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OECD (UK & EU) Home Country Measures and FDI in Developing Countries: A Preliminary Analysis

Prepared by

Dirk Willem te Velde
Overseas Development Institute

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Key Messages

1. Many OECD governments employ home country measures (HCM's) to promote foreign direct investment (FDI) to developing countries. These measures include support for risk reduction, technical assistance to improve the host country investment climate and home country market access
2. More research is needed on the effectiveness of HCM's but preliminary analysis of UK measures suggests that country specific investment related aid is useful in attracting FDI. The presumption is that FDI is good for development but that there are market and coordination failures which deter investment and cause the social benefits of FDI to be greater than the private benefits, in both host and investing countries. This is the rationale for HCMs
3. Since various agencies are involved in providing HCMs, one stop shops for outward investors could be considered to reduce potential confusion among investors.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

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Introduction

1. Many OECD governments desire to raise foreign direct investment (FDI) in developing countries to promote development as well as to promote competitiveness of OECD firms. In this context, there is a need to examine whether and how home countries can affect the level of FDI in developing countries (host countries) using home country measures (HCMs). This policy brief builds on Te Velde (2003), Te Velde and Bilal (2003) and UNCTAD (2001) to discuss what type of home country measures are offered in the UK and the EU, what we do and do not know about the effectiveness of HCMs, and preliminary policy implications.

2. It should be recognised upfront that HCMs are much less discussed than other factors affecting FDI, such as host country policies, international policies or policies of multinational enterprises. Policies on outward investment were traditionally seen as a screening device, restricting the outflow of capital. However, as host countries have begun to realise that attracting FDI is good for development when appropriate policies are in place and have started liberalising the FDI regime accordingly, so too have home countries begun to realise that outward FDI can be good for home country development, and have started lifting restrictions on outward FDI.

3. The UK government clearly regards the promotion of FDI as a win-win situation and has stepped up its efforts to promote FDI to developing countries. The EU has agreed to promote FDI into ACP countries as can be seen from the relevant articles in the 2000 Cotonou Partnership Agreement (now ratified by a sufficient number of members). This paper discusses the following question. Which HCMs are offered by the UK and EU? What is the rationale for offering HCMs? What do we know about the effectiveness of HCMs? And what are preliminary policy implications?

4. We conclude that:

(i) There has been no systematic work on the question of effectiveness of HCMs in stimulating FDI, so before suggesting new HCMs or arguing for more of the same it would be desirable to have further work in this area.
(ii) Nevertheless, some information has emerged during a preliminary analysis of HCMs offered by the EU and EC.
(iii) There are many HCMs offered by OECD countries (with the UK and EC as examples here), which might confuse investors, and support for national one-stop shops for outward investment could be considered, where HCMs are offered as a package, but with each HCM maintaining its own ultimate objective.
(iv) A preliminary analysis of UK HCMs suggests that country-specific investment-related aid provided by home countries in host countries could be useful in pulling FDI.
(v) Whether additional support is needed for UK HCMs to push FDI, such as provision of political risk, or pull, such as scaling-up linkage promotion schemes (www.odi.org.uk/iedg/Publications/tnc_sme_linkage.pdf), should in part depend on whether existing and newly-emerging schemes in this area are achieving their aims.

Home Country Measures (HCMs) Offered by the UK and the EU

5. Home Country Measures include laws, regulations, policies, and programmes in home countries that affect outflows of FDI and fall into the following six categories (Kline, 2003): policy positions (voluntary commitments to promoting FDI); information provision and technical assistance; technology transfer; financial and fiscal incentives; investment insurance; and market access regulations.

6. We examine the scope of HCMs on the basis of how they affect motivations for FDI in theory, defining four categories (Te Velde, 2003):

(i) Support for structural economic fundamentals and governance structures in host countries.
(ii) Support in reducing economic and political risks of an investment.
(iii) Support in providing information surrounding investment.
(iv) Other policies that affect the viability of investment projects, such as fiscal policies and preferential trade policies in home countries.

7. Table 1 shows the type of HCMs offered by the UK and the EC. Specifically, regarding the UK HCMs:

(i) Investment-related UK (bilateral) aid has increased since the 1970s, both in volume and in share of total (bilateral) aid, currently at 30%, see Table 2. Investment-related aid has shifted away from infrastructure towards macroeconomic stability, legal and policy frameworks and human resource development and institution building, which includes provision of public goods (e.g. legal and policy framework and human resource development).
(ii) CDC's new investments have declined since the mid 1990s. Its £1bn portfolio is geared more towards infrastructure projects and less towards agribusiness. It has a substantial presence in low-income countries, including 25% or £250 mn in Africa.
(iii) The ECGD's programme on overseas investment insurance (OII) has increased rapidly to £1bn, faster than in any other major developed country. However, just 6% of the portfolio in 2002 was aimed at Africa, down from some 20% in 1996. Most exposure is in infrastructure.
(iv) The UK trade partners programme for outward mission has increased. Few missions go to low-income countries, e.g. 0.1% in Ethiopia.

Table 1: Major Home Country Measures Provided by the UK and EU

Type	UK		EU - Cotonou	
	Programme	Size and importance	Programme	Size and importance
Support for reducing economic and political risk	CDC group is a partly privatised equity investor and loan provider, with DFID the sole shareholder.	Based on £755 mn loan from government, CDC invests between £100 - £200 mn annually. Stock of investments was worth around 1£bn in 2002.	Investment Facility of EIB. Financially sustainable fund to stimulate investment and commercially viable business and promote local financial markets. Loans backed by member state guarantees	€2.2bn from EDF + €1.7bn own resources + subsidies. New portfolio (2000-2002) €1.1 bn to global SME loans (32%), energy (28%), other (40%) in ACP public and private sector.
	UK ECGD (DTI/FCO) has offered political risk insurance for overseas investment since the 1970s.	The maximum overseas investment insurance liability was £1009 million in 2002. Has increased by 58% over 1998-2001. 6% of programmes in Africa.	Investment Facility, EIB	Part of €2.2 billion from EDF (see below) can be used for guarantees, but so far not used
Provision of information opportunities in host countries	UK Trade Partners / DTI organises and provides support for trade and investment missions in developing countries. Also BIS.	The UK Trade Partners supports outward missions to raise competitiveness of UK companies (£70 million annually) – few missions to small developing countries, e.g. 0.1% in Ethiopia.	PROINVEST to promote investment in ACP companies by strengthening the capacities of private sector intermediaries (IPAs) and professional associations and to support companies to develop partnerships.	Approximately €10 million annually
Support for economic fundamentals governance structures	Various DFID aid programmes, classified as Investment related aid.	Around 30% of UK bilateral aid (in OECD-CRS) is investment related, worth around £500 mn annually.	National and regional indicative programmes; some countries have chose private sector development as one of the priority areas.	€11.3 billion (9th EDF minus contribution to EIB) over five years
	E.g. DFID Challenge Funds have been implemented recently, including BLCF,	The £18 mn BLCF over five years, committed £6.1 million for 26 projects by 2002 leveraging £11 mn of investment.	E.g. CDE provides technical assistance for companies and intermediaries	CDE has budget of approximately €20 million annually.
Others	DTI Trade policy on market access; FCO Investment policy; Treasury Tax incentives	Difficult to quantify	Not under Cotonou, but many by individual EU member states.	

Sources: see Te Velde (2003) and Te Velde and Bilal (2003)

Table 2: UK Bilateral Aid Distribution by Sector

	1973-1979	1980-1989	1990-1996	1997-2002
Investment related aid	**18**	**25**	**33**	**30**
Infrastructure	10	13	13	6
Macroeconomic stability	0	8	6	7
Legal and policy frameworks	0	0	2	3
Private sector support	2	3	4	3
Human resource development	6	1	9	11
Other aid (e.g. humanitarian)	**82**	**75**	**67**	**70**

Source: Te Velde (2003)

Rationale for Offering HCMs

8. The rationale for offering HCMs is based on the following premises:

(i) FDI is good for development;

(ii) there are market and co-ordination failures which deter investment and cause social benefits of FDI to the home or host economy to be greater than the private benefits of FDI; and

(iii) HCMs can overcome such market and co-ordination failures. We concentrate on (ii) why investment does not take place, and (iii) the fact that HCMs could overcome this on the basis of the four HCM categories described above.

9. First, investment-related aid can support structural governance structures and economic fundamentals necessary for investment projects by overcoming market failures in the market for skills, technology and capital in *host*-developing countries. Increased growth (prospects) and improved fundamentals can make individual projects more profitable, helping to attract FDI. There is a more general debate as to whether aid causes growth and investment, and if so, under what circumstances (Hansen and Tarp, 2001).

10. Secondly, HCMs may reduce the risks associated with investment in developing countries. We should distinguish between economic and political risks (Moran, 2001).

Economic risks relate to uncertainties in costs and benefits of investment projects. Uncertainty can have significant negative effects on investment, when investment involves large sunk and irreversible costs and there is the option to delay the decision to make the investment until further information becomes available (Dixit and Pindyck, 1994). This would suggest that improved information about projects and demonstration effects may reduce uncertainties for foreign investors, because they are either new to the country situation or make investments that involve relatively large sunk costs. Collier and Pattillo (2000) argue that the major impediment to private investment is the perceived high level of (economic) risks.

11. *Political* risks may also deter investments, particularly in countries with frequent policy reversals. Political risks are often defined as 'threats to profitability that are the result of forces external to the industry and which involve some sort of government action or inaction' (Moran, 2001). There is a perception that political risks (of expropriation, war and breach of contract) are particularly great in sensitive sectors such as infrastructure, where investments involve large sunk costs and where host-country governments may be weak and may be forced to breach their part of the contract.

12. A foreign investor can manage political risks in a number of ways. First, it can forego the investment opportunity. Secondly, it can absorb the consequences and develop contingency plans. Thirdly, an investor can prevent a loss from political events (currency swaps etc.). Fourthly it can transfer some of the risk to other parties by joining into international alliances, in which case other parties bear not only political risk but also economic risks. Finally, it can insure against political risk provided by home countries, i.e. an HCM.

13. The third area where HCMs can stimulate FDI in developing countries is to reduce the information gap in home countries surrounding an investment abroad. Investors are alleged to suffer from a perception bias that when one country is in trouble they perceive all neighbouring countries to be so, requiring superficially high gross rates of return. In this context, it is remarkable that over the past decade profit rates on UK

and US FDI have been greater in Africa than in the world as a whole. This suggests that certain types of information could help to realise profitable opportunities, although from the raw figures it is not clear whether it needs to be tailored to sectors and investors or certain types of information such as on political risk ratings or commercial opportunities. But in principle public support could aim to overcome information-related market failures as the provision of information can have public goods aspects (it benefits many firms, while obtaining it is too costly for individual firms). The provision of information can also have spillover effects when the investment by one MNE is followed by other investment.

14. Fourth, other policies affect FDI. Trade preferences granted might make projects more profitable in certain countries, at least temporarily, though not necessarily more efficient. Tax policies can also affect locational decisions, such special home country fiscal treatment of profits on MME subsidiaries in host countries (although they would need to be WTO compliant).

Preliminary analysis of effectiveness and efficiency of UK and EU HCMs in stimulating FDI inflows into developing countries

15. There has been no systematic analysis of the effect and efficiency of HCMs. In part this is because one would need to define an indicator on which basis to assess effectiveness and efficiency. Indicators need to reflect the ultimate objective of HCMs, which can vary. They can be defined at micro or macro level, could include total FDI, or from one source, fixed capital formation, growth or poverty reduction. But even when an indicator has been selected, e.g. UK FDI, it is difficult to assess the impact of HCMs. Does one examine this on a case-by-case basis, at the macro level, in the short or long-run, etc? Does the effect differ by host-country, sector or firm? And, what is the most reliable counterfactual in the absence of an HCM? For these reasons, we argue that more detailed statistical and field analysis at country/industry/firm level is required to reach firm conclusions.

16. A preliminary analysis of UK FDI in non-OECD countries at the macro level indicates that aid *flows* are correlated with *changes* in UK FDI stocks over the period 1997-2001, that the *stock* of ECGD insurance and the stock of CDC investment are both positively correlated only with the *level* of UK FDI stocks, not *changes* casting doubt about possible demonstration effects. But analysis at micro level suggests it is more complicated. For example, the chairman of MSI Cellular, a Pan-African telephone company, argues that 'CDC was our first investor and their presence helped MSI attract both other developmental finance and private sector money from the likes of Citigroup and AIG', suggesting that there was a demonstrator effect on private capital.

17. A bank invested in offices in North Africa requiring equipment and initial capital, for which political risk insurance was purchased from ECGD. Because the bank was committed to these markets anyway, and would have invested without risk insurance, political risk insurance in this case has not led to *additional* FDI. Obviously, we should not disregard its usefulness altogether, as in this case risk insurance may have offered comfort to the investor through an efficient and preferred method of mitigating risk.

18. Another example shows that multinationals involving big FDI projects need strong (public) negotiating counterparts. BHP Billiton argued that, while multilateral finance was useful but not critical in investment going ahead, multilateral assistance has been particularly helpful in negotiation and governance issues surrounding the realisation of mega projects such as Mozal in Mozambique. This suggests that investment-related aid for general governance (managing investment flows, the negotiation process and project revenues) could be regarded as a useful HCM. The provision of information (surveys, feasibility studies) was also considered useful.

19. To reflect the heterogeneity found at the micro level, we suggest that the overall effectiveness of individual HCMs depends on:

(i) the type (finance, information, risk insurance, investment-related aid),
(ii) the sector (large sunk cost sectors vs. low-entry/exit cost sectors),

(iii) characteristics of firms involved (size, age),
(iv) motive of investor (market seeking, efficiency seeking),
(v) home country economic conditions (size, sectoral distribution),
(vi) host country economic conditions (HIPC, or access to private finance).

20. Table 3 indicates that the *type of sector* matters for the effectiveness. Some sectors are more likely to be users of certain types of HCMs. For example, CDC equity positions tend to benefit the power and financial sectors most, more so than infrastructure and agriculture. The minerals, oil and gas sector does not tend to use CDC investments very much, despite being the major sector of UK FDI in non-OECD countries. Oil and gas sectors tend to prefer larger development investors for finance such as the multilateral IFC or EIB, who may finance only a small share, but which nevertheless can bring some comfort to the investor through an important 'stamp of approval'.

21. The power and water sectors are the main users of ECGD risk insurance, partly because these sectors involve high upfront investment costs and a long payback period (with receipts in local currency running the risk of default in case of devaluation). Manufacturing and services sectors tend to involve smaller sunk costs, face less risk and require less political risk insurance. The oil and gas sectors also tend to be low users of political risk insurance, despite their importance in UK FDI stocks, suggesting that they design alternative political risk mitigation strategies. In fact, they have invested for decades and may build on that experience to mitigate risk. So, the relative importance of political risk insurance will vary by sector. Other factors behind the effectiveness of HCMs are discussed elsewhere.

Table 3: Sectors Which Use UK Home Country Measures

HCM	High-use sectors	Medium-use sectors	Low-use sectors
CDC (% of total) 2001	Power (30%) Financial Institutions (17%)	Infrastructure (11%) Agribusiness (11%) TMT (11%)	Minerals, oil and gas (7%) Consumer Goods (5%) Healthcare (3%)
OII ECGD (% of total) 2002	Power (35%) Water (30%)	Manufacturing (15%) Communications (11%)	Mining (3%) Services (3%) Oil and Gas (3%)
BTI outward mission (#) 2000-2002	Electronics and Hardware (323) Software and computer services (321) Creative and Media (200) Clothing footwear fashion (183) Engineering (171) Agriculture horticulture and fisheries (155)	Environment (153) Construction (149) Giftware (142) Infrastructure (142) Communication (139) Food & drink (138) Leisure and Tourism (132) Education and training (130) Healthcare and Medical (120) Household Goods (104) Oil and Gas (103)	Automotive (81) Textiles (77) Water (77) Power (75) Biotechnology and Pharmaceuticals (72) Chemicals (70) Fire police security (70) Aerospace (56) Business and consumer services (51) Financial Services (48) Paper printing and packaging (30) Marine (24) Aid business (12) Mining (7) Railways (3) Ports and logistics (2) Sports and Leisure infrastructure (2) Airports (1)
UK FDI stocks in non-OECD countries (% of total) 2001	Mining and quarrying incl. oil and gas (29%) Financial Services (20%) Food products (9%) Chemical products (7%)	Transport and Communications (6%) Textile, wood and printing (4%) Retail trade (4%)	Other man (4%) Metal products (1%) Electricity Gas Water and Construction (2%) Agriculture (0%) IT communications (0%) Transport equipment (1%) Hotels & Restaurants (1%)

Source: Te Velde (2003)

Preliminary Policy Implications

22. It must be noted that we do not have a complete picture of what type of HCM works where and why. Before we suggest new HCMs or argue for more of the same it would be desirable to have further work in this area. Nevertheless, some information has emerged during a preliminary analysis of HCMs:

(i) There are many HCMs in OECD countries and in the UK in particular, perhaps with different objectives, but all trying to stimulate FDI without explicit co-ordination at operational or strategic levels. This may be confusing for investors, who may not know about each individual measure. It could be considered to support one-stop shops for outward investment (similar to investment promotion agencies) to co-ordinate (the provision of) various HCMs and pulling together capabilities.

(ii) A preliminary analysis suggests that investment-related aid is positively correlated to FDI. This is supported by micro-evidence suggesting that governance related aid and information provision (surveys, feasibility studies) are considered useful. The provision of such public goods may help to reduce political and economic risks. It could thus be argued preliminary that more of this would be useful. At the same time it shows that providers of effective HCMs would need to understand country-specific conditions in (and co-ordinate with) host-countries.

(iii) Whether additional support is needed for UK HCMs to push FDI, such as provision of political risk, or pull, such as scaling-up linkage promotion schemes, should in part depend on whether existing and newly-emerging schemes in this area are achieving their aims. (see www.odi.org.uk/iedg/Publications/tnc_sme_linkage.pdf)

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