Promoting Private Investment for Development

THE ROLE OF ODA

OECD

DAC Guidelines and Reference Series

A DAC Reference Document

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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LE RÔLE DE L'APD

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Foreword

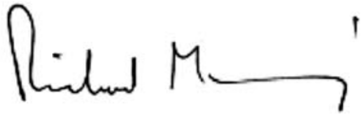
As the Monterrey Consensus emphasised, private investment is a powerful catalyst for innovation, economic growth and poverty reduction. Much more investment will be needed if many developing countries are to reach the Millennium Development Goals, especially that of halving by 2015 the proportion of people living on less than a dollar a day. Official development assistance (ODA) has a critical role to play in improving the environment for private sector activity and in helping enterprises to respond to new and changing demands, and thus in helping to pave the way for robust growth.

With this background, the OECD launched the "Initiative on Investment for Development" in 2003. This policy guidance for donors on using ODA more effectively to promote private investment for development is one component of the Initiative. The other components are the Policy Framework for Investment (PFI) and sharing the OECD's experience with using peer reviews to build capacity for investment policy in developing countries.

Preparation of the policy guidance occurred in two phases, carried out in close collaboration between the Development Assistance Committee (DAC) and Investment Committee. The first, analytical phase noted that donors spent around 20% of their aid on a variety of investment-enhancing activities and highlighted the need for donors to be more strategic, better co-ordinated and guided by more systematic learning of what works and what does not work. They also need to address better the binding constraints, at national and sectoral levels, that are holding back more domestic and foreign investment.

This policy guidance, prepared in the second phase, and which also builds on DAC work on promoting pro-poor growth, has as its main message that donors should focus on helping to lower the costs of investment, reduce risks, improve competition and develop human and institutional capacities. It stresses that economic infrastructure, financial market development and building the capacities of enterprises are priority areas for mobilising investment in the near term and that reforming the investment climate requires political will, drive and leadership to take on entrenched interests and inertia. Development agencies consequently need to stay the course, but they also need to change the way they do business. For example, their internal incentive and evaluation systems should not work against staff pursuing longer-term, programmatic and possibly higher risk interventions.

This policy guidance was approved by the DAC on 15 March 2006 and welcomed by OECD Ministers at the annual meeting of the OECD Council at Ministerial Level on 23-24 May 2006. It complements more general guidance on improving the design, delivery and effectiveness of development co-operation, notably the "Paris Declaration on Aid Effectiveness".



Richard Manning
Chair
OECD Development Assistance Committee

Manfred Schekulin
Chair
OECD Investment Committee

In order to achieve its aims the OECD has set up a number of specialised committees. One of these is the ***Development Assistance Committee****, whose members have agreed to secure an expansion of aggregate volume of resources made available to developing countries and to improve their effectiveness. To this end, members periodically review together both the amount and the nature of their contributions to aid programmes, bilateral and multilateral, and consult each other on all other relevant aspects of their development assistance policies.*

The members of the Development Assistance Committee are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the Commission of the European Communities.

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Acronyms

DAC	Development Assistance Committee
FDI	Foreign direct investment
GDP	Gross domestic product
ICT	Information and communication technology
IFC	International Finance Corporation (World Bank Group)
MDG	Millennium Development Goals
ODA	Official development assistance
PPP	Public-private partnership
SME	Small and medium-sized enterprise
UNCTAD	United Nations Conference on Trade and Development

Key Messages

Vigorous and sustained economic growth, fuelled by investment and entrepreneurship, is needed for the private sector to create more jobs and increase incomes of the poor. In turn, this will generate the revenues that governments need to expand access to health, education and infrastructure services and so help improve productivity. But in many developing countries, investment rates are too low, productivity gains are insufficient, incentives for innovation are inadequate, returns on investment are not sufficiently predictable, and not enough secure, safe and adequately paid jobs are being created in the formal economy.

Developing countries and their donor partners consequently need to do much more to address the market failures and structural impediments that are holding back productive investment (both domestic and foreign), and to do it better, for longer periods and in a more strategic way. Developing countries can help foster an investment climate that enables the private sector to flourish and fulfil its role as the main engine of growth. To do so, they can pursue macro-economic stability, improve the functioning of market-regulating institutions and strengthen procedures for contract enforcement and dispute settlement. Developing country governments can also improve the coherence of their policies in a range of areas – such as trade, tax, competition and investment promotion – that affect the volume of investment and its development impact.

A review of past practices by development agencies highlights that:

i) Donors are supporting a vast range of activities – at the macro-economic, enabling environment and enterprise levels – that affect investment. They spend around 20% of their aid on these. But little evaluative material on the impact of interventions on promoting investment is available.

ii) Insufficient attention has been given to enterprise and supply-side capacity development, and to promoting the institutional and policy reforms that lie at the heart of efforts to promote private sector development.

iii) Donors have focussed too much on assisting specific types of firms (*e.g.* certain sizes, activities or sectors). Experience has shown this can lead to market distortions and poor sustainability.

To help developing countries mobilise more productive investment, and improve the effectiveness of interventions that support this objective, development agencies need to:

i) Be more strategic, and their interventions need to be harmonised and guided by more systematic learning of lessons.

ii) Focus on helping to lower the costs of investment, reduce risks, improve competition and develop human and institutional capacities in developing countries.

iii) Give high priority to economic infrastructure investment and financial market development, as key areas for promoting investment in the near term.

iv) Pay greater attention to the determinants of domestic investment, both formal and informal, and to strengthening the capacities of local firms to respond to new investment opportunities and to expand business relationships with foreign investors.

v) Enhance the contribution of investment to pro-poor growth (*i.e.* increase the impact of growth on poverty reduction) by making labour, land and other markets work better for the poor, tackling constraints to women's entrepreneurship, reducing barriers to formalisation, promoting environmental sustainability, expanding access to knowledge and technology and unleashing the economic potential in rural areas.

vi) Encourage entrepreneurship and innovation by supporting education and vocational training, research and development activities and technology transfers.

vii) Promote responsible business practices in such areas as labour relations, the environment and anti-corruption.

viii) Build on analyses of country and sector-specific constraints, at national and local levels, to private sector development and encourage publication and public debate about the results. Help build up the capacities of developing countries to carry out such assessments.

ix) Seek out reliable, representative and accountable domestic partners who can drive reform programmes and help catalyse change.

x) Use market-based approaches to supporting firms. Targeted assistance should avoid distortions and firms receiving direct support should be selected based on their expected capacity to innovate, create jobs and provide services at local market conditions.

xi) Promote structured and inclusive public-private dialogue, at national and local levels, so as to bring micro and small entrepreneurs and informal firms and workers into consultation and decision-making processes. This will help to build demand for reform and for investments that will improve the investment climate.

xii) Evaluate the cumulative impact of their interventions on promoting investment and share examples of successful and unsuccessful practices.

Reforming the investment climate requires political will, drive and leadership to take on entrenched interests and inertia. Development agencies need to stay the course and support "change agents" within the public and private sectors and civil society.

Development agencies also need to change the way they do business. They need to have access, individually or collectively, to an appropriate range of aid instruments. Their internal systems should not work against staff pursuing longer-term and riskier interventions. Staff working on the range of subjects relevant for promoting investment should be well co-ordinated. More of the goods and services that development agencies procure can be sourced on competitive terms in developing countries, to support local private sector development. Finally, public sector partners in developing countries can be encouraged to engage more with the private sector, such as through public-private partnerships.

Introduction and Context

Too many developing countries are not on track to reach the Millennium Development Goals (MDGs) by 2015 and need to pursue better and more sustained ways of reducing poverty. If progress continued on present trends (Box 1), some countries in sub-Saharan Africa would not reach the MDGs for over a century. The private sector has a central role to play in the war on poverty and mobilising private investment is imperative for promoting the broad-based and sustained growth that will help drive poverty reduction. In today's global economy, private investment is both domestic and foreign and takes many forms, from physical assets to intellectual capital.

Box 1. **Regional trends in growth and poverty reduction are uneven**

Economic growth has begun to take root in developing countries since the mid-1990s although its pace and impact on poverty reduction has been uneven. Spurred by China's performance, the fastest growth over the 1990s was in Asia, which increased by over 6%, and where the share of people living on less than USD 1/day fell from 30% to 15%. Growth in sub-Saharan Africa was negative on average and the share of people in extreme poverty rose from 47% to 49%. Extreme poverty remained at 11% in Latin America where growth was slow.

Source: AFD *et al.* (2005).

Secure, safe and well-paid jobs and productive self-employment are important pathways out of poverty for the billions of poor men and women in developing countries that struggle to survive. 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, in both agriculture and non-farm occupations, and increase 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 growth that involves and benefits the poor. As a result, there is increasing demand from within development agencies for guidance on how official development assistance (ODA) can better support efforts by developing countries to address the market failures and structural impediments that are holding back private investment and on the use of aid instruments that support productive sectors.

An initial set of policy lessons on the role of ODA in mobilising private investment (OECD, 2005a) found that bilateral and multilateral development agencies are supporting a vast range of activities – at the macro-economic, enabling environment and enterprise levels – that affect investment. They spend a significant share of their aid – around 20% – on these (Box 2). But little evaluative material on the impact of these interventions on mobilising investment is available. To improve the effectiveness of these efforts, development agencies' interventions should be more strategic, better co-ordinated and guided by more systematic learning of lessons on what works best to mobilise investment, what doesn't and why.

Box 2. **A significant share of aid expenditures help to promote investment**

The 2005 World Development Report found that "assistance provided by major bilateral and multilateral development agencies for investment climate improvements averaged USD 21 billion per year between 1998 and 2002 — or about 26% of all development assistance. The bulk of that assistance went to infrastructure development."

The World Bank's methodology can also be used to determine how much of the bilateral ODA provided by the 22 DAC member countries goes towards promoting investment in developing countries. DAC member countries spent between about USD 8 and USD 10 billion per year between 2001 and 2003, or 15% to 20% of their bilateral ODA. Infrastructure development was again the largest component.

Source: World Bank (2004) and OECD.

This report provides guidance to members of the OECD's Development Assistance Committee (DAC) on using ODA more effectively to promote private investment for development (investment-enhancing ODA). It focuses on how development agencies can help influence the conditions that lead to increased levels of private investment and on how investment can better contribute to the achievement of broader societal goals, including poverty reduction. A fundamental objective is to help staff in development agencies, both in headquarters and the field, to pursue a more strategic and co-ordinated approach when they design and deliver investment-enhancing ODA.

This guidance is linked to and draws on the wider development agenda. ODA in a variety of areas, such as promoting peace and security, improving health and education and tackling HIV/AIDS, is of broad relevance for promoting development, including promoting investment. Investment-enhancing ODA should base itself on general guidance on improving the design, delivery and effectiveness of development co-operation, including the "Paris Declaration on Aid Effectiveness" (OECD, 2005b) which stresses the mutual accountability of both donor countries and developing country partners for achieving development results. Improving the coherence of government policies that affect development is also crucial. In donor countries, trade, foreign investment and migration policies can have a substantial impact, both positive and negative, on promoting investment in developing countries. In developing countries themselves, policies in a range of areas – including trade, tax, competition and investment promotion – contribute to the investment climate and so affect the volume and the development impact of investment. To help governments improve their investment climate, developing and other countries can refer to the Policy Framework for Investment (Box 3), which complements this policy guidance for donors on how ODA can be used to promote private investment for development.

Box 3. **The Policy Framework for Investment**

The *Policy Framework for Investment* is intended to assist governments to create an environment that attracts domestic and foreign investment, taking into account the broader interests of the communities in which investors operate. The *Framework* helps countries to develop a sound investment environment by fostering an informed process of policy formulation and implementation across government agencies. Based on best practices drawn from OECD and non-OECD experiences, it proposes a set of practical policy considerations in ten inter-related areas that, beyond stable macroeconomic conditions, contribute to such an investment environment. Governments can consider these policy considerations in country self-evaluation and for reform implementation, in regional co-operation and peer reviews and in multilateral discussions.

A checklist of questions in each of the following ten policy areas is included in the *Framework*: *i)* investment policy; *ii)* investment promotion and facilitation; *iii)* trade policy; *iv)* competition policy; *v)* tax policy; *vi)* corporate governance; *vii)* promoting responsible business conduct; *viii)* human resource development; *ix)* infrastructure and financial sector development; and *x)* public governance. The *Framework* also provides explanatory background material on these various issues.

Source: OECD (2006a).

Using ODA to promote investment: What to do

Increasing investment rates and enhancing productivity

In countries where growth is high, total domestic and foreign investment often exceeds 25% of gross domestic product (GDP). But, in sub-Saharan Africa, gross fixed capital formation has hovered at around 18% of GDP for the last two decades. Since the financial crisis in 1997, investment rates in developing countries in Asia (excluding China and India) have remained at around 21% (World Bank, 2005b). One factor contributing to low growth rates in developing countries, especially the poorest ones, is insufficient, inappropriate and poorly maintained physical infrastructure. Improving the investment climate will encourage more infrastructure investors to invest. This in turn will make infrastructure services more widely available and encourage other types of investment. Recent research supports the view that using ODA to promote infrastructure development merits greater attention; studies have found a large, positive, causal relationship over a four-year period between "immediate-impact aid" – *i.e.* budget and balance-of-payments support, infrastructure and aid for productive sectors – and economic growth (Clemens, Radelet & Bhavnani, 2004). A diversified and competitive financial sector is also important for promoting growth in developing countries as it helps maintain economic stability, makes financial transactions secure, mobilises external and domestic savings and facilitates the efficient allocation of capital to productive investments.

The World Bank's 2005 *World Development Report* (World Bank, 2004) similarly highlighted that it is not just the quantity of investment that matters for promoting growth, due to the decreasing marginal impact of additional investment in physical assets. What ultimately counts are the productivity gains that result from product and process innovations brought about through investments, as well as the extent to which jobs and capital flow from declining industries to expanding and emerging economic activities. This will make it possible to invest larger sums in the future. The investment climate consequently needs to provide opportunities and incentives for firms and entrepreneurs to develop, adapt and adopt better ways of doing business.

To help developing countries improve their investment climate, development agencies should support interventions that contribute towards achieving the following intermediate and mutually reinforcing objectives:

i) **Lower the costs of investment.** This refers to the costs of doing business (*e.g.* the costs of complying with the policy, legal and regulatory frameworks in which the private sector operates, including the extra costs created by inadequate infrastructure, crime, corruption and excessive red tape). High costs reduce profits and discourage investment. They also create disincentives for firms to formalise, with a resultant loss of benefits to the economy.

ii) **Reduce risks.** This involves policy and institutional reforms that improve the stability of the investment climate and the predictability, real and perceived, of returns on investment, including by making the implementation of regulations established by national and local governments more predictable and enforcement of the rule of law more rigorous. A well-functioning financial market is crucial for managing the risks associated with creating firms and expanding production, especially for the many small domestic firms that rely on internally generated cash flows and money provided by family and friends.

ii) **Improve competition.** A more competitive investment climate improves efficiency, encourages innovation and is a key factor driving productivity improvements in the short run. This often calls for the sequenced removal of policies or laws that protect markets or allow anti-competitive behaviour by public or private sector actors. A competition law and policy can help curb uncompetitive practices and engender a culture of competition.

iv) **Develop capacity.** Reforming the investment climate is a political process and relies on effective institutions and the ability of the private sector to identify key constraints to investment and to lobby for and help implement change. There is thus a need to support initiatives that build up the capacity of public and private sector stakeholders to engage in political process and to implement policy reforms. Capacity development can also improve the private sector's ability to cope with constraints and changes in the business environment and its capacity to innovate by adopting new technologies and expanding entrepreneurial skills.

To mobilise more investment and to improve risk-adjusted returns, developing countries and their donor partners need to do much more to address the constraints holding back investment and productivity improvements, and to do it better and for longer periods. Greater attention should be paid to domestic investors, both formal and informal, who are the source of the bulk of investment in developing countries.[1] High priority should be given to strengthening the capacities of local firms to respond to new investment opportunities, including those created through stronger international trade and investment linkages, and to enter into business relationships with foreign investors and to expand downstream and upstream linkages. Development agencies' investment-enhancing ODA programmes, new as well as long-standing approaches, should be abandoned if they do not result in cost-effective, significant and sustained increases in investment and employment in developing countries. For their part, developing countries can expand access to health, education and infrastructure services, improve the rule of law and increase the coherence of their policies that impact on investment.

Challenges for developing countries and development agencies

Much is already known about what should help promote private investment. To flourish, the private sector requires a stable and predictable investment climate that comes from macro-economic stability, transparent and accountable government, rigorous enforcement of the rule of law, functioning markets and institutions, a skilled and productive labour force, a strong commitment to fighting bribe solicitation and corruption, affordable and accessible infrastructure, intellectual property right protection and political and social stability. But country contexts differ – including the size and maturity of their markets and governance conditions – as do the needs and especially the risks faced by different types of investors. To improve the investment climate, reforms should build on an analysis of the country and sector-specific constraints to private sector development and an assessment of the country's competitive advantage.

Most of what needs to be done to mobilise investment is the responsibility of developing country governments and the private sector themselves. Nevertheless, ODA can help facilitate processes and promote the supply-side responsiveness of firms in developing countries. But using ODA to promote investment entails several challenges for developing countries and development agencies.

Private investors are diverse

It is important to recognise the diversity of private investors – domestic or foreign, large or small, formal or informal – when assessing barriers to investment. Priority areas for interventions are likely to be different for each group and need different responses:

i) The private sector in developing countries is often made up of a very large number of **small and medium-sized enterprises (SMEs)** and a small number of well-established, larger firms. To help fill this gap, SME growth can be promoted by focussing on their specific needs such as expanded access to financial services and support to participate in processes that set the strategic framework for national development. SMEs can also need greater access to the associations and enterprises that will help them improve their competitiveness and raise their capacity to link up with larger firms, both domestic and foreign. Fixed business costs weigh more heavily on SMEs. Therefore, there is a case for introducing graduated schedules of payments (*e.g.* taxes, registration fees) or regulatory requirements based on firm size, rather than exemptions which can create disincentives for firms to grow or lead to unfair competition. A disproportionate number of women-owned businesses are SMEs. To help unleash women's entrepreneurship, specific, targeted initiatives may be needed to address gender biases that prevent women's enterprises from making their full contribution to growth and poverty reduction although direct interventions should not lead to market distortions. However, concentrating on the SME sector to the quasi-exclusion of micro/informal enterprises and large enterprises should be avoided. Policies are also needed to remove barriers to micro/informal enterprises joining the ranks of the SMEs, as well as to support the latter growing into large enterprises.

ii) The **informal economy** forms a large part of the economies in many developing countries. It provides employment and income to many poor households, including those who lose or cannot find work in the formal economy. It includes a disproportionate number of women and people from disadvantaged groups. But informality is not conducive to sustained growth and poverty reduction – it distorts markets, excludes people from basic protections and reduces revenues for social and other public expenditures. There are substantial assets held in the informal economy[2] that could be used to help spur economic growth but fail to fulfil their productive potential. Formalisation also brings benefits for firms they are often unaware of, including greater access to the financial and other resources that will help their business to grow. It also helps them better deal with risk and vulnerability. Informality is not only a consequence of a weak investment climate; reducing informality will make an economy more attractive for investors. There is a continuum between informality and formality – few firms follow all the rules governing enterprise behaviour and few follow none of them. To promote movement towards a greater degree of formality, constraints to address include regulatory and administrative barriers, fees and financial requirements, corruption in public administration, socio-cultural attitudes and a lack of key business services. Making business services available to associations of informal firms and workers can be a first step along the path to greater formalisation. Development agencies need to ensure that their efforts to improve livelihoods for those in the informal economy do not hold back tendencies towards greater formalisation.

iii) **Foreign direct investment (FDI)** should be encouraged, not only for the extra capital it brings, but because it can lead to technology transfers, better human capital formation, deeper international trade integration and a more competitive business environment. Ideally, FDI projects should provide opportunities for competitive local firms to forge forward and backward linkages. There are four main determinants for attracting FDI: *i)* market size and growth prospects; *ii)* natural and human resource endowment; *iii)* physical, financial and technological infrastructure; and *iv)* openness to international trade and access to international markets. Some of these can be improved through investment-enhancing ODA. In the least-developed countries, which have still to benefit from sizable FDI inflows, particular efforts appear necessary to improve the functioning of financial markets, expand infrastructure, increase skill levels and connect up better with local enterprises. Foreign investors sometimes have difficulties assessing the risks of doing business in developing countries. Making accurate information on market conditions and experiences of other foreign investors more readily available will help address this. In addition, nationals abroad can have more accurate perceptions of conditions at home and can be encouraged to invest in their country of origin.

Trade liberalisation needs complementary policies

Trade and investment are closely linked and complementary activities for modern business operations. For potential foreign investors, the ability to import and export easily is an important aspect of the investment climate. In the long-run, greater openness accelerates growth and leads to greater competition and efficiency in domestic and international markets. But, in the short-run, trade liberalisation may either increase welfare for the poor (if they are employed in export sectors or consume previously protected products) or decrease welfare for the poor (if they are employed in protected sectors or consume goods destined for export). Complementary, compensatory and time-bound measures are generally needed to help the poor adjust to structural changes and take advantage of opportunities created through trade liberalisation. To help firms in developing countries participate in global markets where adherence to high business standards is required, developing country governments and development agencies can promote adoption of responsible business practices in such areas as labour relations, the environment and anti-corruption. The *OECD Guidelines for Multinational Enterprises* are a useful reference as they contain a set of recommendations for responsible business conduct that aim to promote the positive contributions that international business can make to economic, environmental and social progress.

Natural resources can be a mixed blessing

Abundant natural resources provide a basis for growth in many developing countries and investment can help expand these countries' primary export sector. But some of these countries experience a "resource curse" and grow more slowly than those with fewer natural resources. As demand for commodities may remain strong for some time, further investments to expand extractive industries can be expected. Developing value chains that link natural resources up to processing activities using domestic suppliers of goods and services will help produce higher returns, create more jobs and ensure that the resulting growth is broader-based and more sustained. So too will efforts to reduce corruption and strengthen public financial management. It is important that extra revenues that governments may receive through royalties and taxes do not reduce pressures to reform and that developing countries pay attention to the possible environmental degradation that can result from intensive use of natural resources.

Public-private partnerships should help promote private investment

The motivation behind the public-private partnership (PPP) approach is to maximise interactions between the public and private sectors so as to deliver public services, such as water, electricity or telecommunications, more efficiently and to more people, and to improve the quality and the affordability of access to services provided. PPPs can take many forms – ranging from a private firm providing a public service for a specific period to "design-build-operate-transfer" arrangements. As well as leveraging extra funding and encouraging efficiency gains, entering into a PPP can motivate governments to identify and prioritise their infrastructure needs. But, establishing appropriate framework conditions for PPPs has often proved to be a complex task, particularly in small markets and in some sectors such as water. Governments have complained that investors have reneged on contractual obligations, especially regarding the coverage of services, while investors have complained that the business environment has not been conducive to delivering services according to sound commercial principles. Other important issues that have arisen include the pricing of the basic services provided, arrangements regarding poor people's access to services, financing operating and maintenance costs and mitigating non-market risks. A structured dialogue between the public and private sectors can help identify common goals and facilitate better understanding of each partner's objectives. Results to date with PPPs have been mixed and lessons need to be learnt and applied. To avoid pitfalls encountered in the past, careful attention is required when contracts are being negotiated.

Expectations need to be kept realistic

Developing countries vary enormously - from small island states or land-locked mountainous regions to some of the largest and most populous nations on the planet. Their potential for mobilising private investment differs. We now know more about the institutional and policy reforms that should improve the necessary conditions for investment. However, we are less clear about how to bring about the conditions that will lead to more investment, particularly in countries that appear to have low growth potential. This highlights the importance of working both on the enabling environment as well as strengthening the supply-side capacity of the local private sector, including by promoting entrepreneurship and innovation through education and vocational training, research and development, technology transfers, making access to finance and other inputs cheaper and less cumbersome, and reducing the costs and formalities associated with creating and closing firms. Efforts to mobilise investment should not focus only on expanding production of existing goods and services; improving the investment climate will also help new economic activities to emerge.

Reforms need political will, drive and leadership to take on entrenched interests and inertia

Successful reforms of the investment climate call for on-going processes of institutional reform, policy adjustment and engagement with a wide range of private sector representatives. In OECD and non-OECD countries alike, such political processes can be difficult. There is a need to know more about how best to manage such complex processes, overcome resistance to change and catalyse local demand for change that will help promote investment. Development agencies need to stay the course and support "change agents" within the public and private sectors and civil society.

Enhancing the contribution of investment to reducing poverty

To enhance the impact of private investment on poverty reduction, which in turn should make growth more rapid and sustained as well, policies need to ensure that poor women and men participate in, contribute to and benefit from the growth process:

i) Obstacles that limit poor people's access to labour, land and other **markets** need to be removed. The poor may need help to increase their assets and legal rights as well. So that reforms translate into development results throughout the country, efforts are needed to ensure that poor people are aware of the availability of services and of their rights, and that these rights can be enforced. Awareness campaigns in local languages, the establishment of help lines to report abuses by public officials and greater access to functioning small claims and commercial courts can help improve the implementation of reforms.

ii) **Women** face specific constraints to participating in labour, financial, goods and services markets because of social norms, biases, prohibitions and gender divisions of labour. This jeopardises efforts to spread the benefits of growth among the poorest. Policies that can help expand female participation in markets and make the creation or formalisation of women's enterprises easier include increasing access to health care and infrastructure that meets women's needs, expanding school enrolment for girls and supporting laws that reduce gender discrimination in pay and working conditions. Making the experience of successful women entrepreneurs widely available can inspire and motivate other women.

iii) The poor are heavily dependent on natural resources and **environmental** costs bear hardest on the poor. Environmental degradation is not the inevitable cost of economic development. Rather than trying to mitigate the environmental impact of policies and projects, developing countries and their donor partners should use tools such as Strategic Environmental Assessments to help make informed choices. Central to such an approach is effective governance and fiscal policies that change incentives in favour of environmental sustainability and growth.

iv) A well-developed **financial sector**, including a more integrated micro-credit sector, can expand access to an array of financial services (such as payment instruments, saving facilities, credit and insurance) for poor people and micro-entrepreneurs. It is also important for financing long-lived infrastructure assets. In countries with less developed financial sectors, development agencies should give priority to helping create a conducive enabling environment, through support for regulation, supervision and promotion of financial systems. In more sophisticated economies, development agencies can give higher priority to supporting policies and projects that extend the provision of financial services to the poor and small firms, on terms and conditions more adapted to their needs. Expanding access to banking facilities for the many "unbanked" in developing countries – through outreach, use of ICT and more cost-efficient and transparent services – will also help channel remittance payments more cost effectively and enhance their contribution to mobilising investment.

v) Inadequate and insufficient **infrastructure** is a major obstacle to growth, trade and investment and raises the production and transaction costs of doing business. Investments in transport, energy, water and ICT services are also essential to bring poor people closer to local, national, regional and global markets. To meet the infrastructure challenge in developing countries, four guiding principles should be applied: *i)* use partner country-led frameworks as the basis for co-ordinated donor support; *ii)* enhance infrastructure's impact on poor people; *iii)* improve management of infrastructure investment, to achieve sustainable outcomes; and *iv)* increase infrastructure financing and use all financial resources efficiently. To help meet this challenge, private sector participation in infrastructure investment needs to increase, including through PPPs. Where there is official financing support for export credits, these need to bear in mind international obligations about trade distortions and subsidies.[3]

vi) There has been considerable underinvestment and disinvestment in **agriculture**, especially in Africa. In some cases, this has been due to local agricultural produce not being able to compete with imported goods. Yet agriculture remains a key sector because enhancing growth prospects, productivity and diversification will contribute significantly to growth and poverty reduction. Most poor people in developing countries engage in private sector activities through farming and associated agribusiness. Increasing access to markets and assets, improving access to productivity-enhancing technology (especially for small produces and agribusinesses) and boosting investment in power, irrigation and road infrastructure are critical for releasing the economic potential in rural areas and expanding the domestic private sector.

Notes

1. In recent years, domestic investment has represented around 85% of total gross capital formation in sub-Saharan Africa and about 90% in China. *Source*: World Bank (2005b).

2. For example, according to a study conducted by the Institute for Liberty and Development in 2004, the "extra-legal" economy in Tanzania held assets worth USD 29 billion.

3. See the Arrangement on Officially Supported Export Credits, negotiated and monitored in the OECD, and its link to the WTO Agreement on Subsidies and Countervailing Measures.

Using ODA to promote investment: How to do it

To help developing countries mobilise investment and improve the effectiveness of interventions supporting this objective, development agencies can consider a range of issues, including co-ordination, alignment and harmonisation and capacity development. At each stage of the project/programme cycle, development agencies can review their practices so as to make their investment-enhancing ODA more strategic. Development agencies can also review the way they do business.

Cross-cutting concerns

Development agencies should co-ordinate their reform efforts across all levels of intervention, and at national, sub-national and local levels. Care should be taken to ensure that key priorities are agreed on and that reform programmes are **harmonised**, in accordance with the principles set out in the "Paris Declaration on Aid Effectiveness". Investment-enhancing ODA is a new field for some DAC members and there are some specific challenges to harmonisation. Currently, in many developing countries, development agencies act too independently, sometimes competing to fund projects, and donor co-ordination fora serve only as a vehicle for sharing information on new activities. Differences in the terminology development agencies use - such as the "investment climate" or the "business environment" – can reflect some very different views on what is required to promote investment. These views run from consideration of the broad range of external elements that affect the growth and performance of firms to regulatory reform. Another complicating factor is the political and governance implications often involved in promoting investment. Nevertheless, progress on harmonisation can be made, especially if led by the partner country (Box 4). Agreeing at partner country level on some key concepts and approaches at the early stage of programme formulation can facilitate harmonisation at later stages.

Box 4. **Locally-driven donor co-ordination: The case of Viet Nam**

As development agencies started allocating more and more resources to SME and private sector development in Viet Nam, the need for better donor co-ordination became crucial for reducing transaction costs for the Vietnamese and achieving greater impact. The Vietnamese government took a strong leadership position in this process and set up a regulatory framework that assigned to the Ministry of Planning and Investment (MPI) responsibility for managing and co-ordinating ODA funds. The MPI is also in charge of setting priorities for development agencies and for preparing international fora on ODA. A Partnership Group for SME Promotion and Private Sector Development (SMEPG) was created out of the Consultative Group that dealt with private sector development issues. To improve the effectiveness of SMEPG, thematic working groups were established on: business regulatory reform at central level, local economic governance, business development services, sector-wide approaches, SME finance, sustainable business practices and research and monitoring. Moreover, a local version of the "Paris Declaration on Aid Effectiveness" has been developed by the Government of Viet Nam and its development partners in which the government commits to strengthen its leadership role in co-ordinating aid at all levels.

Source: Cuong (2005).

Developing the capacity of people, organisations and society to manage their affairs better is a central and cross-cutting element of all development efforts. In order to make the investment climate more competitive, key areas for attention include helping entrepreneurs and the local workforce to make better use of knowledge and technology, increasing access to financial services for micro and small enterprises, assessing and managing risks better, creating a transparent and predictable legal framework and enhancing the functioning of the public sector, including its capacity to develop coherent policies that impact on the investment climate. To support capacity development, development agencies should: *i)* recognise that strong local engagement is the key and encourage the emergence of country-led, demand-driven capacity strategies; *ii)* take the local context as the starting point; *iii)* think and act within longer time frameworks; *iv)* avoid undermining local institutions; *v)* acknowledge that capacity to manage complex changes and to assume ownership of and be accountable for policies is as essential as capacity for policy implementation and service delivery; and *vi)* design coherent strategies for making use of the Diaspora and for reducing "brain drain". Development agencies' support should be embedded in a comprehensive medium to long-term framework that involves less risk aversion (project implementation units are one consequence of low risk strategies) and greater strategic engagement.

Structured **public-private dialogue** is a means to bring different stakeholders together to identify policies and institutional reforms that promote entrepreneurship and help mobilise private investment. It also helps reduce information asymmetries between the public and private sectors on investment-related policies. A good balance within the dialogue process is key, to ensure that the voice of some does not drown out the voice of others. Development agencies can promote public-private dialogue by supporting the establishment and operation of dialogue processes in developing countries, including new styles of processes that become available through greater access to ICTs. Special efforts should be directed at helping poor entrepreneurs to participate and promote their interests because established consultation fora tend to include large firms and promote vested interests. To do this, development agencies can support, in a time-bound and strategic way, the emergence and strengthening of organisations, at national, sub-national and local levels, that represent the interests of micro and small entrepreneurs and of informal firms and workers. Business associations and trade unions can be important drivers of change but are often institutionally weak and sometimes non-existent. Development agencies should stay clear of imposing their own agendas on dialogue processes or of creating situations where participants respond more to the priorities of development agencies than to their own constituencies.

There is a consensus among development agencies on the need to move towards more market-based and sustainable approaches to providing **support to firms**. To avoid distorting markets, development agencies can promote demand-driven initiatives and apply the following criteria when providing support to firms: *i)* focus on the causes of problems; *ii)* promote a level playing field and the ability to access it; *iii)* avoid or minimise subsidies; *iv)* apply output-based aid principles and link disbursement of public funding to the actual delivery of services or outputs; and *v)* have a clear exit strategy. Targeted assistance may be necessary to reach those who, even where the playing field for market access is levelled, still cannot make use of market opportunities because of lack of assets such as knowledge and skills, capital or land. But such assistance needs to be "smart", to avoid distortions, to address the binding constraints and to reach the intended target group, and it should be temporary. So as not to stifle competition and protect inefficient suppliers of goods and services, firms receiving direct support should be selected on the basis of their performance and their expected capacity to innovate, create jobs and provide services at local market conditions. In situations, *e.g.* after conflicts or natural disasters, where market-driven approaches may not be applicable in the short-term, development agencies should expect to shift gradually to a market-based approach that aims to rebuild the supporting institutional environment for the private sector.

Improving the management of aid projects and programmes

A systematic and comprehensive approach to providing investment-enhancing ODA should connect anticipated outcomes and impacts to interventions that address specific constraints or barriers to investment. A four-stage approach is often used by development agencies involving: *i)* an assessment of the conditions for private investment; *ii)* the design of reform programmes; *iii)* the implementation of reform efforts; and *iv)* measuring the impact of reform on private investment and ultimately on growth and poverty reduction. To make the most of their comparative advantage, avoid duplication and diminish burdens on developing countries, donors should co-ordinate at each of these four stages and strive to undertake activities jointly or co-operatively as much as possible.

Assessment

To better pinpoint reforms that should lead to lower costs, reduced risks or improved competition and to identify other constraints to promoting investment, development agencies should support and build up capacities in developing country governments, the private sector and civil society organisations to carry out assessments, either alone or jointly with international experts, of conditions for investors. Local expertise from research centres or universities should be used as much as possible. Nonetheless, to avoid survey fatigue, existing information sources, such as the IFC/World Bank's Investment Climate Assessment Reports, UNCTAD's Investment Compasses or assessments conducted for other development agencies, should be relied on if available.

Assessments should include consultations with relevant business and civil society stakeholders. This should include business associations that are independent of government and truly representative of the interests of the private sector, not just specific industries or types of firm. Anonymous surveys can allow firms to provide more honest and useful responses.

Even when standardised assessment tools are used, it is important that assessments unearth more than generic issues and identify detailed, country and sector-specific constraints. Assessments should pay special attention to the variations in conditions that may exist for domestic and foreign investors, between formal and informal enterprises, and between large and small firms, and consider how regional integration can be enhanced. Gender analysis tools can help ensure that woman's roles as consumers, workers and entrepreneurs are taken into account in the design of programmes. The Policy Framework for Investment (Box 3) can

Box 5. ***Ex ante* Poverty Impact Assessment**

A Poverty Impact Assessment (PIA)* helps development agencies and their partners to understand better and maximise the poverty reduction impact of interventions. It responds both to the need for accountability to their respective constituencies and for transparent evidence-based decision making. It draws heavily from other assessment tools - such as the Poverty and Social Impact Analysis (PSIA) or the Sustainable Livelihood approach - but is simpler and more cost-effective. The PIA focuses on poor and vulnerable people and follows the multidimensional approach outlined in the 2001 DAC Guidelines on Poverty Reduction. The PIA helps to identify interventions that have a high potential to deliver pro-poor outcomes but also indicates when mitigation measures may be necessary to protect the poor from rapid change in economic and social structures. For instance, it might be used to determine and mitigate the effects of trade liberalisation on the poor. The approach aims to identify: *i)* transmission channels and outcomes of target groups; *ii)* outcomes by selected stakeholders groups; and *iii)* aggregate impacts in terms of the Millennium Development Goals and other strategic goals defined by partner countries and development agencies.

* For further information, see: www.oecd.org/dac/poverty

be used to assess a country's framework conditions for investment. To assess *ex ante* the expected impact of interventions on growth and poverty reduction, a Poverty Impact Assessment can be conducted (Box 5).

A strategic approach to assessments can also help identify groups that may resist change as well as those who may support and be able to lead reform processes. The assessment should also set the baseline scenario that will facilitate monitoring and against which progress with reforms can be tracked.

The results of assessments should be publicly distributed and debated in local languages, including in the media, to promote dialogue among stakeholders, raise awareness about the importance of private investment and the conditions that affect investment levels and catalyse demand for reform. Ideally, this dialogue should be part of a broader process, such as a poverty reduction formulation process, so as to associate relevant stakeholders and make the analysis and priority setting exercise more relevant and credible.

Design

The aim of the design stage should be to create demand for reform by building in incentives for stakeholders to take ownership of the reform process. When designing programmes, development agencies should collaborate closely with governments, the private sector, civil society and other development agencies and use the results of assessments conducted.

It is important to identify reliable, representative and accountable domestic partners who can drive reform programmes. Development agencies should support their efforts and act as catalyser for change. The establishment of platforms and fora for dialogue is needed to promote and facilitate the engagement of representatives of all private sector actors. Consultations with public and private stakeholders should lead to the identification of mutual responsibilities and the assignment of specific tasks to different parties. Development agencies and their local partners also need to agree upon an appropriate timeline and sequencing of interventions.

New regulations should only be introduced if absolutely necessary, and ideally integrated with existing legislation. Regulations should not be introduced if they cannot be implemented and enforced at a reasonable cost.

Regulatory impact assessments (RIAs) on policies and proposed laws can help governments understand the ways the private sector will be affected.

Reform programmes should be closely connected to broader national development strategies, such as private sector development, locally driven poverty reduction strategies and annual budget plans. This can help programme partners to see the relevance of investment climate reform and the contribution this makes to broader social and economic agendas, thereby increasing their acceptability.

Investors seek greater predictability which development agencies can promote by being more consistent and strategic when designing their private sector development programmes. Investment climate reforms can entail significant changes in behaviour and attitude that cannot be expected to occur in the short or even medium term. Interventions should consequently be designed based on a long-term vision.

Implementation

Following through to ensure that reforms are implemented is essential and often depends on capacity constraints being addressed and behavioural changes occurring. Starting with a package of achievable changes and building on successes can help spark a virtuous cycle of improvements, but it is also important to create expectations that there will be steady progress in implementing reforms. Development agencies should allocate time and resources for follow up, to ensure that initial momentum does not dissipate as unforeseen obstacles start to arise and setbacks start to occur.

Communicating information about reforms taking place, for example through the media or by making information available in local languages, supports implementation efforts. Many investors are located in rural and remote areas. National laws can create unmet expectations if implementation at the local level is weak, if it is undermined by corruption and lack of controls or the additional human and financial resources needed do not materialise. Benchmarking progress by sub-national and local governments in implementing reforms and publicising the results can help improve the performance of public officials. Investors can also use this information to decide where to locate or relocate their activities.

When implementing activities, and to enhance long-term sustainability, development agencies should support, add value to and improve reform processes begun by local partners, particularly developing country governments, rather than try to lead reform processes themselves. A financial contribution from domestic partners for a programme can be a sign that the reform has strong local ownership and should take root. Wherever possible, existing institutions should be used and encouraged to grow, become more democratic and develop new products and services. Structures set up by external partners run the risk of being unsustainable in the long run or of fitting poorly into the country's existing social, economic and political context.

Consultants hired, be they local or foreign, to support the implementation of projects or programmes should have good experience with and understanding of facilitating reform processes that impact on the investment climate. They should be credible, understand business operations and be sensitive to political processes. Technical experts should principally be mobilised to address sector-specific constraints.

Monitoring and evaluation

Development agencies should ensure that their programmes are regularly monitored and evaluated against indicators established in the design phase and that are agreed on by their reform programme partners. There are many factors that influence changes in the volume and performance of investment, including economic cycles, and these need to be taken into account in the attribution of results.

Although the ultimate impact of successful reforms will be a rise in the levels of private investment and a reduction in poverty, development agencies should be rigorous in their efforts to measure the impact that programmes are having on the capacity of governments to design, enforce and review their policy, legal and regulatory framework, as well as on the private sector's ability to participate in on-going reform efforts in an informed and strategic way. Since important improvements to the investment climate will take considerable time, development agencies can draw out a small number of critical components of a programme and track progress with these over time.

Greater efforts are necessary to gauge the cumulative impact on mobilising investment of the variety of interventions supported by development agencies (Box 6). Added attention to evaluation will allow better identification and greater sharing of lessons learnt and experience on how – and how not – to use ODA to promote investment for development and which kinds of intervention work best in which circumstances. Developing a common knowledge management system that records examples of successful and unsuccessful approaches would be valuable.

Box 6. **Improving the investment climate: Findings from an evaluation**

The World Bank Group has carried out one of the few evaluations of the combined impact of a donor's various interventions on improving the investment climate. The evaluation identified four main challenges for the World Bank Group as it attempts to achieve better outcomes with its investment climate activities:

Focus on reforms at the institutional level more than at the policy level. Institutions – the "rules of the game" – are key to the quality of the investment climate. Strategies for improving the investment climate have suffered from a lack of knowledge about what kinds of institutional arrangements will work in different environments and about the dynamic process of change that is needed.

Customise interventions to country needs. The quality of the investment climate varies significantly across countries (and even within countries), regions and industries. There is a need to understand better, using local knowledge and expertise, country-specific constraints and opportunities as well as country-specific institutional designs.

Political economy and the sequencing of reforms. The feasibility of reform depends on the political economy of the reform process, and sustainability hinges on broad stakeholder support. There is a need to assess the capacity and incentives facing public sector organisations to implement reforms, and be aware of the likely winners and losers and the political strength of key groups.

Organisational challenges for donors. The broad nature of the investment climate as a topic and the need to work with both the public and private sectors can create internal organisational challenges for donors. For example, sector strategies need to be consistent with each other, and strategies and practice should be harmonised. At the country level, investment climate strategies need to be integrated across sectors and different operational units.

Source: World Bank Group (2004).

Implications for how development agencies do business

A greater focus on promoting investment may require development agencies to review whether they need to change the way they do business:

i) Development agencies should ensure that their internal incentive and evaluation systems do not work against staff pursuing longer-term, programmatic and possibly higher risk interventions. Institutional and policy reforms are not one-off events and efforts may not come to fruition within an agency's typical three or four-year programme cycle, or the period of one staff member's posting to a developing country.

ii) Staff working on private sector development, agriculture, infrastructure, public governance, capacity development, environment and gender are often located in different organisational units and sometimes in different organisations only loosely associated with the core ODA programme. To promote investment more effectively, these staff need to work in close association and, ideally, under a common strategic framework.

iii) The capacity of staff in development agencies may need to be strengthened, to help them better determine, based on differences in a country's investment climate and stage of development, appropriate approaches and aid instruments to use and how best to sequence reforms.

iv) Some development agencies may need to engage more with the private sector in developing countries, including by encouraging their public sector partners to do so. Development agencies can facilitate public-private partnerships by strengthening public authorities' capacities to negotiate contracts and exploring how the mitigation of non-commercial risks can be improved, including through co-ordinated responses by donors.

v) Development agencies can help develop the local private sector by procuring as many goods and services as possible in developing countries, subject to value-for-money considerations. This may require some capacity building in the local private sector to enable firms to participate in competitive and transparent processes and so take advantage of these opportunities. Development agencies can also encourage their suppliers and contractors to adopt responsible business practices.

vi) Development agencies potentially have a wide selection of ODA instruments at their disposal including the direct supply of goods or services, free-standing technical co-operation, grants, concessional loans, partnerships, alliances, equity acquisitions and guarantees. However, few DAC members use all of these instruments and the use of some, such as concessional loans or equity acquisitions, may be limited to a development bank, a development finance institution or another specialised agency. Given the variety of domains that need to be addressed to promote investment, there is a risk that relying on a few aid instruments may inhibit the effectiveness of development agencies' efforts. DAC members should consider whether the selection of aid instruments at their disposal, including through co-ordinated arrangements with other agencies, is right for reaching their objectives, especially in addressing, albeit indirectly, the private sector.

vii) To help ensure that the range of DAC members' policies impact positively on investment mobilisation, development agencies may need to expand their capacity to analyse the impact of non-ODA policies on developing countries and engage with representatives of other policy communities to influence policy formulation processes.

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DAC Guidelines and Reference Series

Promoting Private Investment for Development

THE ROLE OF ODA

More private investment and improvements in productivity will be needed if many developing countries are to reach the Millennium Development Goals. But how can developing countries mobilise more domestic investment and attract more foreign investment? How can the impact of this investment on poverty reduction be increased? What is the role of donors in helping developing countries to mobilise more productive and poverty reducing investment? Are there implications for the way that development agencies operate, individually and collectively?

This report provides policy guidance on using official development assistance (ODA) more effectively to promote private investment for development. It focuses on how development agencies can help influence the conditions that lead to increased levels of private investment and on how investment can better contribute to the achievement of broader societal goals, including poverty reduction. A fundamental objective is to help staff in development agencies, both in headquarters and the field, to pursue a more strategic and co-ordinated approach when they design and deliver investment-enhancing ODA.

www.oecd.org/dac/investment