

## Chapter 10

# Foreign Direct Investment for Development and Productive Capacity Building in LDCs

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### 10.1 Introduction: objective, scope and structure

This chapter discusses Istanbul Programme of Action (IPoA)-related issues with regard to foreign direct investment (FDI) in two aspects. First, it highlights issues related to enhancing FDI flow in least developed economies (LDCs). Second, it discusses FDI in the context of enhancing productive capacity in LDCs. Thus, the purpose of this chapter is to address issues related not only to challenges for attracting FDI in LDCs, but also to challenges for channelling it into productive capacity building.

The actions set out in the IPoA with regard to FDI as a source of financial resources are based on two specific objectives: (a) to retain the existing flow of FDI and to increase it further, which will strengthen the production base, enhance diversification of production and improve productive capacity in the LDCs; and (b) to enhance initiatives to support investment in these countries. On the other hand, the actions related to enhancing productive capacity are highlighted as improving productivity and efficiency in the production system and contributing to improvement in diversity in economic activities. The seven-point goals and targets related to productive capacity building are aimed at increasing the value addition in natural resource-based industries, diversifying local productive and export capability, increasing access to telecommunication services, increasing the supply of energy, enhancing energy production capacity, developing the transport network and so on. Attaining these goals requires a huge amount of financial resources in which FDI could play a major role. However, given the limited role currently played by FDI in the LDCs, meeting those goals would not be easy.

The commitments of the IPoA have taken into account the progress made in the last decade (2001–10) when the Brussels Programme of Action (BPoA) was implemented. However, the achievement in implementing the BPoA was not very significant. Despite the limited success, a number of changes have taken place which include FDI-related governance structure, inward FDI flow and contribution of FDI to capital formation in host countries. More specifically, changes include a few large institutional reforms but, without having adequate resources, very few changes regarding policies to reduce risks and unpredictability; additionally, efforts have been made towards building supply capacity and enhancing domestic economy.<sup>2</sup> Such changes in the 2000s were the result of initiatives undertaken by LDCs and development partners to pursue the commitments of the BPoA.

Nevertheless, a number of new challenges have emerged at the end of the 2000s, particularly due to the global financial crisis, which has increased risks in non-equity investment. Consequently, there is an increasing tendency among the investors in shifting towards equity-based investment. Furthermore, the crisis has reinforced the need for improvement in the risk-based financial system through further strengthening the conditionalities of BASEL II and BASEL III. Such changes in the financial system are likely to have an impact on global FDI flow in general and FDI flow in LDCs in particular. The implementation of FDI-related actions as articulated in the IPoA needs to be strategised by taking into account the ongoing changes in the global financial system. Both LDCs and development partners should look into those changes and should try to adjust their activities on related issues to achieve IPoA targets.

The study comprises six sections. Section 10.2 reviews the literature on three questions: (a) how critical a role does FDI play in economic growth, structural changes and productive capacity building? (b) is the domestic environment of LDCs ready to attract more FDI? and (c) are various incentives, particularly tax incentives, effective in attracting FDI in developing countries and LDCs? Section 10.3 presents a critical overview on FDI-related actions mentioned in the IPoA and identifies major differences in the actions between BPoA and IPoA. Section 10.4 discusses dynamics and changes in the structure of domestic investment in LDCs during 2001–10, particularly the inward flow of FDI and its contribution to capital formation. Changes in the structure of FDI during the 2000s are reviewed from the perspective of implementing the BPoA. This section also highlights the current state of progress in various aspects of productive capacity including infrastructure, energy and information and communication technology (ICT). An econometric exercise has been carried out in Section 10.5 in order to examine which factors are responsible for FDI inflow to LDCs, which helps us to understand the strategising of various actions articulated in the IPoA. Section 10.6 discusses possible measurable indicators for enhancing FDI and its contribution to productive capacity building and other matters. Section 10.7 briefly discusses challenges for implementing IPoA in terms of both generation of resources and productive capacity building. Finally, a set of suggestions is put forward in Section 10.8 for LDCs and development partners in order to ensure effective implementation of the FDI-related actions mentioned in the IPoA, which would enhance the flow of FDI during the 2010s.

## 10.2 Literature review

### 10.2.1 How critical a role does FDI play in economic growth, structural changes and productive capacity building?

The literature shows that FDI could be an important source for financial resources, new technologies and know-how, research and development for the host country. It contributes accumulation of capital in developing countries and it plays a vital role in enhancing investment, tax revenue and reserve of foreign exchange in the developing countries (Smith 1997; Quazi 2007). FDI has a significant effect on host country exports and employment because it establishes foreign affiliations which

increase the foreign market share and exports of intermediate products to affiliates (Stobaugh 1972; Vahlne 1981). However, there are debates over the net contribution of FDI in the host countries when repatriation of profit, dividend and other incomes from foreign-owned firms are found to be significantly high (Bhattacharya 2004).

The impact of FDI could be more visible in the medium to long term if it ensured 'spillover' effects through transfer of technology, introduction of new processes, productivity gains and opening of new market opportunities (Alfaro et al. 2004; Egwaikhide et al. 2005; Dupasquier and Osakwe 2006; Grossman and Helpman 1995; Barro and Sala-Martin 1997). Findlay (1978) and Wang and Blomstrom (1992) found that FDI, through 'contagion' and 'knowledge diffusion' from the advanced technologies in parent countries, could contribute technological progress in the host countries.

Impact at the sectoral level through FDI has been observed in a number of studies. Sen (2009) found that FDI in India has major positive effects on the capital-intensive manufacturing sector but less so in the case of the labour-intensive manufacturing sector. Pradhan (2006) explained the transformation of the service sector by FDI over time in India – from hotels and restaurants, finance and marketing segments in the 1970s to software services in the 1990s. Liu and Daly (2011) found that over the period 1997–2008 China experienced a transition in FDI-related activities by moving from a traditional low-technology to a high-technology manufacturing environment.

A number of authors, however, found a limited role of FDI in host countries' economic growth and productive capacity building. Aitken and Harrison (1999) found an insignificant effect of FDI on firm-level productivity. Green and Cunnigham (1975), Schneider and Frey (1985) and Nigh (1985) showed a negligible effect of FDI on economic growth. A number of studies on host countries found similar results (Balasubramanyam et al. 1996; Borensztein et al. 1998; Carkovic and Levine 2002). There is even evidence of negative correlation between FDI and economic growth (Blomstrom et al. 1992). UNCTAD (2001) argues that the extent of linkages between foreign affiliates and local suppliers determines the level of impact in different sectors – in the primary sector such linkages are rather limited, whereas linkages are high in the manufacturing sector. Kokko (1994) explained that spillovers may not take place in industries that are 'enclave' in nature. Hirschman (1958) and Alfaro et al. (2004) argued that not all sectors may have a similar level of absorption potential for foreign technology. Owing to limited absorption capacity in the primary sector, the spillover effect of FDI is rather less than in the manufacturing sector, which has a high absorption capacity. Similar findings came out from the studies by Borensztein et al. (1998) and Carkovic and Levine (2002). Poor absorption capacity of LDCs indicates limited capacity to accumulate new and modern state-of-the-art technologies, which become weaknesses and have to be upgraded to and caught up with. Improving the absorptive capacity requires a strong facilitating role of intermediate organisations to ensure technological knowledge transfer to potential institutions of public and private sectors. Rodríguez-Clare (1996) showed that the efficiency of production develops in host countries for intensive use of intermediate goods by multinationals.

Several studies have pointed out some prerequisites for a positive effect of FDI on economic growth and productive capacity building. Durham (2004), Blomstrom

et al. (1992), Borensztein et al. (1998) and Balasubramanyam et al. (1996) demonstrated that at the initial level of development the host country's human power and trade policy are the main factors for appreciating the positive impact of FDI. Borensztein et al. (1998) indicate that a trained and educated labour force is the key element for a positive effect of FDI in the host country (Adeniyi et al. 2012). Well-developed physical infrastructure of the host country also has a positive effect on FDI inflow (Cheng and Kwan 2000), which is observed in the case of FDI inflow in China and in developing countries (Mengistu and Adams 2007; Cotton and Ramachandran 2001), emerging economies (Zhang 2001), western Balkan countries (Kersan-Skabic and Orlic 2007) and southeast European countries (Botrić and Škuflić 2006). Maskus (2000) emphasises that the impact of FDI will be negligible for the host country without the protection of intellectual property rights of foreign companies. A number of non-conventional factors are found to be responsible for the low level of FDI in LDCs; these include remoteness, indebtedness and export of minerals, etc., as discussed above.

The literature has found different kinds of impact of FDI on the host country – from both positive and significant to even a negative impact. In this context, examining and understanding the nature of contribution of FDI for the development of LDCs is important.

### 10.2.2 Is the domestic business environment of LDCs ready to attract more FDI?

Locational choice in FDI is influenced by different kinds of factors. Strong positive correlation is usually evident in a number of variables related to the economic condition of the host country such as size of the economy, economic growth, macroeconomic stability, trade openness, less indebtedness and low cost of capital (Addison and Heshmati 2003). Factors related to the overall economic condition of the host country such as population, remoteness, war and degree of democracy have influenced the FDI flow in many countries (Feng 2001; Brunetti et al. 1997). A number of other factors are considered to be important for attracting FDI; these are usually called 'country assets', which include the educational standard, exports of fuel, ores and metals, infrastructure and technological readiness (Cheng and Kwan 2000). Studies on developing countries (Mengistu and Adams 2007; Cotton and Ramachandran 2001), emerging economies (Zhang 2001), western Balkan countries (Kersan-Skabic and Orlic 2007) and southeast European countries (Botrić and Škuflić 2006) reveal a significant positive role of well-developed infrastructure in attracting FDI. The gap in technological abilities between multinational enterprises (MNEs) and local firms is also considered a major factor in the investment decision of MNEs (Dunning and Zhang 2008).

Many studies have pointed out the negative impact of a high level of corruption and a low level of transparency as constraining factors for a higher level of FDI inflow (Voyer and Beamish 2004; Zhao and Du 2003; Habib and Zurawicki 2002; Kersan-Skabic and Orlic 2007). In addition, ensuring property rights was found to be a determining factor in a few cases (Fedderke and Romm 2006; Kapuria-Foreman 2007). An underdeveloped justice system is also said to be one of the critical factors

in influencing capital inflows in developing countries (Wheeler and Mody 1992; Dumludag 2009). An underdeveloped legal system fails to deliver adequate support to private foreign investors (Li and Filer 2007).<sup>3</sup> The inability to enforce contracts and collect debt has a profound effect on private sector development as well as on FDIs, as it erodes investors' confidence and threatens the security of their assets and/or investments (Dumludag 2009). The above discussion shows that the impact of various factors is not the same for all LDCs, particularly because of their heterogeneity in terms of their state of development on different economic issues.

### 10.2.3 How effective are tax provisions and regulatory issues in attracting FDI?

Different studies have found a mixed impact of tax incentives on FDI; more specifically, tax incentives are not the most influential factor for selecting investment locations by foreign companies. Tax incentives are weak instruments for compensating negative factors in a country's investment climate (World Bank 2004). In contrast, FDI financed by retained earnings and external funds is more strongly influenced by the host country's tax rates (Hartman 1984; Boskin and Gale 1987).

Tax incentives and exemptions sometimes create additional costs as tax authorities find it difficult to sort out the 'positive externalities' of investments and thereby fail to determine the exact level of tax incentives required to attract the investors (Morisset and Pirnia n.d.). An important tax incentive is investment tax allowances, which have limitations and drawbacks for projects with long gestation periods and unsound macroeconomic frameworks. Furthermore, these tax incentives impose management difficulties for tax administration and they also require well-developed accounting systems (World Bank 2004). Sometimes these excessive processes have had adverse effects, particularly when the purpose is to attain sustainable, high value added investment projects.

The majority of countries make agreements on preferential tax treatment for encouraging the value of capital held by enterprises, provided the capital is held over a fixed period of time. Preferential tax treatment of long-term capital gains is intended to encourage investors to retain funds for a longer period. Most of the tax incentives for FDI granted by developing countries go to manufacturing, exploration and extraction of mineral reserves, promotion of export and, increasingly, the tourism and leisure sectors (UNCTAD 2000). According to OECD (2002), the legal framework for investment is insufficient unless implemented and backed up by effective institutions and regulatory bodies independent of political pressure and protected from arbitrariness.

## 10.3 Istanbul Programme of Action (IPoA): a critical overview on FDI-related issues

This section discusses FDI-related actions of IPoA on two accounts: first, actions related to attracting more FDI to LDCs and, second, actions targeted at economic activities for productive capacity building.

### 10.3.1 Attracting more FDI in LDCs

The IPoA Declaration has highlighted the rise in FDI flow in LDCs during the 2000s but at the same time it is critical about FDI's limited contribution in capital formation and economic growth in these countries. More importantly, FDI inflow has remained concentrated in a few sectors (resource extracting sectors) and a limited number of locations (a few African countries), which limits the role of FDI in economic growth in the LDCs. Despite the target to raise the investment/ gross domestic product (GDP) ratio in LDCs to above 25 per cent by 2010, only 11 LDCs – Equatorial Guinea, Bhutan, Nepal, Chad, Senegal, Mauritania, Afghanistan, Liberia, Malawi, Burkina Faso and Haiti – have reached that level during that time.

FDI is considered as one of the major instruments for mobilising financial resources for LDCs, along with a number of other means such as domestic resource mobilisation, official development assistance (ODA), external debt relief and remittances. As analysed earlier, the broader role of FDI in the process of economic growth has been realised very insignificantly during the last two decades. Hence, actions are required to attract FDI in such a manner that it necessarily makes a visible contribution to economic growth in LDCs. Against this backdrop, IPoA set a two-pronged approach for enhanced flow of FDI into LDCs: (a) attracting new investment and retaining the existing FDI with the aim of diversifying the production base and enhancing productive capacity in LDCs; and (b) enhancing initiatives from development partners to support investment in LDCs (Table 10.1). Additionally, there is a wide gap in the objectives and targets of LDCs and development partners in terms of FDI flow; often outward flow of FDI from developed and developing countries targets those locations which could maximise returns on their investments, have strategic importance and have locational advantages, and most of those targets have little link with the objectives of the LDCs. Thus, bridging the two entities (i.e. sources and destinations) by matching their objectives require initiatives from both ends.

**Major attributes of FDI-related issues in the IPoA:** A total of eight actions are suggested in the IPoA to enhance FDI flow to LDCs. Of these eight actions, one should be implemented jointly, three actions are to be implemented by LDCs and four actions by development partners. Taking into cognizance the lack of implementation of various commitments made in the BPoA, particularly those related to development of a legal and institutional framework, IPoA continues to put emphasis on these issues. A joint action will be pursued for promoting a strategic and regulatory framework for FDI in the case of agriculture and rural development, particularly in policy areas such as infrastructure development, trade and trade facilitation, research and development of transfer technology.

Actions to be pursued by LDCs are of two kinds. One kind of action is to continue earlier initiatives, particularly strengthening the national policy and regulatory framework, and the second one is to identify priority areas, assessing the investment needs and improving the role of investment promotion agencies in providing better support to existing FDIs and promoting new ones. In the case of development partners, there are again two kinds of actions. The first of these is to undertake home country measures in terms of creating special funds which will contribute

**Table 10.1 Major actions on FDI in the IPoA**

<b>Actions</b>	
Joint actions	a. Promote strategic and regulatory frameworks for foreign direct investment and other resource flows in this sector that include vital policy areas such as infrastructure development, trade and trade facilitation, research and development and transfer of technology
Action by least developed countries	<p>b. Continue strengthening the national policy and regulatory framework for stimulating foreign investment in productive sectors, by, inter alia, removing barriers to investment, securing contract enforcement and promoting respect for property rights, strengthening equitable and efficient taxation systems and providing accurate information about investment conditions and opportunities in least developed countries, and promote public-private partnership in this respect;</p> <p>c. Identify priority areas for investment and assess domestic capacity, resources and the extent of international investment and support needed;</p> <p>d. Establish a one-window facility for registration and oversight of new and existing foreign direct investment and other external financial flows, along with necessary institutional infrastructure</p>
Action by development partners	<p>a. Set up and strengthen, as appropriate, initiatives to support investment in least developed countries such as insurance, guarantees and preferential financing programmes and private enterprise funds for investment in least developed countries, focusing in particular on sectors that are needed to build up a diversified production base and encourage linkages with domestic production activities as well as employment creation;</p> <p>b. Support capacity-building in least developed countries, and at the regional level, as appropriate, aimed at improving their abilities to attract foreign direct investment, including the ability to negotiate mutually beneficial investment agreements and disseminate information about investment opportunities in least developed countries;</p> <p>c. Support and implement initiatives aimed at encouraging investment in least developed countries, such as export credits, risk management tools, co-financing, venture capital and other lending instruments, business development services and feasibility studies;</p> <p>d. Strengthen partnership programmes for technology transfer under mutually agreed terms by fostering linkages between foreign and domestic firms</p>

**Source:** Based on IPoA

to diversification of the economy, and to offer other support measures to mitigate risks and provide preferential credit and non-financial business support; this support would facilitate foreign investors at both pre-establishment and post-establishment phases of investment. Second, given the limited contribution of FDI in technology transfer, actions have been set to strengthen partnership programmes for technology transfer under mutually agreed terms and conditions.

### 10.3.2 FDI in productive capacity building

IPoA has put the highest emphasis on enhancing productive capacity of LDCs as it identifies 'limited productive capacities as the major constraints in LDCs' ability to produce efficiently and effectively and to diversify their economies'. The IPoA has set specific strategies to address the broader goals, which include a significant rise of value addition in natural resource-based industries, diversifying local productive and export capability, a significant increase in access to telecommunication services, striving to increase primary energy, a significant increase in the share of electricity generation through renewable energy, enhancing capacity in energy production, trade and distribution, and a significant increase in physical connectivity. Various aspects of productive capacity are covered under variables comprising infrastructure, energy, science, technology and innovation, and private sector development. Annex 10.1 presents various actions related to productive capacity building.

#### *Major attributes of IPoA*

Given the limited flow of FDI in LDCs, various actions related to FDI for enhancing productive capacity as articulated in the IPoA would be considered to be relevant only when the expected level of FDI flow to LDCs could be ensured.

In the case of infrastructure building, LDCs and development partners have committed to pursue ten actions (five actions by LDCs, four by development partners and one by joint action), of which eight seem to be relevant for FDI. LDCs have committed to take action to build their ICT infrastructure, expand broadband connectivity and improve bilateral, regional and sub-regional connectivity. On the other hand, development partners have committed to take action on technical and financial support for infrastructure development, support for technology transfer and higher flow of FDI, including investment under public-private partnership in infrastructure building projects. Implementation of a number of these actions may need financial support from development partners in addition to a rise in FDI.

In the case of energy sector development, a total of four actions committed by two sides (one action by LDCs and three by development partners) seem to be relevant with regard to FDI. Actions by LDCs include expansion of energy generation capacity by putting emphasis on renewable energy, while actions by development partners include technical and financial support for building power and energy infrastructure, support for appropriate and affordable technology transfer, and so on.

In the case of science, technology and innovation, a total of four actions is committed by LDCs and development partners – one joint action and three actions by LDCs. The joint action is to establish a technology bank and an information-supporting mechanism. On the other hand, actions committed by LDCs include investment to promote innovation and facilitate innovative activities in co-operation with private sector research organisations and other bodies.

In the case of private sector development, major actions are related to ensuring an enabling environment for investment in LDCs and ensuring availability of financial resources to invest across the sectors. In this context, development partners are

expected to take action through providing financial resources and transferring modern technologies to LDCs.

### 10.3.3 Differences between BPoA and IPoA on FDI-related actions

The programme of action related to FDI as stipulated in the IPoA has a number of distinctive features. First, the actions committed to in the IPoA would be regarded as the 'next' step of the BPoA. If BPoA is regarded as the baseline for strengthening actions on regulatory, infrastructure, human resource and capacity-building issues, IPoA would be considered as the 'next' step of those actions. In this regard, IPoA is a step forward from the BPoA. But the role of FDI as articulated in the IPoA indicates a somewhat narrower scope than what was mentioned for FDI in the BPoA. Unlike the limited set of actions mentioned in the IPoA, the actions in the BPoA were widened both within the area of resource mobilisation and in other areas such as physical infrastructure development, trade and trade facilitation and enterprise development. This is also reflected in the differences in the number of actions between BPoA and IPoA. In BPoA the total number of actions related to FDI was 16, of which 6 were to be implemented by LDCs and the other 10 by developing countries. In contrast, IPoA included eight actions only; of which one will be implemented jointly, three by LDCs and the other four by development partners.

However, the actions to be implemented under the IPoA are more specific. A major criticism of the actions suggested in BPoA was their lack of clarity and specificity of actions to be undertaken by LDCs and development partners. In that respect, actions in IPoA are more specific and clear, both for the LDCs and for the development partners. Most of the actions in the IPoA to be taken by LDCs put emphasis on strengthening national rules and regulations regarding contract enforcement, property rights and the taxation system. Other major actions include establishment of one window facility, identification of suitable investment opportunities including public-private partnership (PPP) projects, and assessment of domestic capacity, resources and the extent of international investment and support needed. In the case of development partners, FDIs have been encouraged through specific support facilities such as insurance, guarantees and preferential financing programmes and private enterprise funding. A number of other measures are also suggested, including export credits, risk management tools, co-financing, venture capital, other lending instruments, business development services and feasibility studies.

The approach to facilitating FDI through supplementary actions has changed in the IPoA. In BPoA, supplementary actions were related to non-market initiatives such as strategising aid-supported programmes to enhance FDI. In contrast, supplementary actions in IPoA are focused more on market-based approaches such as providing financial and non-financial benefits at pre- and post-establishment phases. Still, a number of actions mentioned in the IPoA seem to be non-measurable.

Regarding productive capacity building in LDCs, little difference is observed between the commitments made in the BPoA and the IPoA. However, targets, strategies and actions have been more specific in the IPoA. The scope of productive capacity building has been widened in the IPoA, covering issues related to ICT on a broader

**Table 10.2 Structure of the economy of LDCs during the 2000s**

	2000	2005	2009	2010	2011
GDP (current billion USD)	181	317	552	616	680
GDP growth (annual %)	4.5	7.2	5.0	6.0	4.0
Gross national income per capita, PPP (USD)	774	1,052	1,158	1,231	1,318
GDP share (%)					
Agriculture	33	28	25	23	
Industry	24	27	27	28	
Services	44	45	48	49	
Gross capital formation (% of GDP)	20	23	24	23	25

**Source:** WDI database 2012, (available at: <http://data.worldbank.org/data-catalog/world-development-indicators>)

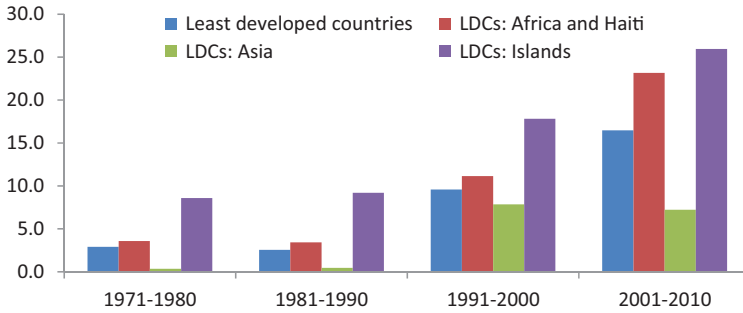
scale, inclusion of activities targeted at promoting agro-based industries and the tourism sector, etc. The actions related to the development partners have advanced further from a dialogue-based approach towards one based on physical and financial support. Technology transfer to the LDCs has been re-emphasised, with more specific actions to be taken by the development partners.

## 10.4 Domestic investment and FDI flow in LDCs during the 2000s

### 10.4.1 Economic growth and domestic private investment in LDCs during the 2000s

Most LDCs have experienced a moderate level of economic growth during the 2000s, although that growth was not consistent, particularly in the second half, mainly because of the global financial crisis in 2008 and the consequent economic slowdown in the developed countries (Table 10.2). Average GDP growth in LDCs was at its peak in 2005 (7.2 per cent), decelerating in 2010 (6 per cent) and continuing to decelerate afterwards. Asian LDCs were affected more than African LDCs by the crisis (0.66 per cent of GDP in Asian LDCs v.0.13 per cent in African LDCs), mainly because of strong linkages of Asian LDCs with the global economies (Bhattacharya and Dasgupta 2013). Most of the LDCs have experienced structural transformation, with a rising share of industries and services included in the GDP.

The rise in LDCs' GDP during the 2000s was contributed to by a gradual rise in domestic investment. The investment/GDP ratio has accelerated to 19.9 per cent of GDP in the 2000s against 17.1 per cent in the 1990s and 16.1 per cent in the 1980s. This rise in investment is, however, far below the required level of investment for attaining targeted GDP growth. African LDCs made limited progress in capital formation during the 2000s – gross fixed capital formation (GFCF) was 18.7 per cent in the 2000s versus 15 per cent in the 1980s. It still lagged behind that of Asian LDCs (21.6 per cent of GDP). Island LDCs have maintained a high rate of GFCF (27.5 per cent of GDP). Most of the formation of capital has been caused by the rise in domestic savings, particularly in African LDCs. Domestic savings as a share in GDP

**Figure 10.1 FDI in GFCF in LDCs: 1970–2010**

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

have doubled in the 2000s – from less than 8 per cent of GDP in the 1990s to over 16 per cent. A rise in external resources, including FDI, has partly contributed to this rise in investment. Figure 10.1 shows FDI's share in GFCF since the 1970s. FDI's contribution to the formation of capital in LDCs has increased during this period, mainly due to a large volume of FDI flow to African LDCs (20.5 per cent of GFCF in Africa and Haiti v. 16.9 per cent in Asia during 2001–07).

#### 10.4.2 Structure and trends of FDI inflow in the 2000s

##### *Global FDI flow and share of LDCs*

The global FDI flow has registered a considerable rise during the 2000s, although it was adversely affected by the global financial crisis and subsequent economic slowdown. Inward FDI flow has reached USD 1.5 trillion in 2011, up from USD 817.8 billion in 2001. Between 2007 and 2008, FDI flow to LDCs has experienced different kinds of changes: about half of the LDCs experienced positive growth in 2006, with 23 LDCs experiencing growth over 5 per cent and the other two less than 5 per cent; while the other half of LDCs have experienced negative growth, with 17 experiencing a negative growth above 5 per cent and the remaining six LDCs less than 5 per cent. The share of FDI flow to developing countries has significantly increased, which changed the ratio between developing countries and LDCs from 73:27 in 2001 to 49:44 in 2011. The rising share of LDCs in the overall FDI inflow during this period has not been sustained since the crisis, although FDI flow to LDCs has significantly increased – from USD 7.2 billion in 2001 to USD 15.0 billion in 2011 at a yearly growth rate of 7 per cent (Table 10.3).

Because of the global financial crisis, growth of FDI flow to LDCs has declined by 15.6 per cent in 2008, and this trend continued afterwards (39.0 per cent). According to UNCTAD (2009), FDI flow to LDCs is likely to decline over the next few years because of continued adverse pressure on host and home economies. This has a direct impact on the businesses of MNEs in the form of (a) lower expectation of profitability; (b) reduced access to credit for financing new investments; and (c) balance sheet consolidation by MNEs in the face of financial pressure (Waeyenberge and Powell

**Table 10.3 Inward flow of FDI to major regions, 2001–08**

Region	2001	2005	2007	2008	2010	2011	Average yearly growth (2001–11)
Global FDI flow (million USD)	817,833.8	958,232.8	1,913,709.2	1,616,090.5	1,309,001.3	1,524,422.2	6.0
Developed countries	595,266.0	613,053.1	1,358,627.7	962,259.2	618,586.1	747,860.0	2.0
Developing countries	215,439.0	329,327.8	529,344.2	620,733.3	616,660.7	684,399.3	12.3
LDCs	7,128.8	15,851.9	25,737.3	33,098.5	16,899.2	15,010.9	7.2
% of global FDI inflow							
Developed countries	72.8	63.9	70.9	59.5	47.3	49.1	
Developing countries	26.3	34.4	27.7	38.4	47.1	44.9	
LDCs	0.87	1.7	1.3	2.1	1.3	0.9	

**Source:** Based on UNCTAD database

2010). In view of continued volatility in the prices of oil and minerals, investment in natural resource extraction is expected to slow down in the coming years. This may reduce the prospect of a large volume of FDI being targeted to LDCs engaged in oil exporting and mineral resource extraction (UNCTAD, 2009). Distribution of FDI flow to LDCs

Despite the rise in FDI flow to LDCs in the 2000s, its distribution is still narrow and undiversified both at intra- and inter-regional levels (African LDCs v. Asian LDCs) (Table 10.4). Compared with the 1990s, FDI inflow has further concentrated to African LDCs in the 2000s. The distribution of FDI flow between African and Asian LDCs in 2000–11 was 80:18, against that of 67:33 in the 1990s. Reduction of the share of FDI to Asian LDCs is mainly because of reduction of the comparative advantage of Asian LDCs, particularly in the manufacturing sector, in terms of preferential market access to the developed countries in the 2000s (Rahman and Moazzem 2010). The benefit of preferential market access enjoyed by manufacturing products of LDCs in the 1990s has gradually eroded in the 2000s due to liberalisation of the trade regime. FDI inflow within Africa has further concentrated to a limited number of countries, including Angola, Equatorial Guinea, Sudan and Zambia, mostly oil-exporting countries, received about 63.3 per cent of total FDI flow to LDCs in 2011 (against their comparable share of 57.6 per cent in 2000) (Figure 10.2). Low investment in the manufacturing sector in Africa is mainly because of lack of a political stability, lack of availability of skilled workers, and the subsequent low return from investment. Although FDI inflow to Asia doubled between 2000 and 2008, its share in total FDI flow to LDCs has substantially declined compared with the 1990s (11.3 per cent in 2001–08 against 33.3 per cent in the 1990s).

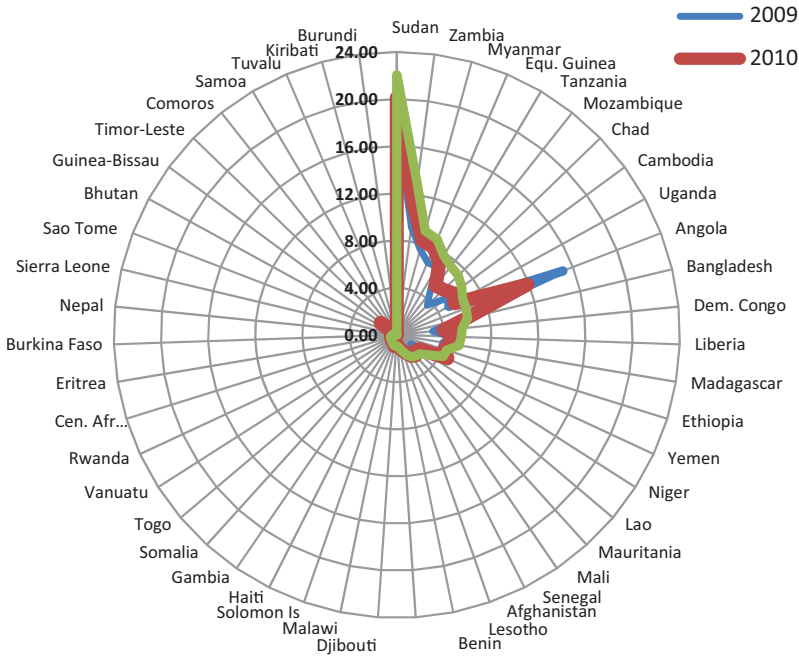
FDI stock has, like FDI flow, remained highly undiversified at the end of the 2000s. Resource-seeking FDI has accounted for the majority of FDI's share of total FDI stock to LDCs and has been mainly located in Africa (Figures 10.3 and 10.4). Unlike in other regions, African LDCs have poor resource governance, which might make the investment cheaper because conditions become loose (UN-OHRLLS 2010). Within resource-seeking FDI, the major share has shifted from mineral-exporting to oil-exporting countries (Figure 10.3). MNEs have tended to favour oil and mineral resource industries in their FDI decisions because of their high profitability and

**Table 10.4 Inward FDI flows, by host region and economy, 1981–2011**

	Average annual inflow (million USD)			Share of LDC inflow (%)			Share of global inflow (%)		
	1981– 90	1991– 2000	2001– 11	1981– 90	1991– 2000	2001– 10	1981– 90	1991– 2000	2001– 11
LDCs	510	2,878	12,337	100.0	100.0	100.0	0.47	0.56	1.04
Africa and Haiti	465	1,920	9,885.1	91.2	66.7	80.2	0.44	0.37	0.84
Asia	45	958	2295.0	8.9	33.3	18.6	0.04	0.18	0.19

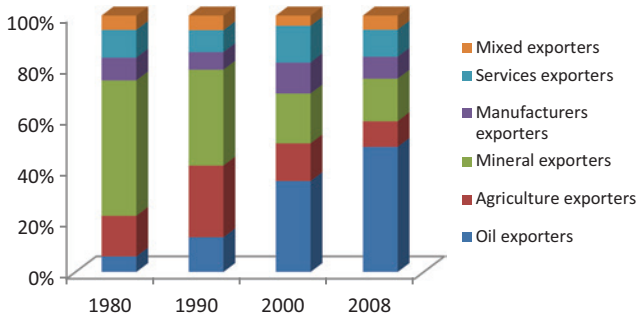
**Source:** Based on UNCTAD database

**Figure 10.2 Concentration of FDI in LDCs**



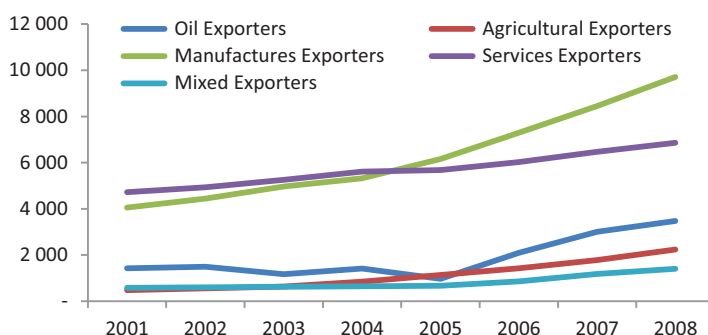
Source: Based on UNCTAD database

**Figure 10.3 Distribution of FDI stock**



Source: Based on UNCTAD database

strategic importance, and they have not expanded their industries beyond these sectors (UNCTAD 2007). Efficiency-seeking FDI, on the other hand, received a low share in total FDI flow in 2010 compared with that in the 1990s and 1980s. The share of FDI inflow going to the LDCs with the smallest economies declined between 2000 and 2010 – from 1.92 per cent of total LDCs’ share in 2000 to 1.04 per cent in 2011 (Table 10.5). The locational disadvantages of these economies have remained and are regarded as ‘natural constraints’ for landlocked countries (such as Nepal, Bhutan and Central African Republic), island states (such as Vanuatu, Tuvalu, Kiribati, Samoa and Comoros), and small-size economies (such as Vanuatu, Kiribati, Guinea-Bissau,

**Figure 10.4 FDI stock in Asia**

**Source:** Based on UNCTAD database

Comoros, Samoa and Timor-Leste). LDCs without a large domestic market and with poor endowments of natural resources are also less likely to attract more FDI (Cleeve 2008; Nunnenkamp 2004; Musila and Sigue 2006).

According to UNIDO (2007), most of the investment outside oil and mineral resources is largely targeted at domestic markets, whereas regional markets have got little attention in terms of the sales strategies of investors. The nature of involvement in the domestic market-oriented tertiary sectors is largely attributed to marketing and sales and financial intermediation, where the scope of employment is relatively high for skilled workers and professionals and relatively low for unskilled workers. Among the modes of investment, reinvested earnings comprise a major share of FDI in the case of oil-exporting countries, because of the requirement for long-term investment in mining and extraction. Within the backdrop of global trade liberalisation, the high level of trade integration of Asian LDCs has not been of much benefit to them. Overall investment in the manufacturing sector of Asian LDCs did not gain momentum in the 2000s because of a number of factors such as the deceleration of the margin of preferences owing to gradual trade liberalisation in the markets of developed countries, the end of the quota facility in 2005 for the export of

**Table 10.5 Inward FDI flow in LDCs**

Measures	Economy/year	2001	2008	2009	2010	2011
FDI inflow (million USD)	Africa and Haiti	6,216.9	13,418.6	15,313.8	13,858.8	11,935.7
	Asia	876.8	4,762.0	2,783.0	2,699.6	2,808.1
	Islands	13.8	316.2	245.7	340.8	267.1
	Total	7,107.5	18,496.8	18,342.5	16,899.2	15,010.9
Share of LDCs	Africa and Haiti	87.5	72.5	83.5	82.0	79.5
	Asia	12.3	25.7	15.2	16.0	18.7
	Islands	0.2	1.7	1.3	2.0	1.8
Percentage of GDP	Africa and Haiti	5.8	3.7	4.4	3.6	2.8
	Asia	1.1	2.7	1.4	1.2	1.1
	Islands	1.2	9.9	7.4	9.2	6.1

**Source:** UNCTAD database, different years

apparel, uncertainty over new initiatives for preferential market access for LDCs in the USA and the revision of the US–GSP scheme. However, since Asian countries are largely exporters of manufactures and services, a rise in investment in these sectors is likely to have a better developmental impact because of relatively better linkage and employment effects.

Overall, FDI-led industries in LDCs are often found to be ‘enclave’ in nature. This means they have limited backward and forward linkages, are largely capital intensive, are based on imported materials, have a limited scope for employment generation, and largely export unprocessed materials. Additionally, these ventures are usually wholly owned by foreign investors and a large share of their foreign exchange earnings is held abroad, and channels for knowledge circulation between foreign and local companies are highly limited (UNCTAD 2007). Additionally, opportunities for strengthening linkages are limited because of low resource commitment of FDI, lack of long-term investments, and production and export of a narrow range of highly specified low-value-added products (Yamin and Sinkovics 2009).

#### *Sources of FDI*

Although developed countries were the major sources of FDI in African LDCs during the 2000s, developing countries, including India, Malaysia, China and Pakistan, have become increasingly visible as sources of FDI to many African LDCs. The outward flow of FDI from developing countries has significantly increased in the 2000s (from USD 36.5 billion in 2001 to USD 383.8 billion in 2011), part of which is targeted at strategic sectors of many African LDCs. Intra-regional investment in Africa is not so high, despite a number of regional trade and investment agreements currently in operation. Regional investors have limited interest in utilising preferential market access for export which is provided under different regional trade agreements (RTAs).

Although developed countries are the major sources of FDI for most of the Asian LDCs, developing countries are increasingly becoming important there. Considering the kinds of developmental needs of the LDCs, the growing investment from the South in low-technology and labour-intensive industries in Asia is likely to make significant contribution.

#### **10.4.3 State of productive capacity in LDCs during the 2000s**

Infrastructure development in LDCs has been emphasised through both traditional and non-traditional modes of infrastructure (e.g. ICT-related infrastructures). Although infrastructures in LDCs as a group, as well as in individual countries, are far behind those of developing and developed countries, there are signs of improvement in ICT infrastructure in LDCs during 2001–11 (Table 10.6). This is reflected in terms of rise in fixed broadband internet subscribers, import of ICT goods, availability of secure internet servers and number of telephone lines and other means of communication. In general, more FDI is needed to develop the infrastructure of LDCs.

**Table 10.6 State of ICT and telecommunication sector in LDCs**

Indicator name	2001	2005	2008	2009	2010	2011
Fixed broadband internet subscribers	36	30,678	293,469	356,445	553,890	739,054
Fixed broadband internet subscribers (per 100 people)	0.0000	0.0041	0.0371	0.0478	0.0679	0.0936
Secure internet servers		94	244	336	480	668
Secure internet servers (per 1 million people)		0.18	0.34	0.43	0.60	0.81
Telephone lines	3,940,416	6,340,812	7,555,750	8,329,052	8,314,931	
Telephone lines (per 100 people)	0.58	0.85	0.95	0.99	1.07	1.10

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

With the rise in demand for energy, LDCs have put emphasis on both generation and import of energy during the 2000s. While energy production has almost doubled during the last decade, import of energy has simultaneously increased (Table 10.7). Energy production is overwhelmingly dependent upon non-renewable sources such as oil, gas and coal, and their share in total electricity production, instead of reducing, has further increased. Despite various efforts undertaken to reduce losses in electricity transmission and distribution, the proportion of losses is still very high (15.4 per cent in 2001, reducing to 12.0 per cent in 2011). Efforts have been made to increase electricity production by using renewable sources; however, the share of renewables is still at a very low level and has not changed much during the last decade. Overall, LDCs should continue to look for more investment, particularly FDI, for the development of their energy sector.

LDCs are far behind in technological development due to lack of investment in generation of scientific knowledge and promotion of research. Little information is available on technological development in LDCs. During the 2000s, little improvement was discerned with regard to development of science and technology in LDCs, which is reflected in a number of indicators such as the number of scientific and technical journal articles (Table 10.8).

A weak business-enabling environment is a major challenge for enhancing investment in LDCs (Table 10.9). Most LDCs are burdened with various challenges related to the business environment, which include the long time required to start a business and get an electricity connection, the long lead time for international trade, the delay in paying taxes, enforcing contracts, building warehouses and so on. During 2005–11, considerable improvement was discerned in respect of time to start a business and

**Table 10.7 State of energy sector in LDCs**

Indicator name	2001	2005	2008	2009	2010
Energy imports, net (% of energy use)	-36.70	-49.99	-60.68	-55.54	-54.26
Energy production (kt of oil equivalent)	259,791.3	326,754.8	401,467.3	403,269.1	412,118.0
Electricity production (million kWh)	85,923.1	113,369.7	138,062.6	150,113.8	161,781.3
Electric power transmission and distribution losses (% of output)	15.4	14.9	13.5	12.3	12.0
Electric power transmission and distribution losses (million kWh)	10,191.0	12,983.0	14,385.0	14,171.0	14,932.0
Electricity production from oil, gas and coal sources (% of total)	32.9	36.9	39.4	38.1	39.0
Electricity production from renewable sources (million kWh)	37,651.0	45,159.0	51,770.0	58,194.0	61,272.0
Electricity production from renewable sources, excluding hydroelectric (% of total)	0.1	0.1	0.1	0.1	0.1
Electricity production from renewable sources, excluding hydroelectric (million kWh)	66.0	73.0	72.0	103.0	101.0

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

**Table 10.8 State of science and technology in LDCs**

Indicator name	2001	2005	2008	2009
Scientific and technical journal articles	874.0	1,076.6	1,265.1	1,398.9
Tertiary education, teachers (% female)	20.5	19.9	20.7	20.4
High-technology exports (% of manufactured exports)	1.4			

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

**Table 10.9 State of business enabling environment**

Time required	2005	2008	2009	2010	2011	2012
Start a business (days)	67.6	53.3	50.2	45.4	35.7	33.8
Get electricity (days)			167.2	140.4	138.6	135.9
Export (days)	40.4	36.4	35.0	33.8	32.9	32.5
Import (days)	48.2	40.8	39.2	38.2	37.2	36.8
Prepare and pay taxes (hours)	314.6	294.3	274.9	277.2	279.7	282.2
Enforce a contract (days)	721.1	719.3	703.7	699.1	695.9	690.6
Register property (days)	142.6	118.6	111.0	98.1	94.9	93.8
Build a warehouse (days)	252.1	246.8	228.5	222.2	216.4	216.2

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

time to register property, while marginal improvement has taken place in getting an electricity connection, improving time to export and import and enforcing a contract.

IPoA has put emphasis on development of the sustainable tourism sector with the support of development partners in building infrastructure and human capital. A number of indicators show improvement in the tourism sector in LDCs; these include travel services as a share of commercial export, number of arrivals of international tourists and related matters (Table 10.10). In contrast, export receipts from the tourism sector as a percentage of total exports declined during 2001–10.

## 10.5 Factors responsible for FDI in LDCs during 1990–2010 and their implications with regard to IPoA: an econometric exercise

An analysis has been carried out to identify factors responsible for inward flow of FDI in LDCs. Such an analysis will help us to take appropriate and effective measures based on the guiding actions of the IPoA.

### 10.5.1 Model specification

A panel data regression analysis based on random effects estimation is carried out in order to identify factors responsible for FDI inflow to LDCs. A generalised least-square (GLS) estimation procedure has been applied for this analysis. The 'Inward FDI Performance Index' is considered as a dependent variable while a total of 13 variables have been used as independent variables. These variables can be categorised into four categories. The first category of variable is related to the economic condition of the country, which includes lagged FDI (i.e. F-1), indebtedness (D), share of

**Table 10.10 State of tourism sector in LDCs**

Indicator name	2001	2005	2008	2009	2010
Travel services (% of commercial service exports)		47.2	56.9	56.5	51.8
Travel services (% of service exports, BoP)		42.5	46.9	47.8	45.8
International tourism, number of arrivals (million)	4.9	8.3	12.8	12.9	14.8
International tourism, receipts (% of total exports)	7.8	6.8	5.7	7.2	5.8
International tourism, receipts (current million USD)	3,371.2	5,727.7	10,388.3	10,163.0	10,979.2
International tourism, expenditures (current million USD)	2,853.5	4,591.2	8,001.0	7,366.9	8,409.8
International tourism, expenditures for passenger transport items (current million USD)	1,018.9	1,211.5	2,464.2	2,256.3	2,510.6
International tourism, expenditures for travel items (current million USD)	1,780.2	3,318.2	5,435.6	5,015.6	5,786.4

**Source:** WDI database 2012, available at: <http://data.worldbank.org/data-catalog/world-development-indicators>

the industries and services sector in the GDP (I), real interest rate (Ir) and official development assistance (ODA) (A) (Addison and Heshmati 2003). The second category of variables represents overall conditions of the host country, including population (Po), remoteness (R), war (W) and degree of democracy (De) (Feng 2001; Brunetti et al. 1997). The third category consists of 'country assets', which include the educational standard (E), exports of fuel (F) and communication infrastructure in the form of telephone lines per 100 people (Ci) (Cheng and Kwan 2000). The last category interprets the macroeconomic stability of the host country, which includes the current value of inflation (p).

The estimated equation is as follows:

$$F(\text{FDI}) = \beta_0 + \beta_1(F-1) + \beta_2(D) + \beta_3(I) + \beta_4(F) + \beta_5(Ci) + \beta_6(Ir) + \beta_7(P) + \beta_8(De) + \beta_9(W) + \beta_{10}(A) + \beta_{11}(E) + \beta_{12}(p) + \beta_{13}(R) + u$$

### 10.5.2 Results for Africa

Table 10.11 presents the GLS estimation results for African LDCs. Most of the conventional factors are found to be less significant in the context of these countries. For example, share of industries and service sector in GDP and share of fuel export in GDP and indebtedness are not significant determinants for FDI inflow to African LDCs. The lagged value of FDI and developed infrastructure in terms of access to a telephone are found to be significant at the 1 per cent level of significance. Other factors found important at 10 per cent and 5 cent levels of significance respectively

**Table 10.11 Regression result for the GLS on random effect estimation for African LDCs**

Dependent variable: inward FDI performance index (FDI)			
Variables	Coefficient	Standard error	Probability
Lagged FDI (F-1)	0.478	0.0988	0.000***
Indebtedness (D)	0.002	0.0067	0.706
Share of industries and services sector in GDP (I)	-0.0132	0.0234	0.512
Share of export fuel in GDP (F)	0.0254	0.06899	0.712
Telephone lines per 100 people (Ci)	2.47	0.641	0.000***
Real interest rate (I <sub>r</sub> )	0.055	0.031	0.079
Population (P)	0.00023	0.00043	0.592
School enrolment (E)	0.0248	0.0132	0.067*
Degree of democracy (De)	-0.577	0.7438	0.438
War (W)	-0.282	0.5921	0.633
ODA (A)	-2.37	3.4038	0.048**
Current value of inflation (p)	0.00158	0.02856	0.956
Remoteness (R)	-0.329	1.8123	0.856
_cons	-1.703	2.4522	0.487

**Note:** \*at 10 per cent significance level; \*\*at 5 per cent significance level; \*\*\* at 1 per cent significance level.

**Source:** Authors' estimate

are school enrolment and inflow of ODA. By and large, conventional factors could not attract FDI in African LDCs.

### 10.5.3 Results for Asia

The regression result for GLS estimation for Asian LDCs is shown on Table 10.12. Among 13 conventional factors, only a few have significant effects in the context of FDI flow in Asian LDCs. As in Africa, the lagged value of FDI and school enrolment are considered to be important for inflow of FDI in Asia but they are less significant. Infrastructure-related factors such as telephone lines and remoteness are not influential factors for FDI inflow in Asian LDCs; similarly, indebtedness, share of industry and service sector and export of fuel have no noteworthy effect on FDI inflow. Unlike in Africa, ODA is important for Asia but with a positive effect, perhaps due to the larger flow of ODA which directly contributes to economic activities in Asia.

Taking the analysis into account, it appears that implementation of IPoA would be challenging for most of the LDCs, on two accounts. First, a large number of LDCs in Africa, island LDCs and Asian LDCs are not in a position to attract FDI because of their various weaknesses as reflected in the regression analysis. It appears that four kinds of variables considered for the analysis – economic condition, overall conditions of the host country, country assets and macroeconomic stability – are in most instances improved enough to become a determining factor for enhancing FDI in LDCs. Thus, LDCs should primarily work on improving the benchmark situation of their economies to build confidence among the investors abroad. Various suggestions

**Table 10.12 Regression result for the GLS on random effect estimation for Asian LDCs**

Dependent variable: inward FDI performance index (FDI)			
Variables	Coefficient	Standard error	Probability
Lagged FDI (F-1)	0.56	0.22	0.012**
Indebtedness (D)	-0.08	0.06	0.21
Share of industries and services sector in GDP (I)	0.02	0.039	0.52
Share of export fuel in GDP (F)	-0.19	0.04	0.61
Telephone lines per 100 people (Ci)	-0.26	0.19	0.17
Real interest rate (I <sub>r</sub> )	-0.01	0.161	0.94
Population (P)	0.024	0.06	0.71
School enrolment (E)	0.23	0.07	0.001**
Degree of democracy (De)	-5.30	2.79	0.06*
War (W)	-3.46	4.75	0.47
ODA (A)	19.97	11.16	0.07*
Current value of inflation (p)	-0.01	0.19	0.94
Remoteness (R)	-3.33	2.53	0.19
_cons	-12.52	9.11	0.17

**Note:** \*at 10 per cent significance level; \*\*at 5 per cent significance level; \*\*\* at 1 per cent significance level.

**Source:** Authors' estimate

put forward in the IPoA as regards attracting more FDI could smooth the process to improve the confidence for doing business in LDCs; however, the confidence building would be stronger if basic benchmark conditions were to be improved.

## 10.6 Possible monitoring indicators for FDI-related actions

According to the actions set out in the IPoA, it is important to identify appropriate indicators for properly monitoring and measuring the committed actions. There are a number of global databases which provide information on various indicators that are suitable for monitoring the progress of IPoA on a time-bound basis.

### 10.6.1 Monitoring indicators related to FDI for resource generation

Along with basic indicators such as FDI inflow and stock in LDCs and their different forms, which are publicly available, a number of other measurable indicators can be identified. A list of possible other indicators relevant to LDCs have been suggested in Table 10.13. These additional indicators are the signing of bilateral investment treaties (BITs) with developed, developing and LDCs; level of liberalisation of a country's FDI regime; number of barriers to doing business; laws related to enforcement of contract and property rights; tax regime for FDI coupled with signing of a treaty on avoidance of double taxation; an information facility for foreign investors at IPAs; new foreign investment under PPP; assessment of the resource gap; and outward transfer of income by FDI firms.

**Table 10.13 Indicators for monitoring actions related to FDI**

Groups	Monitoring indicators
LDCs	<ul style="list-style-type: none"> <li>• National policies on FDI, trade and investment</li> <li>• Bilateral investment treaties and avoidance of double taxation treaties</li> <li>• Doing business index, global competitiveness index and its sub-indices, FDI performance index</li> <li>• Number of investment projects under PPP</li> <li>• Total value of projects</li> <li>• Activities carried out by investment promotion agencies</li> <li>• Composition of FDI (equity capital, reinvested earnings, intra-company loans)</li> <li>• Sectoral distribution of FDI</li> <li>• Assessment of resource requirement for investment</li> <li>• Technology uptake</li> <li>• Tax structure (tax/GDP ratio, direct and indirect tax, tax structure)</li> <li>• Employment generation</li> </ul>
Action by development partners	<ul style="list-style-type: none"> <li>• Home country measures</li> <li>• Private equity fund insurance</li> <li>• Investment guarantees under MIGA</li> <li>• Investment promotion agencies</li> <li>• International investment agreements (IIAs)</li> <li>• Supporting measures at pre-establishment phase</li> <li>• Modification of the definition and scope of development issues as mentioned in the IIAs</li> </ul>

**Source:** Prepared by the authors

In the case of actions related to development partners, possible measurable indicators are the different kinds of insurance; guarantees and preferential financing programmes and private enterprise fund to be used for investment in LDCs; various kinds of financial support to FDI firms for investment in LDCs, such as export credits, risk management tools, co-financing, venture capital and other lending instruments.

All the above-mentioned indicators would largely monitor the extent of actions to be taken by LDCs and development partners in accordance with the IPoA targets, but they would not monitor how those initiatives, as well as the changing flow of FDI, contribute to economic growth in LDCs. In this regard, it is important to measure the impact of FDI on LDCs by a number of measurable indicators such as FDI as a percentage of GFCF, distribution of FDI in different sectors, net inflow of foreign exchange through FDI-related activities (particularly repatriation of profit, dividend by foreign firms, etc.) and contribution of FDI toward employment generation and poverty reduction.

For example, investment promotion to LDCs could be monitored if LDCs gain registration with the World Association of Investment Promotion Agencies (WAIPA) (Table 10.14). This organisation provides support for strengthening information-gathering systems and promoting efficient use of information. The organisation also shares country and regional experiences for attracting FDI and enhancing outward

**Table 10.14 LDCs that are members of WAIPA**

	African LDCs		Asian LDCs	Island LDCs
Angola	Kiribati	Senegal	Afghanistan	Samoa
Benin	Lesotho	Sierra Leone	Bangladesh	
Congo	Madagascar	Solomon Islands	Nepal	
Djibouti	Malawi	Sudan	Yemen	
Ethiopia	Mali	Tanzania		
Guinea	Mauritania	Uganda		
Gambia	Niger	Vanuatu		
Haiti	Rwanda			

**Source:** WAIPA website

FDI. In addition, advisory support is provided to better formulate investment-related policies. A total of 28 LDCs are members of WAIPA so far, of which 23 countries are from Africa and 5 are from Asia.

Monitoring of actions could also be done in the case of support provided for business development services and feasibility studies. A number of global organisations the Multilateral Investment Guarantee Agency [MIGA], the Overseas Private Investment Corporation [OPIC] and the International Centre for Settlement of Investment Disputes [ICSID]) are involved in providing different services including insurance, risks, private fund support and support in settling disputes. The United Nations Conference on Trade and Development (UNCTAD) DAE could be another important source of information, particularly in relation to FDI and BITs. Investment promotion agencies in different LDCs could provide information on various support measures offered to FDI at both pre- and post-establishment phases.

### 10.6.2 Monitoring indicators for productive capacity

There is information available at the global database level with regard to monitoring productive capacity building for a number of actions to be commenced by LDCs and development partners (Table 10.15). While monitoring of some of the actions requires micro-level data, monitoring of other actions may need to be done through macro-level data. It is difficult to get micro-level information on all those indicators for all LDCs; in that case, macro-level data should be used. The indicators largely help to understand the broader aspects related to development of productive capacity in LDCs. Table 10.15 provides a detailed list of possible indicators for monitoring productive capacity building in LDCs.

### 10.6.3 Strengthening the regulatory regime of FDI in LDCs: signing of international investment agreements with developed and developing countries

One of the major issues that is still in a weak state in LDCs and that has been addressed in the consecutive programme of actions is to strengthen the regulations related to facilitating FDI inflow. A number of LDCs have signed BITs and avoidance of double taxation treaties (DTTs) with a number of developed and developing countries.

**Table 10.15 Monitoring indicators for productive capacity**

	<b>Actions to be taken by</b>	<b>Monitoring indicators</b>
Overall	LDCs	<ul style="list-style-type: none"> <li>• Institutions for product standardisation</li> <li>• Number of clusters allowing FDI</li> <li>• Business-enabling environment index (WB)</li> <li>• Share of agro-processing industry in GDP</li> </ul>
	Development partners	<ul style="list-style-type: none"> <li>• ODA for productive capacity building</li> <li>• FDI in productive capacity-related sectors</li> <li>• ODA for promoting diversification</li> <li>• International investment agreements</li> <li>• Private equity fund insurance</li> <li>• Investment guarantees under MIGA</li> <li>• Investment promotion agencies</li> </ul>
Infrastructure	Joint actions LDCs	<ul style="list-style-type: none"> <li>• National infrastructure policies</li> <li>• Internet access, mobile broadband</li> <li>• Broadband connectivity</li> <li>• Public–private partnership for transport and ICT sector</li> <li>• RTAs and bilateral FTAs</li> </ul>
	Development partners	<ul style="list-style-type: none"> <li>• Concessional fund for infrastructure development</li> <li>• Cases of technology transfer to LDCs</li> <li>• FDI in LDCs' infrastructure sector which have condition of technology transfer</li> </ul>
Energy	LDCs	<ul style="list-style-type: none"> <li>• FDI in energy sector, particularly for projects related to transmission and distribution</li> <li>• Investment in renewable energy sector</li> </ul>
	Development partners	<ul style="list-style-type: none"> <li>• ODA for improving efficiency in generation, transmission and distribution and sustainable use of energy resources</li> <li>• Cases of transfer of appropriate and affordable technology on mutually agreed terms and conditions</li> </ul>
Science, technology and innovation	Joint actions LDCs	<ul style="list-style-type: none"> <li>• Joint gap analysis</li> <li>• Cases of collaboration between private sector and university/research organisations</li> <li>• Cases of promotion of investment for modern and cost-effective technologies</li> </ul>
	Development partners	<ul style="list-style-type: none"> <li>• ODA for research, science and technology</li> </ul>
Private sector development	LDCs	<ul style="list-style-type: none"> <li>• Business enabling environment index (WB)</li> <li>• Share of investment in diversified economic activities</li> </ul>
	Development partners	<ul style="list-style-type: none"> <li>• ODA for technology transfer</li> <li>• ODA for improvement of competitiveness of small and medium enterprises</li> </ul>

**Source:** Prepared by authors

The number of BITs signed by LDCs has increased from 224 in 2000 to 455 in 2010. The rate of enforcement of these agreements was rather low, being about half of the total of signed agreements (Table 10.16). Most of these BITs were enforced by African and Asian LDCs. Island LDCs have enforced few BITs with other countries, which reflects institutional weakness to facilitate investment. Most of the LDCs have signed a limited number of BITs have signed BITs (i.e. with less than five countries) although some have signed BITs with more than 20 countries. In this context there is scope for signing new BITs with other countries. During the 2000s, the majority of BITs were signed with developed countries, although a number of countries signed BITs with developing countries, particularly African countries. In general, the proportionate distribution of BITs enforced with different categories of countries remains unchanged.

Distribution of BITs, either signed or enforced, shows little relationship between the number of agreements and the flow of FDI in LDCs. Both the number of agreements on avoidance of DTT and their share for developing countries has improved between 2001 and 2011. Island LDCs have signed and enforced a number of DTTs (Annex 10.2). There is a momentum to sign agreements on BITs and DTTs with developed and developing countries with a view to attracting FDI from those destinations. A large number of countries, however, have still not signed an adequate number of treaties with developed and developing countries.

The impact of signing international investment agreements (IIAs) with developed and developing countries is not conclusive. In most cases, FDI originates from a limited number of sources targeting few sectors which are mostly of an enclave nature. It is usually argued that the first generation of IIAs signed by LDCs with developed and developing countries addressed little on development issues such as admission and establishment, employment, the environment, fair and equitable treatment, home country measures, host country operational measures, incentives, social responsibility, transfer of technology and transparency. LDCs, unlike developing countries, are largely recipients of FDI and the development policies of LDCs put the highest emphasis on the eradication of poverty in major economic activities. Such development objectives of LDCs are largely absent in the IIAs signed by LDCs with other countries.

**Table 10.16 BITs signed by LDCs**

	Until the year	Developed countries	Developing countries	LDCs	Total
Africa	2001	60 (74)	18 (22)	3 (4)	81 (100)
	2011	108 (71)	40 (26)	5 (3)	153 (100)
Asia	2001	28 (53)	24 (45)	1 (2)	53 (100)
	2011	50 (57)	36 (41)	1 (2)	87 (100)
Island LDCs	2001	0 (0)	1 (100)	0 (0)	1 (100)
	2011	1 (50)	1 (50)	0 (0)	2 (100)
LDCs	2001	88 (65)	43 (32)	4 (3)	135 (100)
	2011	159 (66)	77 (32)	6 (2)	242 (100)

**Note:** Figures in the parenthesis indicate share of respective country groups in total number of BITs signed by in a year.

**Source:** UNCTAD (2014)

Although services and intellectual property rights are often found in the definitions of investment of IIAs signed by developed and developing countries, there is little reflection of these items in the definitions signed by LDCs. This has happened primarily because of lack of adequate policies, regulations and enforcement of rules in LDCs; there is often flexibility in the case of enforcement of various regulations pertaining to intellectual property rights, and the same is true for liberalisation of services (which is still confined to a limited level of commitment for opening services sectors). Any initiative to include services and Intellectual Property Rights (IPRs) should not go beyond World Trade Organization (WTO) requirements. More importantly, this should happen in tandem with an individual LDC's commitment to the WTO.

The promotion of investment by the home country is considered to be a major instrument for enhancing investment in the host country, especially in the LDCs. BITs signed by LDCs with developed and developing countries do not always have a specific clause on the promotion of investment in the recipient country. Most IIAs signed by LDCs specifically allow full repatriation of profit, dividends and other income. There are situations when LDCs get marginal net FDI flow because of the substantial outward transfer of profit, dividends and other income. An economy with poor capital reserve could face difficulties in view of outward transfers originating from FDI. In the new generation of BITs these issues should be addressed properly in the scope and definition of FDI in LDCs.

According to UNCTAD (2011), home-country measures could facilitate FDI inflow in LDCs. These measures would include provision of 100 per cent or a large percentage (50–80 per cent) of tax credits, rebates or deductions on equity invested by the home-country companies in LDCs against their tax liabilities in their own countries and establishing a special-purpose LDC infrastructure investment fund that would provide equity and debt financing to infrastructure projects in LDCs.

Regarding governance, the track record is positive for the second half of the decade. Various independent anticorruption commissions had been or are being set up. It should be noted, however, that this process is far from complete, the end of serious corruption is far from assured and the whole process continues to be slow and halting (ECOSOC 2009). There are problems as regards implementing institutional reform issues. However, improvement in institutional and regulatory issues has contributed to build better co-operation and responsiveness between public and private sectors.

## 10.7 Challenges for implementation of IPoA actions of the IPoA

There are a number of challenges for implementation of IPoA over the next decade. One of the major constraints is lack of binding commitments, both for LDCs and for development partners, to undertake the necessary actions in a time-bound manner. Hence, the actions to be undertaken by LDCs and development partners will be on a voluntary basis. There is no formal institutional arrangement to oversee

the progress of actions to be taken either at home or in host countries. In order to monitor progress, a comprehensive database would have to be maintained and made accessible to all concerned parties to appreciate the progress that has so far been made. A comprehensive database could only be prepared if the relevant data are made accessible for the purpose of monitoring. Without an institutional set-up, such activities could not be done properly.

One of the major challenges with regard to implementation of IPoA will be the extent of IPoA's alignment with the targets to be set in the post-2015 Millennium Development Goal (MDG) agenda. It is thus important to have a proper framework in place for the MDG agenda which will sufficiently reflect the IPoA agenda. While a number of unfinished items on the MDG agenda will be taken into consideration in the new framework, a number of new issues will also be added. FDI-related issues should be addressed properly in the post-2015 MDG framework, particularly its role in helping LDCs to meet their capital constraints and contribute to building up their productive capacity.

It is important to note that all efforts and actions, either to be taken under IPoA or other initiatives, should be pursued in support of graduation of LDCs. Both LDCs and development partners should make an effort with regard to FDI which ensures the ultimate objective of reducing the number of poor countries within the next decade. Financial support from development partners as committed in the IPoA should be provided, ensuring macroeconomic stability in the LDCs.

A major challenge for LDCs will be to attract FDI in productive capacity building. At present a major share of FDI is targeted at resource-extracting industries, and diverting resources from those industries to productive and manufacturing industries will require incentives and support from both LDCs and development partners.

Finally, a post-crisis phase has emerged with a business environment where investment has to bear more risks. Under such circumstances, attracting investment in LDCs on a large scale would not be very easy unless favourable financial instruments for FDI inflow in LDCs are offered to mitigate those risks.

## 10.8 Conclusion

The commitments made by LDCs and development partners have focused on the strong role of FDI in promoting economic growth and productive capacity building in LDCs, taking into cognizance the limited success achieved under the BPoA. The actions set out in the IPoA would be considered as the 'next set of actions' after the end of BPoA. Although the scope for FDI has narrowed in the IPoA, the agenda for action is more specific and clear than that of BPoA. Within this backdrop, this chapter has suggested that LDCs and development partners play a proactive role in order to attain the targeted actions set out in the IPoA during 2011–20.

*Successful implementation of IPoA.* There should be a proper institutional arrangement to monitor progress as well as to inform the respective stakeholders in this regard from time to time. In 2011, UNCTAD published a report entitled 'Foreign

Direct Investment in LDCs: Lessons Learned from the Decade 2001–2010 and the Way Forward’, which put forward a set of actionable agenda to be implemented in the next decade. Most of these suggestions are entwined with the actions suggested in the IPoA. The latter actions need to be ‘demystified’ in the form of a specific agenda for both host and home countries.

*Innovative incentive measures need to be offered by both LDCs and development partners in order to attract more FDI into LDCs.* The possible measures that can be offered to foreign investors are fiscal incentives in the form of reduced corporate taxes, financial support in the form of equity and loans, financial incentives and insurance for the mitigation of risks of investment in LDCs, dissemination of information on potential investors and provision of support in matchmaking.

*Set up a ‘Global FDI Fund’ from the contribution of developed countries to support foreign companies interested in investing in LDCs.* This fund could be a good source for foreign investors to raise capital on favourable terms and conditions to invest in LDCs. Foreign investors who are interested in investing in LDCs, particularly in productive capacity building sectors, should get financial support. According to the World Investment Report (2012), sovereign wealth funds (SWFs) bear a significant potential for investment in development, although FDI by SWFs is still relatively small. SWFs can be used for investment in LDCs for projects such as infrastructure, agriculture and industrial development.

*Preferential market access in developed and advanced developing countries is essential to attract FDIs in the manufacturing sector of LDCs.* A significant improvement of competitiveness is required for LDCs in order to attract large-scale FDI in their manufacturing sector. This will require duty-free market access in developed and advanced countries for all products originating from LDCs, preferential market access under RTAs for major exportable products of LDCs, availability of skilled and unskilled workforces and development of physical infrastructure. Developed and developing countries should encourage their investors to invest in projects related to regional connectivity in Asia and Africa.

*Regional investors or investors from the ‘South’ should have special preferences and incentives.* Taking into account the increasing interest of the ‘South’ as investors, LDCs should go for partnership with the South for easy access to markets, resources and technologies that are available in the developing countries.

*IAs with LDCs should include development issues and concerns of LDCs.* Various development issues such as technology transfer, performance requirement, employment generation, home-country measures such as information provision and technical assistance, financial and fiscal incentives, investment insurance and market access regulations need to be included in the IAs in order to ensure broader gains from the FDI in LDCs. On the other hand, issues such as competition and labour standards need to be less emphasised in the IAs, as most of the LDCs are not ready for that level.

*Development partners and LDCs should negotiate with MNEs for acceleration of investment in LDCs and meeting domestic requirements of LDCs.* Development partners should consider cost-sharing partnerships with MNEs investing in LDCs

in order to forge links with domestic firms and increase their willingness to invest in LDCs. LDCs, on the other hand, should negotiate with MNEs for commitments on minimum levels of local sourcing and further processing of primary products, favouring the establishment of joint ventures with local firms, negotiating on minimum levels of employment for nationals, establishing training centres and supporting the development of infrastructure.

*FDI should be encouraged in various projects to be carried out under public–private partnership (PPP) in LDCs.* Since PPP is being considered a major investment arrangement in many LDCs in order to implement large-scale projects, mainly infrastructure development projects (road, power and energy, port, etc.), developed countries should encourage their private sector to be the ‘private’ partner in these PPP projects.

*Specialised investment and trade mechanisms should be explored for countries facing ‘natural constraints’ such as landlockedness, small island status and small size of population.* Opening and smoothing transit facilities for landlocked countries must be seen as a positive move to overcome such impediments. Small-island states may focus on sectors where large-scale physical infrastructural facilities are not critically important. IT-related investment could be an option for small-island states; allowing free movement of capital (tax haven) may attract FDI. Regional trade agreements that include services, especially movement of natural persons, may create employment scope in different sectors of the region.

*A permanent quantitative and qualitative monitoring framework should be set up in all LDCs.* This monitoring framework will help to examine the structure and composition of FDI flow to LDCs and to determine country-specific causality and impact between the commitment made and achievements. A binding commitment from development partners as regards FDI flow to LDCs in their preferred sectors may help to predict the possible contribution of FDI in economic and social development of LDCs.

## Notes

- 1 The authors would like to register their deep appreciation to the reviewers and participants of the conferences organised in Dar es Salam, Tanzania and London, UK, for their detailed comments and suggestions for improvement of the chapter. In this regard, the authors would like to thank Dr Debapriya Bhattacharya for his overall guidance in preparing this chapter.
- 2 A number of larger investment projects have been initiated in LDCs, including green field projects, and a number of contracts have been renegotiated such as with mining companies in Zambia.
- 3 This is a critical problem for many investors in many LDCs. In Tanzania, for example, debts cannot in practice be enforced through the courts because of backlogs, inefficiencies, corruption, and the absence of knowledge and awareness of commercial law in the court system.
- 4 LDCs were even marginalised in terms of the flow of FDI to the developing countries (it had only a 2.2 per cent share of total FDI flow to developing countries in 2011).

**Annex 10.1 IPoA on building productive capacity in LDCs: issues related to FDI**

	<b>Joint actions</b>	<b>Action by least developed countries (LDCs)</b>	<b>Action by development partners</b>
Overall	Establish or upgrade quality assurance and standards of products and services to meet international standards	<p>(a) Foster economic activity by promoting, inter alia, economic clusters, removing obstacles to business and prioritising domestic and foreign investments, which increases connectedness;</p> <p>(b) Support the LDCs' efforts to develop a sustainable tourism sector, in particular through infrastructure and human capital development, increased access to finance and enhanced access to global tourism networks and distribution channels;</p> <p>(c) Strengthen programmes for promoting agro-processing industries with value addition as a means to increase agricultural productivity, raise rural incomes and foster stronger linkages between agriculture and industries</p>	<p>(a) Provide enhanced financial and technical support to LDCs to develop productive capacities in line with LDCs' priorities;</p> <p>(b) Support LDCs in diversification and value addition by their firms to effectively participate in the global value chains;</p> <p>(c) Adopt, expand and implement investment promotion regimes, as appropriate, in the form of risk and guarantee schemes and other incentives in favour of their firms seeking to invest in productive capacity development in LDCs.</p>
Infrastructure	Develop and implement comprehensive national infrastructure development and maintenance policies and plans encompassing all modes of transport, communications, energy and ports	<p>(a) Develop modern ICT infrastructure and internet access, including expansion into rural and remote areas, including through mobile broadband and satellite connections;</p>	<p>(a) Provide enhanced financial and technical support for infrastructure development in line with LDCs' sectoral and development needs and priorities and use concessional funds, where appropriate, to catalyse and leverage other sources of funding for infrastructure development and management;</p>

*(continued)*

### Annex 10.1 IPoA on building productive capacity in LDCs: issues related to FDI (continued)

Joint actions	Action by least developed countries (LDCs)	Action by development partners
	<p>(b) Build and expand broadband connectivity, e-networking and e-connectivity in relevant areas, including education, banking, health and governance;</p> <p>(c) Promote public-private partnerships for the development and maintenance of transport and ICT infrastructure and their sustainability;</p> <p>(d) Promote bilateral, sub-regional and regional approaches to improve connectivity by removing infrastructure bottlenecks</p>	<p>(b) Support LDCs' efforts to facilitate the transfer of relevant skills, knowledge and technology for the development of infrastructure on mutually agreed terms;</p> <p>(c) Actively support private sector investment, including through public-private partnerships and grant/loans blending, for infrastructure development and maintenance in communication and multimodal transport such as railways, roads, waterways, warehouses and port facilities;</p>
Energy	<p>(a) Expand power infrastructure and increase capacity for energy generation, especially renewable energy which includes, inter alia, hydro power, geothermal, tidal, solar, wind and biomass energy</p>	<p>(a) Provide enhanced financial and technical support to the LDCs to improve efficiency in the generation, transmission and distribution and the sustainable use of energy resources with the aim of ensuring access to energy for all;</p> <p>(b) Support LDCs' efforts to develop the energy sector in generation, distribution and energy efficiency, including in renewable energy, other clean energy sources and natural gas, inter alia, through financial and technical assistance and by facilitating private sector investment, in accordance with national priorities and needs;</p>

(continued)

**Annex 10.1 IPoA on building productive capacity in LDCs: issues related to FDI (continued)**

Joint actions	Action by least developed countries (LDCs)	Action by development partners
Science, technology and innovation	<p>Undertake on a priority basis by 2013 a joint gap and capacity analysis with the aim of establishing a technology bank and a science, technology and information supporting mechanism, dedicated to LDCs, which would help improve LDCs' scientific research and innovation base, promote networking among researchers and research institutions, help LDCs to access and utilise critical technologies, and draw together bilateral initiatives, support by multilateral institutions and the private sector, building on the existing international initiatives</p>	<p>(a) Build or expand strategic partnerships with a broad range of actors, including the private sector, universities and other research institutions and foundations, in order to support innovation;</p> <p>(b) Promote investments and engagement in innovative solutions for the development of modern and cost-effective technologies that could be locally adapted, particularly in the fields of agriculture, information and communication, finance, energy, health, water and sanitation and education;</p> <p>(c) Facilitate co-operation and collaboration between research institutions and the private sector, with a view to promoting research and development and innovation in the field of science and technology</p>
		<p>(c) Facilitate the transfer of appropriate and affordable technology on mutually agreed terms and conditions for the development of clean and renewable energy technologies in accordance with relevant international agreements</p>

*(continued)*

### Annex 10.1 IPoA on building productive capacity in LDCs: issues related to FDI (continued)

Joint actions	Action by least developed countries (LDCs)	Action by development partners
Private sector development	<p>(a) Continue promoting an enabling environment for private sector development including for small and medium-sized enterprises through a transparent and rule-based regulatory framework</p> <p>(b) Make efforts to promote the availability of financial services, including banking and insurance, to enhance private sector development and investments across sectors</p>	<p>(a) Provide enhanced financial and technical support, and facilitate transfer of technology, on mutually agreed terms to LDCs to remove structural and institutional constraints on the private sector;</p> <p>(b) Support initiatives to strengthen the institutional and managerial capacities and the productivity of small and medium-sized enterprises in LDCs to improve their competitiveness</p>

**Annex 10.2 DTTs signed by LDCs**

LDCs	DTTs by LDCs			LDCs	Total
	As of the year	Developed countries	Developing countries		
Africa	2001	38 (65.5%)	17 (29.3%)	3 (5.2%)	58
	2011	45 (56.3%)	31 (38.8%)	4 (5%)	80
Asia	2001	20 (46.5%)	23 (53.5%)	0 (0%)	43
	2011	22 (38.5%)	35 (61.4%)	0 (0%)	57
Island	2001	16 (100%)	0 (0%)	0 (0%)	16
	2011	17 (100%)	0 (0%)	0 (0%)	17
Total	2001	74 (63%)	40 (34%)	3 (2.6%)	117
	2011	84 (54%)	66 (42%)	4 (2.5%)	154

**Source:** Calculation based on international investment agreements, UNCTAD

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