



## **Mobilising Private Investment for Development: Policy Lessons on the Role of ODA**

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*This report on the role of official development assistance (ODA) in mobilising private investment is a joint product of the Development Assistance Committee (DAC) and the Investment Committee. It includes two main parts, namely preliminary policy lessons that the two Committees made available to the 2005 OECD Ministerial Meeting and a synthesis of the analytical material underpinning the policy lessons.*

*The report focuses on the role of ODA to support the efforts of developing countries to improve their investment climate, including through policy capacity building. The experiences with intervention in areas such as regulatory reform, upgrading of infrastructure and strengthening the trade/investment linkage are reviewed. More targeted approaches to enhancing investment are also analysed, including ODA as a means of supporting public-private partnerships in developing countries and linkages between foreign-owned and domestic enterprises.*

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## INTRODUCTION

This report on the role of official development assistance (ODA) in mobilising private investment for development is a component part of the broader OECD Initiative on Investment for Development<sup>1</sup>, which was launched following the OECD Ministerial Council Meeting in 2003. The report is a joint product of the Development Assistance Committee (DAC) and the Investment Committee.

The first section contains the Policy Lessons on the role of ODA in mobilising private investment for development that were approved by the two committees at a joint meeting on 6 April 2005. These were subsequently presented as background documentation for the OECD Ministerial Council Meeting on 3-4 May 2005, as part of the broader progress report on the OECD Initiative on Investment for Development.

The second section of this report draws on the evidence assembled in a series of background papers prepared for this project. Part 1 discusses the importance of private investment for development. Part 2 provides an overview of the range of activities undertaken by DAC members that promote investment in developing countries. Emerging findings on using ODA better to mobilise investment are presented in Part 3.

In the next phase of this project, to be completed in time for the DAC High-Level Meeting and the OECD Ministerial Council Meeting in 2006, further consultation and dialogue with relevant stakeholders is proposed to verify the Policy Lessons and to derive from them more concrete and pragmatic policy guidance for donors on how to use ODA more effectively to mobilise investment for development.

## POLICY LESSONS<sup>2</sup>

*At the United Nations Millennium Summit, the world's leaders vowed to "spare no effort to free [their] fellow men, women and children from the abject and dehumanising conditions of extreme poverty to which more than a billion of them are currently subjected". Five years on, and with only ten years to go until 2015, it is apparent on current trends that the Millennium Development Goals (MDGs) may not be achieved in many developing countries, especially in Africa. Decisive action and more sustained and strategic approaches are consequently required, by developing countries and development agencies, and can legitimately be expected.*

*As the Monterrey Consensus emphasised, mobilising domestic resources, attracting international capital flows and promoting international trade are critical for generating the higher, more sustainable and more inclusive economic growth patterns needed to meet the MDGs. Sub-Saharan Africa needs to sustain an annual economic growth rate of more than 7% over the next ten years - more than double its recent performance - if it is to reach the first MDG of halving the proportion of people living on less than a dollar a day. A critical role for official development assistance (ODA) is thus to support such growth patterns by catalysing domestic resource mobilisation, promoting foreign direct investment (FDI) and increasing the contribution of trade to development and poverty reduction.*

*By supporting developing countries' own efforts to provide an attractive environment for private investment, ODA can play an important catalytic role and help leverage additional private financing for development. This is particularly important at a time when ODA has reached its highest level ever, and further increases are expected, but when progress towards the MDGs is too slow. A more concerted effort by development agencies to help partner countries mobilise domestic and foreign investment will not only allow donors to achieve more development with their ODA, it is one of the most direct and substantial means of delivering a sustainable reduction in poverty and achievement of the MDGs. Care must be taken to ensure that donors do not find themselves subsidising or redirecting investment that would have happened anyway, or creating an uneven playing field.*

In response to the Monterrey Consensus' emphasis on the importance of mobilising private investment for development to enhance growth and reduce poverty, the Development Assistance Committee (DAC) and the Investment Committee have been carrying out a joint project on ODA/investment synergies. The work forms part of a broader OECD Initiative on Investment for Development, launched in Johannesburg in November 2003 and designed as a contribution to implementing the Monterrey Consensus and achieving the MDGs. This project is timely, as many developing countries and development agencies are intensifying efforts to reduce poverty by mobilising more and better investment.

Today, everyone accepts that jobs and self employment constitute an important pathway out of poverty. As the private sector is the main source of employment, vigorous and sustained economic growth, fuelled by investment and entrepreneurship, is needed to provide jobs and incomes for the poor. This will also help generate the revenues that governments need to expand access to the health, education and infrastructure services that will increase productivity and lead to more rapid economic growth that involves and benefits the poor. The logic of spending ODA to mobilise investment is that it can facilitate this process by correcting market failures and tackling structural impediments. The challenge for ODA is to stimulate genuinely additional investment.

Collectively, development agencies already spend a significant share of their aid on activities that contribute to mobilising more and better private investment – 26% of all foreign assistance, according to one analysis of mostly OECD/DAC data. Their activities include initiatives at the macroeconomic level (e.g. inflation and fiscal sustainability), the enabling environment level (e.g. relevant legislation, governance and infrastructure) and at the enterprise level (e.g. investment and trade promotion and facilitation and capacity development for policy making and implementation). It is not clear, however, that these various activities are sufficiently strategic in their overall effect. To improve the impact and effectiveness of this ODA, more focus, strategic targeting and co-ordination is needed behind a clearer objective to achieve the MDGs by increasing the quantity and buttressing the development benefits of investment.

To guide future interventions and help focus attention on areas with the greatest impact on mobilising more and sustainable investment in poor countries, more detailed assessment is required of what works best in terms of using ODA to mobilise investment, what doesn't work and why. While DAC members do evaluate specific aspects of their support for private sector and infrastructure development, very few assessments of the overall effect of these activities on mobilising investment have been conducted. Joint assessments at a more aggregate and programme level could gauge how the individual and collective actions of donors are impacting on critical factors for mobilising investment.

Drawing on the evidence reviewed by the two Committees, some preliminary policy lessons emerge on the role of ODA in mobilising private investment for development:

- a) *Build on partner countries' own development objectives.* The starting point for donors' interventions is to support partner countries' own plans for providing a healthy investment environment. These should be incorporated into a Poverty Reduction Strategy (PRS) or a similar national development plan. Where available, diagnoses of the investment climate should inform the preparation of development plans. This approach provides a framework for more co-ordinated and comprehensive support by the donor community.
- b) *Address impediments to private investment.* The private sector needs a policy and institutional environment that allows it to thrive, thus major obstacles to the growth of and investment by private businesses need to be identified and addressed. In many developing countries, perceived risks to doing business are too high, basic services such as infrastructure are deficient, government regulations are applied unpredictably, the costs and complexities of starting and doing business are often excessive and corruption can be widespread. There is a need for greater efforts to consult with other stakeholders, including the private sector – domestic enterprises as well as foreign entrants – for their assessment of where governments and donors can best help. Development agencies can support processes instigated by developing countries to address binding constraints that impede growth and promote reforms, including at the sectoral level.

Internationally agreed good practice can serve as a point of reference for such analyses and for benchmarking progress. Depending on the specific situation in each developing country, donors could take a more strategic and focussed approach to their interventions, prioritising activities in such areas as:

- i. *Legal systems.* The development of legislation for company incorporation, contracts and other areas related to economic activities provides the backbone for private sector activity in the formal economy and needs to be backed up by strong implementation mechanisms and judicial recourse. For example, ineffective or unpredictable dispute settlement mechanisms are often cited as hindering investment in developing countries. Nevertheless, few donors appear active in this area which merits greater attention in order to help mobilise investment.
- ii. *Regulatory reforms.* These have a cross-cutting impact and a catalytic effect on improving the enabling environment but require expertise in a range of specific subjects including taxation, competition policies and investment policy transparency and openness. These are areas where many DAC members have not been active, yet they are critical for facilitating the task of doing business. To enhance their capacities to promote reforms in these domains, development agencies can facilitate the “South-South” transfer of knowledge and experience by officials from other developing countries who have already implemented reforms or mobilise contributions from experts in other government agencies at home. As such interventions need to be sensitive to the local institutional and cultural context, “South-South” approaches are often more effective and sustainable than heavy reliance on experts from donor countries.
- iii. *Institutional change.* Reform is possible only where governments see the need for change and take measures to improve their capacity to mobilise investment and stimulate economic growth. The ability of reforms to deliver desired outcomes depends critically on the ability of institutions to “own” and implement reform processes and their sustainability hinges on broad stakeholder support. Development agencies can help support these processes by stimulating debate around reform issues; they can also facilitate dialogue with private sector organisations, civil society and even the local media in these processes. The sequencing of reforms is also crucial and needs to take account of both feasibility and urgency of reform.
- iv. *Human and institutional capacity.* Developing capacity lies at the heart of efforts to deliver more favourable conditions for private investment. Firms require people with well developed professional, entrepreneurial and vocational skills. It is similarly important to build up human capacity in key government institutions, including agencies responsible for promoting domestic and foreign investment. Development agencies should address the complexity and difficulty of the capacity development agenda in their dialogue with partner countries on strengthening human and institutional capacity.
- v. *Infrastructure.* In many developing countries, the poor state of economic infrastructure (notably transport, telecommunications, energy and water) is a critical constraint on the scope for productive investment. There is significant underinvestment in infrastructure because providers are often discouraged by weaknesses in the enabling environment. Actions to address these can consequently have a large impact if they help to create a

virtuous circle of improvements in the enabling environment leading to new infrastructure investments. There is renewed interest by partner countries and the donor community to tackle infrastructure needs, including at regional levels. Donors are working to avoid problems encountered in the past by working within the context of sector strategies and medium-term expenditure frameworks, by involving stakeholders in planning and decision-making, by focusing attention on maintenance and service delivery to users, by making adequate provision for financing recurrent costs and by targeting support to those areas where there are major bottlenecks to growth and investment.

- vi. *Financial markets.* In many developing countries, creating a more favourable environment for domestic savings is necessary to mobilise capital for productive investment (and also to help reduce the vulnerability of poor people to negative shocks). Difficulties encountered in this area include structural problems, institutional shortcomings and discretionary policies. ODA can be used to help develop financial sector regulation and supervision, in both the bank and non-bank sectors, as well as to help integrate microfinance institutions into the mainstream financial system.
- c) *Combine ODA and private investment in a sustainable manner.* In general, the use of concessional funds to mobilise private investment has to be carefully considered, *inter alia* with a view to not damaging local capital markets or undermining market-determined private flows. Among the various approaches, there is an interest in how to develop ODA-backed public-private partnerships (PPPs) that can encourage investment, not least in the infrastructure sector. PPPs hold much promise as a means of bringing together public and private - as well as local and international - resources and expertise, but much is required from all involved to move from expectation to reality. To avoid some of the pitfalls that have been encountered to date, more attention is needed at the time contracts are negotiated, to ensure that PPPs maintain an appropriate balance between political and commercial risks and do not depend on commitments that the public partner cannot meet. Development agencies can assist in exploring responses such as promoting sector and public service delivery reforms, channelling support through partner country systems, output-based aid and mitigating non-commercial risks. In addition, other challenges to deal with include the pricing of basic services, affordability issues and financing maintenance and operating costs. The latter raises issues regarding the design and duration of subsidies.
- d) *Promote supply-side responsiveness.* Improving the enabling environment is essential but, in itself, not sufficient. To maximise the quantity as well as the development impact of private investment, complementary supply-side measures are also required to strengthen the capacity of local firms to take up the opportunities that arise from an improved investment climate and greater international linkages. ODA can support strategies to encourage entrepreneurship, support business development services and services that expand access to knowledge and technological innovation. ODA can also be used to promote greater access to financial services and increase the capacity of local firms to partner directly with foreign corporate presence. The latter is particularly important for increasing the development impact of FDI but again, much has still to be done to scale up the many good examples that do exist to maximise the synergy between local and foreign enterprises.
- e) *Reduce disincentives to formality.* Much private sector activity in developing countries takes place in the informal economy. There is a need to understand better the disincentives to

formality, and to understand how risk and vulnerability can result in suboptimal strategies for informal enterprises, so as not to impede movement over time to the formal economy. This is an important issue for donors to address in their dialogue with partner countries on promoting growth and increasing employment, especially in the formal sector. There are also supply-side implications as it is easier for local firms in the formal economy to forge linkages with and reap the benefits from international integration.

To mobilise private investment for development, most of what needs to be done is the responsibility of developing country governments and investors themselves. ODA can help by facilitating these processes. But, as a scarce resource, aid should be used where it is most likely to make a difference. ODA clearly has a contribution to make to improving the enabling environment for more and better investment. This includes helping partner countries implement commonly accepted good standards for investment policies and conditions, and facilitating adequate supply-side responses. To mobilise private investment, the evidence suggests that ODA programmes should take account of the following considerations:

- To be effective, interventions must build on strong local ownership and commitment. ODA support works better when conditioned on broad-based domestic support, including a willingness to undertake and implement necessary reforms. ODA can be instrumental in building a community for such undertakings.
- To maximise the contribution of investment, interventions need to address binding constraints, including in the provision of infrastructure. A thorough assessment is needed to identify key obstacles and to prioritise resources to overcome them.
- Aid efficiency is a prime concern. It is important to use partner countries' own planning, procurement and financial systems for the delivery of ODA, conditioned on their efficiency and integrity. A more strategic and co-ordinated approach by development agencies will also improve the collective impact of ODA programmes.

In the next phase of this project, further consultation and dialogue with relevant stakeholders is proposed to verify these policy lessons and to derive from them more concrete and pragmatic policy guidance for donors on how to use ODA more effectively to mobilise investment for development. That work should seek to identify lessons of experience based on donors' project and programme evaluations as well as draw on the policy guidance for donors on growth and poverty reduction currently being developed by the DAC's Network on Poverty Reduction (Povnet). It is intended, subject to meeting resource needs, to present this guidance to the DAC High-Level Meeting and the OECD Ministerial Council Meeting in 2006.

## SYNTHESIS OF BACKGROUND MATERIAL

### 1. The Importance of Mobilising Private Investment for Development

Progress in reducing poverty has been too slow in many developing countries. With just a decade left to 2015, it will be a challenge to reach the goals contained in the United Nations Millennium Declaration, especially in sub-Saharan Africa. More rapid economic growth will be required to achieve the first goal of halving the proportion of people living on less than one United States dollar (USD) a day; sub-Saharan Africa, for example, needs to sustain an annual economic growth rate of more than 7% over the next ten years, more than double its recent performance. A better economic performance will also make achievement of the six social and environmental MDGs more sustainable. In most developing countries, accelerating growth will require greater involvement of poor men and women in the process – as consumers, workers and entrepreneurs – and an increase in their productive capacity through expanded access to education, health and infrastructure services.

The private sector is the main engine of growth in market economies. It thrives and delivers sustained growth when a number of factors combine to produce a conducive environment for the private sector to develop. Private investment is a crucial pre-requisite for economic growth because it allows entrepreneurs to set economic activity in motion by bringing resources together to produce goods and services. Rapid and sustained growth is facilitated by a virtuous circle whereby entrepreneurship and investment lead to higher productivity, making it possible to invest larger sums in the future. In the course of this process, jobs are created and new technologies are introduced, especially through international trade and investment linkages. Competitive and well-functioning markets are crucial because they promote and reward innovation and diversification, foster firm entry and exit and help to ensure a level playing field for all private sector actors. They also have an important role in making the growth process more socially and geographically inclusive, which expands the opportunities for poor people to participate in and benefit from growth. Successful mobilisation of private investment is thus increasingly important for creating employment, raising growth rates and reducing poverty. Not only the expansion of private production capacity matters for economic growth; the productivity gains that result from capital deepening and modernisation are important as well.

#### 1.1. *Paving the way for more private investment*

Investors, from micro-entrepreneurs to multinational companies, make their investment decisions based on the risk-adjusted returns they foresee. This is important in the development context because, as indicated by a number of empirical studies, the returns *per se* from investing in developing countries (including, notably, least-developed countries) tend to be higher than elsewhere. In the course of an economic growth process, the rates of return will eventually come down, but presently one of the greatest challenges in developing countries is reducing the risks, real and especially perceived, facing private investors. In a high-risk environment, economic activities are normally confined to a few sectors (not least the resource-intensive ones) and regions. The pattern of economic growth can consequently result in large segments of the population being bypassed, including the poor.

Sources and perceptions of risk differ between local and foreign companies, between large and small firms, between private and state-owned enterprises and between those operating in the formal and the informal economies. As a result, actions to diminish risks have a variable impact on investment

decisions, depending on the specific circumstances of the business concerned. At the same time, a number of risk factors and related weaknesses in the enabling environment discourage business activity generally, including discrimination, corruption, weak rule of law, high transactions costs, a heavy regulatory burden, lack of transparency and administrative inefficiency.

Domestic resources are the main source of funds for private investment in developing countries, and will remain so. However, in developing countries much domestic business takes place in the informal economy<sup>3</sup>, which tends to exacerbate many of the risk factors mentioned above, and the companies found there may not always be the best suited to compete in an increasingly globalised economy. Moreover, many developing countries face constraints on their access to external finance or domestic financing limitations due to weak credit intermediation. In this situation, foreign assistance, FDI and remittances can serve as important complementary or supplementary sources of capital. With the emergence of different investor groups, care must be taken to maintain a level playing field to ensure that no group is unduly disadvantaged.

To encourage more private investment, developing countries need to pursue strategies that alleviate binding constraints on growth, in the right sequence and in the right manner. Institutional reforms have a key role in sustainably mobilising additional private investment for development, as highlighted in Box 1. Through their ODA programmes, development agencies can help to leverage this additional financing for development by supporting developing countries in their efforts to implement such reforms. While the Monterrey Consensus stressed that “a substantial increase in ODA and other resources will be required if developing countries are to achieve the internationally agreed development goals and objectives” including the MDGs, it also recognised that “ODA can be critical for improving the environment for private sector activity and can thus pave the way for robust growth” (United Nations, 2002).

## ***1.2. The development benefits of FDI***

The Monterrey Consensus identified private international capital flows, including foreign direct investment, as “vital complements to national and international development efforts” and emphasised the need “to create the necessary domestic and international conditions to facilitate direct investment flows”. FDI has proved to be a resilient source of private international capital flows. However, many developing countries, especially the least-developed countries, have yet to benefit from sizeable FDI inflows. Nevertheless, FDI can constitute a significant proportion of overall capital formation and developing countries offer considerable opportunities for additional investment.

### Box 1. The role of institutions in mobilising investment

All societies rely on institutions to implement and enforce the “rules of the game” which ideally ensure that markets function efficiently and allow stable, secure and fair transactions for all private sector actors. The whole set of rules and organisational structures associated with the creation of opportunities for private sector development is consequently extremely important. However, in many developing countries, market imperfections exist that tend to be detrimental to poor people's economic and social opportunities. Country-specific institutional and policy reforms are at the core of donors' and developing countries' efforts to mobilise investment and to maximise its development impact:

- Institutions influence *market outcomes* – job opportunities and wage levels, returns on goods sold and accessibility and affordability of goods and services - because they determine the formal and informal rules governing market exchanges as well as the governance exercised over those rules. Institutional changes and policies can lower certain risks and costs of doing business, removing obstacles to investment and potentially leading to more rapid and more pro-poor patterns of economic growth.
- By reducing the *time and costs associated with doing business* in the formal economy, institutional changes and policies affecting entrepreneurship and investment can help reduce informality. As well as evading taxes, firms and entrepreneurs operating informally face a more risky business environment and lack access to short-term finance and most kinds of risk capital.
- Appropriate institutions and infrastructure can help developing countries *integrate into regional and global markets*. Better international linkages, through trade and FDI, can lead to rapid economic growth. Providing there are sufficient incentives for business, greater integration allows the economy to focus resources on sectors of competitive advantage and stimulates productivity by enabling private sector actors to access larger and rapidly growing markets.
- Appropriate institutions can foster *sustainable development* by helping to ensure that private sector actors take account of social and environmental impacts while maximising wealth creation.

A recent World Bank Group evaluation found that its strategies for improving the investment climate have suffered from a lack of knowledge about what types of institutional arrangements will work in different environments, and about the dynamic process of change that is needed to carry out reforms. As the feasibility of reforms depends on the political economy of the reform process, and their sustainability hinges on broad stakeholder support, it is important to assess the capacity and incentives facing public sector organisations implementing reforms and to be aware of the likely winners and losers. (World Bank Group, 2004). Current work in the DAC Network on Governance (Govnet) to prepare a Good Practice Paper on Capacity Development will help to address this need for clearer guidance on how to approach institutional reforms. The Govnet is also developing tools (through Drivers of Change and Power analysis) which will help donors set realistic expectations for the sequencing of institutional change and how to assess different entry points to support change.

The case for encouraging FDI rests on the conviction that it offers developmental benefits that other sources of finance can not (see Box 2). In addition, FDI can create linkages that increase local value creation and result in substantial indirect employment creation in local companies that supply inputs to multinational enterprises (MNEs), either directly or through sub-contracting for other local companies. In many cases, the local supply companies are farmers, particularly outgrowers, or small and medium-sized enterprises.

Among the main determinants of a country's ability to attract FDI, a number of factors have been identified, many of which can be improved through appropriate ODA-backed interventions. The determinants include: i) market size and growth prospects; ii) regulatory and policy frameworks; iii) natural and human resource endowments; iv) physical, financial and technological infrastructure; and v) openness to international trade and access to international markets.<sup>4</sup>

## Box 2. Development advantages of FDI

An OECD survey of the experiences with direct investment for development has documented the following advantages of FDI (OECD, 2002):

- *International integration.* Inward direct investment contributes to a country's further integration into the global economy by boosting foreign trade flows. By gaining access to MNEs' international networks of related enterprises, developing countries become better equipped to benefit from their comparative advantages.
- *Direct impact on economic efficiency.* The entry of large, well-financed and/or managerially sophisticated enterprises into a developing country can have important effects on economic efficiency – especially if large segments of the commercial sector were previously shielded. Two of the main channels are:
  - *Enterprise restructuring.* When an existing enterprise is acquired – for instance through privatisation – a direct impact usually occurs as a result of the acquiring MNEs' efforts to raise productivity, reduce costs, introduce new management methods and develop new activities. In addition, efficiency gains may occur in unrelated enterprises, *inter alia* through demonstration effects and competition.
  - *Competition.* The entry of foreign enterprises often acts as a spur to domestic competition, thereby leading to higher productivity, lower prices and a more efficient resource allocation. However, this needs to be balanced against the risk that the entry of MNEs could raise the levels of concentration in an economy to the point of imperilling competition.
- *Spillovers and externalities.* The presence of foreign-owned enterprises can have important effects on previously unrelated parts of the economy. Two of the main channels are:
  - *Technology transfers.* The spread of new technologies as one of the most important channels through which foreign corporate presence can produce positive externalities. The evidence of spillovers is strongest and most consistent in the case of “vertical backward linkages” – i.e. MNEs' interactions with domestic suppliers and subcontractors. Foreign-owned enterprises often put great effort into providing technical assistance, training and other information to raise the quality of suppliers' products.
  - *Human capital.* MNEs in developing countries are consistently found to provide more training to their staff than comparable domestic enterprises. However, as they also enjoy a comparably high degree of staff loyalty, the spillovers through migration of labour are limited. One of the main sources of human capital spillovers is probably the entrepreneurship of individuals previously employed as specialist staff by MNEs.

An important indirect benefit of FDI in developing countries is its effect on public governance. International investment is guided by formal and informal rules, ranging from customary law, to the obligations laid down in investment agreements, to commonly agreed best practices. The values that are thus promoted – including non discrimination, transparency and due process – cannot be taken for granted in all countries. By promoting them on a trans national basis, sound FDI policy contributes to creating a better business environment for domestic enterprises as well.

## **2. How ODA can mobilise private investment**

In 2003, net ODA from DAC member countries reached USD 69 billion, its highest level ever (in nominal and real terms). This corresponded to 0.25% of DAC member countries' combined gross national income (GNI).<sup>5</sup> If commitments by donors are delivered, including those made in 2002 at the Monterrey conference, by 2006 net ODA should reach USD 88 billion (at 2003 prices and exchange rates), or 0.30% of GNI<sup>6</sup>. This expected additional ODA is welcome but will still not be enough to help achieve the MDGs; a report released recently by the UN Millennium Project suggested that ODA levels need to rise to 0.44% of GNI in 2006 and 0.54% of GNI by 2015, if the goals are to be achieved (UN Millennium Project, 2005). There is consequently an urgent need, as identified in the Monterrey Consensus, to mobilise other resources, including by intensifying "efforts to ... [p]romote the use of ODA to leverage additional financing for development, such as foreign investment, trade and domestic resources."

Donors already spend a significant share of their aid on activities that contribute to mobilising private investment for development. According to an analysis of mostly OECD/DAC data prepared for the World Bank, bilateral and multilateral donors spent an average of USD 21 billion a year between 1998 and 2002 improving the investment climate in developing and transition countries, about 26% of all foreign assistance<sup>7</sup>. The bulk of this went to infrastructure development and was mostly provided as loans. Not all of it was formally motivated by a need to bolster private investment, but all of it contributed to enhancing the enabling environment for investment. In addition, donors spent an average of USD 3 billion a year on firm-level assistance, principally support for microfinance and business development services (Migliorisi and Galmarini, 2004).

Development agencies' actions impact on key determinants for mobilising private investment through a considerable array of activities at the "macro", "meso" and "micro" levels. In each of these domains, a wide range of aid instruments is used, including grants, concessional and non-concessional loans, equity stakes, guarantees, debt relief and technical co-operation. Developing human and institutional capacity in partner countries is always a central concern.<sup>8</sup>

At the "macro" level, macroeconomic stability and debt sustainability are fundamental for promoting economic growth and, in that sense, act as a pre-condition. International financial institutions in particular are working with developing countries in these domains. Similarly, efforts in a variety of areas where DAC members are more substantially engaged (e.g. peace and security, market access and health and education) are of broad relevance for development and their impact goes well beyond that of mobilising investment. While acknowledging the critical contribution of ODA in these areas for underpinning investment, these broader aspects of development co-operation are not addressed in further detail in this project.

The importance of the "meso" level enabling environment for mobilising investment has long been understood and donors, both bilateral and multilateral, are involved in making the enabling environment more supportive of efforts by the private sector to set economic activities in motion. Working with the relevant policy communities, development agencies are active in a wide range of areas at this level including the regulatory framework (e.g. investment legislation, competition policies, tax policies, trade policies and financial markets), governance and infrastructure. Activities in these areas are discussed further below.

Improvements to the enabling environment help to mobilise investment but, in themselves, are not enough to maximise the investment potential in developing countries. One challenge that has received a lot of recent attention is encouraging direct and indirect linkages between large international investors and small domestic enterprises. For this reason, development agencies also work at the "micro" level, to strengthen the ability of enterprises in developing countries to respond to the lowered trade barriers and new opportunities arising from a better enabling environment and greater international integration. Several activities at this level are discussed further below, including investment promotion and facilitation, promotion of business partnerships between firms in industrialised and developing countries and support for the development of local businesses.

Although public financing will remain important for new physical infrastructure investments in many developing countries, especially for roads and water and sanitation, the scope for private participation remains substantial. But, this can be problematic because investing in infrastructure projects in many parts of the world is not financially viable from a private sector perspective. Even where profitability could in principle be obtained, private operators often hesitate in view of the significant commercial and political risks involved. In this setting, and as discussed further below, there is growing attention to expanding the use of PPPs in utilities, using ODA to enhance the quality of projects, reduce some risks and raise profitability.

## **2.1. *Improving the enabling environment***

Reforming institutions and changing policies are complex processes and need to be approached sensitively. The experience of the last 15 years has shown that the impact of reforms is heavily dependent on circumstances and specific country contexts. Reforms consequently need to be tailor-made, based on rigorous economic and social analysis that recognises a country's institutional characteristics. For changes to succeed, analyses of who stands to win and lose and what their specific interests are can help reveal how vested interests may be overcome. Resistance can be contained through evidence-based dialogue, piloting reforms and compensating losers. OECD Members and non-member partners have agreed to work on the development of a Policy Framework for Investment as a checklist of issues in support of government efforts to create an attractive investment environment. The Framework could "... serve as a reference point for other international organisations, investment promotion agencies, donors as they assist developing country partners in improving the investment climate, and businesses, trade unions and non-governmental organisations in their dialogue with governments"<sup>9</sup>.

### **2.1.1. *Legal and regulatory framework***

The development of legal systems for company incorporation, contracts and other areas related to economic activities provides the backbone for private sector activity in the formal economy. In addition, systems in which individual laws are consistent and non-discriminatory, and where rights can be defended and disputes settled, is important for a country's internal stability and external credibility. Ineffective or unpredictable dispute settlement mechanisms are often cited as hindering investment in developing countries. Nevertheless, few donors appear active in this area which merits greater attention in order to help mobilise investment. In certain regions, a range of developing countries have entered into investment protection agreements with OECD and other capital exporting countries.

DAC members actively support efforts by developing countries to reform their regulatory framework by funding assistance with policy, legal and regulatory changes as well as services that

improve the enabling environment. The specific experiences of Viet Nam, a country that has made extensive use of ODA in its legislative process, is provided in Box 3.<sup>10</sup>

Governments face a challenge in determining tax policies and setting tax rates in ways and at levels that do not hold back economic growth. At the same time, tax revenues are needed to finance the delivery of health, education and infrastructure services. Developing countries' statutory tax rates do not differ considerably from those of industrialised countries but their tax revenues are reduced by high levels of informality coupled with poor administration and corruption. This puts a disproportionate burden on those who do comply and on activities where taxes are more easily collected (e.g. trade-related activities). It also results in a distortion of competition and the sending of wrong signals to entrepreneurs. Supporting the simplification of tax structures and strengthening tax administrations are avenues donors pursue with developing countries to help increase the tax revenues needed to underpin sustainable growth patterns through investments in health, education and infrastructure services.

The legal and regulatory reform challenge also includes promoting a process of economic growth that is consistent with a wider range of social and environmental objectives and avoids an international contest for investment resulting in a "race to the bottom". Sound environmental policies and regulations generally do not discourage investment because they tend to reduce the financial, legal and reputational risks that investors face. Well designed, ODA-backed efforts that raise environmental standards in developing countries are consequently likely to have a positive impact on mobilising private investment.

#### *2.1.2. Public and corporate governance*

Good governance is a prerequisite for well functioning markets, attractive investment conditions and a sustainable allocation of investment capital. The principle elements of good governance, as identified by the OECD's Public Management Committee, are accountability, transparency, efficiency and effectiveness, responsiveness, forward vision and the rule of law. Many DAC members promote better governance in developing countries by encouraging and supporting change processes and political reforms. Actions are spread across the main public governance areas and all levels of government. The importance of well functioning public institutions for economic development is also widely recognised and promoted.

### Box 3. The role of ODA in mobilising private investment in Viet Nam

Far-reaching reforms over the last 20 years have turned Viet Nam into one of the region's success stories – in terms of economic growth, private sector development and mobilising foreign direct investment – and the number of people living in poverty has halved, driven mostly by large declines in urban poverty. However, despite significant labour mobility, there has been limited movement out of agriculture, limited movement into formal employment and poverty rates among ethnic minorities remain high. It has been argued that an achievement of the Vietnamese government's ambitious poverty reduction goals for 2010 will only be realised if growth rates can be maintained at the high levels of the past and the rise of inequality can be limited (Klump and Bonschaub, 2004).

Viet Nam registered an average annual growth rate of 7.5% over the last decade, notwithstanding the Asian financial crisis in 1997. Progress dates back to the introduction of the government's *Doi Moi* economic reform process in the late 1980s, which was instrumental in jumpstarting private investment and bringing previously unregistered businesses into the formal economy. ODA played a key role in the process. Over the last decade, Viet Nam has been a major recipient of ODA and much of that assistance has focused on areas supportive of private investment. Most of this assistance financed physical infrastructure, but another important activity was developing expertise in relevant policy areas.

Some of the main findings from an examination of Viet Nam's experience of using ODA to mobilise investment are:

- The experiences with using ODA to support reforms of the legal system, institutions and governance have been mixed, but they include a few spectacular success stories. Foremost among these is the enactment of the new Enterprise Law in 2000. The Law, which includes greatly simplified registration procedures, is seen as a major factor behind the establishment of 73 000 new enterprises in the last three years, and the creation of close to 1.7 million jobs. These achievements have been made in a context of a strong political commitment to reform. ODA support for regulatory reform in other areas of potentially great importance to investment has produced little or no results owing to conflicting objectives among different parts of the public sector.
- ODA for physical infrastructure has focused on the twin objectives of modernising Viet Nam's road infrastructure and up-grading its insufficient power generation capacity. A couple of ODA-backed road construction projects around Hanoi and Ho-Chi-Minh City stand out with respect to mobilising investment. Formally motivated by a need to connect the country's two largest cities with the coast and the hinterland, they also led to a considerable creation of enterprises that had previously been held back by the scarcity and cost of industrial land in the metropolitan areas.
- Development agencies have also helped up-grade human capital in several ways relevant to investors. One example of targeted approaches is bilateral donors' support for technical and vocational education that, after initial inertia within the education system, has been effective in alleviating skills shortages. At the most general level, "tacit learning" seems to have been a major factor. The interaction with foreign actors – investors as well as development agencies – has greatly enhanced the understanding of decision makers at all levels of government of the demands of a market economy and the elements of a sound business environment.

Overall, a few observations offer themselves. First, ODA can be highly effective in mobilising private investment – though in the case of Viet Nam the effect may have been compounded by a considerable "latent entrepreneurship" already present in the communist economy. Second, ODA in support of institutional reforms can, at a low cost, greatly encourage private investment. However, the effectiveness is contingent upon local buy-in and broad-based commitment to reform. Third, more costly approaches such as ODA for physical infrastructure can have great effects as well, but their geographic scope needs to be carefully considered. Infrastructure projects "spread thinly" seem to produce much less of an impact on mobilising investment than efforts to enhance the infrastructure of regions in which investors are already showing an interest. Fourth, the impact of ODA on mobilising investment goes beyond the sum of individual projects. The use of ODA to enhance the business climate triggers a learning process through which a large segment of society becomes better equipped to act in a market-based economy.

Transparency should be promoted both with regards to the acts of public authorities and within the business community – including by tackling corruption. Emerging lessons with regards to fighting corruption stress the importance of focusing on the needs of partner practitioners and a stronger awareness of corruption as a development issue. Development agencies could usefully synthesise experiences in this area and make more transparent evaluations of them. To ensure credibility, donors should not only treat corruption and other un-transparent practices as investment-climate issues but also make an effort to address them via supply-side measures.

To mobilise more investment, many developing countries must overcome major barriers to improve their corporate governance. Developing economies tend to be dominated, on the one hand, by large, family-owned, state-owned or foreign-owned corporations that do not have widely traded shares on local stock markets and, on the other hand, by a large, non-listed sector. Countries seeking to improve the overall investment climate and promote economic growth have taken steps to move beyond this reality by enacting legal and institutional reforms as well as voluntary initiatives to improve corporate governance.

The OECD works with the World Bank Group to build capacity in the area of corporate governance. Over the last five years the Regional Roundtables on Corporate Governance have brought together decision-makers and stakeholders of some 40 non-OECD countries to develop reform plans that draw upon the OECD Principles of Corporate Governance. The Global Corporate Governance Forum, co-funded mainly by development agencies, has helped to broaden the regional coverage of the initiative.

An additional issue for foreign investment is that international businesses operate to high ethical standards, consistent with applicable law. In this respect, the OECD Guidelines for Multinational Enterprises provide a set of principles of good corporate conduct, and a reference point for stakeholders. Another recent example is multilateral development agencies' adoption of voluntary guidelines for the financial sector.

### *2.1.3. Physical infrastructure*

Insufficient, inappropriate and poorly maintained physical infrastructure is a major bottleneck to economic growth and investment in developing countries, particularly the poorest ones. The availability of relevant infrastructure therefore has a major impact on the enabling environment for private sector activities and expanding physical infrastructure, including at a regional level, can generate high returns. For most firms and entrepreneurs, energy, water supplies and telecommunications are vital while transport infrastructure allows companies to move beyond local markets to buy from and sell to other countries in the region or around the world. Under-investment in public utilities, inefficient management and under-pricing have in many developing countries caused energy shortages which have held back economic growth.

As with other investors, incentives for providers of infrastructure to invest in developing countries are affected by the enabling environment. Actions that encourage infrastructure investments can consequently have a potentially large impact if they help to create a virtuous circle of improvements in the enabling environment leading to new infrastructure investments that in turn encourage further investment. However, as part of this process, adequate provisions need to be made for financing the maintenance and operating costs of new infrastructure.

A significant share of DAC member countries' bilateral ODA finances activities related to infrastructure. In 2003, the share was 9% (down from 12% in 2002). To strengthen the growth and poverty reduction impact of infrastructure, guiding principles for donors are being developed by the DAC Povnet's Infrastructure Task Team. Among the specific issues being addressed are providing co-ordinated support to partner country-led strategies and plans, improving the impact of infrastructure on pro-poor growth, ensuring sustainability and increasing financial resources.

Some aid for infrastructure activities is provided as grants but concessional and non-concessional loans are also common in this sector. In addition, many DAC members have set up funds to provide risk capital for the implementation of infrastructure and other projects and have mechanisms for providing insurance to mitigate certain political and other non-commercial risks (this is discussed further below).

#### *2.1.4. International integration*

Better access to international trade is an important source of economic development in its own right, but it is also pertinent in the context of mobilising private investment for development. A large, and by some measures increasing, share of international trade either takes place between related enterprises or in the context of links between end-of-line producers and their global network of suppliers and sub-contractors. In other words, to a potential investor, the quality of the business environment depends strongly on his/her subsequent ability to import and export.

Additionally, unleashing exports expands access for foreign exchange, allows firms to exploit economies of scale, lowers costs and allows the diffusion of technology. Official and unofficial constraints to the movement of goods, particularly across borders, remain a frequent problem. Developing countries still tend to have higher barriers to free trade than industrial countries (average tariffs of 13% for developing countries compared to only 4% for industrialised countries). Impediments to trade tend to be larger among developing countries themselves than between developing countries and the rest of the world. This is particularly problematic for countries with small home markets whose best chance of attracting market-seeking investment is to broaden the "relevant market" to include neighbouring countries. It should, however, be recognised that lower tariffs and non-tariff barriers in industrialised countries would generate significant global welfare gains, including for developing countries.

In many countries, a virtuous circle of trade liberalisation, investment and welfare enhancement has been observed. Trade liberalisation is not a panacea, however. In some cases, trade reforms have brought few gains, and to be fully effective in attracting investment, trade policy needs to be accompanied by other policies which enable capital and labour to move to higher productivity activities and facilitate the entry and exit of firms.

Through their ODA programmes, DAC members are helping developing countries to derive benefits from economic liberalisation by strengthening their trade-related institutions. In addition, donors are strengthening the capacity of developing countries to fulfil obligations and exercise privileges as part of the multilateral trading system. Frequently, donors' support enables developing countries to improve their positions in bilateral and multilateral trade negotiations, translate commitments made into national legislation and design and implement trade promotion strategies.

### *2.1.5. Financial markets*

In many developing countries, creating a more favourable environment for domestic savings is necessary to mobilise capital for productive domestic investments but also to help poor people reduce their vulnerability to negative shocks. Developing countries can face a number of difficulties in this area including structural problems (e.g. state intervention and monopolies), institutional shortcomings (e.g. with insolvency, with collateral, title and property rights and dealing with informality and micro loans) and discretionary policies (e.g. directed lending and subsidised credits). Promoting and liberalising foreign ownership of domestic banks can increase competition, thereby enhancing efficiency in local financial markets, and may also contribute to lowering the probability of systemic banking crises. DAC members may assist with financial market deepening, through support for financial sector regulation, supervision and development in both the bank and non-bank sectors, as well as helping to integrate microfinance institutions into the mainstream financial system. Development of local financial markets can also facilitate and reduce the costs associated with transferring remittances.

## **2.2. *Developing supply-side responses***

### *2.2.1. Investment promotion and facilitation*

A major component of a country's efforts to promote and facilitate investment is a comprehensive investment promotion policy which is consistent with domestic industrial policies and export promotion policies. Experience in OECD countries in these areas indicates that investment and export promotion policies need to be market oriented and designed to overcome specific market failures. Targeted approaches are rarely sustainable. Strengthening relevant institutions in developing countries may equally be important and it may be necessary to reform policies or institutions that restrict competition or investment. Assisting with the building up of human capacity in key government institutions, such as agencies responsible for promoting domestic and foreign investment, is another avenue pursued by development agencies.

Many DAC members have also established mechanisms to provide risk capital for private investment in developing and transition countries through development finance institutions. These schemes, which provide funds on a broadly market basis, are important for financing projects that otherwise may be hampered by perceptions of excessive risk. There is often a requirement that development finance institutions invest a certain proportion of their funds in the poorest countries. This objective is rarely attained, however. A review of the obstacles that development finance institutions from donor countries encounter when considering investments in least-developed countries and sub-Saharan Africa could be useful to reveal systemic issues that constitute major impediments, including for investors less predisposed to enter these markets. (For an overview of the challenges facing investors in Africa, see Box 4) Most DAC members also facilitate investments by offering insurance against political risks such as losses due to war or civil war, expropriation and nationalisation and inconvertibility of profits and dividends.

Public funds, in the form of ODA, can also be combined with private funds to reduce lending risks to levels where competitive, long-term debt finance can be offered to finance commercially viable and developmentally sound private sector infrastructure projects in developing countries.

#### Box 4. ODA and investment synergies in Africa

A synthesis of experiences with using ODA in support of the investment climate in Africa<sup>11</sup> concludes that development agencies have generally been active in most of the areas suggested in this chapter. The study also suggests that certain changes in priorities and implementation may have taken place in recent years.

For example, assistance to upgrade legal and regulatory frameworks for investment, as well as the public and corporate governance improvements needed to put them into practice, has moved to the centre. Trade capacity building and technical assistance in the context of international trade negotiations have also gained in importance, spurred *inter alia* by the Doha development agenda. In the area of physical infrastructure, development agencies have placed increasing emphasis on involving the private sector in the financing and implementation of projects. In enterprise financing, a long-standing priority of donors in Africa, the emphasis is shifting from the provision of loans and guarantees towards more comprehensive approaches to financial sector reform. In other relevant areas (the study specifically mentions human capital development) activities have been long underway but have generally not been directed at assisting investment and private sector development.

Based on recent African experiences, a number of lessons for developing countries and their development partners can be proposed, among which:

- *Building a “demand for reform”.* Reform is possible only where governments see the need for change and take measures to improve their capacity to mobilise investment and stimulate economic growth. However, development agencies can help to stimulate debate around reform issues; they can also facilitate the involvement of private sector organisations, civil society and even the local media in these processes.
- *A need for political commitment.* ODA-based efforts to mobilise investment in Africa have only worked well when they were driven, owned and managed by domestic agents. Developing country governments need to exhibit a commitment to reform from the highest level down.
- *Building domestic institutions.* Development agencies need to consider, and have been paying more attention to, how they can build stronger domestic institutions, although the difficulty with doing this is also widely acknowledged.
- *A sequenced approach.* Moving from analysis to reform, finding appropriate starting points for reform, and establishing a mutually agreed upon sequence of reform interventions have been major challenges for investment-oriented ODA in Africa.
- *Collaborative monitoring, adjustments and co-ordination.* Development agencies recognise the value of using well-established and strategically focussed institutional frameworks for managing aid. Also, investment-oriented ODA has its own needs for good co-ordination. Sound co-ordination increases credibility with the partner country and improves efficiency and effectiveness of donor efforts.
- *Sub-national levels of reform.* Increasing attention is paid to the role of sub-national levels of government. While on the one hand this involves support for reforms that enhance the decentralisation of government services, it can also address the roles of local and provincial governments in improving sub-national investment climates.
- *The role of the local private sector.* Recent experiences have shown that the competitiveness of the domestic private sector is important – not only in fostering an indigenous business environment, but increasingly also to attract FDI.

### *2.2.2. Supporting local business development*

Firms require people with well developed entrepreneurial and vocational skills as well as access to knowledge and services that aim to promote technological innovation, if they are to operate efficiently and successfully and to grow and expand. Through their ODA programmes, several development agencies support entrepreneurial education and vocational training, as a means of promoting private sector development. However, in the field of education and training more generally, many donors have been focussing increasingly on basic education in recent years. Although most kinds of education can be potentially relevant for facilitating business and investment in a medium-term perspective, this trend may have resulted in entrepreneurial education and vocational training receiving less support than they merit.

Businesses also require access to a wide range of services to support their operations including accounting, audit, quality assurance, telecommunications, internet, business planning, legal advice, training, production engineering, market research, labelling and packaging and design services. These services help to increase productivity, improve competitiveness, expand market access and accelerate enterprise growth. In many developing countries, such services are not available to the same extent that they are in industrialised countries, or may hardly be available at all.

Many DAC members have promoted the expansion of business services, especially for micro, small and medium-sized enterprises, but concerns about sustainability have led several DAC members to move away from direct service delivery in favour of brokering services through local consulting firms and business associations. Business services, which may involve both large and small enterprises, are thus viewed as a tool to promoting private sector development and not an end in themselves. To ensure sustainability, donors should abstain from getting directly involved and becoming part of the system, allowing interventions to be driven by market forces.

There has been a tendency for DAC members to move away from supporting government institutions for research and extension while local public funding available has also been diminishing, as a result of structural adjustment programmes. The private sector and non-governmental organisations were expected to fill the gap but this has not happened in many regions and sectors, including agriculture. There could be a need to redress this situation by developing and supporting, including with some public funds, new mechanisms for local technology development.

DAC members have also set up facilities to establish or promote business partnerships between companies in industrialised and developing countries by providing information on foreign markets or matching firms with related needs or interests. These facilities may take the form of public-private partnerships (PPPs), involving either individual enterprises or business associations. These activities may nevertheless require some rethinking, in part to take account of greater access to information through information and communications technologies. A rapid internationalisation of both exporters in developing countries and importers in industrialised countries has taken place and external barriers in the form of high tariffs and restrictive quotas have also decreased considerably. As a result, to increase market penetration, it is now more important to focus on up-grading quality, competitiveness and stability in exporting countries.

### 2.3. *Direct support for investment: ODA-backed public-private partnerships*

Developing countries have been engaging in PPPs<sup>12</sup> in infrastructure for some 15 years, with actual investments growing from USD 18 billion in 1990 to a peak of USD 131 billion in 1997. The main areas of activity have been telecom services (46% of total private investment) and energy generation and distribution (33%). But private participation in infrastructure has declined since 1997. While this is partly due to a corporate retrenchment following financial crises in the second half of the 1990s, it also reflects a more widespread disappointment on the part of investors and public authorities.

The reasons that PPPs have sometimes performed below expectations vary from case to case. However, many of the difficulties experienced have been linked to more general weaknesses in the enabling environment for investment. PPPs may therefore in many cases be considered as second-best to addressing more fundamental weaknesses or a stop-gap while appropriate measures take effect.

Difficulties with enforcing contracts lie at the heart of many problems experienced with PPPs. One common complaint from developing country governments is that investors have reneged on their contractual obligations, especially regarding the coverage of services. On the other hand, enterprises often complain that public authorities have failed to provide an environment in which they can deliver their services according to sound commercial principles. The latter problem often manifests itself as a lack of willingness by public authorities to accept the social and political cost of private operators' measures to boost productivity and set tariffs at market levels. ODA can help address such issues (see box 5).

#### **Box 5. Using ODA to enhance the effectiveness of PPPs**

Three channels have been suggested through which ODA can help address some specific issues related to PPPs by enhancing the environment for such partnerships and contributing to more socially and commercially satisfactory outcomes:

- *Risk mitigation.* Most foreign investors already have access to market-based insurance against risks such as "regulatory takings" through home country export credit agencies and multinational bodies such as the Multilateral Investment Guarantee Agency (MIGA). However, risks go well beyond this and they are so high in some cases that PPPs are unlikely to take place in the absence of subsidised risk mitigation. Discussion continues as to the appropriateness of extra risk coverage being provided by bilateral development agencies, which benefit *inter alia* from the fact that they (unlike more market-based insurance schemes) partner directly with the authorities in developing countries.
- *Technical assistance and capacity development.* ODA can be used to fund a host of educational and experience-exchange programmes to build authorities' capacity to deal with PPPs, including contract negotiation. An alternative to building capacities in-house is to support the outsourcing of regulatory functions to external specialists. A recent survey indicates that as many as three fourths of national regulators contract out certain tasks to external parties.
- *Output-based aid.* Even if host country regulatory capacities and risks can be dealt with satisfactorily, a number of infrastructure projects will have positive economic but negative financial rates of return. This gap can be bridged by ODA, for instance through targeted subsidies to the service providers or by subsidising consumption during a transitory period to full cost recovery pricing. Such "output-based aid" can be highly effective in meeting specific targets – contingent upon the clarity of objectives and project design. Several development agencies provide grant-based instruments to promote cost-recovery pricing while supporting those least able to pay the full price for services.

Another major problem faced by companies is governments renegeing on past agreements (sometimes made by a previous government) or changing the rules of the game in the middle of a contract. This is an important reason behind the insistence of the international private sector for schemes to mitigate such political risks that are a result of weak governance. This highlights the need to address underlying governance issues, if additional investment is to be mobilised sustainably. In the meantime, risk mitigation schemes can be a bridging solution.

The PPP model has also been used to provide a broader range of services in developing countries that indirectly benefit investment. These include the implementation of social and environmental standards, social enhancement and public health.

### **3. Using ODA better to mobilise investment: emerging findings**

There is a strong case for promoting synergies between ODA and investment. Private investment, domestic as well as foreign, is critical for development. A key role for ODA is to leverage private investment and generate a significant multiplier effect, potentially allowing development agencies to achieve more “development” with their ODA. However, the logic of spending ODA thus is to correct real market failures, tackle structural impediments to investment and mobilise genuinely additional investment. Care must be taken to ensure that donors do not find themselves subsidising or redirecting investment that would have happened anyway, or creating an uneven playing field. The most fruitful context for ODA-backed strategies to encourage investment is in support of on-going reform efforts in developing countries. As a scarce resource, aid should be used where it is most likely to make a difference.

#### **3.1. What to do?**

Improving the *enabling environment for investment* is fundamental, hence the importance of developing countries' own efforts to promote sound economic management, good governance, anti-corruption, modern infrastructure and an environment within which the private sector can thrive on a sustainable basis. The processes emerging in many low-income countries around the preparation and monitoring of Poverty Reduction Strategy Papers (PRSPs) or their equivalents present opportunities to promote ownership and to institutionalise interaction between representatives of the state, the private sector and civil society in the definition of development objectives. To date, however, most PRSPs have not sufficiently considered the range of policy actions required to enhance the impact of economic growth on poverty reduction and so need to address more directly the issues of promoting entrepreneurship and mobilising investment.

As shown by the evidence assembled for this report, development agencies can, through their ODA programmes, play a catalytic role in supporting developing countries' efforts to provide an environment within which the private sector can develop in a sustainable and dynamic way:

- Development agencies can provide developing countries with the analytical support required to use diagnostic tools, including assessments of their investment climate, that reveal weaknesses in the enabling environment and other binding constraints on growth. This may require help with data collection and analysis, so as to generate the reliable information needed for informed decision making on the highest priority actions and the appropriate sequence of reforms.

- Through capacity development and technical assistance, ODA can be used to support legal and regulatory reforms - as well as to address corruption and excessive bureaucracy. The difficulty for development agencies is that while such activities can have very high returns, outcomes are uncertain and may take a long time to realise. Alternatively, serious bureaucratic impediments to business can persist for long periods, but quickly disappear once given attention and publicity. Activities may fail if they do not generate sufficient enthusiasm, commitment and ownership in developing countries. Development agencies should consequently promote and support processes of stakeholder engagement, involving representatives of the state, the private sector and civil society, that can lead to appropriate and locally-owned reforms.
- Institutional changes (e.g. the rule of law, public and corporate governance, integrity and transparency) can lead to large improvements in the investment climate, sometimes with relatively modest amounts of ODA. However, sustainable reforms have rarely been imposed from the outside and a positive outcome mostly depends on policy processes driven, owned and managed by developing countries themselves. Successful ODA-based strategies to mobilise investment consequently depend on both a strong political commitment to undertake reforms and an ability to implement them. There is a need to understand better what necessary pre-conditions should be in place before developing countries will engage in processes to introduce the sometimes difficult reforms that will ultimately have a substantial and sustainable impact on improving the investment climate.
- In many developing countries, the poor state of infrastructure is a critical constraint to the scope for private investment. Large amounts of aid are used to support the development of physical infrastructure. However, considering the high costs involved, a particular effort should be made to focus on the main impediments at national and regional levels to development of the private sector, particularly those identified by partner country governments and the private sector itself, and to avoid the well-known problems of the past by focussing on sustainable service delivery to users. On-going work in the DAC Povnet is pointing to some key messages and implementation lessons learnt by donors to strengthen the contribution of infrastructure to growth and poverty reduction. These include: i) making better and more co-ordinated use of sector programmes for transport, energy, etc.; ii) adequately addressing local private sector involvement, gender-specific needs and wider risk and vulnerability issues; iii) ensuring sustainability by strengthening local capacities and resources and ensuring cost recovery through appropriate methods of tariff collection; and iv) increasing financial resources for infrastructure including through developing more effective ways of leveraging resources for district and community-based infrastructure.

To maximise the quantity as well as the development impact of private investment, complementary *supply-side measures* are also required as they can strengthen the capacity of local firms to take up the opportunities that arise from an improved investment climate and greater international linkages. For instance, the provision of microfinance and business development services is important for small and local enterprises to be able to seize business opportunities. By supporting entrepreneurial education and vocational training, ODA can help ensure that local businesses have the staff needed for them to operate efficiently and successfully and to grow and expand. To improve access to knowledge and innovation, mechanisms can be developed that set research priorities better by promoting participatory technology development and that better diffuse information on new technology. Supporting moves by firms into the formal economy can have a large and sustainable impact on expanding employment, accelerating growth

and generating tax revenues, as well as on enabling local firms to more easily partner directly with, and benefit from, the presence of foreign-owned enterprises.

A direct way of promoting ODA/investment synergies is to involve aid in individual investment projects, for instance through *public-private partnerships*. To date, the record with PPPs has been mixed, particularly in small markets. More efforts may be needed to ensure that market distortions do not occur, and that contracts do not require too much from the private partner and do not depend on commitments that the public partner cannot meet in the long run. Addressing weaknesses in the investment climate will also be helpful, as many of the more sobering experiences with PPPs so far appear to have reflected general weaknesses in the regulatory framework and public governance. Experience with PPPs has been particularly disappointing in water and sanitation, a critical area for many aspects of development. Development agencies can assist in exploring responses such as promoting sector and public service delivery reforms, channelling support through partner country systems, output-based aid or private firms paying a rent to use publicly funded capital investments. The issues of pricing of basic services and mitigating non-market risks could also be addressed in a more effective way.

Some important *caveats* need to be taken into account when designing ODA activities to mobilise investment. For instance, in many developing countries the uncritical emulation of other countries' regulatory systems has been found to be inappropriate. OECD and other internationally recognised good practices and standards have served as useful reference points in support of reforms that produce significant economic and social benefits in the medium term. However, reforms are in practice difficult to introduce if, in the short term, they entail threats to vested interests and re-allocation of capital and labour resources. It is important to target the structural causes of investment impediments, even while taking measures to deal with their immediate symptoms. Thus, where there is a strong case to support political risk mitigation schemes, it should not be forgotten that weak governance is at the heart of the problem. There is growing recognition that carefully constructed interventions that draw on deep knowledge of local law and social practices can be effective, but results may not become apparent for several years. From this perspective, the tying of technical assistance to the provision of services by nationals of the donor country can be problematic, as it often results in interventions that are not sufficiently sensitive to the local ideological, institutional and cultural composition and as it generally does not build sustainable technical capacities in developing countries. In general, the use of concessional funds to mobilise investment should be carefully thought through if it is not to damage sustainable local capital markets or undermine market-determined private flows.

### **3.2. *How to do it?***

While DAC members spend a lot of ODA, directly or indirectly, promoting private investment in developing countries, it is not clear that these various activities are sufficiently strategic in their overall effect. A stronger co-operative effort seems needed both within DAC members' administrations and between bilateral and multilateral donors, particularly at the field level, behind a clearer strategic objective to mobilise investment for development. Donors could usefully transfer lessons from experience in other areas, such as the education and health sectors, in terms of the value of more co-ordination within the donor community in support of developing country-led strategies, including PRSPs. An informative finding from a recent study is that developing country governments often prefer to work with multilateral agencies on enabling environment issues because they are considered to be more neutral, and without commercial considerations influencing approaches and activities (White, 2004). Specific activities may consequently be more appropriately carried out by bilateral or multilateral donors. Another interesting finding, from evaluations of the PRSP process, is that many donors believe

that they are working to promote investment within the PRSP context, a view not fully shared by their developing country partners.

Some other considerations that development agencies may wish to take into account include:

- Established good practices for the management and implementation of development co-operation programmes could be applied more systematically to activities that impact on mobilising investment. Tailoring activities to partner countries' needs and ensuring the participation of all stakeholders on the basis of ownership by the developing countries themselves are important guiding principles.
- There is a need for greater efforts by developing countries and donors to consult with and listen to the private sector – domestic enterprises as well as foreign entrants – especially in terms of what enterprises say they most need and where governments and donors can best help. To facilitate interaction between different stakeholders at the partner country level, development agencies can foster the emergence of change agents and facilitators who are able to institutionalise stakeholder engagement but also to build constituencies for change and overcome vested interests. To ensure that changes are sustained, donors should not intervene directly but aim to change the system, without becoming part of the system.
- A comprehensive approach to supporting private sector development is essential. The private sector may fail to develop despite massive support because there may be several binding constraints but not all of them are targeted. Multi-faceted, multi-sectoral approaches are likely to succeed better than single-factor, focussed and project-like interventions. Integrating a private sector development perspective into country programme strategies will help mobilise investment but is also a useful way of raising awareness in development agencies of the crucial role that the private sector can play in achieving the MDGs. There is also a need to understand better what the disincentives to formality are in developing countries so that these can be reduced and not hold back natural tendencies for movement over time from the informal to the formal economy.
- The sequencing of reform interventions is important. The use of ODA to mobilise private investment involves a multilayered interdisciplinary process, which spans a substantial period of time. Beginning with achievable changes and building on success is important for building up momentum for further reforms. The process needs to involve collaborative monitoring and adjustments, as well as strong institutional mechanisms for accountability.
- To mobilise investment, development agencies need to draw on a broad range of expertise from a range of sources. Development agencies are experienced in dealing with developing country authorities and facilitating development processes and these efforts can benefit from leveraging the expertise of government agencies at home that habitually deal with policies for the business sector. Development agencies can similarly facilitate the transfer of knowledge and experience by officials from other developing countries who have already implemented reforms, through triangular or “South-South” co-operation. Such interventions nonetheless need to be sensitive to the local ideological, institutional and cultural context.
- Efforts to use ODA to mobilise investment need to involve all levels of government in developing countries and activities to expand access to infrastructure and reform institutions should have a broad impact throughout the partner country. Development agencies need to ensure that their activities have an impact on strengthening local as well as national levels of

government. Some targeted interventions at local levels may thus be warranted, in addition to activities at the national level. Support for decentralisation initiatives can consequently be important to complement other activities that aim to mobilise investment for development.

Donors' past experience with support for private sector development has provided evidence of some pitfalls that can be avoided. For example, interventions have led to market distortions, sometimes because they have been guided by the preferences of a few public or private actors in developing countries. This risk is compounded by the fact that, while donors recognise the significance of high quality institutions and the role of macro factors, micro-level interventions have often predominated. New approaches have attempted to avoid this problem, *inter alia* through policy dialogue with partner countries that highlights the importance of "market deepening" and internally driven institutional change.

These issues could be relevant for development finance institutions from donor countries as well. The evidence is that these organisations can, with a very modest injection of public funding, catalyse significant private investment on a sustainable basis. However, issues of how far they achieve additionality and concerns over possible competition with fully private investment funds may exist in the more viable sectors and economies.

To guide future interventions and help development agencies focus on areas with the greatest impact on mobilising more and sustainable investment flows to poor countries, more detailed information is required on the impact and efficiency of using ODA to mobilise investment, to understand better what works, what doesn't work and why. While DAC members evaluate specific aspects of their support for private sector and infrastructure development, very few assessments of the overall impact and efficiency of these activities on mobilising investment have been conducted. Joint assessments at a more aggregate level would be especially appropriate as they could gauge how the various and collective actions of donors are impacting on critical factors for mobilising more and better investment throughout partner countries.

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## Notes

- 1 . The OECD Initiative on Investment for Development comprises three inter-related components. The other two components are: i) development of a Policy Framework for Investment; and ii) building policy capacity based on OECD peer learning methods.
- 2 . These Policy Lessons were presented as background documentation for the OECD Ministerial Council Meeting on 3-4 May 2005.
- 3 . In Africa, as much as 78% of non-agricultural employment is estimated to be informal and the rates in many South Asian and Latin American countries are not much lower.
- 4 . For empirical evidence of the importance of these factors in a large selection of developing and transition countries, see OECD (2004), *ODA and investment for development: What guidance can be drawn from investment climate scoreboards?* Working Papers on International Investment 2004/5, OECD, Paris, a paper prepared specifically for this project.
- 5 . In addition to ODA, DAC member countries provided USD 7.1 billion in net “official aid” (OA) to transition countries in 2003. Net “other official flows” (OOF) were negative in 2003 (USD -1.1 billion) due to substantial offsetting entries for the cancellation of mainly export credit debt. OOF consists mainly of development lending that is not concessional enough to qualify for recording as ODA or OA (because the grant element is less than 25%) and trade-related transactions (e.g. export credits).
- 6 . Preliminary estimates show that net ODA from DAC member countries increased further in 2004 to reach USD 79 billion (USD 72 billion at 2003 prices and exchange rates). This corresponded to 0.25% of GNI.
- 7 . World Bank’s analysis included ODA, “official aid” to transition countries and “other official flows”.
- 8 . For further information on how ODA can mobilise private investment, see: *OECD (2004), ODA and investment for development: Review of ODA uses and experience*, OECD Papers Volume 4, No. 7, a paper prepared specifically for this project.
- 9 . OECD Initiative on Investment for Development: Progress Report by the OECD Investment Committee, 28 April 2005.
- 10 . See also: OECD (2004), *Mobilising investment for development: Role of ODA – The 1993-2003 experience in Viet Nam*, Working Papers on International Investment 2004/6, OECD, Paris, a paper prepared specifically for this project.
- 11 . See also: OECD (2005), *Mobilising investment for development: ODA and investment synergies in Africa*, a background paper prepared specifically for this project tabled at the NEPAD-OECD Investment Policy Roundtable in Entebbe on 25-27 May 2005.
- 12 . In this report, PPPs principally refer to business relationships involving private resources (capital, management and know-how) to expand the provision or production of infrastructure services or utilities (such as water and sanitation or waste collection). In practice, the focus is often on foreign participation.