

The importance of investment promotion in the poorest countries

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There is probably not a developing country in the world—even the most isolated, such as North Korea—that does not work hard to attract more foreign direct investment (FDI). Political leaders and policymakers know that FDI brings with it capital, technology, jobs and links to the world economy. The debate has raged about how best to accomplish this goal. Do investment promotion activities matter? What about tax holidays, grants of infrastructure, duty drawbacks and the myriad other, sometimes controversial, tools in use?

Lessons from Malaysia's success

A look at one of the world's most successful investment promotion agencies, the Malaysia Industrial Development Agency (MIDA), gives us some idea of the basic challenges faced in investment promotion. MIDA is now in the process of implementing Malaysia's ninth Five-Year Plan. MIDA and the government ministries have identified key targeted sectors for investment promotion as part of the overall national development plan. MIDA is now deploying teams to analyse the business needs of each specific sector, in terms of infrastructure, skilled labour, regulation and market access. MIDA is also establishing direct contact with leading global companies in each sector and is geared to play a detailed and hands-on roll in closing investment deals. It also has key responsibilities for negotiating incentive packages to attract the targeted firms.

As the Malaysian economy has evolved in recent years, so too have the targets, instruments and challenges that MIDA faces. Most important, today Malaysia is on the transition from labour-intensive

and commodity-intensive industrialisation to knowledge-intensive activities, a process that can be described as “moving up the value chain”. The goal is to raise productivity and incomes per worker, and to stay out of direct competition with low-cost Chinese and Indian firms by bringing advanced technologies and skills to bear. Yet MIDA is finding, quickly, that the demands of foreign investors are changing along with Malaysia's progression up the international value chain. Potential foreign investors are no longer as focused as in the past on Malaysia's basic infrastructure, tax rates and public administration, since they assume that these are all up to international standards. They are now more concerned with the availability of highly skilled labour and the proximity of major universities that can train the future labour force. MIDA is asked, for example, whether it can ensure several thousand high-quality engineers for a major project. Can MIDA guarantee that local universities will be turning out qualified graduates in the years ahead? The quality of higher education becomes a core competitive advantage for attracting industry in countries such as Malaysia that are moving up the value chain.

There are three general lessons to be taken from MIDA's long-term success.

- Investment promotion matters a great deal. Malaysia's success in being an attractive investment destination is the result not only of a strong business environment, but also of years of skilled work defining and implementing specific promotional tools.
- Direct and aggressive campaigning for investment projects is needed. Any country that believes it is not in competition with other countries for footloose global capital will find itself left behind.
- The specific promotional tools depend on the

targeted sector, the country's phase of development, and even the physical geography of the host country, which may define specific transport, climate and other challenges that need to be overcome for an investment to be successful.

There is, in short, a world of difference between attracting a labour-intensive apparel firm, a mining company, a wafer fabrication plant and a software design company. The first depends mainly on low labour costs and tax holidays; the second on the quality of mineral deposits and access to international markets; the third on clean water, reliable power and a local supply of qualified engineers; and the fourth on partnership with local universities and low-cost telecommunications.

Investment promotion agencies therefore need a careful and detailed approach that addresses the specific circumstances of the host country: geography, targeted sectors and stage of development. Governments should (and do) look askance at the World Bank and IMF orthodoxy that a good investment climate is all that is needed to attract FDI. That IMF-World Bank advice, which continues to this day, has frustrated the inflows of foreign investment into many of the countries bound by IMF-World Bank conditionality. A good investment climate is a necessary condition, but it is not sufficient. It is true that tax holidays do not matter much in a miserably governed country. Yet they may prove to be the slim margin for success in a well-governed poor country trying to attract foreign investment in manufacturing and services industries for the first time.

The challenge for the poorest countries

The biggest failure to attract FDI is found in the world's poorest-of-the-poor countries, most notably those in tropical Africa. In 2004 combined FDI inflows into tropical Africa were a meagre US\$13bn, and most of that investment was actually directed to the oil and gas sector and to other high-value commodities. If we remove the oil producers—Angola, Chad, Equatorial Guinea, Gabon, Nigeria, Congo and Sudan—combined FDI inflows into tropical Africa were a shockingly low US\$4bn, less than 1% of total FDI inflows worldwide,

despite the fact that tropical Africa constitutes more than 10% of the global population. Most of the tropical African countries have been under long-term IMF and World Bank tutelage, and these agencies have been singularly unsuccessful in helping their clients to attract investment inflows, in part because they have advised against the practical investment promotion activities that are needed. Among emerging markets, it is today's middle-income countries—not the poorest—that pull in the lion's share of FDI. For example, Brazil alone had FDI inflows of US\$18bn in 2004, nearly 50% more than the whole of tropical Africa.

For the poorest countries, five areas of interest are most likely to attract investment inflows. The first, of course, is the most traditional: raw materials sectors such as oil, gas, minerals and agricultural commodities. The second is resource-based manufactures based on locally sourced resources. Cotton textiles and apparel, using local cotton production, is an obvious example. The third is tourism, which also takes advantage of local resource endowments (such as a beach front, biodiversity, local culture). The fourth is labour-intensive manufacturing using internationally produced inputs, such as apparel and other assembly operations. The fifth, and newest, possibility is low-end services sector activities based on information and communications technology (ICT), such as call centres, data transcription and basic business-processing operations (BPO).

Attracting FDI into any of these sectors requires a basic level of infrastructure and public administration. Investors will invariably require electricity, water, physical security, basic public health facilities, and access to airports, ports and telecoms. Administrative services such as port clearance and predictable tax administration are also essential. So too is the absence of civil conflict, although in the case of hydrocarbons, precious stones and high-value minerals, investors are often willing to invest even in war zones. In most cases, the public sector has to provide the infrastructure in advance of the FDI inflows. Only the most profitable of natural resource deposits can spur private-sector financing of the complementary infrastructure.

As any shopping mall developer knows, an anchor tenant is vital to get a new project under way. Once the anchor tenant is confirmed, other businesses more easily agree to locate in the mall. As a result, anchor tenants are often given extremely favourable rental terms to start the process of filling the mall. The same goes for FDI. The first investors in any of these new sectors will usually require rather generous concessions in order to be pioneers. (Again, the case of hydrocarbons and high-value minerals is an exception.) Corporate tax holidays, government grants of land and duty-free imports are all standard tools to attract the initial inflows of FDI. One of the most successful strategies has been to declare a special economic zone (SEZ) or export-processing zone (EPZ), in which the investors will face simple, clear and highly favourable tax and administrative treatment, and in which the basic necessary levels of infrastructure will be guaranteed. Such SEZs and EPZs played a pivotal role in supporting emerging Asia's initial take-off into manufactured exports from the 1960s through to the 1990s. Similarly, SEZs are now being used in India to promote new industrial exports.

What Africa needs

Similar institutions are vitally needed in Africa, but unfortunately they have been frustrated in part by the traditional advice of the IMF and the World Bank. That is only now beginning to change, as more and more African countries insist on establishing SEZs, EPZs, industrial zones and favourable incentive schemes. This trend should be applauded and supported. In addition, African governments should be encouraged to emulate institutions such as MIDA, and long-standing institutions in the emerging Asian economies should be encouraged to share their knowledge and experience with fledgling bodies in Africa.

One of the most interesting issues will be the ability of Africa's cities to attract ICT-based industries and services. ICT allows for international services sector exports without the traditional physical infrastructure requirements, such as roads and ports. India's new—and booming—ICT-based sectors in Bangalore, Hyderabad, Chennai and elsewhere got started

despite India's inadequate infrastructure, because ICT-based businesses could put up their own satellite links and power generators, and did not depend as much as typical industrial enterprises on the quality of India's roads and ports. The main prerequisite was investment in human capital, which was initially provided by India's Institutes of Technology (IITs) and Institutes of Management (IIMs). Whether Africa can emulate India, albeit initially at the low-skilled end of ICT services, is an important question. There are indeed glimmers of hope, but they are still only glimmers.

What donors can do

Aid donors and international organisations should do their homework to understand the challenges of attracting FDI in low-income countries, and especially in the very poorest. Aid donors are committed to helping countries to achieve the Millennium Development Goals (MDGs). Increased FDI inflows will be vital to success in meeting the MDGs. FDI is needed to ensure the job creation, capital accumulation and export growth required to end extreme poverty. Donors can help the poorest countries to attract such FDI in at least three big ways:

- They can do more to ensure that the international financial institutions offer sound views on FDI promotion.
- They should deliver on their long-standing but unmet promises of aid, since aid is urgently needed to build the infrastructure required for the FDI to operate. Donors need to replace the tired and false slogan of "trade not aid" with the much more accurate slogan of "aid for trade". Specifically, aid is needed to finance the road, power, port and telecoms infrastructure that will be needed to make the poorest economies into profitable destinations for FDI.
- The rich donor countries can and must open their markets to exports from the low-income countries.

In recent decades a handful of emerging-market economies have reaped the lion's share of FDI inflows

into developing countries. It is time to widen the circle of beneficiaries. Fortunately, host countries in the developing world, even the poorest countries, have more interest in attracting FDI than ever before—and better policies to do so. Around the world, poor countries want to learn from the successful trade,

growth and investment promotion strategies that they have long seen in Asia. As they do so, they are likely to succeed in jump-starting unprecedented rates of growth. Of course, the foreign investors that move in early will be the biggest beneficiaries of the growth take-off that lies ahead.