind biofuels development. Many of the new biofuels programmes are also being conceived as an element of farm-support policies or a way to provide new-end markets for agricultural products, providing new opportunities for rural employment and income. A less traditional driving force behind this renewed global interest in biofuels is their alleged potential to reduce greenhouse gas (GHG) emissions compared with fossil fuels. This could enable

nations to comply with commitments under the Kyoto Protocol and help to mitigate the effects of climate change.

Biofuels are considered a serious alternative to oil in the transport system, compared to other options such as hydrogen, because biofuel technologies are already well developed and available in many countries. Bioethanol and biodiesel, the most common liquid biofuels, can be mixed with the petroleum products (gasoline and diesel respectively) they are substituting and be burned in traditional combustion engines. Blends can contain up to 10 per cent biofuels without the need for engine modifications. Flexi-fuel vehicles (FFVs) can run with any type of fuel blend from pure gasoline to blends containing up to 85 per cent biofuels and can be introduced in any country. Moreover, the current high oil prices makes production from the most efficient producing countries competitive.



Source: Dufey, Vermeulen and Vorley (2007)



Source: Dufey, Vermeulen and Vorley (2007)

The above factors indicate that biofuels could become a viable complement and, perhaps in the long term, alternative to fossil fuels in the transport system. This would explain the rapid development the market has experienced in recent years, reflected by many countries in the industrialised and the developing world implementing ambitious targets to increase the proportion of biofuels within their energy portfolios.

3. Trends in FDI in the biofuels sector

3.1. FDI trends

Global investment in sustainable energy has more than doubled in the last two years reaching US\$70.9 billion in 2006. Investment forecasts predict up to US\$85 billion for 2007.² The wind sector attracted 38 per cent of the total investment in 2006, followed by biofuels (26 per cent) and solar energy (16 per cent).

Global investment in biofuels surged during 2006. Development of the biofuels sector is a new global phenomenon with many industrialised and developing countries leveraging investment to implement their national biofuels programmes. However, developing countries' governments often lack resources and their financial markets are often not sufficiently well developed to provide all the required financial resources for sector development. In this context, governments are increasingly offering foreign investors a major role in the sector's development. Although available information on FDI flows and activity in the biofuels sector in developing countries is minimal and rather anecdotal, the following analysis suggests that biofuels already constitute a new focus for attracting foreign investment.

Brazil, the second largest biofuels producer after the US, is the developing country receiving most attention from foreign investors. There were more than 15 international mergers and acquisitions in sugar and bioethanol between 1996 and 2006 and six international investments in bioethanol facilities between early 2005 and June 2006.³ According to the Sao Paulo Sugarcane Agroindustry Union (UNICA), FDI in Brazil's sugar and bioethanol is around 6 per cent of total investment in the sector, and this is expected to increase to 10 per cent by 2013.⁴ These figures are not small considering the size of the biofuels production chain. The vast majority of FDI comes from the US. Malaysia, the largest palm oil producer, is also pursuing an aggressive policy for biofuels development and is attracting increasing amounts of investment from both local and foreign investors. According to the Malaysian Industrial Development Authority (MIDA) 75 projects had been approved with a total investment of RM 7.01 billion (US\$2 billion) by the end of 2006, 69 per cent of which were domestic investments and 31 per cent foreign investments. The major

2. UNEP-SEFI-New Energy Finance 2007.

3. Brewer, 2006.

4. El Economista, 2007.

Box 2: Selected examples of FDI in biofuel in developing countries**Latin America**

Brazil: Archer Daniels Midland (ADM), the largest US bioethanol producer, is planning one of the largest biodiesel plants in Brazil. Cargill, the largest shipper of raw sugar from Brazil,⁵ is also expanding its operations to the bioethanol sector. Investment from other countries is significant too. For instance, the Brazilian Petrobras and Japan's Mitsui & Co Ltd are setting up a Brazilian-based subsidiary to finance distilleries aimed exclusively at the Japanese market. The total investment would amount to US\$8 billion. Likewise, Japan's Mitsubishi Corp established a 30-year supply contract and a 10 per cent equity stake in Usina Boa Vista in Brazil. Japan's investment in Brazil also includes financing biofuels transport infrastructure.

Colombia: The bulk of investment projects involve Colombian groups, but foreign companies including Svensk Etanol of Sweden⁶ and the Chilean Campos Chilenos (US\$250 million investment) are also present.

Argentina: Foreign investors such as the Spanish firm Repsol in the biodiesel sector and Japan's Mitsui in bioethanol have plans to invest in the country.⁷

Jamaica: The US company Cargill has invested in a processing facility.

Peru: The US energy company Maple Corporation is setting up a sugarcane plantation and a bioethanol plant costing US \$120 million to produce 120 million litres by 2009.

East Asia - Australasia

Indonesia: There are important FDI inflows for biodiesel development from Malaysia. Also, the UK oil company BP, which entered into a joint venture with the UK D1 Oils Plc, plans to invest in the development of a large plant in Indonesia (in addition to India and Africa). Likewise, ADM, together with Wilmar International Ltd, plans to invest US\$1 billion in biofuels projects through a joint venture with palm oil producer Mapoli Raya. Sweden BioEnergy plans to invest 1.3 trillion rupiah (US\$143.5 million) to establish a *Jatropha curcas* plantation on 100,000 hectares of land in the province of East Nusa Tenggara to produce biodiesel. For bioethanol, the South Korean Ingen Company plans to build a plant in the Lampung province that will be supplied with cassava from a 200,000-hectare plantation. The chemical manufacturer Cho Yang Fine Chemical is investing in a bioethanol refinery and large-scale cassava plantations. China National Offshore Oil Corp has a US\$5.5 billion joint venture project for palm oil biodiesel and sugarcane or cassava bioethanol. Likewise, Genting Biofuel, in cooperation with Sinopec, invested US\$3 billion while Indomal invested US\$1 billion in biofuels development.

Philippines: The state-owned Philippine National Oil Co. has a number of joint venture projects with foreign companies, including:

Samsung of Japan, who plan to set up a 200,000-tonnes per year *Jatropha* biodiesel plant;

Biogreen Energy of Malaysia, with whom they signed a US\$1 billion biofuel deal for a *Jatropha*-based biodiesel refinery;

5. Grain, 2007.

6. IADB, 2007.

7. IADB, 2007.

NRG Chemical Engineering Pte (UK) who signed a US\$1.3 billion deal for the construction of a biodiesel refinery and two bioethanol distilleries and a US\$600 million investment in Jatropha plantations, which will cover over 1 million hectares, mainly in Palawan and Mindanao; and

Sumitomo of Japan.

Moreover, in January 2007, the Philippines government signed biofuels deals with Chinese corporations, including a US\$3.83 billion deal with the Fuhua Group to set aside over 1 million hectares of land for the production of bioethanol feedstocks for export to China. Petron, the Saudi Aramco's subsidiary in the Philippines, the country's largest oil refiner, has an exclusive bioethanol supply agreement with San Carlos Bioenergy. San Carlos Bioenergy is a joint venture between UK based Bronzeoak and Zabaleta & Co but controlled by the president of the Philippines Sugar Millers' Association. The Japanese Mitsui is also building a coconut biodiesel refinery in the country.

Africa

South Africa: The UK company, D1 Oils, the leader in international investment in Jatropha based biodiesel has set up operations in different Southern African countries with its main operation centre based in South Africa. Other countries include Swaziland, Zambia and Madagascar. The Japanese company Mitsui is also building a large Jatropha biodiesel refinery.

Mozambique: The national oil company Petromoc is planning a US\$408 million biodiesel project with Brazilian companies involving 45,000 hectares of Jatropha to produce 226 million litres of biodiesel a year. The Canadian Energem Resources took a 70 per cent stake in a Jatropha plantation company, investing US\$5.5 million a year. The UK based ESV bought the Mozambican Inveragro, which is planting 5,000 hectares with Jatropha in Inhambane. Sweden also announced cooperation with Mozambique to develop a sugarcane-based bioethanol industry supplying both the domestic market and exports to Europe.

Liberia: One US firm started a major palm oil-based biodiesel venture in post-war Liberia while another one invested in Nigeria's first sugarcane-based ethanol plant.

Ghana: Thai entrepreneurs have been invited to invest in Ghana's nascent bioenergy industry.

Republic of Congo: The Spanish Aurantia is investing in a cluster of palm plantations in the country to produce biodiesel. Anegon is conducting feasibility studies to analyse different plantation and mill sites, and to assess the state of the existing logistical infrastructure in the country.

Cote D'Ivoire: The US-based company 21st Century Energy is planning to invest about US\$1.4 billion to produce bioethanol over a five-year period. The project is expected to produce 3.5 billion litres of bioethanol annually from maize and sugarcane.

Nigeria: Chinese firms are investing in cassava plantations to produce bioethanol. Nigeria is the world leading cassava producer.

sources of foreign investments are Australia, Singapore, the US, India, Italy and Japan.⁸

Although the biggest producing countries are likely to attract the bulk of FDI in the sector, FDI in biofuels is also taking place into other developing countries, as illustrated in Box 2.

Increasing investor interest in the biofuels sector is demonstrated by the fact that international consultancies such as Ernst & Young have already developed specific “Biofuels Country Attractiveness Indices”. The indices rank the top fifteen countries to invest in biofuels according to their attractiveness. The countries’ attractiveness is assessed on the basis of such issues as market regulatory risks, supporting infrastructure, access to finance, off-take incentives, tax climate, special loans, current installed base, domestic market growth potential, export potential and feedstocks.⁹ Table 1 shows the results of the index for the second quarter of 2007. Five developing countries are included amongst the top 15: Brazil, Thailand, China, Indonesia and India.

3.2. Motivation for FDI in biofuels

There are at least three key motivations driving foreign investors’ decisions to invest in developing countries’ biofuels sectors. These are: availability of natural resources in the host country to produce feedstock; opportunities for biofuels to supply the host market; and opportunities to take advantage of the host country’s preferable market access conditions to key international markets.

Natural resource availability: Many foreign investors are attracted by countries with good natural resource endowments for biofuels production such as tropical and semi-tropical climate, land availability and cheap labour. This is the case for FDI flowing to traditional agricultural commodity producers such as Brazil, Argentina, Malaysia and Indonesia. FDI is targeting both national and export markets in countries such as Brazil but biofuels development is strongly export-oriented in countries such as Malaysia, although local use is being considered by the government in the near future. In other contexts, foreign investors are investing in these countries to guarantee a long-term future supply of biofuels or raw material for their home country, especially where the home country (e.g. Japan, India and China) has little capacity to supply its national market (See Box 3 for the case of Japan). Moreover, the optimism regarding the potential for biofuels development is rapidly expanding to other agricommodity-producing countries such as Colombia and Peru in Latin America, Mozambique and Zambia in Africa, or the Philippines in South East Asia. The existence of favourable natural conditions for biofuels production is usually accompanied by generous fiscal incentives to promote investment in the sector.

8. Datuk Peter Chin Fah Kui, 2006.

9. EY, 2007.

Table 1: Ernst & Young biofuels country attractiveness indices¹⁰

Country	Ranking	All biofuels	Bioethanol	Biodiesel
US	1	75	69	69
Brazil	2	71	66	66
Germany	3	67	64	64
France	4	66	67	67
Spain	5	65	64	64
Sweden	6	59	56	56
UK	7	58	58	58
Canada	8	57	49	49
Italy	9	53	55	55
Thailand	10	52	52	52
China	11	51	49	49
Netherlands	12	51	51	51
Indonesia	13	49	50	50
India	14	48	46	46
Australia	15	47	45	45

Source: EY, 2007

Box 3: Japanese investment in Brazil – securing a long term supply of bioethanol in the home country

Japan's Mitsui & Co together with the Brazilian Petrobras, is setting up a Brazil-based subsidiary to secure bioethanol for the Japanese market. The initiative, in which Japan's National Development Bank will help with financing distilleries producing exclusively for the Japanese market, involves a total investment of US\$8 billion. The money will be used to take minority stakes in 40 bioethanol distilleries that will be built or purchased (investment in each distillery could total US\$200 million). This will ensure Japan has a stable supply for 15 years as it prepares to mandate an obligatory mix of bioethanol in gasoline. Mitsui's interest even goes beyond bioethanol processing facilities to looking to finance transport infrastructure (a pipeline) to help export bioethanol to Japan.¹¹

10. The indices are calculated on a weighted basis including: offtake incentives (25 per cent); tax climate (8 per cent); grants and soft loans (8 per cent); current installed base (11 per cent); domestic market growth potential (15 per cent); export potential (15 per cent) and feedstock (10 per cent).

11. Biopact, 2007a.

The size of the host market: The optimism about the potential of biofuels is reflected by the implementation of ambitious voluntary or mandatory national targets for biofuels in many countries around the world. The targets typically include a minimum percentage on both bioethanol and biodiesel within the transport fuel system, thus creating and assuring a long-term domestic market for biofuels. Other types of policy measures often accompany these targets to incentivise consumption and supply, e.g. fuel tax rebates and subsidies on feedstock production. These policy frameworks, though new, are giving many national and foreign actors the incentives to invest in the sector, especially in host countries with large domestic markets such as the US, EU, Brazil, India and China.

Taking advantage of the host country's favourable market access conditions in key markets: Foreign investors are also allocating resources for biofuels development in countries that enjoy preferential access to key international markets, e.g. through preferential trade agreements. Countries from the Caribbean Basin Initiative (CBI) are a good example here. Their bioethanol exports enjoy duty free access, under quotas, in the US. This is acting as a focal point for foreign investors. For example, the US company Cargill has invested in a processing facility in Jamaica, where the feedstock is imported from Brazil and the bioethanol is exported tariff-free to the US. Cargill, in a joint venture with the Brazilian Crystalsev, is also shipping hydrated bioethanol from Brazil to El Salvador (also a CBI country), where the bioethanol is dehydrated in a dedicated plant and re-exported to the US.¹² A similar situation can be found in Trinidad. In Peru, the US energy company Maple Corporation, is setting up a sugarcane plantation and a bioethanol plant costing a total of US\$120 million. The goal is to export production, thus taking advantage of the country's low production costs and favourable bioethanol export access to the US.¹³

3.3. Type of foreign investor

Foreign investment in biofuels involves actors from a wide range of sectors including agribusiness, energy, technology, infrastructure and the financial sector (including private and development banks). From the agricultural commodity side ADM, one of the largest global agricultural commodity companies and top US bioethanol producer, is planning to open biodiesel plants in Brazil and Indonesia. The Brazilian plant is expected to be the nation's largest.¹⁴

In the energy sector, in addition to the Japanese Mitsui, the British oil company BP, through a joint venture with D1 Oils, plans to invest around US\$50 million in Indonesia's biofuels industry, using *Jatropha* oil as feedstock. BP will build biofuel

12. Ethical Sugar, 2004.

13. Reuters, 2007a.

14. Biopact, 2007b.

plants with an annual capacity of 350,000 tonnes. *Jatropha curcas* plantations covering 100,000 hectares of land will be needed to guarantee a supply of feedstock.¹⁵

In the technology and machineries sectors, the largest producers such as the US and Brazil are pushing for the creation of a global biofuels market, not only to expand their exports (e.g. Brazil) and to reduce market risks through ensuring a more diversified long-term global supply, but also to expand global demand for technologies and services that they could export.¹⁶ The 2007 US-Brazil Biofuels Cooperation Agreement¹⁷ includes the development of a biofuel industry in Central America and other developing countries so that US and Brazilian firms can export technology. Likewise, the Brazil:UK:Africa Partnership on Bioethanol¹⁸ also looks for opportunities in technology exports. Technology export opportunities are not restricted to the big producers: the Finnish engineering firm Pöyry Oyj, for instance, has been awarded contracts in the Philippines by San Carlos Bioenergy Inc. to provide services for the first bioethanol plant in the country. The plant, involving a €10 million investment, is expected to deliver 120,000 litres per day of bioethanol and 4 MW of excess power to the grid.¹⁹

In the financial sector, the Inter-American Development Bank (IADB) is considering investments worth US\$3 billion to promote biofuels projects in Brazil and in other Latin American and Caribbean countries.²⁰ Likewise the private equity investor Origo Sino-India entered into an agreement with Roshini International Bio Energy Corporation Ltd (RIBEC) to take a 20 per cent equity position to create an international joint venture focused on the renewable bioenergy sector. RIBEC is a leader in feedstock production and processing of *Jatropha*- and *Pongamia*-based biodiesel. It has operations in India, China, Brazil and Africa.²¹

3.4. Origin of FDI in the biofuels sector

One important characteristic of FDI in the biofuels sector is that it does not only involve traditional “North-South” investment. Indeed, there is an important South-South dimension as more experienced developing countries in biofuels production such as Brazil, India and China are also eager to expand their business opportunities through technological transfer and market development in other countries. Box 4 provides some examples of North-South, South-South but also South-North FDI in the biofuels sectors.

15. Biopact, 2007b.

16. Moustapha Kamal Gueye, ICTSD, personal communication, November 2007.

17. See for example IPS, 2007.

18. See for example Business, Enterprise and Regulatory Reform website, 2007.

19. Biopact, 2007b.

20. Reuters, 2007b.

21. Biopact, 2007c.

Box 4: Examples of North-South, South-South and South-North FDI in biofuels

North-South FDI: Brazil is the largest developing country recipient of FDI, especially from the US and Japan. Substantial FDI (and European development aid) is also underway elsewhere, notably in Africa. The UK company D1 Oils has set up operations in various southern African countries (South Africa, Swaziland, Zambia and Madagascar) for *Jatropha* based biodiesel development. Likewise, Sweden is planning to invest in Mozambique to develop a sugarcane-based bioethanol industry.

South-South FDI: Many developing countries are looking at Southern investors from countries such as Brazil, India and China that have more experience with the development of biofuels sectors and are helping with technology transfer, knowledge and global markets creation. Brazil is involved in projects in a number of countries, especially in Latin America and Africa. Likewise, India is capitalising on its experience with *Jatropha* and has pledged to contribute up to US\$250 million to West Africa's newly created Biofuels Fund, mainly because the fund will invest most of it in *Jatropha*. Both Brazil and India are supporting a programme in Senegal to produce biofuels, in which Senegal supplies the land and labour, Brazil provides scientific and technical knowledge and Indian entrepreneurs contribute the necessary capital. China is also pursuing biofuels investment in countries such as Nigeria, Malaysia, Indonesia and the Philippines.

South-North FDI: The Brazilian oil company Petrobras and Japan's Nippon Alcohol Hanbai created 'Brazil-Japan Ethanol', a company to be based in Japan, destined to import and distribute Brazilian bioethanol. Petrobras is represented by its international subsidiary Transpetro BV, based in Holland, which has a 50 per cent stake in the company. Nippon Alcohol Hanbai holds the remaining 50 per cent. Likewise, Malaysia's Federal Land Development Authority (FELDA) intends to buy 100 per cent (US\$69 million) of Twin Rivers Technologies LLC, the third largest fatty acid producer and a major producer of biodiesel in the US. A Malaysian-based joint venture with Bio Sweet is to build a 1.5 million tonne-per-year palm oil biodiesel refinery on China's Hainan Island.

4. Key sustainable development benefits and risks of FDI in biofuels

The links between biofuels investment and sustainable development are complex and diverse and depend on a number of variables including:

- the energy crop;
- method of cultivation;
- conversion technology;
- scale of operation; and
- the prevailing conditions and available alternatives within the specific country.

This section aims to identify the impacts related to FDI in the sector.

4.1. Economic issues

Increasing energy costs and uncertainty regarding future energy supply are encouraging many governments to produce petroleum substitutes from agricultural commodities. Energy diversification makes countries less vulnerable to oil price shocks, which can compromise macro-stability and affect variables such as the exchange rate, inflation and debt levels.²² Energy security is a particular concern in oil-importing countries. It is a feature of many developing countries and is particularly acute in sub-Saharan Africa and East Asian countries. 98 per cent and 85 per cent of their oil needs are met by imports, respectively.²³ Changes in oil prices, therefore, have devastating effects in these countries.

Developing country governments and the private sector also often lack the financial resources needed for development of the biofuels sector, and their financial markets are often not sufficiently developed to provide the required financial resources. This lack of domestic funding can be particularly pertinent in the biofuels sector due to its novelty and the high risk associated with it. In this context, FDI can play an important role as an additional source of finance for sector development, helping countries to achieve their goals of greater energy security and a reduced oil imports bill. FDI from countries with greater experience in biofuels development can also be seen an opportunity to boost the transfer of biofuels technologies and knowledge and provide better access to financing opportunities within the agricultural sector.

However, there is also the risk that many of the potential benefits will simply not materialise if FDI only focuses on the feedstock production phase or if the processing of the biofuel takes place in the importing country. This is the case for investment taking place in the biodiesel industry in countries such as Malaysia and Indonesia, where palm oil is usually exported and processed in the importing country. A similar situation is occurring in respect to soya from Argentina and Brazil, which is mainly imported to the EU where it is then processed into biodiesel.

Likewise, the economic benefits in terms of technology transfer and employment generation can be reduced when the FDI concentrates on building bioethanol dehydration plants, as is already happening in several CBI countries. In these countries, “hydrated” bioethanol is exported from Brazil, dehydrated in the host country and then re-exported to the final market. From a technological point of view, the conversion of hydrated to dehydrated bioethanol is a much simpler procedure than processing it from scratch. Furthermore, it also implies missed opportunities for rural employment creation, since the greatest impact on local employment occurs during the feedstock production phase.

Partly due to biofuels’ higher production costs compared to those of fossil fuels, almost all countries promoting biofuels development offer a wide range of policy tools

22. Cloin, J., 2007.

23. ESMAP, 2005.

to incentivise private investment. Although recognising the importance that these policy tools may have in attracting investment for sectoral development, they also run the risk of imposing a serious burden on government revenue (e.g. the use of tax rebates). Although the literature on FDI suggests that economic incentives only have a marginal role to play in attracting FDI, they still have a role in foreign investors' decisions. There is now an increasingly competitive environment for attracting FDI among countries with similar natural resource endowments, geographical locations and macroeconomic conditions for biofuels development. The implications associated with the use of economic incentives for FDI attraction should be carefully assessed for at least two reasons. First, the rationale is based on an expected benefit from the FDI that may not always materialise (e.g. access to finance and technology, higher expected value added to the agricultural sector, higher rural employment, or reduced GHG emissions compared to fossil fuels) or that may be difficult to quantify. In this situation, the use of economic incentives for FDI attraction can lead to distorted investment decisions. There is also a risk that the use of incentives could unleash a bidding war among countries that are keen to attract FDI for biofuels development. This poses a significant challenge in a developing country context as financial resources are scarce and there is a multitude of urgent issues competing for these scarce financial resources. Therefore, careful analysis of the costs and benefits and the cost-effectiveness of FDI in biofuels development is needed.

4.2. Environmental issues

The cultivation of energy crops could trigger or exacerbate the many environmental problems associated with traditional agricultural commodity production, including expansion of the agricultural frontier and related deforestation, monocropping, water shortage, land degradation and water pollution. Of these, the expansion of the agricultural frontier is a key concern, especially the impacts this may have upon tropical forests, savannah and biodiversity. Deforestation has been linked to the expansion of agricultural commodities in several countries, for example palm oil in Indonesia and Malaysia and soya in Brazil. However, certain energy crops (e.g. *Jatropha* and grasses) require fewer inputs, and they can sometimes be grown on more degraded land, which promotes land restoration.

Although many of these environmental concerns may be present in both domestic and foreign investment, they become critical for the latter as the scale of operations associated with FDI is usually larger than that for domestic investment. Additionally, large-scale foreign investment projects are often approved at the highest political decision-making level without requiring investors to undergo standard investment processes and without subjecting them to environmental and sustainability impact assessment processes.²⁴

24. Moustapha Kamal Gueye, ICTSD, personal communication, November 2007.

Another issue relates to the GHG emissions associated with biofuels compared with fossil fuels. The available evidence shows considerable variation in GHG savings from biofuel use, depending on the type of feedstock, cultivation methods, conversion technologies, and energy efficiency assumptions. The greatest GHG reductions can be derived from sugarcane-based bioethanol and the forthcoming “second generation” of biofuels. The developing countries whose biofuel production shows good performance in terms of reduced GHG emissions could explore the possibility of using the Clean Development Mechanism (CDM) of the Kyoto Protocol for attracting FDI (See Box 5).

Box 5: Using the CDM for FDI attraction in biofuels²⁵

The CDM allows developed countries (or their nationals) to implement project activities that reduce emissions in developing countries in return for certified emission reductions (CERs). The CERs generated by such project activities can be used by the developed countries to help meet their emissions targets under the Kyoto Protocol. However, taking advantage of the CDM in the context of liquid biofuels can present a number of challenges for the host developing country:

- So far there is no approved liquid-biofuel baseline and monitoring methodology. Calculation of GHG emissions is not straightforward and for many countries biofuels are still an expensive means of reducing GHG emissions relative to other mitigation measures.
- Existing experience with CDM projects shows that approved projects are strongly concentrated in a handful of large developing countries, with over 60 per cent of all CDM projects distributed across China, India and Brazil.
- While there are simplified procedures for small-scale projects, the current structure of the CDM tends to select large-scale projects. The transaction costs associated with registering a CDM project are often prohibitively expensive for smaller developing countries, which imply that economies of scale are relevant.²⁶
- For bioenergy projects specifically, the exclusion of all land-use activities from the CDM except for afforestation and reforestation is another significant limiting factor, since in the poorest developing countries, land use-related emissions make up the bulk of GHG emissions from biomass energy systems.²⁷

Source: based on Dufey, Vermeulen and Vorley 2007

4.3. Social issues

Biofuels production can be used to improve agricultural employment and livelihoods, especially when cultivation involves small-scale farmers and the conversion facilities are located near the crop sources in rural areas. The World Bank reports that biofuels industries require about 100 times more workers per unit of energy produced than

25. See also Chapter 8.

26. Bakker, 2006.

27. Schlamadinger and Jurgens, 2004.

the fossil fuel industry. In the case of the Brazilian bioethanol industry, it has provided more than half a million direct jobs. Most bioethanol-related jobs involve low-skilled and poor workers in rural areas. However, the need to reduce production costs of biofuels offers considerable incentives for large-scale, mechanised agribusiness and concentrated land ownership. Tensions can therefore emerge when a key policy goal for biofuels development is promotion of rural development while FDI is targeting large-scale production systems (e.g. for biofuels exports). Usually the involvement of smallholders is minimal and the investment therefore has little impact on rural employment. Targeting large-scale production systems can also result in landlessness and resultant deprivation and social upheaval.²⁸ However, it should be noted that large-scale and small-scale systems are not mutually exclusive and can interact successfully in a number of different ways, e.g. coordinated supply by smallholders into large-scale processing facilities, as is typical for palm oil in South East Asia.²⁹ Indeed, there is some evidence of foreign investors targeting large-scale production but involving small-farmers. The UK company D1 Oils carries out contract farming for their *Jatropha*-based biodiesel plantations in Africa, whereby D1 Oils and partners provide farmers with seedlings, assistance with arranging finance for planting, and technical assistance. In return, farmers sell their crops to D1 Oils.³⁰ In the case of the company's operations in Malawi, it entered into a ten-year contract with Stancom Tobacco Ltd for plantation management and supply, with Stancom in charge of contracts with the farmers. The project is expected to involve more than 27,000 farmers in Malawi and Zambia.³¹

Another key concern involving large-scale biofuels production is related to land rights, especially when these are not well defined or when different types of land rights systems overlap.³²

There are also concerns that widespread biofuel production may result in, or exacerbate, poor labour practices. There is evidence in some developing countries that the cultivation of some feedstocks, notably sugarcane and palm oil, has been linked to poor working conditions, health and safety risks, child labour and forced labour.

Social impacts of FDI in biofuels will also depend upon how the value chain is governed. Studies of several agricultural commodity markets assert that benefits from export production in the developing world have increasingly gone to actors in upper parts of the chain while the primary producers have received comparatively little. This is a valid concern for FDI in the biofuels sector as many of the concentrated market power structures are associated with large foreign companies. For instance, Cargill and ADM control about 65 per cent of the global grain trade.³³ Where producers are dependent on a very few international traders bringing their products into the

28. Dufey, Vermeulen, Vorley, 2007.

29. Dufey, Vermeulen, Vorley, 2007.

30. D1 Oils, 2007a.

31. D1 Oils, 2007b.

32. See, for example Chapter 7.

33. Vorley B, 2003.

market, there is a risk that primary producers will receive very little benefit.

The massive scale of biofuels production also poses concerns about its impacts on food security, particularly since few relevant studies of the biofuels–food security relationship have been conducted. In 2006 in Malaysia, into which significant levels FDI is flowing for biofuels development, the government temporarily suspended the awarding of new licences for biodiesel production projects amid concerns that the large number of biofuels project applications could deprive the food market of palm oil, which is widely used in cooking.³⁴ The suspension will continue until the government completes a study of the palm oil downstream industry. The government is concerned that the overwhelming number of biofuels projects could supplant crude palm oil reserves meant for food and oleochemical industries.³⁵

5. Government policies for a attracting FDI in biofuels: the role of IPAs

5.1. General review³⁶

The global enthusiasm about the potential of biofuels has propelled several governments to include them within their promoted sectors and to draft and implement ambitious biofuels programmes. These programmes usually involve a range of government agencies, and IPAs are usually responsible for attracting investment to finance the programmes.

Given that in most countries national biofuels programmes are in their infancy, IPAs' approaches to investment promotion in the sector are only explicitly reflected within their investment promotion strategies in a very few cases. Generally, IPAs are beginning to promote the sector, including biofuels within their representatives' speeches and presentations, and providing information about the opportunities the country offers for biofuels production to foreign investors.

Some have gone one step further and “formally” included biofuels within their promoted sectors. But while some IPAs (e.g. MIDA in Malaysia) have included them within the general “renewable energy sector”, others (e.g. the Indian Investment Centre (IIC) in India and PROSPERAR in Argentina³⁷) have included them as an individual sector. Some IPAs are already issuing and streamlining procedures for obtaining investment licences or permits for biofuels development for foreign investors. The MIDA in Malaysia had already approved 75 projects by the end of 2006, 31 per cent of which were foreign.

34. EB, 2006.

35. The FAO's “2007 Food Outlook” report indicates that global expenditures on food imports increased almost 5 per cent above their 2006 level, partly driven by demand for biofuel production. Developing countries as a whole are anticipated to face a 9 per cent increase in overall food import expenditures in 2007.

36. This section is mostly based on a review of IPAs websites and related “grey” literature.

37. Nofal, 2007.

Box 6: Biofuel incentives in Malaysia

Tax incentives are provided for investment in generating renewable energy including biofuels. Companies generating energy from renewable sources such as biomass, hydro power (not exceeding 10 MW) and solar power are eligible to apply for the following incentives:

- i) Pioneer status with tax exemption of 70 per cent to be increased to 100 per cent of statutory income and the incentive period to be extended from five years to ten years.
- ii) Investment tax allowance of 60 per cent to be increased to 100 per cent on the qualifying capital expenditure incurred within a period of five years with the allowance to be offset against 100 per cent of statutory income for each year of assessment.

Additionally, the incentive package of pioneer status and Investment Tax Allowance (ITA) as well as import duty and sales tax exemption will be extended for another five years until 31st December 2010.

The company is required to implement the project within one year of the date of approval. The proposal is effective for applications received by the MIDA from 1st October 2005. However companies granted approval within one year prior to 1st October 2005 who have not implemented the project or whose applications are still under consideration are also eligible for the incentives.

IPAs are also removing restrictions to foreign investors' participation in the sector. In India, for example, the government is strongly promoting FDI in the biofuels sector, allowing 100 per cent FDI under the automatic route.^{38 39} In Indonesia, the Investment Coordinating Board (BKPM) has announced that the government is drawing up a regulatory package to ease the way for foreign firms to invest in the biofuels sector and to encourage them to finance investment. The government is now allowing foreign oil firms such as Petronas of Malaysia and Shell of the Netherlands to distribute biofuels in the country so as to boost competition in the domestic market. The foreign firms will be allowed to buy biofuels from producers and sell them back to the public as long as they are sold for transportation purposes.⁴⁰ More widely, the Indonesian government's tools to attract foreign investors include tax incentives, biofuel subsidies over fossil fuels, and streamlining procedures for obtaining permits.⁴¹

Indeed, the use of fiscal incentives to attract foreign investors is becoming standard practice. As a new sector, biofuels development is perceived as a high-risk activity and governments are introducing policy incentives to reduce the perceived sectoral risk in

38. Nerve, 2007.

39. In India, in general, allowed FDI participation through the automatic route changes on a sectoral basis (e.g. up to 49 per cent in private banking; 26 per cent insurance sector; 49 per cent telecommunications; 51 per cent in trading; 100 per cent in power, pharmaceuticals, call centers, infrastructure, pollution control/management, tourism and business process management).

40. People's Daily Online, 2006.

41. Soni Solistia Wirawan and Armansyah H. Tambunan, 2006.

order to promote private investment. IPAs are usually responsible for making this information available to foreign investors, for example, through their websites or in their country missions. In general, the types of fiscal incentive vary but they usually include tax holidays, custom duties exemptions and special economic zone regimes. Box 6 shows the incentives used for biofuels investment promotion in Malaysia.

Many governments consider these fiscal incentives crucial for attracting FDI in the sector. In Argentina, the government hopes to attract foreign investors through the biofuels bill (Law 26,093), which offers fiscal incentives for the production of biofuels (bioethanol and biodiesel) over a period of 15 years. To be eligible for incentives, companies have to operate in Argentina and be dedicated exclusively to biofuels production, with the majority of a company's equity in the hands of the government or agricultural producers (and producers' cooperatives). Biofuels governed by this promotional regime will be exempt from several specific taxes on fossil fuels. Biofuels producers targeting the domestic market will also enjoy tax breaks and other advantages including exemption from VAT, anticipated refund of sales tax, exemption from fuel taxes and tariff exemption for equipment imports. Countries such as Mozambique also have generous tax incentives and duty-free import of capital goods in place.⁴²

In Paraguay, REDIEX (Red de Inversiones y Exportaciones), as part of the "Sectoral Committee on Biofuels", is receiving investors' attention by organising seminars where business actors, including potential foreign investors and government representatives, are invited to discuss investment conditions and opportunities for biofuels in Paraguay.⁴³ More widely, the Paraguayan government is making aggressive efforts to position the country as a "good host" for FDI inflows for biofuels compared to its neighbours such as Argentina or Brazil. The government is emphasising issues such as the country's lower taxes (9 per cent against 20.4 per cent and 21.4 per cent in Argentina and Brazil, respectively) and lower labour costs, in addition to the existing *maquila* regime that provides generous tax exemptions in terms of VAT and import/export tariffs, special economic zones and other tax exemptions.⁴⁴

Other IPAs are helping investors to implement their project ideas through assistance in the project design. ProInversion, Peru's private IPA has provided assistance to Maple Etanol S.R.L to invest some US\$100 million in the development of a sugarcane-based bioethanol project in the region of Piura.⁴⁵ Since late January 2007, ProInversion has coordinated a subcommittee responsible for outlining technical standards for bioethanol and biodiesel as part of Probiocom. Representatives of the fuel and agro-industries, automobile manufacturers and local universities participate in the subcommittee.⁴⁶ All these activities are framed within Peru's aggressive policy to promote the production and trade of biofuels, strengthen research

42. See for example IIG, 2007.

43. REDIEX, date unknown.

44. Navactiva, 2007.

45. ProInversion (date unknown).

46. IADB, 2007.

and development initiatives, invest in human resources and create incentives for trade.

5.2. Approaches to increase the sustainable development benefits of investment in biofuels

Some IPAs are actively implementing measures to increase the development benefits of investment in the biofuels sector. In Indonesia, according to the BKPM, the biofuels promotion policy constitutes a tool designed for poverty reduction and includes especially designed pro-poor programmes to promote FDI.⁴⁷

The use of joint ventures is also becoming normal practice. In China, foreign companies are usually required to enter the country through joint ventures, and the biofuels sector is no exception. Performance requirements have been identified as a potentially important tool to increase the FDI benefits in sustainable development e.g. technology transfer. However, industrialised countries associate these tools with interventionist policies from the past and question their effectiveness. Moreover, the World Trade Organization's (WTO) agreement on Trade-Related Investment Measures (TRIMs) prohibits some performance requirements such as local content requirements (e.g. use of domestic technical staff or inputs). The TRIMs apply to manufacturing industries, not to the services sector. Therefore it would apply to the construction of a bioethanol plant, but not to the sale of technology or the provision of an energy service.⁴⁸

In other cases, tools are incentivising small-scale companies and smallholder inclusion. In Brazil, the "Social Fuel Seal" of the biodiesel programme includes tax incentives for promoting smallholder inclusion throughout the new fuel's production and value chain. In Argentina, the tax benefits incorporated in the biofuels bill promoted by the investment agency are mainly directed at small and medium-sized companies.

Moreover, the IPAs such as APEX-Brasil (Brazilian Export and Investment Promotion Agency) or Uganda Investment Authority (UIA) also promote the biofuels sector as an opportunity for foreign investors to benefit from carbon credits obtained through initiatives in the areas of biofuels, wind and solar energies.⁴⁹

5.3. Key points of concern

In most countries, the biofuels sector is fairly new and its sustainable development links are complex and not well documented. Caution is therefore required. A key area of concern is the promotion of biofuels investment before all the impact studies or the regulatory frameworks for sector development are fully designed and implemented in the host country. In Malaysia, the MIDA began issuing investment

47. BKPM, 2006.

48. Murphy, forthcoming.

49. APEX-Brasil (date unknown); NCCS, 2007.

licences before studies on how to divide the raw material between food and fuel was conducted (see section 3.3). As a result, the MIDA has stopped issuing licences for new biodiesel manufacturing projects until the government completes such a study. Likewise, in Indonesia, the massive amount of foreign investment going into the biofuels sector forced the government to suspend new private sector initiatives to allow more time to develop appropriate policies. According to the Chairman of the Indonesian Biofuel Development National Team, Al Hilal Hamdi,⁵⁰ “The private companies’ commitment to develop the biofuel sector in Indonesia is beyond our expectations’. This highlights the need for IPAs to wait for the host government to design and implement robust and comprehensive legal frameworks to increase benefits and minimise risks of biofuels development before starting to attract FDI. The way the Indonesian government is considering addressing the issue is to ensure biodiesel producers own dedicated plantations in order not to disrupt supplies of vegetable oils to the food industry.

A successful approach to promoting FDI in the sector not only involves having appropriate regulation in place to incentivise investment and manage risks, but crucially to have the domestic capacity to implement and enforce it, and to retain some policy space for further improvement while the sector develops. The experience in some countries, under specific investment agreements⁵¹ – although not in the biofuels sector – shows that national government attempts to introduce new regulation on environmental or social grounds after FDI is already operating in the country has resulted in high financial demands from foreign companies against host governments.

There is also concern that politics overrides the normal process of foreign investment approval. Large-scale projects are being approved at the highest political decision-making level without investors completing standard investment processes.⁵²

Finally, the use of fiscal incentives to increase the attractiveness of one country against another country also creates concern (see section 3.1). Such an approach risks creating bidding wars between countries that can be very costly for the host country, especially in a context where fiscal resources are scarce and the benefits of the FDI are uncertain or have not been properly assessed.

6. Recommendations for IPAs

FDI offers host countries opportunities in the form of financial resources and knowledge to achieve the different policy goals associated with biofuels. However, FDI can also create significant risks.

IPAs are the government bodies usually at the forefront of attracting the required investment to implement national biofuels programmes. Given that the biofuels sector

50. Biopact, 2007d.

51. See for example the experience with the NAFTA in the US, Mexico and Canada.

52. Moustapha Kamal Gueye, ICTSD, personal communication, November 2007.

is “new”, the role of IPAs regarding investment promotion in the sector has so far been limited. This offers opportunities to promote and implement proactive approaches within IPAs’ strategies to increase the overall sustainable development benefits of FDI in the sector.

IPAs, in coordination with other government bodies, need to be aware of the desired policy goals behind biofuels development as well as the benefits and risks of FDI in the biofuels sector before designing their strategies for investment promotion. Therefore, caution is required. Only such an approach will enable them to design the right strategies to target foreign investment that maximises the sustainable development contribution to the host country. It is one thing to succeed in attracting FDI and quite another to be in the position to reap its benefits. In this context, some recommendations for IPAs are set out below.

First, IPAs need a very good understanding of the policy goals and sustainable development impacts of FDI. This type of approach will allow them to design suitable policies. This involves, in coordination with all the relevant government bodies, conducting and analysing all the relevant economic, environmental and social studies related to biofuels development. This will enable identification of a suitable role for foreign investment and the appropriate tools to promote linkages with the local economy in terms of technology transfer, value added and other social and/or environmental impacts expected from biofuels development. However, because the sector is in its infancy, it can be difficult to conduct ex-post assessments to obtain a greater understanding of the actual benefits and risks of FDI.

Second, before attracting FDI and issuing investment licences, IPAs need to ensure that comprehensive domestic regulatory frameworks are in place in the host country. This includes the existence of suitable, clear and enforceable environmental, social and land regulations to manage the risks associated with FDI in the biofuels sector. This can pose an additional challenge to developing countries as they often lack robust regulatory and enforcement systems. IPAs could also target foreign investors who already have good track records in terms of technological, environmental or social performance. A comprehensive analysis of all the benefits and costs of biofuels promotion policies is also required.

Third, although they are working in an increasingly competitive environment for attracting FDI in biofuels development, IPAs they should avoid entering into fiscal incentive wars, particularly in a developing country context where fiscal resources are scarce, and more often than not the benefits of the FDI are not assured or have not been properly assessed.

Finally, IPAs’ communication strategies are crucial. As the government bodies often at the forefront of investment promotion, IPAs play a strategic role in making available the relevant information on the sector. In order to facilitate foreign investors’ decisions or to help target the right type of foreign investor, this information should be available through IPAs’ websites, workshops and brochures among other marketing tools. Key information should include:

- the country's vision for biofuels development e.g. policy goals to be achieved;
- the country's natural conditions for biofuels development (land availability, types of biofuels/feedstock to be promoted, availability and cost of labour including skilled labour, etc);
- information on specific project needs;
- regulatory frameworks (economic, environmental and social) and other relevant environmental and social standards;
- any available fiscal instruments to foster technology transfer, environmental protection or social development in the sector;
- links with potential sources of funding (e.g. development banks, private banks or other financial institutions interested in financing biofuels in the country);
- the country's macroeconomic and social fundamentals; and
- existing or future transport infrastructure facilities.

More widely, it is imperative to further document FDI trends in the sector and further analyse the role of IPAs in targeting sustainable FDI. Institutions such as UNCTAD could consider doing this in its "Investment, Technology and Enterprise Development Programmes" and/or under the "Biofuels Initiative". Private sector, and in particular, institutional lenders, can also play an active role in ensuring that FDI projects are subject to environmental or sustainability impact assessments, as many small host countries may not be able to ensure that happens.

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Chapter 6

Attracting FDI with good CSR practices in the tourism sector

Eugenio Yunis

Introduction

This chapter refers to foreign direct investment in tourism (FDI-T), understood as the “category of international investment whereby an entity resident in one economy (direct investor) acquires a lasting interest in a tourism specific enterprise... engaging in tourism growth fixed capital formation (a direct investment enterprise) resident in an economy other than that of the direct investor.”¹

After this introduction, which defines some concepts and establishes the scope and coverage of the chapter, a brief presentation of the major trends in tourism and its growing economic importance is made. This is followed by a review of some considerations regarding the opportunities open to developing countries in the field of tourism and the imperative need for these opportunities to be taken with

1. UNWTO, 2005; IMF/OECD, 2000.

sustainability principles in mind if tourism is to serve the Millennium Development Goals (MDGs). The central part of this chapter looks at FDI-T. It describes the usual practices to date from the viewpoints of both the recipient countries and the foreign investors, followed by a number of recommendations for developing countries' governments on how to attract FDI-T that is committed to social and environmental sustainability, i.e. responsible FDI-T. Some examples are given of countries that have experienced rapid tourism development over the last few decades, and in which FDI-T has played a role.

The notion of FDI-T as presented above does not include investments in non-specific tourism enterprises, which are normally included in International Monetary Fund (IMF) and United Nations World Tourism Organization (UNWTO) definitions. Their inclusion here would necessitate a much wider analysis to cover investments in the relatively huge transport sector, thereby diverting from the main purpose of this chapter – responsible FDI-T.

Tourism-specific enterprises are those that are engaged in the creation of “tourism-characteristic products”: “those which, in the absence of visitors, in most countries would probably cease to exist in meaningful quantity or for which the level of consumption would be significantly reduced, and for which it seems possible to obtain statistical information”²; and of “tourism-connected products”: “a residual category including those that have been identified as tourism-specific in a given country but for which the attribute has not been acknowledged on a worldwide basis.”³

Tourism-characteristic enterprises include hotels and similar accommodation establishments, second homes, restaurants and similar, travel agencies and similar, all types and modes of passenger transport enterprises including rental car companies, cultural services, and sporting and other recreational services. However, and only for the purposes of this study, the analysis in this chapter will refer mainly to those companies providing accommodation services for tourists (i.e. hotels, resorts, second homes, camping sites, etc.); travel agencies, tour operators and similar tourism service providers; and to sporting and recreational services catering mainly for tourists. The transport segment has not been included given its wide variety and the different characteristics that FDI takes in the field of transport.

Tourism trends

In spite of many difficulties that have affected tourism over the last few years – including natural disasters, health scares, oil price rises, exchange rate fluctuations, wars and terrorism, and economic and political uncertainties – international tourist arrivals worldwide have continued to grow steadily, reaching 898 million in 2007⁴, demonstrating the resilience of tourist movements and reflecting people's need and

2. UNWTO and UN Statistical Commission definitions.

3. UNWTO and UN Statistical Commission definitions.

4. UNWTO, 2008.

desire to travel. Tourism includes all travel motivations: leisure, holidays, business, health, sports, religious purposes, conferences, etc.

The forecasts UNWTO make indicate that in 2010 there will be 1.1 billion international tourist arrivals and 1.6 billion in 2020, i.e. double the current volume of international trips.⁵ These forecasts, prepared during the mid-1990s, have proved to be quite accurate so far, with actual data from 1996 to 2006 deviating only marginally from the forecast figures; in 2000, with growth higher than expected, and in 2003 lower than forecast with the presence of the Iraq war. Yet, the rapid development of Chinese outbound travel over the first few years of the 21st century may result in the need to revise and increase the forecasts over the next decade.

The foreign exchange earnings generated by these huge international tourist movements reached US\$730 billion in 2006⁶, with tourist spending (i.e. earnings for recipient countries) increasing at a faster rate than the growth rate of tourist arrivals (i.e. higher average expenditure per trip). Thus, with this volume of transactions, tourism is today the largest sector of international trade in services, and one of the three largest in international trade. Although accurate figures regarding the contribution of tourism to Gross Domestic Product (GDP) are only available for some countries, they indicate that it is a major contributor to GDP in many nations, both in developed countries such as Spain (11 per cent, 2005), France (6.4 per cent, 2005) and developing countries such as Mexico (8 per cent, 2002), the Dominican Republic (8 per cent, 2003) and Indonesia (estimated at 6 per cent).⁷

The figures above, both for arrivals and earnings, do not include domestic trips, which in many large and/or highly populated countries, like China, the United States, the Russian Federation, France, Brazil or Spain are much greater than international trips, generate more income and contribute more to GDP. Though domestic tourism is difficult to quantify accurately, it is estimated that, globally, some 4 billion tourist trips within the same nation take place every year.

Since the early 1960s, tourism has been growing uninterruptedly at rates that, in many countries, have exceeded the growth of GDP. The practice of tourism in developed societies has become common and is no longer reserved only for the high-income layers of the population. Today, tourism is an expression of democratic access to goods and services, being an identifiable part of every family's essential consumption patterns in Europe, North America, Australia, Japan, Korea and a good number of middle-income countries. However, the level of tourism expenditure, the frequency of travel, the duration of trips, the distance travelled, and the type of accommodation services used by travellers varies widely from one country to another, depending on their overall economic conditions and other social and cultural characteristics.

5. UNWTO, 2001.

6. UNWTO, 2007.

7. Various national sources, especially from the corresponding National Statistics and National Tourism Administrations.

Tourism growth has been characterised over the last couple of decades by, among others, two main trends. On the one hand, there has been the consolidation of what we could call “traditional tourism destinations” (i.e. those that have existed as such since the beginning of mass tourism in the mid-1960s), such as in Western Europe, North America including Mexico, and some Caribbean islands. Such consolidation is represented by a continuous expansion of tourism infrastructures in these countries, the modernisation of older hotels, the reinforcement of hotel chains in all categories, together with the continuous creation of new independent hotels to cater for a more sophisticated clientele, or for new segments of demand, among other characteristics.

The second main trend in international tourism has been the pronounced geographical expansion of tourism destinations. There has been substantial diversification of destinations over the last 50 years. In 1950 barely 15 countries, all of them European, plus the United States and Canada, accounted for 97 per cent of total international tourist arrivals; in 2006, the market share of the top 15 destination countries, which differed from those of the 1950s, had fallen to around 54 per cent.⁸ In parallel, many developing countries saw their tourist arrivals increase significantly, including North African countries, Thailand, Turkey, Indonesia, Brazil, South Africa and several others, plus of course China, which is set to become the number one international destination by the mid-2010s, if current trends continue.

Tourism has thus come to represent an increasingly strong sector of the world economy, with an estimated 10 per cent share of global GDP, and providing around 100 million people with direct employment. In the European Union alone, in 2005, direct employment in tourism reached a little over 8 million, along with an estimated 16 million indirect employment opportunities.⁹ The so-called “tourism economy”, which also includes the indirect and induced economic effects of tourism in other industries, seems to be much larger, but at the same time more difficult to quantify.

Tourism in the economic development strategy

The economic dimension of the tourism sector, plus its multiplier effects on the rest of the economy has attracted the attention of many governments, who see a development opportunity in tourism for their countries. This is especially true in the developing world, but it is also true in regions or cities within developed nations, with local authorities wishing to diversify their economies and generate employment, to replace traditional agricultural activities or obsolete manufacturing industries.

Yet, many governments, at central and local levels, have overlooked the need for such development to be environmentally, socially, economically and culturally sustainable; i.e. a development that respects the natural environment and preserves it for the use of future generations, that does not disturb the socio-cultural fabrics of host societies, and that generates economic benefits for all layers of population in

8. UNWTO, *Tourism Market Trends, 2005 and 2006*.

9. European Commission Tourism Unit, 2005.

these societies. This has resulted, in some cases, in the destruction of precious resources and attractions that were at the base of tourism development, in the total loss of character and authenticity of the destination, and/or in severe damages to the natural environment or the cultural assets of a place. It is only when it is properly planned, developed and managed that tourism can realise the strong potential it possesses to take up many challenges of our planet and our societies.

The sustainable development and management of tourism requires, first and foremost, responsible behaviour from private tourism companies. Given that most tourism investments and operations fall within the realm of the private sector, even in countries with a state controlled economy, the exercise of the concept of corporate social responsibility (CSR) in tourism becomes paramount.

Furthermore, the tourism market is quite liberalised in most countries, with extremely low barriers to entry, as evidenced by the wide spectrum and huge number of tourism enterprises of all sizes currently in the market. Therefore, the only way to generate fully sustainable tourism that contributes to the sustainable development of the host society and increases the welfare of its citizens, is by promoting the full exercise of CSR by all tourism companies present in each country.

The concept of CSR in tourism means that companies adopt transparent business practices, based on ethical values, with regards to their clients, their employees and also in respect of the populations of the countries they operate in or visit. Some large tourism companies, both in the accommodation and in the tour-operating businesses, have adopted triple bottom-line reporting, whereby social and environmental results are measured and reported next to financial results. The commitment to CSR by small- and medium-size tourism enterprises is more difficult to determine, given their large number in most countries; yet, there are excellent examples of small to medium enterprises (SMEs) working with local communities, fully respecting the natural and cultural environments where they operate, and educating tourists about environmental, cultural or social issues in the countries visited.

Prospects for tourism in the developing world

The key figures of international tourist movements shown above underline the resilience that this sector has demonstrated over the last few years, in spite of a number of different crises in various parts of the world.

UNWTO has predicted an average growth rate for international tourism in the forthcoming decade of between 4.2 and 4.5 per cent per year for international tourist arrivals with higher rates in some regions, such as Asia and Africa. The growth of domestic tourism is also expected to continue, especially in the newly emerging mega-economies of China, India and Brazil, as well as in other, smaller countries of Eastern Europe, South America and South East Asia.

These growth trends provide excellent opportunities for spreading prosperity in developing, least developed and transition countries, as well as for continuing to generate fresh employment opportunities in the developed world. It is true that

industrialised countries today enjoy considerable competitive advantages in tourism, but for the very same reason low-income countries can substantially enhance their competitiveness in tourism by using some of the comparative advantages they still enjoy, which are absent or already over-exploited in the developed world. Some of these comparative advantages are:

- a) excellent, usually unspoilt natural attractions, suitable for nature-based forms of tourism, renovated forms of beach tourism in warm environments and more exotic landscapes, and all forms of ecotourism and adventure tourism;
- b) unique, authentic cultural attributes, including rare archaeological sites, less-known historical and urban settings, as well as intangible cultural heritage, including folklore, handicrafts, etc;
- c) abundant, low-cost labour, especially women and young people, who can easily be trained to work in tourism occupations; and
- d) abundant land for extensive tourism developments, with better design and landscaping, avoiding the already saturated coasts and other areas of developed countries.

Sustainable forms of tourism, and especially ecotourism, can be strategically important for preserving delicate ecosystems and biodiversity in these countries, providing a sustainable form of economic use as opposed to more aggressive industrial activities. Similarly, cultural tourism can help in preserving and restoring cultural, historical and archaeological objects and buildings, which often fall into decay due to a shortage of financial resources, while at the same time educating tourists and residents alike about the spiritual and cultural values of these sites.

More importantly, there is an increasing appreciation of the potential role of tourism in reducing poverty, through bringing a source of income, entrepreneurial potential and employment to poor communities. Reducing poverty is the first MDG established by all world leaders at the beginning of the century, and sustainable tourism could be a powerful tool for bringing people out of poverty. But tourism can also contribute to achieving other MDGs, such as those referring to gender equality, since it offers plenty of entrepreneurial and employment opportunities to women; and to nature conservation for the reasons already stated.

However, it is well known that if not well developed and managed, tourism can present considerable challenges and potential threats to the natural and built environments, and to local communities, altering their cultural and value systems, especially in the traditional societies of less developed and developing countries. Some of these negative impacts can be irreversible, hence the need to predict and prevent them as far as possible.

FDI-T in developing countries

The role that FDI-T plays in the tourism sector of many developing and least developed countries is quite important and could become even more so in the near

future as governments of these countries realise their potential and open their doors to foreigners, both tourists and investors. The impacts of these investments can also be both positive and negative, so it is essential not to assume FDI-T will always be a blessing or panacea for tourism development.

The need to promote foreign investment has to be acknowledged. In addition to the injection of fresh capital for new tourism infrastructure, foreign tourism companies also help to attract foreign tour operators and tourists, and there are many emerging tourism destinations competing for these objectives. Therefore, promotion of FDI-T becomes necessary, so Investment Promotion Agencies (IPAs) should specifically include tourism in their agendas. Yet, it is always convenient to adopt a two-pronged approach – i.e. promote both foreign and domestic investments in the sector, to avoid becoming over-dependent on the former. Domestic investments in tourism by SMEs normally provide a better reflection of the cultural characteristics of the country and place visited, and this is a key element in emphasising the unique natural characteristics of any destination and hence in offering tourists a “unique selling proposition.”

The potential negative impacts of FDI-T need to be assessed and prevented as far as possible before any proposal can be approved, and no foreign investment project should be authorised if it is likely or certain to have substantial negative effects. Later in this chapter, a more detailed analysis of potential impacts will be undertaken.

The role of governments

In general terms, most of the impacts of tourism, positive and negative, are the result of actions taken by both private sector enterprises and tourists. However, this does not mean to say that public agents are devoid of responsibility regarding tourism. On the contrary, there is a clear need for central and local governments to take a leading role, if truly significant progress is to be achieved in making tourism a sustainable socio-economic development option for any given society.

There are a number of reasons that justify public, governmental action in the tourism sector:

- The tourism industry is very fragmented. It is difficult for the individual actions of many micro companies, SMEs, or even for large companies to make a positive difference in terms of sustainability. Coordination is therefore required, both among all these small- and medium-sized service providers and with the larger domestic and foreign hotel investors and tour operators. Such coordination should normally be provided, or at least stimulated, by national or local governments.
- Sustainability relates to areas of public concern, such as water and air quality, natural and cultural heritage, protected areas, public spaces, beaches, and the quality of life in general, all of which relate to tourism in one way or another. Moreover, many of these resources and a good number of tourism attractions (e.g. museums, archaeological sites, beaches, airports, etc.) are generally owned and managed by governments.

- Governments hold many of the tools that can be used to make a difference in the level of social and environmental sustainability of tourism, such as the power to legislate, make regulations and ensure compliance, the offer of economic incentives for investment, the approval or refusal of FDI, the establishment of fiscal regimes, as well as the resources and institutions to promote and disseminate good practices.

Governments should therefore, provide a policy framework as well as suitable legal and regulatory arrangements that enable and encourage the local and foreign private sector, the international and domestic tourists, the local authorities and all other tourism stakeholders to respond to sustainability issues. This can best be achieved by establishing and implementing a set of policies for tourism development and management, including foreign investment, drawn up in consultation and in concert with other national stakeholders, and especially with local communities living in the regions or areas where tourism is intended to be developed. These policies and the corresponding regulations should place sustainability and social responsibility at their centre.

FDI-T: current practices

FDI-T started flowing into a number of developing and also relatively developed countries, such as Mexico, Thailand and Turkey, before these countries' governments had established any suitable, well-conceived regulatory framework for foreign investment, let alone specific requirements for investment in tourism projects.

On the contrary, in the early stages of tourism development, public bodies tend to set up quite liberal and advantageous regimes for tourism investment projects, applicable to both domestic and foreign investors. In the 35-year period from 1970 to 2005 for instance, Thailand received 15.6 billion Baht (around US\$470 million) in foreign investment in the hotel sector alone, representing a sizeable proportion of total investment in the accommodation sector.¹⁰ In 1982, Turkey established a law for the development and encouragement of tourism that included generous incentives to investors, such as allocation of public land for tourism projects, grants and loans from public funds or investment banks, permission to employ foreign personnel, discounted prices for water, electricity and gas supplies, customs exemptions and tax, duty and fee exemptions.¹¹

Recent growth in FDI-T in many rapidly developing economies has resulted from the creation of incentive schemes, together with mild regulatory frameworks – including laws, decrees, regulations and standards – supported by the endorsement of international treaties and agreements. In Vietnam, for example, foreign investment in hotel projects, golf courses and other tourism-related activities has been growing at a fast pace since the early 1990s, while new regulations for FDI-T were promulgated in 2006.¹²

10. Office of the Board of Investment, Thailand, 2007.

11. US Foreign and Commercial Service and US Department of Commerce.

12. Vietnam National Tourism Administration.

Additionally, as well as aid policies and incentives for FDI plus the enactment of laws that indirectly promote FDI-T, businesses have also helped to bring foreign capital into the tourism sector of many developing nations and transition economies. In Croatia, for example, FDI-T was practically non-existent during the first four years of the country's independence (1991 to 1994); a modest €4.1 million was invested in hotels and restaurants in 1995, more than doubling the following year, reaching €82.5 million in 2002, and totalling €326 million in the twelve-year period 1995 to 2006.¹³ Due to tax and employment incentives among other things, these are no longer available with a new Law on Investment dated 29 November 2005 (N° 108-2006-ND-CP) and the Decree (N° 80/2006/ND-CP), on guiding the implementation of the Law on environmental protection.

An overall increase in the speed and volume of FDI-T worldwide in even more recent years has been the result of a new wave of deregulation in investment legal systems.¹⁴ In Argentina, for example, foreign investors can invest in any project without even requesting authorisation and under similar conditions to local investors; they can transfer their profits or the total value of their investment abroad freely at any time; and can borrow on the domestic financial market with the same conditions as locals. In Mexico, in the six years from 2001 to 2006, FDI-T reached US\$3.25 billion, out of a total investment in the same period of US\$12.8 billion. Nearly 50 per cent of foreign investment was realised during the 2005 to 2006 biennium, where FDI-T represented 31 per cent of total tourism investment.¹⁵

In parallel, some countries have signed bilateral agreements for the reciprocal promotion and protection of investments, and such agreements serve to facilitate and even stimulate investments by private developers of one country in the other. For instance, Mexico and Spain signed such an agreement in 1995, and this has certainly been a factor in the huge flow of investment capital from Spain to the tourism sector of Mexico.

The most common conditions normally required by, or that have served to attract foreign investors in tourism in developing countries are outlined below.

1. Social and political stability are key factors for attracting foreign investors in tourism, and perhaps much more so than in other economic sectors. This is so not only because investors generally avoid politically risky countries, but also because to make a tourism investment commercially viable and profitable, the arrival of tourists in the country and at the particular place where the investment is physically located must be guaranteed, at least up to a certain minimum occupancy rate. Tourists are highly sensitive to any insecurity derived from social conflicts; they normally stay away from destinations where there is war, social unrest, terrorism or high levels of criminality. Risk and the perception of risk in the eyes of tourists must be reduced to the minimum level possible.

13. Croatian National Bank.

14. UNCTAD, 2002.

15. Secretariat of Tourism, Mexico, 2007, with data provided by state governments, investors, chambers and trade associations, 2007.

- 2. Economic and fiscal stability** is a major requirement, as is also the case with FDI in other economic sectors. Related to this is the presence of a low inflation rate in the host economy, together with a stable foreign exchange rate in relation to major currencies, and a relatively low interest rate to allow foreign investors to borrow money from the domestic financial market for operational expenses. The latter factor serves also to stimulate local purchases by hotel establishments financed and managed by foreign investors, thus reducing their tendency for foreign procurement. Tax exemptions or fiscal subsidies, related to, for example, employment creation, are also elements that serve to attract FDI.
- 3. Transparency in the administrative and approval procedures for investment project applications**, including detailed information on the levels of institutional organisation for tourism (i.e. central government and municipal level attributions in tourism) and the stages required in the process are essential. Appropriate coordination between the various public bodies involved in the pre-investment process is essential to facilitate the arrival of investors. The so-called “one-stop-shop” for sorting out all necessary approvals is becoming a common requirement of major investors, which diminishes the risk of corrupt practices and bureaucracy.
- 4. Good, complete and readily-available information on the legal framework directly applicable to the tourism sector and its operations**, as well as any laws and regulations that may indirectly affect tourism investments should be provided to potential investors. Ideally, these conditions should remain valid for a relatively long period of time, thus preventing surprise changes that might affect foreign investors. Yet, governments should also exercise their prerogative to modify laws, rules and regulations, in the most democratic manner and with due consultation with all stakeholders, in the interest of the nation’s priority objectives.
- 5. Availability of abundant and, if possible, cheap local labour that can be easily trained in hotel, catering and related tourism occupations, as well as qualified manpower with a knowledge of foreign languages.** Tourism is a labour-intensive service activity, with close contacts and interaction between employees of tourism establishments and the clients (the tourists). The quality of service is highly dependent on the quality of the staff that provides the service, and therefore training is a key element in ensuring the delivery of quality services. Similarly, communications between clients and staff must be facilitated and the knowledge of common international languages (e.g. English, Spanish, French and German, as well as Japanese and Chinese in some Asian destinations) becomes essential. Foreign investors should be required to provide training to locally recruited personnel at all levels, to ensure as wide a spread of benefits to local people as possible.
- 6. A local authority committed to tourism development**, which is capable of providing the necessary infrastructure and services that are part of the tourism package, such as airports and/or port facilities, public transport infrastructure and

services, parking areas, water and energy, solid waste collection and disposal services, wastewater collection and treatment plants, urban furniture, policing and security, beach cleaning services, etc. The local government should also ensure the provision of information to tourists, before and during their trip is adequate.

7. **Adequate governance structures at the local level**, especially to ensure that all tourism stakeholders, public and private, work in a coordinated fashion to provide the variety of services normally required by tourists when visiting a destination. Destination management organisations are becoming common in many destinations to coordinate both promotional and marketing activities, as well as tourism management, and sometimes also monitoring tourism impacts. Good relations between the public and private sectors, and the presence of private sector representatives in investment administration and tourism decision-making bodies are often a requirement too.
8. The commercial success of any tourism investment is closely linked to the **existence of a clear, well-focused and systematically implemented marketing and promotion strategy for tourism**, at the national or local level. Foreign investors will normally be more attracted to invest in those countries that have an effective tourism marketing and promotion strategy, ideally defined, funded and implemented under a public-private partnership, with participation from private tourism businesses and local and national public authorities. Of course, some larger international investors in tourism, such as multinational hotel chains, rely more on the prestige of their brand name and on their own internal marketing and promotion structures, as well as their central reservation systems. This is certainly positive for the host country, which can therefore rely on a more international and professional handling of its marketing and promotion; but it may also lead to a loss of national control in the image creation process for the country as a tourist destination. Governments and destination management organisations in developing and least developed countries must, therefore, be informed in advance of the promotional messages that the foreign investor intends to convey for its proposed investment in order to avoid any distorted or biased image. Ideally, foreign investors should be invited to join and financially support any existing marketing and promotional programme and campaign for the destination as a whole.
9. **Availability of land at low cost in attractive natural environments or close to major cultural attractions** is a key magnet to catch the attention of investors and housing developers, as the case of many countries with sun-bathed coastal areas demonstrates. Yet, this can be a double-edged factor, since it may lead, as it has in several countries, to land speculation and an over-occupation of coastal areas to the extent of destroying its basic resources or seriously affecting its environmental quality.
10. **The closeness and/or the ease of access of a region or site to major tourist generating markets** represents a key factor for attracting foreign

investors into that region or site. Turkey with regards to Western Europe, Mexico with regards to the United States, and the Caribbean islands, with excellent air connections to both Europe and the United States are good examples of how determinant this factor is. Although this seems to be an obvious condition for tourism development, it is often forgotten by governments wishing to attract investors and tourists into their country or to a particular region within it. Accessibility is a major condition for tourism success, and if such accessibility does not exist or is not planned in government programmes for the short- or medium-term, it is highly unlikely that foreign investors will decide to put their money into a tourism project there. An “open skies” policy with respect to air transport, especially regarding allowing the operation of low-cost carriers, seems to be an important factor for attracting investments in tourism, as shown by the example of Mexico.

11. Information and promotion of tourism investment opportunities has also been common practice for a number of countries wishing to receive foreign investment. Mexico is again a case in point; the government, in a joint effort between the Secretary of State for Tourism and the IPA have been organising the Mexican Tourism Investment Exchange for a number of years. During this event, central and local government officials, as well as Mexican businessmen looking for foreign partners, present a portfolio of investment projects to potential investors, together with an exhibition of tourist attractions, seminars and lectures on specific destinations within the country, etc.¹⁶

Responsible FDI-T: recommended practices

1. Responsibility with regards to the natural environment

Responsible investment in tourism means that investors respect the natural environment in which they establish their infrastructures and operations.

The natural environment – including coastal areas, mountains, flora and fauna, seas, lakes, rivers, forests, volcanoes, marshes, small islands, wetlands, deserts and any other natural features – represents the basic raw material for tourism. Indeed, most IPAs do describe their natural and geographical attractions to attract foreign investors in tourism. In the case of Latin American countries, the emphasis is placed on biodiversity and the conservation of nature, while African countries put the accent on wildlife and natural parks. An analysis of 85 IPAs’ websites shows that 20 per cent of them specifically mention ecotourism as a segment for potential investments, while some, such as Colombia and Gambia, offer tax exemptions for ecotourism FDI projects.¹⁷

So, it is first and foremost in the interest of any tourism investor, foreign or national, to preserve the richness, beauty and variety of these assets that serve to

16. Fonatur.

17. Hayles, 2007.

attract visitors to the destination. Without these attractions, tourists will not visit and tourism cannot be viable. But over and above that, there is today a generalised awareness about the fragility of many natural areas and ecosystems, and the associated risks of the disappearance of some species and reduction of biodiversity with severe negative consequences for human life on the planet.

Therefore, investments made in tourism, more so than those in other sectors of economic activity, should be extremely careful about potential negative impacts upon the natural environment and the landscape. For a proposed tourism investment in a given area to be deemed responsible, its proponents should undertake an in-depth environmental impact study in advance of its submission for approval, in order to identify potential negative impacts that may irreversibly damage the natural environment. These studies can also serve to propose and include in the investment project whatever mitigation measures are deemed appropriate to prevent any negative impact identified.

In the case of foreign investment in coastal resort areas, which tend to be fairly large, these requirements should be strengthened, as impacts can be more significant and also affect the nearby sea or lake.

Another factor calls for rigorous pre-investment environmental impact studies. Many foreign direct investors in tourism in least developed countries tend to count on a fairly short period for recovering their investment, sometimes as short as three or four years, due to higher economic or political risks. These periods are often too short to appreciate any lasting negative environmental impact caused by the investment, and hence the pre-investment impact assessment should be very strict and a condition *sine qua non* for approval by the host country.

Several countries have established some conditions regarding environmental impact assessment and/or the need to protect nature in their investment codes (e.g. Croatia, Lao PDR, Mexico, Morocco,¹⁸ Seychelles, Uruguay, and Vietnam¹⁹). The extent to which these conditions are enforced is not known, but government IPAs authorising FDI projects in tourism, ideally in consultation with the corresponding national tourism administration, should be extremely vigilant to ensure that no damage is done to the natural environment in zones with tourism potential.

2. Responsibility with regards to the built environment and cultural heritage

The same principles concerning respect for local natural conditions should apply for the built environment, especially when FDI-T refers to rich heritage sites, whether listed as World Heritage Sites by the United Nations Educational, Scientific and Cultural Organisation (UNESCO) or not.

18. E.g. Morocco's current Plan Azur for coastal tourism development is very explicit in this respect.

19. E.g. In Vietnam, investment is "prohibited...in projects which harm the people's health or which destroy natural resources and the environment", Law on Investment, Vietnam, 2005.

Such cities and indeed many culturally rich towns or villages, are becoming very popular among tourists, and international hotel chains as well as some international fast-food chains do not wait long before establishing one or several outlets with their brand in the most frequented and central parts of the urban area, or in the vicinity of major archaeological or historical sites. The loss of local identity is evident and shocking for most foreign tourists, thus reducing the overall quality of the destination.

National and local governments responsible for town planning and for heritage conservation should set up very stringent regulations for any investment project that may alter the urban landscape, avoiding for example, high-rise buildings that will break the skyline of heritage cities. Regulations should be rigorous in respect of any particular traditional building that foreign companies may wish to reconvert into a hotel or a restaurant or any other tourism-related use.

Contrary to the aforementioned requirement regarding natural assets protection, the conservation and protection of cultural heritage sites does not commonly appear in investment codes. One of the few cases where it does appear is in Vietnam's investment law, which prohibits "projects which are detrimental to historical and cultural traditions and ethics, and Vietnamese fine customs."²⁰ But at the same time, Vietnam's law on cultural heritage encourages organisations and individuals owning or managing cultural heritages "to create favourable conditions for.... individuals to travel to and study cultural heritages."²¹

3. Promoting joint ventures and developing local entrepreneurial capabilities

One of the advantages of FDI in general, (and for investments in tourism) is the promotion of local entrepreneurial capabilities. When foreign investors and managers of foreign companies in a developing country work with local businessmen, the latter acquire entrepreneurial and business capabilities that will assist them in developing their own businesses at a later stage, and eventually help the entire economy of the country.

This can best be achieved, in an initial stage at least, through joint ventures between foreign and local partners in a fresh investment project, or by incorporating foreign partners into an existing, locally-owned tourism business. The former can thus provide not only fresh capital funds for the initial investment, but also technologies and management skills for its operation.

Governments should encourage the creation of such joint ventures between foreign and local investors and, whenever possible, with local communities too, so that the latter become beneficiaries of the investment project, either as full partners (e.g. by providing community-owned land) or as suppliers of labour or other inputs in the project's operation. South Africa's policies explicitly call for "joint ventures in

20. Vietnam Op.cit.

21 Vietnam, Law on Cultural Heritage, June 2001, N° 28/2001/QH10, June 2001.

which communally-owned land forms the basis of equity for community partnerships with the private sector and state conservation agencies.”²²

4. Diversification of the tourism supply

In small- and medium-sized economies, diversification in the tourism sector and in the ownership of tourism infrastructure must be sought in order to reduce dependence on one or two forms of tourism (e.g. beach tourism, cruise tourism, gambling, conferences) or on one or two foreign investors.

Therefore, in promoting FDI-T, governments should attempt to attract a wide variety of foreign companies, offering different types of hotel services e.g. large hotels of three, four or five star ratings, serving business and holiday visitors; resort-type establishments, with spas, health and sport centres etc; small, boutique style up-market hotels; yachting and marina facilities; etc.

Furthermore, in the case of small islands and other small nations, tourism should be considered as only one of the components of the overall sustainable development strategy of the country, and should be fully integrated into it. One of the objectives of attracting FDI-T in these countries should be to reinforce their capacity to face crises, which generally affect only some sectors of their economies, by diversifying their economic base, rather than by replacing existing activities and becoming over-dependent on tourism.

Among developing countries, South Africa is perhaps one of the few cases where the government explicitly welcomes, with a clear priority, foreign “investors that invest in rural communities and less developed geographic regions”, and “investors that develop products that help to diversify the tourism product, e.g. cruise tourism, ecotourism, heritage tourism, Afro-tourism, etc.”²³

5. Maximising benefits to the host community

To maximise the contribution of tourism to the prosperity of the host destination, a high proportion of the visitors’ spending must remain in the local economy. This means that reducing economic “leakage” (i.e. when a portion of tourist expenditure goes abroad to pay for external goods and services) should be a major concern when promoting FDI-T. This can be achieved by developing linkages within the local economy.

Many international hotel chains tend to have centralised procurement systems based at their headquarters or at a regional base, with the multiple purpose of ensuring brand homogeneity in their provision of services to tourists, making some economies of scale by bulk purchasing, and facilitating the tasks of local managers in their properties spread around the world.

22. DEAT, 1996.

23. DEAT, 1996.

In developing and least developed countries the result of this practice is that a fairly high percentage of money spent by the tourists at the destination is taken away from the local economy in the form of imports, paying royalty fees, or in remunerating expatriate managers and other services. Host countries thus miss an opportunity to develop linkages with local producers who could benefit from the presence of tourists in their country. Indeed, in developed countries the multiplier effect of tourism is considered to be one of its most important economic benefits and it has been estimated that US\$1 spent by a tourist in a hotel may generate up to US\$2.5 in the rest of the economy.

Countries wishing to attract foreign investment in hotels or other accommodation establishments are often inhibited²⁴ from instituting import constraints on potential investors, for fear that they may eventually decide to withdraw their project, or to choose an alternative, more liberal location in another country. This should not be the case if most countries in a given region adopt similar policies regarding local inputs.

Furthermore, and to counteract the high import practice, host governments should show potential foreign investors all the inputs that are currently available within the country, with the contact details of suppliers, prices, etc., and facilitate the contacts between the former and the latter. On the same note, governments should demand a complete inventory of the major inputs they require in the operation of the hotel or restaurant from foreign investors, so that, while the project is being developed, they can investigate the local market and eventually give local manufacturers support to produce the required goods and services in the quantity and quality required by the foreign hotel investor.

6. Promoting the transfer of suitable technologies

FDI-T can be a very important mechanism for the transfer of technologies from developed to developing countries, and this includes both hard technologies (such as air conditioning, food processing equipment, information and communications hardware and heavy furniture) and soft techniques (such as management methods, marketing skills, promotion in foreign markets and ICT software). South Africa, for example, explicitly gives priority to foreign “investments that will result in the transfer of skills and technology to locals”²⁵ and the Maldives FDI regulations specify that “all investments must introduce new skills, enhance technology transfer and be capital intensive and environmentally friendly.”²⁶

The choice and transfer of technologies, however, has to be carefully done and adapted to the local economic and social characteristics of each specific destination,

24. Vietnam’s investment law of 2005, for instance, explicitly guarantees foreign investors that the state “will not compel them to give priority to the purchase or use of domestic goods or services”.

25. DEAT, 1996.

26. Invest Maldives, 2007.

including its endowment of qualified human resources. Indeed, it is common that the main purpose of the latest available technologies developed in the more advanced societies is to reduce labour inputs in the production process, due to the high direct and associated labour costs prevailing there. But, is this the most appropriate policy for developing nations where there is a great abundance of labour? Do tourists visiting these countries need automatic vending machines for food items for instance?

Governments in the countries hosting FDI-T should therefore be cautious when examining and approving investment applications, in terms of the technologies and associated equipment to be introduced into the country as proposed by the applicant. Furthermore, the maintenance of over-sophisticated equipment and machinery may require the presence of expensive foreign experts, paid in foreign currency, and the continuous import of spare parts, both of which will lead to leakage of foreign exchange.

In other words, the indiscriminate transfer and adoption of new technologies in the tourism industries of developing and least developed countries is not advisable. Each country and each specific destination should select the technologies and equipment that will serve their current conditions better, achieve their global development policy objectives better and better preserve their identity.

Conclusions

In summary, tourism appears as a promising, dynamic sector of economic activity that can trigger, or at least substantially contribute to sustainable socio-economic development while respecting the natural and cultural environments of host societies. However, for tourism to play that role, a suitable policy framework is needed, plus a concerted effort between public authorities and private stakeholders, including foreign companies.

The potential importance of FDI-T projects is certainly large, as tourism activities are intrinsically international. For developing and least developed countries, the arrival of foreign tourists and foreign investors is, to a large extent, a condition for success. Yet, national tourism administrations (NTA) and IPAs of these countries should be extremely vigilant in attracting FDI in this sector, establishing stringent conditions with respect to their natural environment, their cultural assets and their communities.

IPAs have a particular role to play in this respect. Firstly, they need to involve, and work closely with the NTA in the establishment of specific guidelines for FDI-T, bearing in mind all the criteria specified in the previous section of this chapter. As a minimum, such guidelines should include at least the following:

- a) priority types of tourism to be developed in the country, compatible with the National Tourism Strategy and Plan; and in line with these, priority types of foreign investment to be attracted;
- b) types of pre-investment evaluations to be demanded from foreign investors

applying for approvals, especially regarding environmental and socio-cultural impacts of the proposed tourism investment project (in addition, of course, to those of an economic and financial nature);

- c) linkages to be established by the applicant investor with the rest of the local economy; and
- d) proposed marketing and promotional actions envisaged by the applicant investor, especially in foreign markets.

A second aspect that IPAs need to address is an appropriate selection of potential foreign companies investing in tourism. They should examine the declared and actual commitment to environmental and social issues of large multinational tourism companies carefully, by collecting information from other countries where these companies operate and evaluating their performance there. In particular, IPAs, in cooperation with NTAs, should try to identify any possible tendency towards monopolistic behaviour of large tourism companies in some tourism destinations.

Large multinational hotel chains have widely expanded in some regions, such as the Caribbean, sometimes controlling a high percentage of the accommodation supply of small destinations. Similarly, the vertical integration of transport, accommodation, catering and other tourism services is a relatively common practice of international companies; although this provides some guarantees in terms of bringing visitors to a destination, it may lead to a dangerous dependency situation, making the destination very vulnerable.

IPAs should also be aware, before approving any project, of the contracts that foreign hotel investors and developers intend to sign with hotel management companies. This is again a common practice in this sector, in which the investor/owner is not always responsible for the management of the hotel or resort. A high concentration of accommodation supply at a destination in one international hotel management company, even if the property of the hotels is in different hands, may also put the destination in a dependent, vulnerable situation, in terms of prices negotiated with tour operators, remunerations to local employees, market segments, country markets, etc.

Finally, IPAs and NTAs should work closely to establish limits to FDI-T, based on two main criteria; first, the overall limits to tourism development in any particular destination or region within a country, commonly known as “carrying capacity”; and second, the reasonable limits that need to be set to foreign ownership and management of tourism operations in the destination, in order to protect its character and authenticity.

In conclusion, tourism, as a tool for sustainable development, is meant to contribute to the social and economic prosperity of each country’s local communities and to safeguard its natural ecosystems and cultural heritage. If FDI-T fails to contribute to achieve these key objectives, then it might be better not to accept the investment proposal at all.

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Chapter 7

Investment promotion agencies and access to land: Lessons from Africa

Lorenzo Cotula and Camilla Toulmin

1. Introduction

Securing access to land is a key step in the implementation of most investment projects. Commercial ventures in sectors as diverse as agribusiness, manufacturing and tourism all depend on the identification and acquisition of suitable land to host the investment project. Yet for outside investors with few reliable in-country contacts and limited knowledge of local institutional arrangements, gaining access to land may prove a difficult challenge involving long and cumbersome procedures, unclear and insecure land rights, and corruption.

Recent surveys of firms investing in Africa have identified gaining easy access to land as a critical factor in investment decisions. For instance, in a survey from Mozambique, 27 per cent of the sample firms identified land access as a major problem. According to the survey, the average time for acquiring land was 12 months,

and the average total cost US\$18,000. These constraints on land access were considered to be a major reason why potential investors shy away from Mozambique.¹ Similarly, a recent World Bank survey found that 57 per cent of the sample firms in Ethiopia and 25 per cent in Kenya reported access to land as their main obstacle.²

At the same time, in much of rural Africa land constitutes a major livelihoods source for the majority of the population, as it provides the basis for both subsistence and market-oriented agricultural activities. In addition, land is much more than a production factor; it is a source of political power, a basis for complex relations of alliance and reciprocity, and a central component of social identity. In many parts of Africa, population pressures and other factors have resulted in greater competition for land, while socio-economic change has, in many places, eroded the customary rules and institutions that traditionally administered land and managed conflict.

This context creates the need for institutional arrangements to accompany prospective investors in their efforts to gain access to land, while ensuring that investors' acquisition of land does not occur to the detriment of the land claims of local groups. Where local land rights are infringed, local groups may be deprived of the land they have used from time immemorial, with negative consequences for their land-based incomes and livelihoods.

Investors may lose out too, particularly when dispossessed and disenfranchised local people resort to protest or even sabotage to defend their land rights. For instance, research from Ghana has documented the resistance strategies deployed by farmers who lost their land to large-scale investment projects since the 1980s – strategies ranging from court action to crop damage.³ On the other hand, prompt and secure land access for investors coupled with effective protection of local land rights may result in win-win situations in terms of both commercial viability and equitable benefit-sharing with local groups.

IPAs thus must address the challenge of helping investors gain access to land while ensuring that local land users benefit from the investment. Several IPAs in Africa have sought to address this challenge – to varying degrees and using different legal and institutional models. As this experience is relatively recent, there is limited empirical research documenting how these different models have been implemented on the ground, and to what effect.

This chapter analyses experiences concerning the role of IPAs in land access. It focuses on sub-Saharan Africa, drawing on countries such as Ghana, Mozambique, Senegal and Tanzania. The chapter is based on an analysis of relevant legislation and on a review of information available on the official websites of several IPAs and in the (rather limited) literature. The purpose of the chapter is to map out issues and pave the way for further research, rather than to offer definitive policy recommendations –

1. Nasir *et al.*, 2003:30.

2. World Bank, 2005.

3. Amanor, 2005.

although some implications are identified for the work of IPAs.

The next section briefly sketches some of the key features characterising land tenure in Africa. Section 3 compares the role played by different IPAs in land access, while section 4 focuses on the procedures to obtain land access, including the safeguards that may be built into them in order to protect local land rights. Section 5 analyses the nature, content and duration of the land rights that investors may be vested with in different countries. Finally, a conclusion summarises key findings, identifies areas for further research, and outlines some implications for the work of IPAs in Africa.

2. Land tenure in Africa

Much legislation in sub-Saharan Africa provides the state with a significant degree of control over land. After independence, many African governments nationalised or otherwise took control over land, often following the colonial model. This was justified as a means to promote agricultural development on the one hand, while ensuring government had control of a valuable asset and a source of political power on the other.

For instance, land was nationalised in Burkina Faso (under the *Réorganisation Agraire et Foncière* 1984), Mozambique (at independence in 1975, and more recently under the 1990 Constitution and the Land Act 1997), Nigeria (where the Land Use Act 1978 vests land ownership with the governor of each federated state) and Tanzania (after independence and more recently under the Land Act 1999 and the Village Land Act 1999).

Other countries promoted private property. Kenya, for instance, has long had a land titling programme to register private property, converting customary land rights into freehold. In Ghana, part of the land is owned by the state but most of it belongs to private entities, such as customary chiefdoms, extended families and individuals.⁴

In the 1990s, political democratisation and economic liberalisation brought about law reforms introducing, or strengthening, protection of private land ownership in several countries that had previously nationalised land – for instance in Burkina Faso (revisions to the *Réorganisation Agraire et Foncière*, in 1991 and 1996).

However, in most cases, the state remains the key player in land relations. With important exceptions (e.g. Kenya), private land ownership tends not to be widespread even where it is formally recognised – particularly in rural areas. This is due to the long and cumbersome procedures required to establish private ownership, particularly land registration. The World Bank estimates that, across Africa, only between 2 and 10 per cent of the land is held under formal land tenure; and this mainly concerns urban land.⁵

4. Kasanga and Kotey (2001:13) estimate that 80 to 90 per cent of all undeveloped land in Ghana is held under customary tenure.

5. Deininger, 2003:xxi.

With much control over land vested in the state, and with limited spread of private ownership, many people enjoy land use rights so long as they put land to productive use, for instance under “*mise en valeur*” requirements found in the legislation of much of Francophone Africa (e.g. Cameroon, Chad, Mali and Senegal). In these cases, land management institutions may be mandated to monitor productive use, and to reallocate land to third parties in case of non-use. Where land use rights are withdrawn, compensation is paid for loss of “improvements” (crops, buildings) but often not for loss of land rights as such (e.g. Cameroon, Senegal).

This legal regime, along with a lack of clear definition of what constitutes “productive use” plus the ensuing broad discretion of government officials responsible for monitoring fulfilment of this requirement, may open the door to abuse, and undermines the security of local land rights. This is particularly so for those groups whose resource use is often not considered as “productive enough” due to widespread (mis-)perceptions – particularly of pastoral production systems.⁶

In much of rural Africa, lack of financial resources and of institutional capacity in government agencies, lack of legal awareness and, often, lack of perceived legitimacy of official rules and institutions all contribute to limit the outreach of state legislation. On the ground, much of the rural population continues to access land through local tenure systems. These systems are based on usually unwritten rules founding their legitimacy on “tradition”, as shaped both by practices over time and by systems of belief. Because of this, they are usually described as “customary”. In reality, they have changed profoundly over time as a result of cultural interactions, population pressures, socio-economic change and political processes.⁷

According to the dominant, if somewhat stereotyped, view of customary resource tenure systems in Africa, land is usually held by clans or families on the basis of a diverse combination of group and individual rights. Land is accessed on the basis of group membership and social status. In reality, customary resource tenure systems vary considerably depending on the context. Important differences exist, for instance, between pastoral and farming contexts, and between patrilineal and rarer matrilineal systems.

In farming contexts, for instance, customary systems usually entail collective landholding by the family lineage or wider clan, and the allocation of farming rights over specific plots by the land management authority (e.g. the “chief”) to smaller family units. The nature of these smaller units and of the farming rights they hold vary considerably from place to place. In many cases, farming rights are conditional upon the continued use of the plot. And, while such rights are often inheritable, restrictions usually exist on sales (especially to outsiders), although certain transactions may be allowed (gifts, loans, etc.).

While in the eyes of local groups “customary” rights may be real and legitimate, these rights tend to enjoy little formal legal protection. However, several countries

6. Hesse and Thébaud, 2006:17.

7. On these aspects, see Cotula with Neves, 2007.

have recently taken steps to strengthen protection of customary rights – even where land is state-owned or vested with the state in trust for the nation. Customary rights are, for instance, protected – to varying degrees – under Mali’s Land Code 2000, Mozambique’s Land Act 1997, Namibia’s Communal Land Reform Act 2002, Tanzania’s Land Act and Village Land Act 1999 and Uganda’s Land Act 1998.

As a result of the limited implementation of state legislation at the local level and of the continued application of customary rules, several systems – statutory, customary and combinations of these – tend to regulate land rights in the same territory (a phenomenon referred to as “legal pluralism”). In this context, the boundaries between the “customary” and the “statutory” are very fluid: rather than a dichotomy between opposing extremes, local reality more commonly resembles a continuum combining both customary and statutory.⁸ This situation often results in overlapping rights, contradictory rules and competing authorities.

3. The role of IPAs in land access

The nature, role and powers of IPAs vary substantially across countries. This diversity reflects broader differences in political orientation on issues such as foreign investment and the role of the private sector and of government regulation. For instance, while in Mozambique all investment projects (whether foreign or national) require government approval (under the 1993 Regulation to the Investment Act), in Ghana no such approval is required outside the mining and petroleum industries (although foreign investors are required to register with the Ghana Investment Promotion Centre under the Ghana Investment Promotion Centre Act 1994).

With specific regard to land access, the role of IPAs ranges from facilitating investors’ dealings with government land agencies, to a more direct role in allocating land to investors. In Senegal, for instance, the *Agence Nationale Chargée de la Promotion de l’Investissement et des Grands Travaux* (APIX) acts as a one-stop-shop, accompanying investors in the rather complex and cumbersome process to obtain land from relevant government agencies.⁹

Similarly, in Ghana and Mozambique, IPAs act as one-stop-shops, facilitating the acquisition of all necessary licences, permits and authorisations. Their direct role in facilitating land access seems focused on helping investors in their dealings with other agencies. In Mozambique, for instance, while investment legislation makes no explicit mention of the role of the *Centro de Promoção de Investimentos* (CPI) in facilitating land access, the application form for prospective investors to seek government approval of the investment projects does mention, among possible areas where CPI assistance is sought by the investor, the “identification and licensing of land.”¹⁰

A somewhat more “hands-on” role is played by Tanzania’s IPA, the Tanzania

8. Benjaminsen and Lund, 2003.

9. APIX website.

10. CPI website.

Currently available land for investors	Parcels	Area (ha)
Agriculture	386	1,100,398.00
Housing estate	21	1,469.47
Industry	156	537,880.60
Mining	11	445.80
Ranching	49	238,939.20
Tourism	127	711,027.80
Grand total	743	2,590,161.00

Source: TIC website

Investment Centre (TIC). Under the Tanzanian Investment Act 1997, the TIC is mandated, among other things, with identifying and providing land to investors, as well as with helping investors obtain all necessary permits (Article 6). This entails identifying land not currently under productive use, and directly allocating it to investors. Under this arrangement, the land is vested with the TIC, and transferred to the investor on the basis of a derivative title (see section 5 below).

In order to perform this function, the TIC has set up a "land bank" – it has identified some 2.5 million hectares of land as suitable for investment projects.¹¹ The breakdown of this land area is provided in Table 1 above.

4. Land access procedures and safeguards for local land rights

In several African countries, the procedures for securing access to land are long and cumbersome. This issue emerged in several World Bank "Doing Business" reports, which identified cumbersome land access procedures as a significant constraint for business.¹² For example, Table 2 summarises the time and costs of registering property in sub-Saharan Africa, in comparison with other parts of the world. It shows the wide disparity in cost and the uncertainty associated with securing access to land for business.

These data mask significant cross-country variation, however. Although the hurdles in some African countries are extreme, others, such as Botswana, Kenya, South Africa and Uganda, have shorter, less costly and more efficient procedures (as shown in Table 3).

Procedures for accessing land may perform a useful role in establishing safeguards for local land rights. These safeguards aim to ensure that, at a minimum, local groups are not arbitrarily dispossessed of their land as this is made available to investors.¹³

In this regard, a particularly interesting example is provided by Mozambique, where investors are legally required to consult "local communities" holding rights in

11. TIC website.

12. World Bank, 2005.

13. For a comparative analysis of different approaches to establishing these safeguards, see Cotula (2007).

Number of days	Region	Percentage of property value
34	OECD high income	4.8
51	East Asia and Pacific	4.2
54	Middle East and North Africa	6.8
56	South Asia	6.1
62	Latin America and the Caribbean	5.6
133	Europe and Central Asia	3.2
116	Sub-Saharan Africa	14.4

Source: World Bank, 2005

Number of days	Country	Percentage of property value
335	Angola	11.0
107	Burkina Faso	16.2
340	Côte d'Ivoire	10.2
382	Ghana	4.1
274	Nigeria	27.2
114	Senegal	34.0
69	Botswana	5.0
39	Kenya	4.0
20	South Africa	11.3
48	Uganda	5.5

Source: World Bank, 2005

the land area sought for the investment project (Article 12 of the Land Act 1997 and Article 27 of the Land Act Regulation 1998).

Under Mozambique's Land Act, community consultation must be undertaken regardless of whether the land has been registered. The consultation process is required before land use rights are allocated to investors; the specific purpose of this consultation is to ascertain that the land area is "free" and "has no occupants" (Article 13(3) of the Land Act; see also Article 24 (1)(c) of the same Act). The mandatory community consultation process is meant to pave the way for the negotiation of benefit-sharing agreements between local groups and the investor applying for land.

This model constitutes an interesting approach to facilitating investors' access to land while protecting local land rights – both of which were explicit objectives pursued by the National Land Policy that preceded the adoption of the Land Act. However, shortcomings in the design and implementation of the community consultation process have been reported in the literature.¹⁴ The system is centred on a one-off consultation between the investor and the community. This is at odds with the long-term duration of land allocations and forest concessions.¹⁵ In practice, several agreements between communities and investors emphasise one-off compensation for loss of land rights rather than long-term benefit sharing, and usually involve very small payments compared to the value of the forest concessions acquired by the investor.¹⁶

In addition, there are no established mechanisms to monitor compliance with the agreement on the part of the investor. No effective sanctions exist in case of non-compliance – non-compliance does not affect the concession.¹⁷

The implementation of these provisions has been riddled with difficulties. In many cases, consultation processes only involve a few community members, usually customary chiefs and local elites who also monopolise the benefits.¹⁸ In some cases, the consultation did not take place at all – or at least there is no record of it.¹⁹ Even where consultation takes place as required, communities lack the bargaining power and technical skills to negotiate with foreign investors on an equal footing.²⁰

Recently, government authorities have taken steps to reduce what are perceived as constraints on investors' land access. For instance, in October 2002 a government decree set a 90-day time limit for the processing of investor land applications (including community consultations).²¹ The tightening of the legal regime of local consultation processes is putting pressure on the quality of these processes. The period of 90 days may seem long, but meaningful consultation of large communities in contexts characterised by significant power asymmetries between private companies and local groups would require sustained investment in time and effort in order to build local capacity to engage in consultation and negotiation exercises.²²

Government interventions to ease the requirements and time set aside for community consultation came partly from the assertion that such requirements impose an excessive burden on investors, and may therefore discourage firms from investing in Mozambique. However, while land access for investors is indeed perceived as an issue by many firms in Mozambique (see the results of the survey referred to in section 1 above), much of the burden perceived by investors is linked to

14. Johnstone *et al.*, 2004; Norfolk, 2004; Chilundo *et al.*, 2005; Durang and Tanner, 2004.

15. Johnstone *et al.*, 2004; Durang and Tanner, 2004.

16. Norfolk, 2004; Durang and Tanner, 2004.

17. Johnstone *et al.*, 2004; Durang and Tanner, 2004.

18. Norfolk, 2004; Durang and Tanner, 2004.

19. As documented by Norfolk, 2004, and Johnstone *et al.*, 2004.

20. Johnstone *et al.*, 2004; Durang and Tanner, 2004.

21. Kanji, *et al.*, 2005.

22. Kanji, *et al.*, 2005.

bureaucratic red tape imposed by government agencies (e.g. concerning investment approval requirements) rather than by local consultations per se.

Despite the shortcomings in the design and implementation of local consultation processes under Mozambique's Land Act 1997, the very existence of a legal requirement to consult is a promising feature that differentiates Mozambique from several other African countries.

Another country where on paper local groups have a say in decisions to allocate land to outside investors is Senegal. Here, the exact nature of this say varies depending on the legal status of the land in question – whether it belongs to the central state, to private actors or to the “*domaine national*”, a land area held by the central state and the bulk of which (“*zones de terroir*”) is managed by local governments (“*communautés rurales*”). Where land belongs to the central state (or to parastatal agencies established, for example, to promote the development of a particular area, such as the Société d'Aménagement et de Promotion des Côtes et Zones Touristiques du Sénégal (SAPCO)), state agencies can directly allocate land to investors without much local consultation. On the other hand, local governments have a say in the allocation of land within the “*zones de terroir*”, over which they hold considerable powers.

The extent to which local governments have the skills and confidence to resist an investment project enjoying central government backing, and the extent to which they have been able to use their legal powers to influence the distribution of the costs and benefits generated by the project, deserve closer attention.

5. The nature and content of investors' land rights

The nature, scope, content and duration of the land rights that investors – particularly foreign investors – are vested with varies across countries. This diversity reflects diverging political orientations with regard to land tenure – particularly as to whether private land ownership is allowed, and whether non-citizens may gain access to it.

In Mozambique, for instance, all land is vested with the state under the 1990 Constitution (Articles 98 and 109) and the Land Act 1997. Foreign investors and local groups alike may not own the land, but may enjoy long-term use rights (“DUAT”). However, while for local groups these land use rights are of indeterminate duration, investors (foreign or national) may be granted use rights of up to 50 years, subject to their complying with a production plan.²³

In Ghana, while nationals may own land, foreigners may not – they can only acquire land leases of up to 50 years (Article 266 of the 1992 Constitution). Similarly, in Tanzania (where land is vested with the President in trusteeship for the nation), foreign investors face restrictions on the land rights they can hold. In particular, under the Land Act 1999 (Article 20(1)), foreigners cannot own land, and may acquire long-

23. Investors are granted a provisional land allocation of two years (if foreigners) or five years (if nationals), and a “definitive” allocation if they comply with the production plan within that period (articles 28-30 of the Investments Act Regulation 1993).

term use rights only for the purposes of investment under the Tanzania Investment Act.

Under Tanzanian legislation, these long-term use rights usually entail land being vested with the TIC and then allocated by the TIC to the investor on the basis of a derivative title (under Article 19(2) of the Land Act 1999). After the end of the investment project, the land reverts back to the TIC (Article 20(5) of the Land Act).

Tanzania's Land (Amendment) Act 2004 introduced another land access arrangement: the establishment of joint ventures between foreign investors and local groups (under Article 19(2)(c) of the Land Act, as amended). Under this arrangement, local groups retain land rights while the investor obtains lesser land rights from the local group.

6. Conclusion

In recent years, several African countries have taken steps to facilitate investors' access to land. IPAs play a role in this – a role that varies significantly across countries and ranges from accompanying investors in their dealings with other government agencies to more direct involvement in identifying and providing available land. The procedures for investors to obtain access to land and the nature, content, scope and duration of the land rights that investors may obtain also vary.

A key challenge in much of rural Africa relates to facilitating access to land for investment while ensuring that this does not happen to the detriment of local groups. This challenge is particularly pressing given that land registration in rural Africa remains very rare, and most local resource users obtain access to land through local (“customary” but continuously evolving) resource tenure systems that may have only limited legal protection. Policy, legislative and institutional approaches to tackle this challenge have been developed (e.g. Mozambique's mandatory consultation process), although shortcomings in design and implementation have affected the outcomes of these approaches.

Given the limited literature publicly available, there is a need for empirical research to document how different legal and institutional arrangements are working on the ground – for instance, whether and to what extent they are effective in helping investors gain access to land as well as in protecting local land rights. This need is particularly acute with regard to documenting “successful” experience, analysing the conditions that made it possible and the extent to which such experience can be replicated elsewhere.

While this greater body of empirical research is in the making, the scoping analysis undertaken already provides some insights for the work of IPAs, particularly in Africa.

First, the limited information publicly available on how IPAs handle land access issues calls for greater efforts on the part of IPAs to disseminate information. Providing clearer information on the websites of IPAs would be an obvious first step.

This would help investors better understand institutional roles and procedures, thereby making it easier for them to acquire the required land. It would also make procedures and land allocation decisions more transparent, thereby strengthening safeguards for local land rights.

Second, the diversity of institutional arrangements documented here highlights the need for exchange of experience among IPAs as well as other stakeholders as to the different options that can be used to help investors gain access to land. Lesson sharing would enable IPA officials to learn from each other's experience, and generate insights on what arrangements work better where and under what conditions.

Third, the land access issues relating to investment projects are not limited to facilitating investors' acquisition of land. Investment projects may have long-term impacts on the land claims of other stakeholders, including local groups. In performing their land access facilitation role, IPAs must take full account of these impacts. There is a need to devise institutions and processes that can reconcile competing land claims, and facilitate investors' land access while protecting local land rights. Creative thinking and lesson-learning from the wealth of existing experience are important ingredients of this.

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APIX www.investinsenegal.com

CPI www.cpi.co.mz

TIC www.tic.co.tz, particularly at

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Chapter 8

New instruments for attracting FDI: carbon finance in Africa¹

Gregor Pfeifer

Since the United Nations Framework Convention on Climate Change (UNFCCC) first entered into force in 1994, one of the major political impediments to securing real and effective action to tackle global warming has been the cost of reducing greenhouse gas (GHG) emissions into the atmosphere. Wealthier countries objected that the restrictions they were required to impose on industry would stifle their competitiveness and economic growth, while developing countries argued that they were not responsible for historic emissions of GHGs and should therefore be exempt from any legally binding targets. Small Island States, Least Developed Countries and many African countries that stand to bear the brunt of global warming could do little but stand by until an agreement was reached.

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“Carbon finance” is a new and highly variegated form of international commercial and development project funding. It is defined by the World Bank as “the general term applied to resources provided to a project to purchase GHG emission reductions (“carbon” for short).”

Carbon finance is driven mainly by voluntary and mandatory regulatory structures that quantify and limit the right to emit GHG into the atmosphere. The main regulatory structures are the Kyoto Protocol and the European Union Emission Trading Scheme (ETS). The Kyoto Protocol of the UNFCCC is the underlying international architecture that has inspired and informed the other systems. Following ratification by Russia, the Kyoto Protocol and all its mechanisms entered into force in February 2005. The Protocol has set mandatory GHG emissions reduction targets of 5 per cent below 1990 levels for 39 developed countries (the so-called Annex I countries).

It is the twin purpose of carbon finance to: (i) help create sustainable development through the Clean Development Mechanism (CDM) and (ii) reduce the economic burden facing governments, corporations and individual citizens of mitigating global climate change derived from anthropogenic GHG emissions that they create. In many respects, carbon finance represents a breakthrough in economics by being one of the first instances whereby a negative externality (GHG pollution) has been internalised into the cost-benefits of certain productive activities.

One of the main qualities of carbon finance is that it permits governments, companies or other organisations to generate, sell or buy emission reduction “credits”. Credits can be generated via two methods (i) by emitting less than a company or government’s assigned emissions quota and putting the remaining emissions allowances to market, for sale to another organisation or government short of its target or (ii) by investing in projects that create reductions in GHG emissions (through the CDM).

Each credit is measured in tonnes of CO₂ equivalent (tCO₂e), with the equivalency rates calculated on the basis of the global warming potential (GWP) of the type of GHG in question. GWPs are themselves calculated as a function of the “radiative forcing” potential of carbon dioxide. For example methane (NO₄) has a GWP of 21, meaning that one tonne of this flammable gas is worth 21 tonnes of CO₂e.

Creating GHG emission reductions in developing countries has become attractive for developed country governments and the private sector due to the emission caps imposed on developed countries by the Kyoto Protocol and on European countries by the National Allocation Plans of the European Union ETS. These two pioneering and complementary regulatory systems combine the power of the free market with the power of government oversight to minimise the economic burden of reducing global GHG emissions, thereby helping the world tackle the immense challenge of climate change.

Individuals and organisations are also becoming increasingly concerned about their impact on the global climate. Managers of multinational corporations (MNCs) with

large GHG emissions may find the opportunities presented here particularly useful. There are already a number of companies around the world that have made an active commitment to go “carbon neutral” through energy efficiency drives, switching to renewable power supplies and via the purchase of GHG offset credits. Here it is argued that through investment in voluntary GHG offsets in Africa, managers can help mitigate the impact of future regulation pertaining to GHG emissions, prove themselves good corporate citizens and help meet the Millennium Development Goals (MDGs).

The CDM

The CDM is one of two “project-based mechanisms” of the Kyoto Protocol designed to promote investment in projects that reduce or sequester emissions of GHGs in developing countries. It is founded on the basic assumption that creating emissions reductions in developing countries is cheaper than implementing costly new technologies and upgrades to reduce domestic emissions. At the same time all CDM projects are obliged to contribute to the sustainable development of the country that hosts them, and the host countries have the right to approve or reject any CDM project.

The CDM has three stated objectives:

1. To assist parties not included in Annex I of the Kyoto Protocol (developing countries) in achieving sustainable development.
2. To contribute to the ultimate objective of the convention, to stabilise GHG concentration in the atmosphere at a level that would prevent dangerous anthropogenic interference with the climate system.
3. To assist parties included in Annex I (developed countries) in achieving compliance with their quantified emission limitation and reduction commitments under Article 3 of the Kyoto Protocol.

The CDM is a unique example of an artificially created international commodity market, regulated by the parties to the UNFCCC but intended for the participation of private businesses and investment funds. CDM projects can be financed through a variety of public and private sources but must not result in a diversion of official development assistance (ODA). All CDM project activities are overseen by the CDM Executive Board (EB) of the UNFCCC, with a separate Methodology Panel responsible for approving new methods of calculating GHG emissions baselines and subsequent reductions from different types of energy efficiency, renewable energy, forestry, methane capture or industrial gas abatement. Full, up-to-date information on the activities and decisions of both the EB and methodology panel can be found on the UNFCCC website (<http://cdm.unfccc.int>). Projects that fulfil the stringent project screening and approval process are issued with Certified Emissions Reductions (CERs), equivalent to the number of tonnes of CO₂e they prevent from escaping into the atmosphere. CERs can then be used to reach the Kyoto targets of the country that purchases them or traded with other countries short of their targets. The EU ETS has passed a special “linking directive” meaning that companies falling under the scheme

can also use CERs for reaching their targets, the effect of which has been to greatly increase demand for CDM projects across the world as private corporations seek to cut the cost of meeting their targets.²

All project developers looking to attract carbon finance from domestic or foreign sources must first ascertain whether their proposed project activity is likely to fulfil the requirements of the “procedures and modalities” of the CDM, drawn up as part of the Marrakech Accords to the Kyoto Protocol. One critical requirement of all CDM projects, aside from contributing to sustainable development is that the emissions reductions must be additional to those that would have occurred in the absence of the registered CDM activity. To that extent, project developers must be able to demonstrate that the emissions reductions they are claiming would not have occurred in a business-as-usual situation. The additionality component is critical to ensuring the CDM’s environmental integrity (i.e. that the transfer of carbon finance created real and lasting reductions in GHG emissions) without which the system would be baseless and the price of CERs would collapse.

There are four types of risk related to the financing of CDM projects:

- 1. Project registration risks** – whether the project will be approved by the host country and obtain validation and registration by the Executive Board;
- 2. Technology risks** – whether the technology will deliver expected emission reductions, and be installed and maintained properly;
- 3. Political risks** – whether the CERs will be valid in any post-Kyoto agreement and whether the host country government will tax the carbon credits, or take over ownership of the project activity;
- 4. Counter-party risks** – whether the organisation implementing the project can be given a long-term credit since carbon projects often have lengthy crediting periods.

For foreign investors interested in carbon projects, there is a host of financing structures available for carbon projects. These structures and their accompanying contract arrangements vary according to which stage in the project cycle the CDM project activity has reached. Project developers seeking carbon finance at an early stage of the project cycle should expect discounted prices for the CERs they expect to generate.

Generally speaking, private carbon funds will not release carbon finance until close to or upon delivery of the CERs. Public carbon funds on the other hand (especially those administered by the World Bank) are more willing to take on the risks of non-delivery and provide up front funds for project capital and CDM transaction costs. Recently, some private carbon funds have also started to cover all transaction costs. Most investors in CDM projects from the private sector will seek to offset much of the market risk associated with long-term price volatility of CERs by selling all credits from the project “forward”, usually for conversion into EU Allowances (EUAs), i.e., by finding a private purchaser ready to offer a fixed price per tonne of CO₂e in advance of the CERs being issued.

2. At the same time, this possibly has certain limits, as each Annex 1 country determines which percentage of the commitments can be met by CDM.

Box 1: Case study - The Durban Landfill Gas Project

The flaring (burning) of landfill gas is not common practice in South Africa, so communities near landfills are often exposed to strong odours from the escaping gas, as well as the threat of fires from accidental ignition. Burning the gas is therefore an important first step in removing these risks and in itself provides a substantial reduction of GHGs – 21 tonnes of CO₂-equivalent for each ton of methane flared. In the case of Durban, studies showed that using the gas to generate electricity rather than simply flaring it would provide additional financial as well as GHG mitigation benefits.

The three proposed sites for the project – La Mercy, Marianhill and Bisasar Road – were evaluated independently, the last site showing by far the greatest methane extraction potential. The project design document proposed simultaneous development of all three sites, yielding a potential emissions reduction of approximately 420,000 CERs/annum when fully operational.

Unexpectedly, the environmental review process revealed strong public opposition to the largest of the three sites, Bisasar Road. Opposition centred around the potential presence in the landfill of toxic substances, rather than around the methane destruction/power generation aspects of the project. As Bisasar Road abuts closely on a large number of low and middle-income settlements, this opposition was perhaps not unexpected, although the developers had probably assumed that the opportunity to reduce GHG emissions would provide sufficient justification for approval in itself.

Public concerns led to a strategic decision by the city's managers to separate this site from the other two sites in order that the latter two could continue the CDM process while the Bisasar Road project was redesigned. This first project, combining La Mercy and Marianhill and providing 69,000 CERs/annum, was therefore validated and eventually registered separately in July 2006. The Project Design Document for the Bisasar Road site was revised to deal with public concerns, and eventually received approval. The project is now at validation stage, and final registration by the CDM Executive Board is expected in the first half of 2008. The PDD suggests a yield of 350,000 CERs/annum.

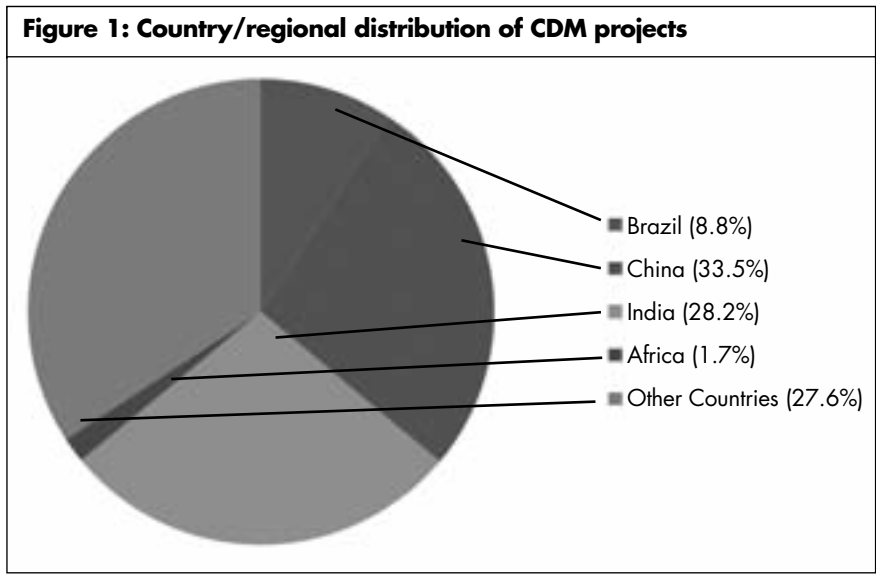
Despite all of the problems encountered by the Durban Landfill Project, the project still promises to deliver significant financial and health/safety benefits to the city. Although the transaction costs of the project were far higher than anticipated, the lessons learned can now be applied to other landfill sites in Durban, and indeed to other CDM projects being contemplated by the city.

For project developers, even if the Emissions Reduction Purchase Agreements (ERPAs) do not permit up-front payment for carbon credits, they can serve as a note of credit to access finance from local lending institutions. In some instances, project developers from non-Annex I countries (i.e. developing countries) with sufficient access to capital take on the risk exposure themselves and sell the CERs after they have been issued (often at a premium). This type of financing structure is called “unilateral CDM”. Prevalence of unilateral CDM depends on the availability of project finance for the CDM activity within the host country. This is often down to the awareness of local lending institutions as to the risks and returns on CDM projects and the rate of interest they are prepared to lend at (in most African countries, interest rates are prohibitively high).

The carbon market and CDM in Africa

The carbon market created by this regulatory framework is currently doubling every year and expected to reach a total volume of US\$200 billion by 2010. As of 1 March 2008, the CDM Pipeline³ contained 3,150 CDM projects, including 948 of them registered with the Executive Board of the UNFCCC for the issuance of carbon credits (CERs).

At the same time, the market has been characterised by stark geographical imbalances in the distribution of CDM projects, with China, India and Brazil accounting for more than two thirds of the projects in the pipeline (70.5 per cent or 2,220 out of 3,150 projects as of 1 March 2008). Africa, on the other hand, accounts for less than 2 per cent with most of those projects concentrated in a handful of more advanced countries. This market share is small even compared to Africa’s contribution to global warming, which is about 4 per cent of the global total. As a mechanism specifically intended to foster sustainable development in poorer Parties to the Kyoto Protocol, the CDM has, thus far, failed most African countries, countries that stand to gain most from the investment the CDM can bring. These benefits entail not only the transfer of new technology and sustainable development but also added resources for helping African countries adapt to the serious effects of climate change.



Source: UNEP Risoe CDM/JI Pipeline Analysis and Database, March 2008; Chart by author

3. The CDM pipeline includes all projects that have been submitted to the UNFCCC except for the twenty rejected and the five withdrawn projects.

Africa	Number	Share in %	kCER2012 ⁴	Registered projects
South Africa	23	40.4%	22,941	13
Egypt	8	14.0%	14,057	3
Morocco	5	8.8%	2,153	4
Nigeria	2	3.5%	25,026	1
Kenya	5	8.8%	2,548	0
Tanzania	2	3.5%	2,808	1
Tunisia	2	3.5%	4,125	2
Uganda	3	5.3%	567	1
Ivory Coast	2	3.5%	6,016	0
Mauritius	1	1.8%	1,764	0
Senegal	1	1.8%	784	0
Mali	1	1.8%	240	0
Mozambique	1	1.8%	228	0
Congo	1	1.8%	2,106	0
Total	57	100.00%	85,362	25

Source: UNEP Risoe CDM/JI Pipeline Analysis and Database, March 2008

	Number	Share in %	Registered projects
Afforestation	1	1.8%	0
Biogas	4	7.0%	1
Biomass Energy	5	8.8%	2
Coal Bed/Mine Methane	2	3.5%	0
Energy Efficiency (households)	1	1.8%	1
Energy Efficiency (industry)	1	1.8%	1
Energy Efficiency (own generation)	3	5.3%	0
Energy Efficiency (supply side)	1	1.8%	0
Fossil Fuel Switch	6	10.5%	2
Fugitive Emissions	3	5.3%	1
Geothermal	1	1.8%	0
Hydro Power	6	10.5%	1
Landfill Gas	13	22.8%	7
N ₂ O Abatement	5	8.8%	5
Reforestation	1	1.8%	0
Solar Power	1	1.8%	1
Wind Power	3	5.3%	3
Total	57	100.0%	25

Source: UNEP Risoe CDM/JI Pipeline Analysis and Database, March 2008

4. kCER2012 = calculation of the amount of CERs expected to be accumulated by the end of the first commitment period in 2012.

Main opportunities and challenges for sustainable development using carbon finance

The CDM is a valuable tool not only for reducing the economic burden of reducing GHG emissions but also for the partnerships that it fosters and the sustainable development benefits that it brings to poorer Kyoto signatories.

For host country recipients of carbon finance the opportunity to use the latest clean green technology assists these countries to leapfrog the so-called “dirty stage” of development. Since energy is the driving force behind every economy, ensuring that energy sources in these countries remain cheap is a priority for ensuring their competitiveness in a rapidly globalising world. Any international agreement that would impose caps or force these countries to adopt and pay for clean technologies would inevitably stymie their economic development and penalise them for a problem (global warming) for which they are not, historically, responsible. This was one of the main conclusions of the Eighth Conference of the Parties (COP 8), as expressed in the Delhi Declaration. The declaration acknowledges that “significant cuts in global emissions will be necessary” to meet the Convention objective of stabilising atmospheric GHG concentrations, but also reaffirms that “economic and social development and poverty eradication are the first and overriding priorities”.

The CDM helps these countries bypass the financial burden of adopting these technologies, thus encouraging them to develop with minimal impact on the global climate. At current levels, the contribution of the CDM to this process is, admittedly, modest but this is due to international political and bureaucratic constraints, not to any inherent weakness in the system itself.

Second, it is part of the (complex) nature of the CDM that it necessitates close collaboration and partnership between governments and the private sector in both host and recipient countries: Memoranda of Understanding are usually issued between the respective country governments; local project developers or corporate entities work closely with CDM consultants; Designated Operational Entities (DOEs), most of whom are from Annex I countries, conduct project appraisals and verification on site; technology is sourced and imported from producer countries. Such close collaboration has important secondary benefits. It facilitates technical and cultural knowledge sharing. It exposes entrepreneurs, companies and universities in non-Annex I countries to the realities of international business, financial negotiations and global policy processes. It fosters globalisation and new international business linkages. Finally, and perhaps most important, its primary purpose is to create sustainable development. Figueres (2002) explains that the developmental benefits of the CDM are:

“The funding channeled through the CDM should assist developing countries in reaching some of their economic, social, environmental and sustainable development objectives, such as cleaner air and water, improved land-use, accompanied by social benefits such as rural development, employment, and poverty alleviation and in many cases, reduced dependence on imported fossil fuels. In addition to catalysing green

investment priorities in developing countries, the CDM offers an opportunity to make progress simultaneously on climate, development, and local environmental issues. For developing countries that might otherwise be preoccupied with immediate economic and social needs, the prospect of such benefits should provide a strong incentive to participate in the CDM.⁵

Indeed, it could be argued that without a strong sustainable development component to the CDM, the benefits accruing to non-Annex I countries hosting such projects would be minimal, creating a strong disincentive for governments to allocate precious resources towards setting up and running a Designated National Authority (DNA). What is more, the sustainable development requirement was put in place because the CDM will not in itself reduce overall levels of GHG emissions. It only acts to neutralise or offset current emissions from Annex I countries, in effect giving them an ongoing “right to pollute”. It is for these two important reasons that sustainable development is the primary objective of the CDM – something that private sector actors would be wise to bear in mind.

In the highly politicised context of the negotiations on climate change, the CDM is one of the only components of the Kyoto Protocol that brings any concrete benefits to developing countries.

Carbon finance and FDI in Africa

Over the last twenty years, levels of foreign direct investment (FDI) to Africa have increased at record rates. One of the latest United Nations Conference on Trade and Development (UNCTAD) Reports on Economic Development in Africa states:

“Average annual FDI flows to Africa doubled during the 1980s to US\$2.2 billion compared to the 1970s, but increased significantly to US\$6.2 billion and US\$13.8 billion respectively during the 1990s and 2000–2003. On a per capita basis, this translates into a more than fourfold increase compared to the 1980s.”⁶

Much of this new investment has been in the mining, oil and gas and energy sectors – all of which create large emissions of GHGs and are therefore likely to hold great potential for carbon projects. UNEP estimates that by 2012, Africa could generate 100 million carbon credits or US\$1.6 billion of FDI in the form of carbon finance.⁷ The highest amount of investment so far has been in South Africa, followed by North Africa, particularly Egypt and Morocco, where investment is concentrated in landfill gas (see Table 2).

Carbon finance for CDM (and other carbon finance projects) is subject to many of the same laws and economic incentives as FDI, and yet the share of FDI going to Africa is more than double its share of carbon finance. Carbon finance is, of course, also dependent on the institutional capacity of African governments (i.e. establishment of DNAs and sustainable development criteria) but this still does not

5. Figueres, 2002.

6. UNCTAD, 2007.

7. UNEP, 2007.

adequately explain the shortfall in projects going to Africa. This finding suggests that investors may be being overly cautious about the opportunities within the continent. For corporate and fund managers starting out in the market, the poor reputation afforded to Africa by the international media as well as a general under-reporting of business news from Africa can easily lead them to a distorted perception of the African business climate, creating a disincentive to invest.

Carbon finance investors can be public carbon funds set up by governments in Annex I countries (such as the Netherlands, Belgium or Italy). They can also be private carbon funds, which are mainly set-up by investment banks, individual companies seeking to buy carbon credits to meet their emission reduction targets or carbon finance service providers. In addition, the voluntary carbon market is providing an increasing flow of investments in carbon offsetting projects, which are mostly carried out by service providers in the offsetting industry, NGOs and financial institutions, most notably from the UK.

How to promote Africa as a carbon finance destination

What makes a CDM project in Africa special? What are the unique commercial and political advantages to be gained from investing in the CDM in Africa? We present six good reasons for IPAs to promote their country as a destination for carbon finance:

1. Portfolio diversification

The CDM project market in Asia and South America is maturing rapidly with a disproportionate build up of projects in China, India and Brazil. As such, Africa represents relatively uncharted territory and market potential. Geographical diversification of project portfolios is an important investment-risk mitigation strategy for managers of carbon funds and international CDM project developers. CDM projects suffer a greater set of risks than more established project investments, meaning that diversification should be one of the main priorities for investors.

2. Price of CERs

Project developers, be they local or international CDM professionals, recognise that carbon funds are taking on greater levels of risk when investing in less developed countries in Africa. In addition, many of the businesses, municipalities and NGOs in Africa are cash poor, with reduced access to loans for growing/upgrading their facilities or expanding development projects. In Uganda, project developers were keen to let it be known that carbon funds and other investors could secure lower prices for CERs in Africa because of these factors. As the carbon market begins to mature in middle-income countries (especially Brazil and India) the price differential between CERs in established markets and those in Africa is increasing, which should make the continent more attractive for prospective investors.

3. The development dividend

The term “development dividend” has been widely used by the United Nations Development Programme (UNDP) in recent years to describe the development component of CDM projects. The importance of incorporating a development component with the CDM is tied closely with the provision of some kind of incentive for non-Annex I country participation in the CDM. From an investor’s perspective however, funding projects that bring about lasting community, environmental and economic benefits has both commercial and political advantages. For carbon funds administered by international organisations such as the World Bank or International Finance Corporation, investing for development is part of the organisational mandate to help meet the MDGs. For these organisations, purchasing or generating emissions reductions from quality projects is a *sine qua non* of their work in this market. The World Bank Community Development Carbon Fund is one of the largest funds that concentrates on the creation of immediate economic and environmental benefits to local communities. The UNDP is also seeking to promote the development impact of CDM through its MDG Carbon Facility.

In Africa, where demand in most countries for jobs, foreign currency, industrial development and sustainable livelihoods is acute, and where investors get more for their dollar, creating a development dividend through the CDM is more straightforward than in many other locations. This is because unlike a lot of FDI flowing into Africa via the extractive and other export-orientated primary commodity industries, carbon finance is a highly productive form of FDI, often targeted at small to medium size enterprises (SMEs), bringing technology transfer, local job creation and local environmental benefits.

4. Bundled small-scale projects and programmatic CDM

Due to low levels of rural electrification, the widespread usage of biomass for fuel, biomass waste from agriculture and poorly insulated/serviced housing in Africa, opportunities for small-scale, and micro CDM projects are considerable. As the prices paid for CERs begin to rise due to the extra demand created by the EU ETS, the economic viability of many of these projects increases.

Bundling entails the processing of different small-scale project activities and methodologies in one document for submission to the CDM Executive Board. CDM project activities may be bundled at the following stages in the project cycle: project design document, validation, registration, monitoring, verification and certification.

The advantage of bundling is that it can dramatically reduce the transaction costs of the project cycle, making projects with even small emissions reductions worthwhile. Project developers acquainted with and willing to work with bundling procedures and regulations could also stand to generate large quantities of CERs from a group of projects with solid sustainable development credentials.

Within the CDM world, a new form of CDM called “programmatic CDM” has

recently been approved by the CDM Executive Board. As the name implies, programmatic CDM involves the development of programmes – which can be public or private – to carry out a number of *similar* CDM project activities *in many different locations* over a long period of time. Programmatic CDM projects can in fact be multi-country, and can last for up to 28 years. Their main benefit is that by pooling much of the work of project development and documentation under a single “coordinating/managing entity” they incentivise the implementation of technologies which would not be financially attractive if each project developer had to bear the full transaction costs for their own project activity.

According to the rules developed for programmatic CDM, both the programme and the constituent project activities must satisfy CDM rules on additionality, baselines, monitoring, boundaries, etc. In addition, each programme must involve only one technology or interrelated set of measures, and must utilise one baseline and monitoring methodology.

5. CDM for adaptation

The CDM is one of the main instruments of the Kyoto Protocol for assisting with international efforts to mitigate climate change. But even under the targets set by the Kyoto Protocol for Annex I countries, not to mention the inexorable growth in emissions from non Annex I countries, overall levels of GHGs in the atmosphere continue to rise and the symptoms of climate change are already beginning to be felt. Africa, along with small island states and other least developed countries is highly vulnerable to climate change because of the disproportionate exposure of its people to climate-related shocks (such as floods, drought, cyclones, heat waves and the spread of disease).

All mitigation projects that help create sustainable development will lead, directly or indirectly to increased adaptive ability. According to the sustainable livelihoods model, all forms of economic, social, natural and political capital will lead to increased resilience to natural shocks, which can strengthen the development process. Some types of projects however lead to direct benefits to those individuals and communities in Africa most vulnerable to climate change.

In addition, the CDM contributes to the Adaptation Fund under the Kyoto Protocol, which is generated through a 2 per cent levy on all issued Certified Emission Reductions. The revenue that will be generated from this levy until 2012 is projected to be between US\$160m and US\$950m, while the funding presently given or pledged by donor countries to the other two climate change funds is around US\$170m.⁸

6. Corporate responsibility and carbon finance in Africa

Many MNCs as well as SMEs from all sectors may wish to minimise their effect on

8. Müller, 2007.

the environment – both locally and globally. Obviously most companies can reduce their emissions via internally implemented energy efficiency measures and the use of renewable energy sources. However some companies are already acting to neutralise their impact on the global climate whilst supporting clean development abroad.

Who are these companies? Some are simply responsible corporate citizens who want to “do the right thing” in the interests of the planet, society and ethical ideals of responsible behaviour. Some can make a business case, albeit sometimes resting on qualitative assumptions, for taking such responsible actions. Some wish to balance their books according to the “triple bottom line” of social, environmental and financial accountability. Finally there are those companies that recognise that their industry will at some point come under regulation of emissions, such as aviation, other transport, or some types of manufacturing.

The reasons that a company may wish to take action in this way mainly fall under the wider umbrella of “corporate responsibility.” This is, in itself, an extremely broad term, incorporating all elements associated with being a good citizen – paying taxes, doing to others (individuals and companies) as you would have them to do you, avoiding waste or inefficiency, behaving ethically and meeting the reasonable expectations of all stakeholders in the business. These principles can provide some compelling drivers for companies to take their responsibilities regarding climate change and the environment seriously.

Whether because of lofty ideals or thinly-veiled self interest, there are plenty of reasons for corporations to behave in a responsible manner to the environment, increase their own efficiency, and therefore take note of the opportunities offered by carbon finance opportunities in Africa.

Key policies tools and approaches for attracting FDI using the CDM via IPAs

As outlined above, the number of CDM projects in Africa has been very limited to date. Nevertheless there are a number of policy tools and approaches that can be identified for future expansion of the IPA role in CDM. These include:

1. Developing a consistent national policy on the role of the CDM in attracting FDI

The CDM has yet to be linked to national investment policies in any African country, with the possible exception of South Africa. In the latter country, the Department of Trade and Industry has identified environmental industries as a potential growth sector, though it has not explicitly linked this to foreign investment opportunities. It has, however, supported the development of a CDM Industries Association, which includes in its membership a variety of project developers, financial institutions, and parastatal bodies with an interest in CDM

development. Nevertheless, the country's policy on foreign investment focuses primarily on sectoral and specific product opportunities rather than on accessing specific environmental financing mechanisms such as the CDM.

2. Promoting the CDM as an element in FDI promotion

The promotion of the CDM by IPAs requires first that governments provide general guidelines for accessing external financing mechanisms, e.g. development banks and international commercial banks interested in investment in Africa; and then apply these to CDM investment. National IPAs can act as intermediaries for such financing, through a combination of aggressive project identification programmes and provision of supplementary and bridge financing. As an example from South Africa, the Development Bank of South Africa (DBSA) provides a variety of loan and grant instruments to supplement CDM financing. For example, a grant was provided to cover the cost of environmental impact assessment of a CDM wind farm project in South Africa, along with loans to assist in actual implementation of the capital project. As noted elsewhere, DBSA also serves as agent for the World Bank's various carbon funds, which enables it to bring a much wider variety of technical and financial advisory services to bear on CDM work (see Box 2 describing the experience of DBSA and the Ugandan Investment Authority in promoting the CDM).

Box 2: The experience of DBSA in South Africa and the Ugandan Investment Authority

The best known example of involvement by IPAs in CDM development in Africa is that of the Development Bank of Southern Africa (DBSA), which, as noted above, acts as an agency for implementation of several World Bank carbon funds – the Community Development Carbon Fund (CDCF), the Prototype Carbon Fund (PCF) and several others. DBSA's role in CDM development is largely prescribed by this agency role: they provide institutional support for the World Bank in its efforts to mobilise CDM projects in South Africa, acting as an intermediary in both identifying and implementing projects. On the whole, they do not provide technical assistance, as this is delivered through the World Bank's own team of CDM experts. Because municipalities are DBSA's target market in South Africa, there is also a tendency to identify projects which have some linkage to municipal governance, e.g. renewable energy projects that may contribute to the municipality's own power supply capabilities; or landfill projects that involve landfill sites owned by the municipality (and also contribute to power supply by using the extracted methane for power generation).

Because the DBSA's role in CDM is limited to project identification and institutional support and not to technical assessment, there is a potential for projects to move forward without a thorough evaluation of their eligibility for CDM or the applicability of potential methodologies. Also, because the World Bank's goal is to generate Verified Emissions Reductions (VERs) and not CERs, there is a tendency to select projects on the basis of their uniqueness and potential for future replication, rather than on primarily technical grounds. This tendency in turn can lead to a

Box 2: continued

situation where projects that appear to be viable and appropriate on economic and technological grounds encounter problems due to, for example, environmental sustainability issues – as happened in one of the earliest South African CDM project, the Durban landfill gas-to-electricity project (see Box 1).

Nevertheless, DBSA's record in this area has on the whole been positive, with several of the earlier CDM projects in South Africa being a product of their early efforts; e.g. the Durban landfill project and the Bethlehem small-scale hydro project. Although both projects eventually obtained carbon financing from other sources, DBSA's use of World Bank funding enabled them to achieve significant progress at a relatively early stage of development – something that conventional financing institutions would have been unable to do. In its capacity as an IPA, DBSA is committed to assisting capital projects and infrastructure projects in general, which strengthen the role of municipalities in South Africa – in these two cases, by providing support for independent power production that would partially alleviate the dependence of municipalities on coal-fired generation by the national utility, Eskom.

A somewhat different story emerges from Uganda's efforts to utilise IPAs to incentivise CDM. As noted earlier, the Ugandan Investment Authority (UIA) has been involved in a variety of efforts to develop a national CDM portfolio, beginning as early as 2002, in addition to early support from the World Bank and from CD4CDM. By early 2003, the UIA had already identified three or four potential projects, all in the forestry/biofuels sectors. By early 2005, CD4CDM had, on invitation from the UIA, Uganda Department of Meteorology and the World Bank, prepared ten Project Idea Notes (PINs), which were presented at the 2005 Carbon Expo in May. By the end of the same year, eleven CDM projects were listed on UIA's website. These were also listed on the website of the Asia-Africa Investment & Technology Promotion Centre (AAITPC).

Despite this relatively proactive stance, a recent search of the UIA website revealed no references to CDM at all, even in their sectoral summary documents for energy and forestry. Godfrey Ssemakula, Assistant Director of UIA, may have inadvertently revealed the uncertainty surrounding the role of CDM in Uganda when he was quoted in a World Bank publication in 2006 saying "As far as Uganda is concerned, Carbon Expo is a huge success. We brought eighteen projects that cut across sectors – energy, landfill, co-generation – and got a lot of interest from buyers.... If we could turn all these eighteen projects into deals, it would be meaningful to Uganda. But the real challenge is underlying finance for the projects."

In short, Uganda's early success in identifying CDM projects has not translated into firm commitments from buyers of credits, nor has it improved access to overall project financing. This may be because UIA, unlike DBSA, is purely an investment promotion agency with no independent sources of financing. It can, in short, promote CDM but not finance CDM projects.

The lesson learned from this relatively simple comparison is that the sustainability of these two different approaches to CDM lies primarily in the ability of the IPA to create strong links to commercial and/or other non-commercial financing – in short, to "package" CDM investments as part of a larger financial programme, and assure potential CDM buyers that the project is viable in commercial terms, not just for its CDM benefits.

3. Incentivising CDM by eliminating or reducing taxes on CDM-related revenues

This is a major area of concern for investors, since a transparent and fair taxation policy is a minimal expectation for any form of FDI. Again, African countries have largely failed to deliver on this requirement, either ignoring the issue or taxing CDM revenue as they would any other form of revenue. In South Africa, the Treasury has recently undertaken a study of “environmental instruments,” including *inter alia*:

- **Fiscal incentives** to improve environmental outcomes, e.g.:
 - Environmental funds;
 - Partial or soft earmarking of environmentally-related tax revenues;
 - Rehabilitation funds/guarantees;
 - Accelerated depreciation allowances.
- **Specific tax incentives**, e.g.
 - Product taxes on certain goods such as batteries or packaging;
 - Deposit-refund systems;
 - Disposal taxes; and
 - Differential tariffs for waste related services.

While no specific decision has been made on the subject of taxing CDM revenue at the time of writing, the South African Designated National Authority has instigated a specific study of this topic, which should be concluded in 2008.

The Treasury study has also noted that there are a few aspects of non-environmentally-related taxes that create easily identifiable negative impacts on the environment. More specifically, certain deductions under the Income Tax Act create perverse incentives that may undermine conservation activities whilst incentivising land conversion and cultivation practices. In addition, the VAT zero-rating of farming inputs such as pesticides and fertilisers and illuminating paraffin may lead to sub-optimal environmental outcomes, as can property rates unless they are tied to progressive environmental, conservation and land management practices. All of these perverse incentives need to be reviewed in developing a taxation and incentive system which encourages environmentally progressive actions – including the development of CDM projects with high sustainability standards.

4. Requiring investors in new capital projects to identify the CDM potential and eligibility of their projects

It was originally expected that the CDM would produce a significant number of so-called “bilateral” projects, i.e. projects in which the buyer was specifically motivated by the investment in CDM credits, as opposed to merely purchasing credits after the project was established. In practice, this has rarely happened, although FDI in African countries is typically tied to large capital projects, e.g. new infrastructure or industrial and mining activities, which could potentially attract CDM credits if designed for this purpose from the outset. One method for maximising CDM investment would be to

ensure that all investors in capital projects (of whatever size) assess the CDM potential of the project they are proposing before the investment is approved, i.e. as a pre-condition for approval. This would also allow IPAs to assess independently the eligibility of the project for CDM and the applicability of specific methodologies.

5. Capacitating IPAs to better understand the CDM and its role in FDI

The knowledge and capacity gap on CDM-related issues is a major barrier for IPAs wishing to attract this form of FDI. As a general rule, external agencies promoting CDM capacity building (e.g. the CD4CDM project developed by the UNEP Risoe Centre for Energy and Sustainable Development) have tended to focus on building expertise among government officials in key environment and energy ministries (on the assumption that they would be responsible for CDM planning and regulation), rather than on national financial or investment agencies.

The author's own experience with IPAs in Zambia and Uganda suggest that early involvement of IPAs in CDM capacity building can have a significant impact on the level and type of CDM projects being developed. For example, the Uganda Investment Authority showed an interest in the CDM as early as 2003, following attendance at several international conferences on the subject and a workshop sponsored by the World Bank's Prototype Carbon Fund. An earlier workshop in 2002 by a South African group sponsored by CD4CDM also stimulated interest in the subject at UIA. As a result, UIA played an increasingly significant role in attracting CDM projects, developing a regular list of such projects for presentation to potential investors.

By comparison, the Zambia Investment Centre (ZIC) has had almost no involvement with CDM, because it is not a target country for international programmes such as CD4CDM or for the World Bank's funds. Most CDM initiatives in Zambia have instead come from private sector consultants working independently and seeking funds from international donor groups, while the ZIC has been given virtually no capacity-building assistance of any kind. As a result, despite enormous CDM potential because of its strong resource base, business-friendly policies and consequent robust economic growth, Zambia does not have a single CDM project in the official "pipeline" at the time of the preparation of this article (Uganda notionally has three, though in fact there are an additional eight or ten projects in various stages of preparation).

6. Strengthening linkages between CDM developers and IPAs

This follows logically from the point above. The absence of involvement by IPAs can immediately be strengthened by promoting contact between these institutions and both local and international CDM developers. The process should be a relatively straightforward one: IPAs can take a proactive approach to the CDM by advertising their interest in the subject and convening workshops or seminars to attract

developers. This can be augmented internationally through use of the IPA's website and/or through attendance at key international events such as Carbon Expo.

7. Strengthening linkages between IPAs and commercial financial institutions involved in CDM

Recent efforts to involve the African financial community in the CDM, such as the African Bankers Carbon Finance Investment Forum in Johannesburg, will doubtless lead to increased awareness of this mechanism, but not necessarily to strengthened linkages between the commercial and IPA sectors. This requires a deliberate programme of bridge-building between IPAs and commercial banks on the topic of the CDM, potentially including such activities as:

- Joint project development activities, e.g. through memoranda of understanding between banks and IPAs to undertake a coordinated review of potential CDM projects identified by either party.
- Linked financial products, e.g. incentive financing from IPAs linked to commercial project financing by banks, with the CDM serving as a part of the incentive package.
- Coordinated marketing of CDM opportunities through workshops, information sessions, brochures and even public advertising.

Conclusion

As this article has shown, carbon finance represents a real opportunity to increase the FDI flows to Africa and developing countries in general. IPAs can play a key role in supporting the Designated National Authority and related ministries in realising the full potential of this opportunity. While the contribution of carbon finance to sustainable development is becoming increasingly apparent, it is equally important to increase investment flows by marketing the carbon potential of individual countries in the developing world.

Countries and companies are increasingly looking at Africa for new ways to comply with their emission reduction commitments. For some investors this might be relatively new territory and the need for carbon credits can therefore provide an entry point for attracting foreign investors in general. China's success in the CDM market partly stems from the government's proactive role in identifying the most promising sectors, creating an adequate institutional framework and promoting the country as a prime location for CDM projects to foreign investors. This article aimed to provide a starting point for other developing countries and their IPAs to follow this example and to promote the carbon potential of their country to attract additional foreign investments.

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Chapter 9

FDI and CSR: The case of the Uganda Investment Authority

Issa Mukasa

Introduction

Uganda lies on the equator at the heart of East Africa. The country is bordered by Sudan in the north, Kenya in the east, the United Republic of Tanzania in the south, Rwanda in the southwest and the Democratic Republic of Congo in the west (Figure 1). This location, though landlocked, gives the country a commanding base for regional trade and investment. Uganda's terrain is mostly plateau with a rim of mountains, and ranges from wide East African plains and expansive savannah grasslands to impenetrable mountain rainforests and snow-peaked mountains in the southwest. It is generally rainy with two dry seasons per year. The soils are fertile and well watered from the many lakes and rivers, and there is very little mechanised

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Figure 1: Map of Uganda, showing neighbouring countries



irrigation. With a population of around 30 million, Uganda has one of the world's highest population growth rates at 3.6 per cent.

The government that came to power in 1986 implemented a major economic recovery programme (ERP), including support for the private sector as the engine of economic growth. The Uganda Investment Authority (UIA) was established by an Act of Parliament (Investment Code 1991) as an agency of government primarily to promote and facilitate private sector investment. The broader aim of setting up the Authority was to contribute to Uganda's development by supporting the private sector through promotion and facilitation of both local and foreign inward investment. UIA is additionally mandated to advise the government on appropriate investment-related policies in order to enhance the country's global competitiveness and suitability as a destination for foreign direct investment (FDI).

Figure 2: The top ten sources of FDI in Uganda

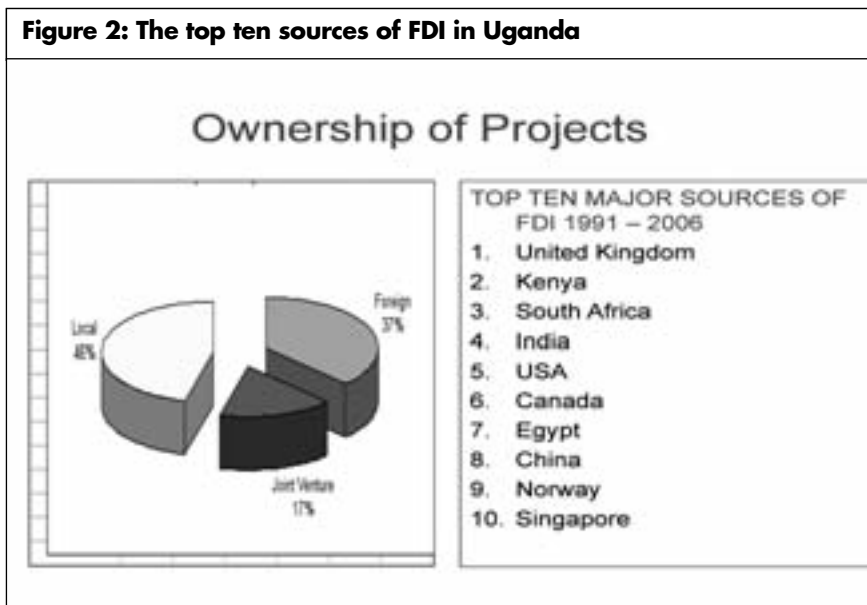
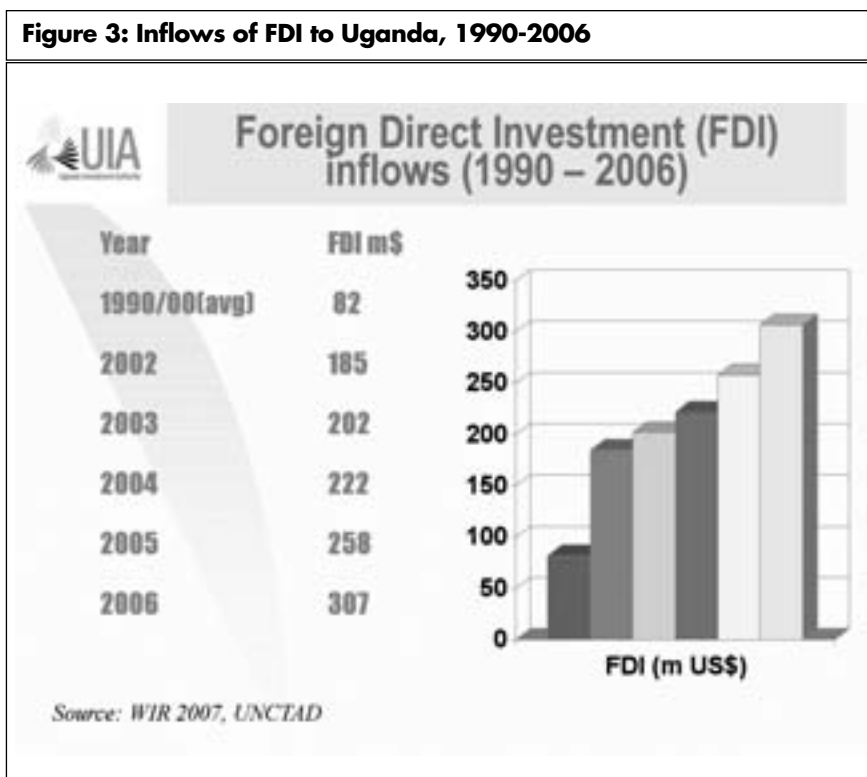


Figure 3: Inflows of FDI to Uganda, 1990-2006



Key trends in FDI

When UIA began in 1991, it faced the challenge of not only attracting direct investment but also of countering the negative image attained by Uganda over previous decades. This involved a comprehensive and ambitious national and international programme of image-building, with later focus on the promotion of investment opportunity. The national programme was implemented through a series of regional workshops to resurrect and build the confidence of Ugandans in the new Uganda. The international seminars had two target groups: the Ugandan diaspora, and the international business community, particularly the departed Asians. Targeting the departed Asians, and assuring them of new legislation to return to their properties confiscated by the fallen regime, was found to benefit UIA's international investment-promotion initiatives. Most of the international image-building and investment-promotion seminars were held in the United Kingdom, India, Kenya and the United States, where most of the Ugandan Asians and some indigenous Ugandans had migrated.

This strategy proved successful, and confidence grew when the law on returning the properties of departed Asians was implemented. Asian returnees played a significant role in assuring audiences for UIA, and in demonstrating the commitment of the new regime to the private sector. UIA repeatedly hosted seminars, working gradually from image-building to image-enhancement. Due to those repetitive campaigns, the countries originally targeted remain the top sources of FDI in Uganda (Figure 2).

Since the 1990s, Uganda has consistently improved its investment climate, and attracted steadily increasing FDI inflows (Figure 3). While the inflows are small, compared to those of many other players, the consistent upward trend offers great satisfaction given Uganda's historical difficulties. It is also interesting to note that many Ugandans living abroad are seriously investing in Uganda in key sectors such as health, accommodation, leisure facilities, education, infrastructure and property development. The annual 'investor of the year' award organised by UIA has, in recent years, been registering an increasing number of projects owned by Ugandans in the diaspora.

Existing investors, on the other hand, have continued to make significant reinvestment. Some have actually diversified into completely new business ventures that have no direct relationship with their existing ones, due to the wide range of investment opportunities the country offers. For instance M/s MTN², a telecommunications company Uganda came into the country with a proposal for infrastructure investment worth US\$10 million, but has currently invested over US\$36 million. Another notable example is Mukwano Industries, licensed to manufacture edible oil but which has since diversified into plastic containers, long-distance haulage, soap manufacturing, property development and commercial agriculture (growing sesame, sunflower and other oilseeds). This trend seems set to continue, given the current pace of continuous improvement in the business-operating environment.

2. MTN's investment proposal was made on the assumption that since GDP per capita in Uganda was US\$310, very few people would be able to afford the facility. They estimated about 20,000 subscribers over a period of five years would join. Their current subscription is over 1 million people.

Key institutions involved in FDI attraction

There are quite a number of institutions involved, directly and indirectly, in attracting FDI to Uganda. The president has consistently stressed to donor countries that the best and most sustainable assistance for Africa, including Uganda, would be to allow its products in their countries (markets) without restrictions. Through these trade interactions, Ugandans would build capacity to be able to produce and supply to the required standards. This would be a sustainable way of assisting Ugandans to overcome poverty. Based on this philosophy, all government delegates, ministries and statutory institutions on any foreign visit meet with potential investors and persuade them to look at Uganda as their possible investment location.

The presidency, (which includes the office of the president and that of the vice president), is a key institution active in the promotion of FDI to Uganda. It has apparently become the policy of the presidency to meet whenever possible with Ugandans in the diaspora and with members of the international business community to disseminate information on Uganda's investment climate, with the ultimate objective of presenting Uganda as a favourable location for investment.

The president has established a private sector forum called the Presidential Investors' Roundtable (PIRT), which identifies obstacles to the private sector and recommends action. This forum is composed of 22 actors from the private sector, half Ugandan and half from the international business community. Microsoft is one of the international companies on the PIRT, and has contributed guidance on how to turn Uganda into a regional hub for information and communications technology (ICT). Uganda now has a recently appointed a Cabinet Minister for ICT. The Prime Minister, other ministers and the Honorary Consuls of Uganda also meet with the international business community and with Ugandans living abroad, to explain Uganda's transformation and promote investment opportunities. The UIA supports or coordinates most of these multiple activities, always at least providing promotional speeches, pamphlets, and other printed and electronic materials.

The above key institutions may have multiple reasons for visiting a particular foreign country, with investment promotion being just one of those reasons. UIA's focus, by contrast, is solely investment promotion, meaning that it can carry out more detailed work. It takes time to decide where to go (market identification), how to enter the market (marketing strategy) and to determine the choice of sector to market in each country, plus the choice of house media or international consultant for follow-up mechanisms. UIA's programmes are successful because of this level of detail. UIA also assesses potential investors in terms of the AIDAS model,³ to determine the nature and depth of a planned presentation, and the promotional materials to carry, companies or corporate individuals to target or invite, size and level of UIA representation and logistical support required.

3. AIDAS is a marketing acronym describing a common sequence associated with the sale of a product or service: A – attention (awareness), I – interest, D – desire, A – action, S – satisfaction.

In all these efforts, Ugandan embassies located in target countries are deeply involved in the entire process, to facilitate follow-up. Crucially, their foreign representatives also undergo annual refresher orientations, usually at the beginning of each year and focusing on a series of topical issues. UIA has been a regular presenter in this forum, and the embassies' commercial diplomacy is designed to attract FDI.

UIA's investment-promotion initiatives also include an inward mission to Uganda. All participants in awareness-creation seminars are thanked for their attendance and asked if they would like additional or more specific information.⁴ With professional management, the dialogues arising between UIA and a potential investor can mature into a plan for a visit, by an individual, group or company. UIA usually prepares and manages itineraries for such visits, making hotel bookings, receiving visitors at the airport, transporting delegates to the hotel, managing a matchmaking programme and site visits.⁵ The delegation's departure marks the beginning of a follow-up programme (by mail) seeking their feedback on the trip, and asking where UIA can provide additional information as necessary to reach a decision on locating in Uganda. This relationship continues even after a company invests in the country, essentially to ensure maximum satisfaction.⁶

FDI and corporate social responsibility

Since its inception in 1991, the UIA has been using a range of methods to attract FDI, and investment promotion is just one of these methods. Others include the creation of a favourable business operating environment by maintaining realistic exchange rates, guaranteeing repatriation of profits, total exemption of import duty and other applicable taxes on plant and machinery, and promising not to expropriate property without adequate and prompt compensation. Tax incentives – initially tax holidays, then replaced with the current depreciation allowances – have also been used. Simplification of the bureaucratic procedures facing potential and existing investors, through policy reforms, have been prioritised. Bilateral tax, trade and investment treaties with countries providing investment have been negotiated. No major infrastructure incentives, such as export-processing zones and developed industrial estates could be provided, but industrial land on concessional⁷ terms has been provided to investors to compensate for other inadequacies. For instance Quality Chemicals Industry Limited, a joint venture between a Ugandan company and an Indian company, was given ten acres of land on concessional terms in an

4. UIA's Clients Charter, conspicuously displayed in the front office, specifies instant response to an enquiry through electronic mail when answers are readily available. It provides responses in specific timeframes for other cases.

5. Site visits are usually optional but encouraged as they help to enhance visitors' interest and confidence in the country.

6. Investor satisfaction after licensing is crucial for UIA, as they have often used satisfied investors' testimonies to attract more FDI from their countries of origin.

7. Concession here means a price below the market value and which has, at times, been zero price.

upcoming industrial park (Luzira), to manufacture anti-malarial drugs and those used in the management of HIV/AIDS.

Although UIA has been attracting FDI using this range of instruments, the potential for targeting projects or companies with good corporate social responsibility (CSR), based on the applied definition,⁸ has not been fully exploited. In brief, CSR involves companies integrating social and environmental concerns into their business operations and their interactions with their stakeholders on a voluntary basis. A few aspects of CSR, such as environmental considerations, have however been part of the requirements for project licensing. Legislation has established the National Environment Management Authority (NEMA) to manage, coordinate, monitor and supervise all issues to do with the environment and its possible degradation. No project with potential negative environmental impact can be licensed by UIA without the express approval of NEMA. This approval is, by and large, issued after a thorough scrutiny of the environmental impact assessment (EIA) report presented by the project promoters. UIA works closely with NEMA to facilitate the private-sector.

CSR also focuses on internal stakeholders, such as employees, and external stakeholders including suppliers, customers and the wider community. While in the process of attracting FDI, UIA has not referenced a corporate code of ethics; it nevertheless does not condone any mistreatment of internal or external stakeholders. There is some enabling legislation with respect to these CSR concerns. For instance, existing labour laws, although fairly outdated, provide some guidelines on the treatment of employees and other internal stakeholders. Uganda also has an active Corporate Governance Institute with the main objective of promoting a business environment rooted in transparency, fairness and accountability. Investors are usually encouraged to join these fora to network and share best practice.

There are well-established laws to protect external stakeholders from fraud, dumping, release of untreated waste and many other social crimes. There is legislation on consumer and community protection from the effects of toxic waste disposal. The relevant institutions periodically carry out routine inspections to ensure compliance and also to provide technical guidance at all stages.

Priority sectors of the economy have been chosen by UIA for their impact on the majority of the population or the economy with regard to poverty reduction, employment opportunities and the potential to earn or save foreign exchange. These sectors include: agriprocessing, tourism, mining and energy, services,⁹ and ICT. Although CSR was not a prominent feature in requirements for selecting priority sectors, some international companies have been seen to practice good CSR through building community primary schools, social and healthcare centres, funding social activities and in certain instances donating to, or sponsoring, underprivileged persons for healthcare services or education.

8. CSR website.

9. Services include education, health and financial services.

An example is provided by the case of Kaweri Coffee Plantation Limited, which is largely owned by Neumann Kaffee Gruppe (NKG). Through UIA's outbound missions to Germany, efforts had focused on attracting companies that could add value to Ugandan agricultural products or transfer technology appropriate for the agriprocessing sector. NKG attended UIA presentations and meetings, and became interested in locating in Uganda. A nucleus coffee farm was suggested to guarantee supply of the required quantities both from within and outside the farm. On submission of their business plan, UIA identified suitable land for NKG in Mubende District. The company has implemented a successful social-responsibility programme that has included building schools, healthcare centres and community halls, and above all grading the local road network.

The company opened its facilities to workers on the coffee plantations, and to non-workers living in the neighbouring villages. At the start of the project, local people were reluctant and resisted the project's establishment, fearing that the company would take their land. The situation is now completely different, and the local community has been fully integrated into the company's outgrowers' programme that provides improved seedlings, training in modern crop husbandry and youth social groups. Kaweri's corporate reputation in this and the neighbouring districts has been enhanced through mutual trust and its visible association with the community within which it operates.

UIA has been at the forefront of promoting Clean Development Mechanism (CDM) projects in Uganda. CDM is based on Article 12 of the Kyoto Protocol, providing for emission reductions at source or where sequestration is achieved under specific conditions.¹⁰ The projects UIA has been promoting include sequestration, energy efficiency, organic farming and methane-related projects. So far, Uganda has registered one project that is currently benefiting from the sale of carbon credits (Box 1). The West Nile Electrification Project was the only project so far located in East and Central Africa to have reached this stage by December 2007. As the internal consulting capacity continues to be developed to carry out baseline studies and estimate project emissions, more projects may be registered in future to benefit from this initiative. Three other projects in co-generation, afforestation and mini-hydro, are already in the pipeline for approval.

In conclusion, while CSR issues have not taken centre-stage in UIA promotion drives, the projects already attracted have in one way or another contributed immensely to all aspects of CSR. The challenge now is to design an appropriate incentive package for those who provide and implement project proposals with ingrained CSR programmes. Incentives could range from tax rebates to public recognition at major state events.

10. See: UNIDO, 2007.

Box 1: The West Nile Electrification Project

Situated between the Democratic Republic of Congo, the south of Sudan and the River Nile, the 1.5 million people in Uganda's West Nile region live in relative isolation from the rest of the country. Road connections are few, and driving conditions difficult. Nowhere in Uganda was oil and gasoline more expensive than here. The national power grid does not reach into the northwest of Uganda, and hence power from generators was available only for the affluent and for only four hours per day. Some entrepreneurs started mills and small workshops, using old diesel generators that were very expensive to operate. Some institutions such as hospitals and schools, and some of the richer households, had their own diesel generators. The growth in the number of generators per capita indicated a general increase in economic activity in the region. But life without good roads, reliable electric power and, until recently, public telephones remained a challenge.

However, a private company, the West Nile Electrification Company (WERECO) now generates and distributes power in the West Nile region, enabled by the Prototype Carbon Fund (PCF). It uses a thermal generator running on Heavy Fuel Oil (HFO) to produce 1.5 megawatts (MW). This initial phase of thermal generation by the company replaced all the small, individual and inefficient power generators that were also releasing huge volumes of hazardous greenhouse gases to the atmosphere.

The second phase of this company's project was to build a hydropower plant (Nyagak Hydro Power Project) to generate and distribute 3.5 MW, that would subsequently replace the thermal generator altogether. Construction of the Nyagak Hydro Power Project was commissioned on February 7, 2006 and is due to be completed in September 2008. Hydropower that is expected to be on stream by September 2008 will significantly increase the emission savings and therefore the income to the company from selling the emission reductions to the PCF. Reliable power supply is available now for 20 hours a day from the thermal generator to facilitate workshops, hospitals, schools and households, and has helped to realise the development potential of the West Nile region.

Key challenges involved in targeting responsible FDI

While Uganda has made progress in attracting some FDI, the country's competitiveness for FDI is still relatively low, and the main reasons for this are outlined in this section. However, targeting FDI with deep-rooted principles of CSR practice should not be an additional filter to FDI inflows.

Basic infrastructure as a component of investment climate is fundamental in attracting FDI, and Uganda's power shortage has been the main impediment to FDI to date. The government has attempted to alleviate this problem by producing additional power from thermal installed generators. UIA is now focused, more than before, on attracting investors in renewable energy – hydro, wind, solar and biomass. Uganda's hydropower potential remains under-exploited, given that it now generates only around 200MW of the potential 2000MW.

One Chinese company is now implementing a mini-hydro power plant in southwestern Uganda (Kikagati). Other companies like Hydromax and Karuma have successfully completed their paperwork and are now ready to embark on resource mobilisation. Since Uganda has sunshine throughout the year, promotion of solar energy appears even more promising and attractive. Uganda's Electricity Regulatory Authority (ERA) has carried out studies on generating energy under the Independent Power Producer (IPP) arrangement.¹¹ This effort is expected to yield positive results.

The railway network between Uganda and Kenya was privatised to a consortium. The hope is that the new company will carry out fast renovations so that the private sector can start using the railway as soon as possible. Currently, most imported raw materials and products for export have to be carried by road, which is comparatively expensive. The road network, however, was considerably improved – partly in preparation for the Commonwealth Heads of Government Meeting in Uganda that was held in November 2007.

Established industrial processing zones with completely built and serviced industrial shells have been lacking in Uganda. Given that investment promotion is now global and not the preserve of a few countries, an investment location providing serviced industrial shells has a distinct advantage in attracting FDI. Uganda is in the process of developing a state-of-the-art industrial and business park. Many other industrial parks are earmarked for future development, and monies were put aside in financial year 2007–2008 to complete Luzira and Kampala Industrial and Business Parks.

Stability is another important component of the investment climate. Macroeconomic stability, with predictable foreign exchange, inflation and interest rates, is a key determinant of location for potential investors. Uganda's macroeconomic management has been rated as satisfactory by the international monetary authorities. Political and social stability are equally important ingredients in the decision process. Uganda has been enjoying relative political and social stability for the past 20 years, and efforts are now concentrated on consolidating this for a continued smooth flow of FDI and wellbeing of the nation.

Policy framework is another aspect of investment climate commonly scrutinised by investors before they locate in a country. Uganda has established a law reform commission with responsibility for studying and keeping Acts and other laws of Uganda under constant review with a view to making recommendations for their systematic improvement, development, modernisation and reform. The challenge is for Ugandans to incorporate a CSR dimension into the reform laws.

The PIRT has benefited immensely from contributions of its international representatives on international best practice. The Free Zone Bill recommended by this forum would introduce a series of competitive fiscal incentives for exporters. PIRT also recommended the establishment of a fully fledged Ministry of Information

11. ERA website.

and Communication Technology. The Ministry has since been established and a Minister appointed. Implementation of this and many other recommendations is a clear demonstration of the commitment of the president and government to private sector development through the continuous improvement of the investment climate.

The other aspect of policy framework that has offered some challenge is related to the promotion of CDM projects. While the investment-promotion aspect of CDM projects has been going on with vigour, the lack of a legal instrument to establish the designated national authority (DNA) continues to pose a major challenge. However, the process of legitimising a DNA office is developing. Consultations are underway with renowned institutions like the Mitsubishi Research Institute (MRI) based in Tokyo, with considerable expertise and profile on climate change. MRI is also helping to complete the project design document for a methane-related project using garbage in Kampala City.

Training stakeholders on issues of CSR is another challenge, and training is required for three groups in particular.

1. Government officials, including those in UIA, need to benefit from this kind of orientation in order to align them with modern business methods; attraction of FDI with CSR practices would be easier if all those involved fully appreciate the nature of FDI likely to benefit the country sustainably.
2. Employees would also benefit from this specialised training. Issues of CSR are being highlighted in all school curricula to ensure that they become central at all stages in the education process.
3. Investors, civil society and media operating in Uganda form another group of stakeholders to be constantly reminded of CSR issues and the attendant benefits. UIA periodically organises investors' regional and national workshops on topical issues, sometimes in partnership with international organisations. Some components of CSR, such as environmental management, have long featured in these presentations, and future efforts will focus on other aspects and on continuously encouraging compliance.

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Chapter 10

FDI and CSR: The case of ProNicaragua¹

Juan Carlos Pereira

Introduction

Nicaragua is the largest and least densely populated of the Central American nations. It is bordered by Honduras in the north and Costa Rica in the south, and is home to over 5.1 million people, 70 per cent of whom are below the age of 30. Often misperceived as a dangerous country due to the violent conflicts that occurred there in the 1980s, Nicaragua today is paradoxically one of the safest countries in Latin America.²

Roughly the size of Greece, at approximately 130,000 square kilometres, Nicaragua contains 7 per cent of the world's biodiversity and houses the second largest rainforest in the Americas – the Bosawas Rainforest Reserve. In fact, close to 20 per cent of the country's territory is protected under national parks or biological reserve

1. Juan Carlos Pereira was the Executive Director of ProNicaragua until August 2007. This case study covers the period to January 2007. Javier Chamorro is the current Executive Director of ProNicaragua.

2. Comunidad Segura website, 2008; Inter-American Human Rights Institute website, 2008.

status. International visitors are quickly discovering these areas, along with its colonial cities of Granada and Leon, its majestic volcanoes, desolate beaches and peaceful fresh water lakes, as some of the last “untouched” tourist attractions in the Americas.

Nicaragua and its people suffered greatly as a result of the Cold War conflicts that took place in the 1980s. The country’s gross domestic product (GDP) was halved, foreign debt rose more than tenfold to over US\$12 billion, and a massive emigration to North America and neighbouring countries caused a severe decrease in the number of workers. Fortunately, international and domestic pressures in the late 1980s opened up negotiations between the ruling Sandinista Party and the opposition, which eventually led to the first democratic election in the history of Nicaragua in 1989. The election of Violeta Barrios de Chamorro as Nicaragua’s first democratically elected president, and Latin America’s first female president, ushered in an era of democracy and peace for Nicaragua’s impoverished population. The democratic and free-market reforms begun by the Chamorro administration in the early 1990s and continued by subsequent governments yielded dramatic changes: the privatisation of more than 350 state enterprises, a reduction in the inflation rate from 13,500 per cent in 1991 to 9.4 per cent in 2006, and a 75 per cent reduction in foreign debt as a result of successful participation in the Highly Indebted Poor Country Initiative (HIPC) initiative.

Building a better business climate

These initial reforms have given way to other important changes that have created a pro-investment business climate. One recent highlight is the ratification of several free trade agreements (FTAs), including the recently implemented Central American Free Trade Agreement with the USA (DR-CAFTA). Along with new FTAs, Nicaragua has implemented measures that provide improved protection of personal and intellectual property and grant equal treatment for local and foreign investors, and allow the free repatriation of profits and capital. Clear legislation and regulations concerning business have also contributed to strong growth in foreign direct investment (FDI). For the second consecutive year, Nicaragua retains its position as the number one country in Central America with favourable conditions to do business in and attract FDI, according to the World Bank’s Doing Business 2007 report. The report measures different sets of business environment indicators such as ease of starting a business, employing workers, enforcing contracts, obtaining credit, closing a business, registering property, and protecting investors, in order to establish the rankings.³

In recent years, the economy has grown at an average annual rate of 4.4 per cent (2004–2006) and export growth has also been strong. Exports reached US\$1 billion in 2006,⁴ after growing at rates well over 20 per cent in the last five years. Although traditional products such as coffee, meat, and sugar continue to lead the list of

3. World Bank, 2007.

4. Central Bank of Nicaragua website.

Country	2005	2006
Mexico	85.5	0.2
Canada	43.2	11.4
United States	37.5	4.1
Europe	35.2	11.4
Asia	21.7	64.3
Central America and Panama	11.8	120.1
Others	3.3	70.8
Total	US\$ 238.2	US\$282.3

Source: Nicaraguan Ministry of Development, Industry and Trade, MIFIC

Sector	2005	2006	% change
Free Zones	77.1	49.0	(36)
Telecommunications	109.0	50.1	(54)
Energy	23.0	20.0	(13)
Tourism	14.3	19.0	33
Transportation	3.0	-	-
Fishing	-	7.5	-
Agri-industry	-	0.8	-
Industry	3.0	14.1	370
Commerce and services	8.0	19.8	148
Bank and finance	-	100.0	-
Construction	0.7	0.1	(86)
Mining	-	1.9	-
Total	238.1	282.3	18.5

Source: Nicaraguan Ministry of Development, Industry and Trade, MIFIC

Nicaraguan exports, the fastest growth is now in non-traditional exports such as manufactured goods (clothing and autoparts), gold, seafood, cheese, beans and new agricultural products such as peanuts, sesame seeds, melons and onions. Rapid expansion of the tourism industry has made it the nation's third largest source of foreign currency, and a burgeoning export services sector, in areas such as call centres and business process outsourcing, is providing much needed job opportunities for college graduates and bilingual workers.

As is the case for many small developing countries, Nicaragua depends heavily upon FDI for its future success. Each year over 100,000 Nicaraguans enter the workforce, and a large amount of private investment, as much as US\$1 billion annually (20 per cent of GDP), must be mobilised in order to provide job opportunities to these new workers. Hundreds of millions of additional investment dollars are required in order to upgrade the jobs and skills of the existing workforce. In an effort to mobilise this critical investment, Nicaragua is making efforts to upgrade its image and find its place in the global economy as a competitive platform for sustainable and socially responsible investment in the manufacturing, agricultural, and services industries. Efforts to further improve the business climate have had notable successes over the past few years, including the creation of a one-stop-shop for investment, plus the government's decision to dedicate very scarce resources to investment promotion efforts through the creation of a well-funded investment promotion agency, ProNicaragua.

FDI flows into Nicaragua have seen dramatic growth since the early 1990s. In 2006, FDI reached US\$282.3 million, an increase of 18.5 per cent from 2005, and a fourfold increase from the average of US\$62 million the country received in the 1992-1996 period.⁵

Even though important progress has been made, the challenges ahead for Nicaragua are quite daunting: it remains the second-poorest nation in the Americas, with annual per capita income of US\$971,⁶ and according to the World Bank, almost half the population (45 per cent) lives on less than a dollar a day. While extreme poverty has decreased significantly, the overall levels of poverty have virtually unchanged. Unemployment is officially around 5.2 per cent, but approximately 33 per cent of the economically active population is considered underemployed.⁷ Even improved economic growth in the short- to medium-term is unlikely to be enough to meet the growing demands of the labour force for decent employment. Sadly, if job opportunities do not materialise at home, the predictable result will be that Nicaragua will continue to export its best and brightest in search of opportunities overseas.

For many experts, however, these efforts are not enough. According to a recent review by consultancy International Development Ireland, "It is not clear that Nicaragua's political leadership recognises that investment, both foreign and domestic, is absolutely *essential* to its growth".⁸ The report goes on to state that "much of the national effort remains focused on alleviating the pain of poverty and supporting subsistence enterprise... virtually ignoring the segment of business most likely to grow the economy and produce jobs." They further claim that "there is still no clear national consensus that the support of business and investment is the only way Nicaragua will break its current vicious cycle of poverty and inequity."

5. ECLAC website.

6. Central Bank of Nicaragua website.

7. Underemployment includes all people who work 39 hours per week or less but who do not desire to work longer hours, as well as those people who work 40 weekly hours or more, but whose salary is below what is established by the official minimum salary wage for their corresponding occupation.

8. International Development Ireland, Ltd, 2005.

Institutional framework

Nicaragua began its foreign investment promotion efforts in the early 1990s with the passage of key laws that paved the way for the first large private investments in sectors such as infrastructure, telecommunications, manufacturing and tourism. A new foreign investment law gave equal treatment to foreign and domestic investment, and allowed the free repatriation of capital under an open investment regime. New Industrial Free Zone and Tourism Incentive Laws gave generous tax benefits to investors in these target sectors, while the Caribbean Basin Initiative (CBI) trade scheme allowed many goods manufactured in the country to enter the US duty free. The creation of the public-private Center for Exports and Investment (CEI), Nicaragua's first investment promotion agency (IPA) in 1992, was also a visible sign of the new government's commitment to attracting FDI and increasing exports. More recently, foreign investment promotion efforts have largely been concentrated in a single agency, ProNicaragua, which recently won the 2006 World Association of Investment Promotion Agencies (WAIPA) Award.

The agency was founded in 2002 in an alliance between the Government of Nicaragua, the United Nations Development Programme (UNDP), the Multilateral Investment Guarantee Agency of the World Bank (MIGA), and Harvard Business School, through its Service Leadership Fellows Program. ProNicaragua is an autonomous agency set apart from government ministries, but reporting through to the Office of the President. It is charged with directing, through private-public cooperation, the "establishment of a national system of promotion capable of attracting significant direct investment by international firms." ProNicaragua to date has supported investments worth approximately US\$250 million, which, in turn, are expected to create over 21,000 jobs.

The Agency's mission is to encourage export-oriented foreign investment in the manufacturing, agribusiness, tourism and services sectors and to choose Nicaragua as a base from which to add value and compete in global markets. In order to achieve its investment goals, the agency conducts sector research to determine Nicaragua's competitive advantages and target sectors. It organises investment roadshows around the world, and participates in industry events to generate interest from targeted investors. It also provides free information and facilitation services to qualified investors. ProNicaragua, like many of its counterparts around the world, also seeks to obtain re-investment from existing investors, and to convince them to add new functions, integrate new processes or manufacture new products in their Nicaraguan operations. Finally, the agency works as an advocate for the foreign investor from a policy point of view and seeks to influence policymakers to create a more competitive business environment in the country.

The agency not only aims to generate a large quantity of jobs, it also tries to attract innovative projects that generate increasing amounts of value added, provide better working and environmental conditions, and help improve the image of the

country. This is the case with its recent efforts to attract investment in industries such as medical products, and in knowledge-based services such as call centres, shared services and engineering operations. These efforts will be discussed in more detail next.

ProNicaragua is, of course, only one of the many actors in Nicaragua's FDI promotion system. Other key players include:

- One Stop Shop for Investors (known in Spanish as Ventanilla Única de Inversiones). This is a single service point for investors seeking to register a company in Nicaragua and obtain basic permits.
- The Ministry of Industry, Trade and Development's Private Sector Development Division (MIFIC) (Dirección de Fomento Empresarial). MIFIC works to strengthen the local private sector so that it may take advantage of the opportunities available in foreign markets. It also strives to promote and facilitate national as well as foreign investments in the country. MIFIC is the key policy-making division of the government for issues related to FDI.
- The Nicaraguan Tourism Board (INTUR). INTUR works to promote Nicaragua as a tourism destination, and serves as the regulator of the tourism industry and Tourism Incentive Law. INTUR also coordinates investment promotion efforts in the tourism sector with ProNicaragua.
- The Free Zone Commission (CZF). CZF is the regulatory body charged with oversight and approval of the Industrial Free Zone Tax Incentive Law.
- The National Free Zone Corporation (CNZF). CNZF is a government-owned industrial park operator that manages over 20 per cent of the industrial space currently under the free zone tax regime in the country. CNZF also coordinates its FDI promotion efforts closely with ProNicaragua and is one of the agency's key counterparts.
- The National Forestry Institute (INAFOR). INAFOR regulates the Forestry Investment Incentive Law and approves applications for companies seeking investment benefits under the law.
- The Ministry of the Environment and Natural Resources (MARENA). MARENA is responsible for environmental oversight and permitting, along with oversight of the carbon credits/clean development mechanism (CDM) mechanism in Nicaragua.
- Municipalities. Many local municipalities are involved in carrying out FDI attraction efforts for their localities and often provide special incentives to targeted investors.
- Ministerio de Energia (Ministry of Energy). The Ministry of Energy, along with INE, the Energy Regulator, is responsible for administering the Renewable Energy Investment Law and approves energy concessions.
- Nicaexport (the Nicaraguan Centre for Exports). Nicaexport provides important information on the country's export capacity, profiles of exporters, market access and regulation information related to exports, as well as a market analysis services used by many investors in the agricultural sector.

The institutional framework in place to interact with investors has improved dramatically over the last decade. However, at times it can still be confusing for investors due to overlap that exists among some institutions and the fact that agencies charged with formulating policies are also often engaged in executing it.

Integrating CSR into the FDI promotion process

Nicaragua and its investment agency ProNicaragua is committed to the goal of attracting FDI with good corporate social responsibility (CSR) practices in order to accelerate the process of creating a better quality of life for the people of Nicaragua. The key objective of the agency – to attract investment and maximise job creation – remains its key performance indicator. However, companies that bring good CSR and environmental practices to the country, along with the traditional FDI benefits of jobs, technology transfer, market access and balance of payments improvements, are considered strategic for Nicaragua, and, as such, are given special attention.

ProNicaragua has developed a multifaceted strategy to attract companies with good CSR practices into Nicaragua. First, as part of its proactive investment promotion efforts, ProNicaragua selects target companies for its investment roadshows based on a number of factors, including a company's reputation, investment horizon, and CSR track record in neighbouring countries. Second, rather than focus merely on sectors that produce thousands of jobs but may bring fewer add-on benefits, ProNicaragua recently added new sectors to its promotion strategy that it considers have a higher potential to provide a positive social or environmental impact. Industry sectors such as sustainable forestry plantations, ecotourism, and shared services are now an important part of the agency's portfolio. Third, Nicaragua has developed a series of special incentives, both tax and non-tax related for sectors that the country believes could have positive social or environmental spillovers. Finally, the agency has developed strong working relationships with non governmental organisations (NGOs) that provide matching funds to companies engaged in social investments such as health and education projects. This multifaceted strategy has allowed ProNicaragua to begin to increase both the quality and impact of the investments it supports.

In a typical year, ProNicaragua organises as many as 20 roadshows and industry events in order to generate qualified investor leads. The agency seeks out companies based on a number of traditional business factors such as company fundamentals (financials, growth, sector focus etc.), and global site selection strategy. However, the company's reputation in the marketplace, its relations with highly-regarded customers, its ability to carry out long-term investments, and a good CSR track record, though not always easy to determine, will usually push those companies to the top of the agency's priority list of prospects and will trigger high-level government involvement in the promotion process. For example, the Nicaraguan ambassador in the country where the company has its headquarters might send a personalised letter

Box 1: A case study

The example below will serve to illustrate how a multifaceted strategy to attract socially responsible companies can actually work in practice.

As ProNicaragua began to seek out investors in the sustainable forestry sector, the agency decided to target companies with existing operations in the Central American region that may have a business interest in expanding into Nicaragua. During its research, ProNicaragua came across a German-run forestry company with operations in Panama that was seeking a location for a large-scale forestry plantation project, backed by one of the world's most prestigious private investment funds. After some initial background research and preliminary contacts, this company quickly became a priority investor for the agency due to the type of project it worked on, its reputation in the region as a company with a long investment future, a record of socially responsible business practices, and an ability and willingness to share its technology with local growers. Unlike most companies operating in the Nicaraguan forestry sector, this company committed itself to paying its workers a fair wage, along with social security and other fringe benefits. It also pledged to provide training in environmental and safety practices for its workers and include a high percentage of indigenous species, along with highly valued ones such as teak, in its plantations of plots formerly used as pastureland.

After much analysis and information sharing, it became clear that the opportunity looked promising for both parties.

Unfortunately, as the legal diligence work began on the project, a serious legal problem put everything on hold; a recently approved forestry incentive law, which was a prerequisite for the project, had not been implemented because the regulations for the law had yet to be drawn up and published by the executive branch. ProNicaragua decided to invest an important amount of time and political capital to ensure that the regulations were published and the new law was implemented. The fact that the company was committed to providing important social benefits to its workers and the communities around its project, in addition to strong economic benefits, made it possible for the agency to generate the political will within the executive and key ministries – agriculture and environment in particular – to move the process forward. After months of persuasion at high levels, including presidential involvement, plus tense meetings with mid-level bureaucrats, the regulations were finally drawn up and published, and the project was approved. Nicaragua is now the proud home to one of the three largest forestry plantation projects in the Americas, which will create thousands of jobs in depressed rural areas, bring important environmental benefits to the country, including carbon reductions, and improve Nicaragua's image as an eco-friendly destination.

to the company, or a key official such as the President or Vice President may personally get involved in the process to try to attract the company to invest in Nicaragua. In some cases, non-cash incentives may be utilised in order to lure the high-quality prospect to the country.

Whereas in its early years, the agency chose to target industries that maximised short-term job creation and economic impact, the agency now includes sectors in its portfolio that may have longer-term positive economic impacts coupled with favourable environmental benefits, positive social spillovers and image improvements for the country. The agency is now proactively seeking out investments in novel tourism sub-sectors such as ecotourism and agritourism, in knowledge-based industries such as call centres, shared services and engineering services, and in environmentally beneficial sectors with carbon-reduction potential such as sustainable forestry. In order to attract top companies in these competitive sectors, Nicaragua has developed a series of targeted incentives, both tax and non-tax related. The simple goal is to make the country more attractive to companies in sectors the government believes have positive social or environmental benefits, in addition to purely economic ones.

The incentive laws now in place to attract high quality investments include a renewable energy incentive law that provides tax incentives for wind, geothermal, biomass and hydroelectric generation; a tourism incentive law that provides benefits to eco and agritourism companies, among others; a forestry incentive law that stimulates sustainable forest management and plantations; and a free zone law that provides tax benefits for eco-friendly service companies such as shared services operations. Nicaragua is also involved in promoting the Clean Development Mechanism (CDM) process, which allows renewable energy and forestry companies to obtain additional financial benefits through the sale of carbon credits. These types of targeted incentive can serve to differentiate Nicaragua from other countries in the region such as Costa Rica and Panama that have developed good reputations for environmental and social responsibility.

Partnerships

Recently the agency has developed strong working relationships with organisations that provide technical assistance as well as matching funds for companies engaged health, nutrition and education projects in the communities where they operate. A USAID-funded programme called Alianzas, offers the ability to match, typically on a one-for-two basis, company resources devoted to qualified health, education and nutrition programmes. A large coffee producer, a petroleum exploration company, and a local financial institution recently became among the first successful participants in the programme. The Alianzas programme provides technical assistance to investors in order to ensure the effectiveness of their social programmes. It matches them up with local NGOs who can help them implement the projects, and provides matching funds to increase the scope of the projects. ProNicaragua seeks to steer new investors to programmes such as Alianzas in order to encourage them to develop high quality social investments in their communities and learn about the benefits that these types of social investment can have for business over the medium- and longer-term.

CSR: a driver of higher quality investment

Countries seeking to attract higher-quality investment in industries with ever greater value added and a larger amount of capital investment per job created must make strong efforts to raise the level of CSR of companies in existing industries in order to become more attractive for these “higher end” investors. In fact, there is evidence that well-known brands or products in the premium segments are more worried about the impact that so-called sweatshop conditions can have on their image, and will therefore be less likely to invest in a country tainted by such practices. Companies from higher value added sectors and high-end segments will be favourably impressed by a country with high CSR expectations, and will be more inclined to invest there, all other things being equal.

In the case of Nicaragua, the arrival of new manufacturing facilities and modern industrial parks has made it possible to arouse the interest of higher-end companies in the medical products, electronics, and shared services industries that once eschewed the country because of the negative impression older industrial parks with poor conditions would have made on their customers. Moreover, good social practices by some existing clothing manufacturers have also caused a favourable impression on prospects in new industries.

The case of Cupid Foundations Nicaragua, a US-based clothing manufacturer with operations in Nicaragua is a notable one. Cupid’s outstanding level of CSR is a good example for the Nicaraguan clothing industry and serves as an example of what can be possible in Nicaragua. Cupid meets and exceeds all local environmental and labour standards and provides its staff with some unique benefits such as: at cost cooperatives with groceries and other basics available for purchase, low interest loans to employees in a situation of personal need, an assistance grant for employees with a death in the family, a company-owned, ultramodern air-conditioned factory where employees work in close-knit teams using a Toyota manufacturing system, and special recognition for employees who stand out, not only in terms of efficiency, but also as members of their community. Each Friday, the production team with the best performance in the factory is given the “golden sewing machine” and is rewarded with upbeat music and dancing, as well as special remuneration, for their efforts. Cupid not only provides several hundred good jobs to Nicaraguan workers, it has also been an important example and has been instrumental in the country’s ability to attract new high-quality investors who will help improve the working and environmental conditions of the local industry and transform the country’s image.

The risks

In the case of Nicaragua, and countries similar to it, there are few negatives to targeting FDI with good CSR practices, as long as policymakers don’t lose perspective of the fundamentals – that a job is the first priority for a poor unemployed person, and a so-called “better job” is the priority of those who are

already employed. Basic standards of care in the working environment and environmental responsibility cannot be compromised. However, the main and first goal of FDI attraction is to create sustainable, decent employment for people, with basic jobs that pay basic wages.

Although there are great benefits to a well thought-out policy of attracting FDI with good CSR practices, the risk of an overly zealous policy to limit investment to those that policymakers deem to be socially responsible must not be overlooked, as it could be highly detrimental to the welfare of the most needy. The lack of standards across the business world to determine the level of social responsibility of a company can lead to problems when policymakers, with the best of intentions, take a firm stand on the issue of CSR. Without standards in place to judge company behaviours such as labour practices and social impact, it is easy to judge certain types of jobs or industries as undesirable, as they are judged solely through the eyes of the often well-off policymaker, instead of the needy unemployed worker who can barely find the resources to feed his/her family, let alone send his/her children to school and/or pay for healthcare. As well meaning policies to attract FDI with good CSR practices are developed, the needs of the poorest must be kept in mind. The bar must not be set so high that people will be unable to pull themselves out of desperate poverty and build a better life for themselves and their families.

The first responsibility of the socially responsible government is to create a business climate that will enhance the attraction of high-quality investment and will allow companies to create job opportunities for the population as a whole. Promoting political stability, reducing bureaucracy and red tape, creating a simple and stable legal framework for investment, negotiating access to key markets, promoting internal competition, providing the needed infrastructure, and developing a high quality educational system are still the factors that will most affect a country's ability to attract investment and generate jobs, and must not be ignored. A good business climate is fertile land upon which to grow new investments from companies with high CSR standards, and should be the top priority for policymakers. For IPAs conducting proactive promotional efforts, CSR should be a key factor in choosing its targets and in allocating precious incentives and the precious time of top government officials. Attracting highly-regarded companies will attract other like-minded companies, and will go a long way towards the creation of a virtuous circle of CSR-focused FDI promotion efforts.

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Chapter 11

FDI and CSR: The case of the Foreign Investment Committee in Chile

Carlos Eduardo Mena K. and Reinalina Chavarri M.

1. Introduction

This chapter sets out the principles governing foreign direct investment (FDI) in Chile, and examines the working of the Foreign Investment Committee (FIC) and its role as the entity that guarantees foreign investment in Chile at a time of intense modernisation and democratic consolidation.

We adopt a theoretical approach to define a framework of actions that can be undertaken by a body such as the FIC and we consider its relationship with corporate social responsibility (CSR) from a medium- and long-term perspective.

2. Foreign investment in Chile

2.1 The Foreign Investment Committee¹

The Foreign Investment Committee is the agency that represents the state of Chile in its dealings with investors who opt to use Chile's Foreign Investment Statute (DL 600). According to Article I, "The regulations of this Statute shall apply both to foreign individuals and body corporates and to Chilean individuals resident and domiciled abroad who transfer foreign capital into Chile and enter into a foreign investment contract".

According to Article 12 of DL 600, "The Foreign Investment Committee is a decentralised public legal entity, having its own assets, domiciled in Santiago. It shall report to the President of the Republic through the Ministry of Economy, Development and Reconstruction. The Committee shall be the only entity authorised to accept on behalf of the Chilean state the inflow of foreign capital from abroad under this decree and to stipulate the terms and conditions of the respective contracts".

The Committee is composed of the Minister of Economy (who acts as its President), the Ministers of Finance, Foreign Relations and Planning, and the Governor of the Central Bank of Chile. In addition, ministers responsible for the economic sector to which a specific investment is related are invited to participate in the corresponding meetings of the FIC.

The Foreign Investment Committee's mission is to help position Chile as a highly attractive destination for foreign investment. It does this by developing and implementing an investment promotion plan that highlights the competitive advantages afforded by the treaties Chile has signed. It focuses its efforts on positioning the country as a platform from which to export goods and services with value added as an incentive for investment.

2.2 The FIC's strategic objectives

The key strategic objectives of the FIC are:

- To administer the DL 600 Foreign Investment Statute in order to ensure its correct application and to support international negotiation of the investment chapters of bilateral and/or multilateral agreements, providing advisory services on matters of the Committee's concern.
- To develop initiatives to provide information and promote, coordinate and implement measures to foster the entry of foreign investment.

On May 31, 2007 the Foreign Investment Committee also announced a special focus on:

1. The Foreign Investment Committee is managed and administered at the operational level by the Executive Vice President, who is appointed by the President of the Republic.

- use of trade agreements in international business;
- promotion of foreign investment in the different regions of Chile;
- opportunities for dialogue and a pro-platform agenda.

Business ethics: a new foreign investment asset

In addition, the FIC has put forward in its Action Plan 2006–2009, a course of action that will assess the impact of its policies on corporate decision making. To achieve this objective, it has defined a series of activities intended to raise the issue with its target groups, keeping in mind that in Chile, ideas about applied corporate business ethics are mainly disseminated in the academic world, specifically through corporate fora held by the Schools of Business and Administration.

This encouragement can motivate institutions, particularly as they bring their policies into line with the improved ethical policies within public sector management, as set out in current Chilean state legislation (see Box 1).

Box 1: Transparent government policy for ethical public management

According to Instruction N° 008, December 2006, issued by President Michelle Bachelet, government institutions are advised to actively make their performance transparent by publicising information from ministries to the general public. To achieve this objective, five ministries – the Ministry of Public Treasury, the Ministry of the Economy, the Ministry of Agriculture, the Ministry of Public Affairs, and the Ministry of Justice – joined the pilot programme “Transparent Government”.

Although the issues of transparency in management practices and appropriate access to information apply to government, corporations are also invited to enhance their performance by adopting the universal values promoted by initiatives such as The Global Compact, ISO 26000 on social responsibility (to be launched in 2010) and the Global Reporting Initiative (GRI), instruments that consider such responsibilities to be voluntary. Thus the FIC considers it necessary to encourage and foster these principles for foreign investors, which in turn will lead to more responsible competition.

In this context, the Foreign Investment Committee recently initiated an internal consultation process to elaborate a set of ethical codes to guide administrative managers. This process aims to achieve consensus among the professionals and officers of an institution.

3. New challenges for foreign investment

Over the past quarter of a century, and particularly since 1990, FDI has played a key role in underpinning Chile’s sustained growth. Since 1990, multinational companies

have, through the development of greenfield projects and by participating in mergers and acquisitions (M&As), committed more than US\$69 billion to Chile, a very significant amount for an economy whose GDP was US\$115 billion in 2005.

In 2006, the Foreign Investment Committee authorised foreign direct investment worth US\$4,815 million, representing an increase of 183 per cent on 2005. The sectors in which authorised investment was highest were electricity, gas and water (US\$1,714 million), mining (US\$1,290 million), services (US\$720 million) and transport and communications (US\$ 538 million).²

Canada was the largest source of authorised investment, representing 60.3 per cent of the total, followed by the United States (10.7 per cent), Germany (8.4 per cent), Austria (4.0 per cent) and Spain (3.8 per cent).³ Today, more than 3,000 companies, from some 60 countries, have operations in Chile.

Chile's strategy of international integration has played a key role in this process. Thanks to its widening network of free trade agreements (FTAs), companies in Chile enjoy privileged, and in many cases zero-tariff, access to more than three billion consumers around the world, and many foreign investors are taking advantage of these opportunities. In addition, multinational firms report being impressed by the excellence of Chile's professionals and their familiarity with other regional markets, by the country's competitive edge in telecommunications services and its frequent air connections to the world's other business centres as well as by the safe and cosmopolitan environment it offers for expatriate staff.

These excellent results are of enormous importance in demonstrating the confidence of foreign investors in Chile. However, the 17 FTAs that Chile has signed with 56 countries, accounting for more than 80 per cent of its international trade, also pose new challenges for FDI and, indeed, all types of investment.

A key challenge now for attracting FDI relates to the "network economy" created as a result of the implementation of FTAs. These agreements strengthen networks between companies that often overlap with the classic relationship between nation states, transforming the global economy through networks of suppliers, producers and customers and technological cooperation, especially for medium-sized enterprises as well as larger players in international markets.

This means increased competition in attracting FDI and this competition is not exclusively economic or confined to interaction between countries. Instead, countries compete in different spheres and on the basis of different variables that include their political and economic systems, transparency, level of corruption, safety, the rule of law, geographical distribution and social cohesion index.

Thus, confidence, low risk, credibility, transparency and responsibility are highly valued by companies and their stakeholders – customers, shareholders, local governments, suppliers, and others who are affected by their activity. As a result, intangible factors are assets that form an integral part of business and investment

2. Carlos Eduardo Mena K., Executive Vice-President of the Foreign Investment Committee.

3. FIC, 2007.

plans, particularly in a globalised world that gives ever greater importance to protection of the environment and anti-corruption measures.

In this context, corporate social responsibility emerges as a vital component of policy design and decision making in the private and public sectors. However, the FIC cannot force companies to adopt these policies, but can only encourage and promote good corporate practice.

4. Chile's business environment

Chile's positive business environment reflects the thrust of the public policies that it has implemented since the re-establishment of democracy in 1990, particularly in four key areas:

- Political stability
- Modernisation of the state
- Economic freedom
- Social cohesion

4.1 Current priorities for the Chilean government

Like her "Concertación"⁴ predecessors, President Michelle Bachelet has continued to give priority to a social agenda that includes a major overhaul of Chile's health system, an ongoing educational reform and the *Chile Solidario* Project (www.chilesolidario.gov.cl), targeting the country's poorest families. These programmes are designed not only to improve productivity and increase Chile's competitiveness but, primarily, to ensure that all the country's citizens share in the benefits of economic growth. Indeed, according to the International Monetary Fund (IMF), "Chile's new government has focused its policy agenda on ensuring conditions for sustained growth while guaranteeing a wide network of social protection for citizens. To meet such goals several policy initiatives have been proposed."⁵ According to an official survey published in June 2007, the poverty rate in Chile has dropped to 13.8 per cent and the 2006 Human Development Index places the country at number 38, the highest in Latin America after Argentina (see Table 1).

In the 2006 World Competitiveness Yearbook, published by the International Institute for Management Development (IMD), Chile also achieved a high position on different aspects of human capital (see Table 2).

5. Corporate social responsibility in Chile: progress and challenges

The concept of corporate social responsibility (CSR) made its debut in Chile in 1999 with the publication of a document⁶ that triggered debate and set the scene for the

4. Concertación is a coalition of centre-left political parties, which has been in power in Chile since 1990.

5. IMF, 2006.

6. Chavarri & Teixidó, 1999.

Table 1: Human Development Index 2006 (selected economies)

Country	Rank	Life expectancy at birth (years) 2004	Combined gross enrolment ratio for primary, secondary and tertiary schools (%) 2004	GDP per capita (PPP US\$) 2004
Norway	1	79.6	100*	38,454
Australia	3	80.5	113*	30,331
Japan	7	82.2	85	29,251
United States	8	77.5	93	39,676
Spain	19	79.7	96	25,047
South Korea	26	77.3	95	20,499
Argentina	36	74.6	89**	13,298
Chile	38	78.1	81	10,874
Mexico	53	75.3	75	9,803
Malaysia	61	73.4	73**	10,276
Russia	65	65.2	88***	9,902
Brazil	69	70.8	86**	8,195
China	81	71.9	70	5,896^
Turkey	92	68.9	69	7,753
India	126	63.6	62***	3,139^^
Niger	177	44.6	21	779^^

* For purposes of calculating the HDI, a value of 100% was applied. ** Data refer to a year other than that specified. *** Preliminary national or UNESCO Institute for Statistics estimate, subject to further revision. ^ Estimate is based on a bilateral comparison of China and the United States (Ruoem and Kai 1995). ^^ Estimate is based on regression.

Source: UNDP Human Development Report 2006 (www.undp.org)

Table 2: Human capital in Chile 2006

Selected Criteria	Position*
Overall position	24
Availability of finance skills	10
Brain drain (absence of)	7
Attitudes towards globalisation	4
Competent senior managers	3
Availability of qualified engineers	7
Labor market conditions	9
Standards of university education	17

*Out of 61 countries considered in the 2006 IMD ranking

Source: Institute for Management Development (www.imd.ch)

new role that companies in Chile are called on to play. This occurred in a context of intense modernisation and globalisation and the challenge of redistributing wealth to lessen the income gap between the rich and the poor.

Since 1999, CSR has been the subject of many meetings and publications and in all of these it has been suggested that social responsibility is not only the responsibility of civil society and citizens but also the of the state and its institutions. Large companies and multinationals have begun to produce sustainability and social responsibility reports. However, this practice has, in general, yet to be adopted to the same extent by smaller local companies.

The present transition of CSR in Chile is taking place on two levels: a) through public declarations, and b) through a strategic approach in which social responsibility is integrated into all areas of company management.

One of the main drivers of social responsibility in Chile is the spread of standards and certification. Many foreign investors in Chile adopt them as a result of policies established by their head offices and as a requirement for accessing demanding international markets. These standards mainly include:

- SA 8000 which has so far been obtained by only one company in Chile;
- Chilean Norm NCh 18002 (2004) / OHSAS 18001 on risk prevention;
- Chilean Norm 2728 relating to the certification that is obligatory for organisations providing training services;
- ChileGAP programme for the certification of good agricultural practices, which is on the point of obtaining international recognition;
- ISO 14000 and 14001 on the certification of environmental management systems;
- ISO 9000-90001 on management quality standards.

Standards and certification of this type are voluntary. Moreover, Article 9 of DL 600 establishes that foreign investors and companies participating therein shall also be subject to the common legislation applicable to domestic investment, and shall not be discriminated against, either directly or indirectly, except as set out in Article 11.

For this purpose, DL 600 specifies that “legal or regulatory provisions affecting specific productive activities shall be deemed discriminatory if they become applicable to the whole or the major part of said activities in the country, excluding foreign investment...”

The most significant sectors in terms of foreign investment are the mining and energy sectors. The mining sector was the first to implement socially responsible policies. This sector has developed relationships and policies with the local communities as well as with its internal clients.⁷

The FIC’s main challenge regarding applying ethical standards through corporate social responsibility is to strengthen its work in the sectors attracting the highest investment levels in order to obtain the best public/private cooperation indexes. By

7. Chavarri & Teixidó, 1999.

Table 3: CSR and/or sustainability reports received by the FIC (2006)

BHP Billiton	Banco Santander
Microsoft	Minera Escondida
Telefónica	Minera Collahuasi
Shell	Nestlé
Aguas Andinas	Anglo American

definition, the Committee has no legal or administrative competence to raise the issue but it can promote and support corporate practices that encourage an ethical approach to business management in Chile.

5.1 Public access to information – a tool to promote CSR

One of the most important aspects of the Foreign Investment Committee's work with regard to its efforts to promote social responsibility among the companies that use DL 600, is the timely publication of database statistics that are useful to the foreign investor. In this area, the aim of the FIC, as a state institution, is to set an example. In May 2006, the FIC took the decision to facilitate access to the information contained in Chile's Free Trade and Political Cooperation Treaties (European Union) and the other 16 FTAs, which together represent around 70 per cent of the country's international trade. In order to achieve this, the FIC reached an agreement with the United Nations Development Programme (UNDP), permitting more effective and faster access to information and, thereby, facilitating efficient use of these trade agreements to tap into the markets they have opened up for Chilean goods and services.

In this context, foreign investment can foster joint ventures between local and overseas companies, particularly those from other Latin American countries, in order to expand into these markets.

The Foreign Investment Committee, together with the country's regional governments, the Under-Secretariat for Regional Development and other public and private agencies, is also working to provide information that will allow Chile's different regions to play a key role in attracting foreign investment to each region's most important productive sectors.

At the same time, multinational companies have gradually begun to publish sustainability and social responsibility reports. These serve to complement the financial information they submit annually to the FIC about their business results and their impact on FDI in Chile (see Table 3).

Moreover, several activities were conducted by the Committee as a way of learning and to highlight the importance of the CSR in foreign investment (see Table 4). During 2007 several meetings were held about FDI in the mining, agriculture and

Table 4: Initiatives by the Foreign Investment Committee to promote business ethics and CSR 2006-2007	
Activity	Objective
<ul style="list-style-type: none"> • Breakfasts with CSR managers of multinationals using DL 600 	To publicise and promote the FIC's concepts and strategic objectives for 2006-2009 with emphasis on CSR and business ethics.
<ul style="list-style-type: none"> • Roundtables with the ambassadors and commercial Secretaries of all countries represented in Chile 	To publicise new approaches and information relating to present-day FDI. To draw attention to the value of intangible FDI assets (trust, transparency, consistency and dialogue with stakeholders).
<ul style="list-style-type: none"> • Lunches and activities with the 17 Bi-national chambers of commerce in Chile 	To publicise and promote the FIC's strategic objectives and the importance of CSR and business ethics for FDI.
<ul style="list-style-type: none"> • Participation in seminars and other local and international events on subjects related to FDI 	As participant and sponsor in seminars and meetings related to FDI, CSR and business ethics in small and medium-sized firms, large companies and multinational investors in Chile.

Source: FIC-Chile

fishing industries. All these activities were very well received by the foreign companies. They also demonstrate the important role that an entity that has no legislative power on the matter can play.

Finally, the FIC seeks to encourage the importance of the social responsibility and/or sustainability reports in strategic sectors, especially the necessity to transition from policy to corporate practice. Only in this way will it be possible to achieve sustained improvement in corporate management and processes. It is essential to measure, verify, compare and audit this transition from policies to practice in order to improve the current management systems in countries such as Chile. This is a key factor in achieving the long-desired environmental, social and economic sustainability.

6. Business ethics in a context of globalisation and FTAs

To increase awareness of the impact of FTAs and the opportunities they have created for foreign investors, the Foreign Investment Committee focused on a number of themes. These were presented at numerous specialised gatherings and events organised by the local and international business community. These themes, which have contributed to the gradual increase in awareness among business people of new trends in FDI and the challenges it poses, are summarised in Box 2.

Box 2: Globalisation and FTAs – opportunities and challenges for FDI and CSR

- In the context of FTAs signed by different countries and regions, with different cultures and differing degrees of labour-market development, it is essential to clarify the issue of the use of different types of labour in this interaction between different states and countries, particularly relating to the use of manual or non-manual labour.
- New companies, particularly those in the field of new technologies, often have different structures to the traditional company. New companies adjust their formal structure to the challenges they face and there is no longer a single model for companies or a universally applicable corporate structure.
- In the context of societies and economic, social and political players acting in networks, it is important to understand that “collaboration and associations and, therefore, the new structure of relations between workers and management is not only a means of sharing costs and resources, but is also an insurance policy against any mistaken technological decision since competitors will also suffer the consequences of that decision as the networks are always interconnected.
- It is imperative, therefore, to clarify the ethical norms that apply to international business, to provide incentives for ethical behaviour in the interaction between different countries and companies, and to enable the conditions required to support and sustain the ethical development of international business as expressed in FTAs between different countries.

7. Conclusions

Corporate social responsibility has only recently begun to feature prominently in debate in Chile, despite almost a decade of seminars and meetings on the topic. Since 2006, the Foreign Investment Committee has begun to incorporate CSR policy into its strategic objectives. To this end, it has met with investors in Chile, represented by company executives responsible for this area, that have been incorporating CSR into their practices since the 1990s. Similarly, the FIC has promoted CSR and business ethics in different organisations in which foreign investors participate, such as the national chambers of commerce from the five continents represented in Chile. It has participated in meetings and seminars and highlighted the importance of intangible assets to the new challenges of investment, particularly in a country with Chile’s characteristics. Finally, the large companies that submit annual financial reports to the FIC accompany these with environmental sustainability reports (particularly companies in sectors that exploit natural resources) or social responsibility reports (financial services and telecommunications companies), indicating a new approach to corporate communications and a new alignment with the objectives and aims of the Foreign Investment Committee.

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Responsible enterprise, foreign direct investment and investment promotion

Key issues in attracting investment for sustainable development

Foreign direct investment (FDI) is widely considered to be a key factor in economic development in middle- and low-income countries. Positively, it can be associated with the introduction of new technologies, job creation, access to new markets and improvements in the competitiveness of host countries. But too often, FDI has been associated with environmental degradation, increased inequality, and lack of integration with the local economy.

A number of host country government departments have a role in influencing the overall investment climate. Among them, investment promotion agencies (IPAs) are often players because they are in the front line of targeting investors and marketing the country as a whole.

This book brings together a series of papers identifying opportunities for IPAs to attract FDI that is associated with positive contributions to sustainable development and good corporate social responsibility (CSR) practices. The papers are written by IIED researchers and other sectoral experts, multilateral organisations working closely with IPAs in attracting FDI, and representatives of IPAs themselves. The book points to a number of opportunities for IPAs in attracting FDI with good CSR practices and highlights key leverage points and practical tools to achieve this. It is intended to provide a primer for IPAs and pointers for approaches that could be deployed in the future.

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Established in 1995 as an NGO in Geneva, Switzerland, the World Association of Investment Promotion Agencies (WAIPA) currently has 223 members coming from 155 countries and acts as a forum for investment promotion agencies (IPAs), to provide networking opportunities and facilitate the exchange of best practices in capacity-building and investment promotion. Supported by its partners, the Foreign Investment Advisory Service (FIAS), the International Economic Development Council (IEDC), Programme of the ACP Group and the European Commission for the promotion of investment (Proinvest) the Organization for Economic Cooperation and Development (OECD), the United Nations Conference on Trade and Development (UNCTAD) and the United Nations Industrial Development Organization (UNIDO), WAIPA also organises trainings for IPA staff and helps IPAs access technical assistance.

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