A New Development Agenda

Trade, Investment, and Procurement

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FEBRUARY 2014

A Report of the CSIS Scholl Chair in International Business and the Project on Prosperity and Development

CSIS | CENTER FOR STRATEGIC & INTERNATIONAL STUDIES

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Executive Summary

The link between economic development and state security has been well established but is still too often overlooked. Former secretary of defense Robert Gates argued in support of development efforts as a form of "preventative diplomacy," preventing the conditions where violent crises occur that may require more aggressive intervention. For example, rising food prices in Egypt have been cited as a major instigator for the protests that overthrew Hosni Mubarak. That does not mean that Mubarak could have stayed in power if only food were more affordable, but higher levels of economic development and the concurrent factors that encourage it could have made the transition more stable and less violent.

As policymakers consider a model for international development that will be best suited for twenty-first-century challenges, the fundamental factor for any successful model must include collaboration between governments and the private sector. The most direct reason is because many donor governments are facing domestic budgetary constraints that are limiting their spending, and public/private partnerships offer the best "bang for the buck" in terms of promoting the broad-based growth that is core to promoting economic and development goals.

The CSIS Scholl Chair in International Business and the Project for Prosperity and Development have produced this report, which examines the myriad ways the private sector can engage in emerging markets. Demand for private capital will certainly exceed supply, leading to the conclusion that economies that enhance investor return and minimize risk will be most successful in attracting private investment. The report looks at and makes recommendations for three specific areas:

- **Trade:** Trade capacity building (TCB) chapters of trade agreements are a familiar component of U.S. trade policy. TCB must become a priority for U.S. development policy, which will require greater coordination between Washington-based agencies and in-country partners, improved implementation of TCB programs, and promoting TCB in agreements beyond FTAs. In this regard, the authors made the following recommendations for the U.S. government:
  - Improve policy coordination;
  - Make TCB part of a reform agenda;
  - Reinforce trade policy through broader use of TCB; and
  - Use Trans-Pacific Partnership (TPP) to advance TCB best practices.

- **Investment:** Financing is essential for private-sector investment in developing countries, evidenced by changes to the mandate and operations of the Overseas Private Investment Corporation (OPIC); the impact of sovereign wealth funds; and approaches to integrate U.S. diplomacy and development policy with our economic strategy and tools. To improve investment flows, the U.S. government should:
  - Expand and use new investment vehicles, including private equity and pension funds/institutional investors;
  - Continue to use development finance institutions to address critical financing shortfalls; and
  - Strengthen support for critical regulatory reforms.
- **Procurement:** Government procurement capacity remains a challenge across the developing world. The World Bank estimates that the average government will spend up to 20 percent of gross domestic product on procurement every year. More efficient procurement would have an immense effect on governance, growth, investment, and transparency, although the development community has yet to pursue procurement reform in a systemic way. To tackle procurement reform in the developing world, the U.S. government should:
  - Put procurement reform on the development agenda;
  - Put procurement reform on the trade agenda;
  - Use procurement reform as a starting point to tackle issues of corruption and transparency; and
  - Monitor the Indonesia Millennium Challenge Corporation (MCC) compact procurement reform project as a potential model.

The good news for developing countries is that the fundamental factors to improve their economies' strengths in these areas—rule of law and good governance—are essential to any economy that is working its way out of poverty. Investors expect to see rules applied consistently and equitably, contracts enforced, efficient bureaucratic oversight, and transparency—essentially the same things that any private citizen in a developing economy would wish from their government and the common denominator among countries who have developed most successfully.

In order to realize this potential, future development efforts should be less about official direct assistance (which should be reserved for the most acute and immediate crises) and more about promoting good governance. Attracting investment as part of economic development is essentially a "self-help program" where individual governments must take the initiative to strengthen governance and rule of law, replacing the more traditional donor state/client state relationship that characterized public development initiatives in the past. Even more critically, citizens of developing countries with better governance will find themselves empowered to build professional skills, start small businesses, and increase their civil participation.

1 Trade: Trade Capacity Building

Scott Miller

Introduction

Today's trade agreements include capacity-building measures intended to maximize the benefits of liberalization. Trade capacity building (TCB) chapters of trade agreements are now a familiar component of U.S. trade policy, but assessments of their effectiveness are limited.

Delivering benefits from new and often controversial trade arrangements is an issue not only for developing countries but for the United States as well. Improved coordination among the multiple agencies can help TCB programs succeed. Furthermore, much can be done to strengthen implementation of TCB measures, which would in turn help partner economies achieve economic growth and development.

What Is Trade Capacity Building?

TCB refers to development assistance that is aimed at increasing a country's ability to engage in global trade. This can be physical assistance, human assistance, or financial assistance that will help strengthen the institutional capacity to trade goods and services on the global market. The term is most often given a very broad definition, so a more focused approach may improve the measurement of effectiveness and data collection associated with it. Because TCB most often refers to all aspects of trade development assistance (capacity building, technical assistance in regulatory agreements, physical infrastructure, and job training, among many others), there are many ways in which government agencies, humanitarian organizations, and private-sector donors participate in TCB.

According to the Trade Capacity Building Database of the U.S. Agency for International Development (USAID), the United States is one of the leading TCB providers in the world, contributing $1 billion in total support in 2011, and a total of $13.3 billion from 2001 to 2011, aiding activities in 125 countries and territories.[1] TCB assistance is provided by the United States to developing economies in a variety of ways through various agencies. The

1. USAID, "Trade Capacity Building Database," http://tcb.eads.usaidallnet.gov/.

most widely known TCB funder is USAID,[2] but the Millennium Challenge Corporation (MCC) is a close second, with over $600 million in support in 2006, more than twice the contribution they made in 2005.[3] Although USAID and MCC are the primary sources, there more than 20 other federal agencies and departments that contribute to the effort. Because so many U.S. governmental agencies provide TCB assistance, all TCB aid is coordinated through the TCB Interagency Group, which is co-chaired by the Department of State and the Office of the U.S. Trade Representative (USTR).[4]

As U.S. development policy has changed over the last 60 years, the types of capacity building have changed as well. Development policy and capacity building have become increasingly interlinked as the global marketplace has grown and nations have become more economically interconnected. Assistance in capacity building has been an increasingly frequent request from negotiating partners in trade agreements as a means of getting countries to agree to higher standards in an effort to provide assistance after the negotiating is done. In large part this is due to the underlying complexity of a more complicated trade environment than what existed 20 years ago. Implementing agreements and putting reforms in place can be difficult if the institutional infrastructure to implement them does not already exist. Institutional capacity building is intended to fill the gap.

Experience in DR-CAFTA

A formal TCB agreement first appeared as a chapter of the U.S.-Dominican Republic-Central America FTA (DR-CAFTA) signed in 2004. The U.S. Congress passed the implementing bill in July 2005, and the FTA entered into force between 2006 and 2009. Cumulatively, the United States provided more than $650 million in trade-related assistance to DR-CAFTA countries; this financial support has come from USAID, the U.S. Trade and Development Agency (USTDA), the Department of Agriculture, the Overseas Private Investment Corporation (OPIC), and MCC.[5]

DR-CAFTA economies have generally experienced significant growth in trade as a result of their membership. The most dramatic change that can be seen among participants was a 50 percent increase in intraregional trade from 2005 to 2010, translating to a total $2 billion dollars.[6] Exports to the United States have grown, and the composition of exports has

2. According to a 2010 report by USAID, from 1999 to 2009 USAID provided roughly $5 billion in TCB aid, roughly 42 percent of total TCB funding. Molly Hegeboeck, *From Aid to Trade: Delivering Results: A Cross-Country Evaluation of USAID Trade Capacity Building* (Washington, DC: USAID, November 2010), http://pdf.usaid.gov/pdf_docs/PDACR202.pdf.

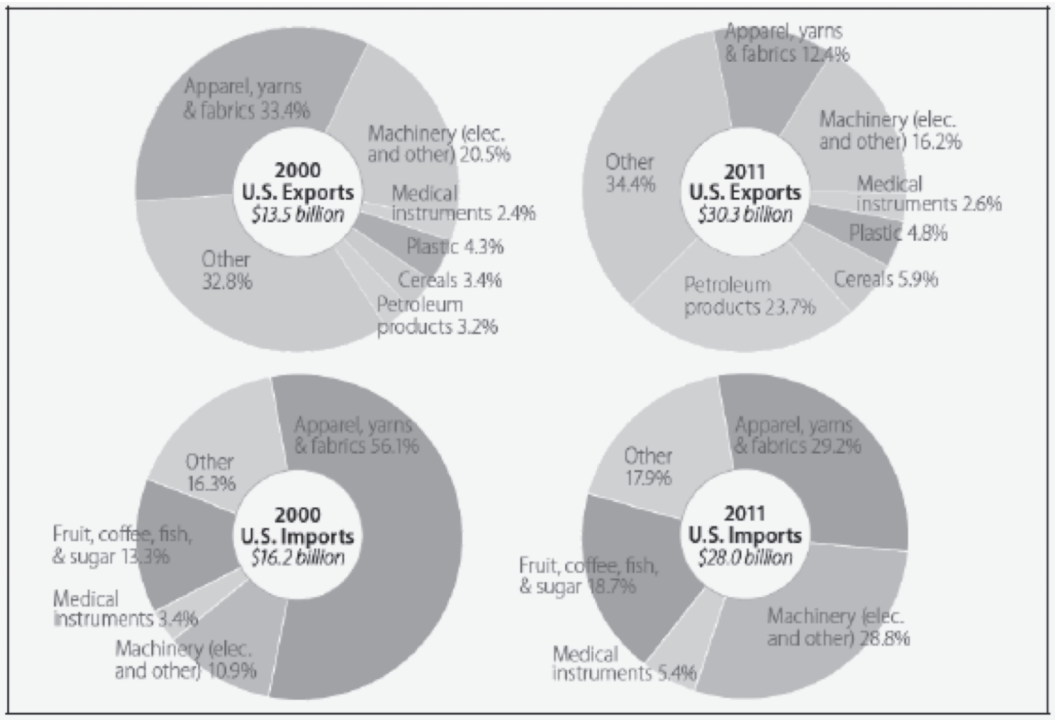
3. 2005 was the first year MCC operated, having been created by Congress in 2004. Year 2005 was also the peak of USAID TCB funding. USAID, "Trade Capacity Building Database."

4. Founded in 2002.

5. USTR, "Trade Capacity Building Success Stories: Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR)," CAFTA Policy Brief, August 2007, http://www.ustr.gov/archive/assets/Trade_Agreements/Bilateral/CAFTA/Briefing_Book/asset_upload_file256_13237.pdf.

6. USTR, "U.S. Trade with the CAFTA-DR Countries," May 2011, http://www.ustr.gov/about-us/press-office/fact-sheets/2011/may/us-trade-cafta-dr-countries.

Figure 1. Composition of U.S. Exports to and Imports from DR-CAFTA Partners



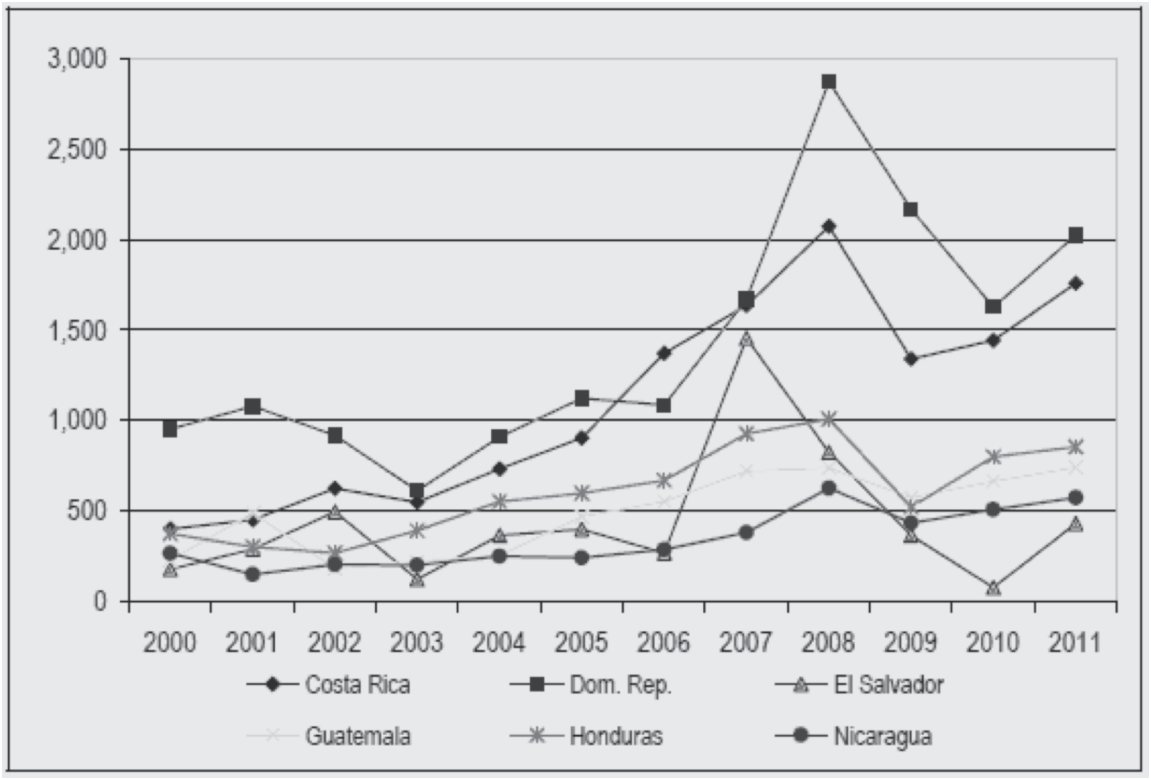
Source: CRS from U.S. Department of Commerce data as presented in Global Trade Atlas.

changed for the better as well because higher-value exports have grown in many economies.[7] Before DR-CAFTA, aggregate exports to the United States from DR-CAFTA countries primarily consisted of textiles, yarns, and fabric in 2000, at 56 percent of imports; in 2010 the share was reduced to 29 percent.[8] The increase in diversity of exports to the United States (the largest trading partner with DR-CAFTA countries) is one of many indicators of improved economic conditions in the region. GDP and exports have increased, formerly underdeveloped sectors have matured into viable industries, and foreign direct investment (FDI) has grown in all DR-CAFTA countries.

Despite this positive story, it is difficult to identify a causal relationship between the inclusion of TCB provisions and the success of the agreement. There is evidence that partner economies with a consistent domestic reform agenda were more successful in utilizing TCB and other forms of development assistance to achieve higher trade and investment performance. Among the six partner economies, Costa Rica and the Dominican Republic stand out across a number of measures. Foreign investment flows made strong progress in these two economies after the Free Trade Agreement (FTA) entered into force.

7. J. F. Hornbeck, "The Dominican Republic–Central America–United States Free Trade Agreement (CAFTA-DR): Developments in Trade and Investment," Congressional Research Service, Washington, DC, April 9, 2012, 1.
8. Ibid., 10.

Figure 2. FDI Flows to DR-CAFTA Economies, 2000–2011



Source: UN Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean, 2011* (Santiago, Chile: United Nations, February 2012), http://www.eclac.org. Reprinted with permission.

In the case of Costa Rica, the government has used DR-CAFTA to dramatically improve the country's trade capacity and export-led growth model. According to the Costa Rican Ministry of Foreign Trade (COMEX), Costa Rica has 10 FTAs in force, six in process, 13 bilateral investment treaties, and two preferential agreements. COMEX has implemented the 2010 *Plan of Action to Optimize the Implementation of Trade Agreements.* Through the modernization of ports, participation in sanitary and phytosanitary (SPS) measures, and transport sector investment, Costa Rica has become a success story for emerging economies that strive to join global value chains by utilizing TCB in conjunction with domestic economic reform.

In contrast, El Salvador initially benefited from DR-CAFTA's improved terms of trade, but it did not sustain a broader reform agenda. While El Salvador's main port infrastructure has been upgraded, inconsistent economic reforms beyond the FTA have limited public and private investment. Political stability, education, and productivity are important parts of increasing growth and investment; these variables along with TCB are necessary to achieve growth.[9]

9. USAID has an outstanding report that analyzes specific steps El Salvador should take to diversify its agro-industrial sectors while taking advantage of unrealized opportunities provided by CAFTA-DR. USAID, *Optimizing the Economic Growth and Poverty Reduction Benefits of CAFTA-DR: Accelerating Trade-Led Agricultural Diversification: Volumes I & II* (Washington, DC: USAID, September 2008), http://pdf.usaid.gov/pdf_docs/pnadm561.pdf and http://pdf.usaid.gov/pdf_docs/pnadm562.pdf.

Opportunity—The Trans-Pacific Partnership

The Trans-Pacific Partnership (TPP), now under negotiation, presents an opportunity to develop and implement best practices in TCB. The TPP currently has 12 negotiating parties: the United States, Japan, Canada, Australia, Mexico, Malaysia, Chile, Singapore, Peru, New Zealand, Vietnam, and Brunei.[10] Of particular interest for capacity building is the range in economic development levels among participating economies. The TPP also aims to be a comprehensive, high-standard agreement.

Member economies like the United States, New Zealand, Australia, Japan, and Singapore typically act to provide TCB assistance. Alternatively, partner economies like Vietnam and Malaysia are expected to seek substantial TCB efforts to make a successful transition to the high-standard TPP disciplines. TPP offers the opportunity to get the TCB implementation right.

Conclusions and Recommendations

TCB can contribute to improved trade policy outcomes and stronger economic performance. While the basic structure of TCB agreements are straightforward, improvements in outcomes can result from better policy coordination and more effective implementation. Specifically:

- *Improve Policy Coordination*: One key challenge for TCB is the need to coordinate efforts with overall development assistance policy and the broader trade policy agenda, along with the partner country's economic development strategy. For the United States, this means coordinating the relatively centralized, capital-based trade policy apparatus with the more decentralized, local market-driven development assistance policymaking structure. The problem is not unique to the United States: a 2006 joint evaluation conducted by the European Commission found policy coordination to be one of the largest barriers for TCB implementation, both at the headquarters level and the field level.[11] Operationally, TCB is both local and centralized: the ongoing operation of TCB initiatives must be responsive to local market and industry issues, while the TCB Committee's goals must remain oriented toward delivering on treaty-based agreements and disciplines.
- *Make TCB Part of a Reform Agenda*: As a trade agreement is ratified and efforts switch from negotiation to implementation and compliance, each trade agreement is bureaucratically "handed off" in the transition. The TCB agreements in U.S. FTAs

10. Adapted from Jeffrey J. Schott, Barbara Kotschwar, and Julia Muir, *Understanding the Trans-Pacific Partnership* (Washington, DC: Peterson Institute for International Economics, 2013), 2. Original data from IMF, *World Economic Outlook: October 2012* (Washington, DC: IMF, 2012), http://www.imf.org/external/pubs/ft/weo/2012/02/pdf/text.pdf; and WTO, *International Trade Statistics 2012* (Geneva: WTO, 2012), http://www.wto.org/english/res_e/statis_e/its2012_e/its2012_e.pdf

11. European Commission, *Joint Evaluation of Co-ordination of Trade Capacity Building in Partner Countries* (Louvain-la-Neuve: ADE, 2006).

create a committee consisting of officials from the parties who then develop and implement a program of work to improve capacity to comply with the FTA. Although trade ministries (the Office of the USTR in the case of the United States) are responsible for creating the agreement, other agencies have the continuous in-market presence and ongoing interest in advancing the work program. For the United States, officials from the Foreign Agricultural Service and Foreign Commercial Service may be better positioned to deliver on the work program. Such a change in mission and scope may help partner economies advance toward their obligations while simultaneously helping U.S. exporters and customers succeed in commercial development of FTA partner customers and suppliers.

- *Reinforce Trade Policy through Broader Use of TCB*: Formal agreements on TCB are typically found only in comprehensive FTAs. Based on the effective use of technical assistance programs in other contexts, such as the APEC Supply Chain Connectivity technical support group sponsored by USAID, TCB work plans should become a regular component of a broader range of U.S. economic engagements, including TIFAs and BIT negotiations. Considering the current U.S. trade agenda, TIFAs are the main format for engagement with developing economies seeking domestic reform and closer economic relations with the United States. Starting early with a TCB work program could advance the interests of the United States, the partner economy, and the exporters and investors engaged in the market.
- *Use TPP to Advance TCB Best Practices*: The Trans-Pacific Partnership presents the opportunity for a "best in class" TCB work program, based principally on the combined expertise of the negotiating patties. Australia, Canada, Japan, New Zealand, and the United States all have substantial development assistance programs, as well as extensive experience regarding what works and what doesn't. Other TPP partners, notably Chile and Singapore, have developed institutional expertise in FTA implementation by virtue of the sheer number of free-trade partner economies. This experience can inform the work program for TPP members who choose to incorporate a TCB work program.

2 Investment: Access to Investment

Conor M. Savoy

Introduction

Over the last 50 years the composition of capital flow from the United States to the developing world has changed. In 1960, over 70 percent of all U.S. capital flows were from the public sector. That figure is now 9 percent. This means that the U.S. relationship with emerging markets is less about development assistance and now increasingly about trade, investment, and finance. The development community understands this and has begun to shift to embrace the need for private-sector development and engaging the private sector as a partner. However, for most bilateral donors the focus remains on meeting the basic human needs of the developing world through large public health programs, agricultural development, and education. Areas such as governance, rule of law, and other broad investment and business climate issues remain relatively low priorities for donors.

The opportunity in emerging, frontier, and developing markets is immense. Many clearly see this: it is estimated that in 2012 approximately $1.5 trillion in foreign capital flowed into emerging markets. This represented 32 percent of all foreign capital flows last year; in 2000, foreign capital flows to emerging markets represented just 4 percent of total flows.[1] Sub-Saharan Africa is frequently used as a barometer to demonstrate the opportunity and growth that occur across the developing world. Over the past 15 years the continent has seen democratic political stability blossom, strong macroeconomic policies enacted, and economic growth rates that are frequently among the highest in the world. This is in marked contrast to earlier years when the continent was ruled by dictators, ethnic and tribal strife consumed nations, and debt threatened to drown governments. This is not limited to Africa or simply the BRICs: Indonesia, the Philippines, Peru, Colombia, Vietnam, Mexico, and other emerging-market nations are all seen as attractive investments, especially when returns on investment are many times higher than in advanced economies.

But equally immense are the challenges, which impact the investment climate across the developing world. Broadly these include: poor governance, byzantine regulatory

1. Susan Lund et al., *Financial Globalization: Retreat of Reset? Global Capital Markets*, McKinsey Global Institute, March 2013, 5, http://www.mckinsey.com/insights/global_capital_markets/financial_globalization.

frameworks, massive corruption, weak rule of law, and low institutional capacity. These issues manifest themselves through crippling energy subsidies, weak judicial systems, deficient land tenure, poor investor protections, and other issues. Investors with a low risk tolerance see only these challenges and seek more stable markets at home or abroad. This means that the investment gaps that exist in the developing countries will go largely unfulfilled. Sub-Saharan Africa alone requires a minimum of $60.4 billion in infrastructure investment per year just to meet its current infrastructure needs.[2] Government—whether local or international donors—cannot possibly supply all of the financing needed. When total official development assistance worldwide is roughly $120 billion per year, it is clear that other sources must be tapped to meet this demand. The private sector must be engaged or encouraged to invest. This could come through greater support through risk sharing, first loss, and other government-subsidized risk mitigation tools. Or donors can work to reduce risk by focusing on improving the local investment climate through regulatory reform, improved governance, and strengthening rule-of-law programs.

DEFINITIONS

In considering how to increase investment to the developing world, it is important to be clear about which countries are struggling to attract investment. "Developing world" is a broad concept that covers everything from China to Zimbabwe to Ghana, three very different economies. Within the developing world there are several layers, including newly industrialized countries, emerging markets, frontier markets, and least developed countries. Across these categories there is significant overlap. Newly industrialized countries include South Africa, Mexico, Brazil, China, India, Malaysia, the Philippines, Thailand, and Turkey. These countries, in particular the BRICs, do not generally struggle to attract investment. Needless to say, this chapter will not deal with attracting investment for these countries. Frontier markets are considered investable, but have lower market capitalization and liquidity than emerging markets. Organizations use different metrics to classify countries as "frontier." FTSE Group, for example, requires that they meet the following five criteria: (1) formal stock market regulatory authorities monitor the market; (2) no objections or significant restrictions or penalties applied to the repatriation of capital; (3) rare incidence of failed trades; (4) clearing and settlement; and (5) transparency of market and trade reporting information.[3]

S&P, for its indices, uses the following to classify a country as "frontier": "Potential frontier markets are analyzed for investor interest and accessibility. In deciding whether to initiate coverage of a frontier market, S&P Dow Jones Indices considers whether a market

2. Vivien Foster and Cecilia Briceno-Garmendia, eds., *Africa's Infrastructure: At Time for Transformation* (Washington, DC: World Bank, 2010), 58, http://infrastructureafrica.org/system/files/Africa%27s%20Infrastructure%20A%20Time%20for%20Transformation%20FULL%20TEXT.pdf.

3. FTSE Group, "FTSE Global Equity Index Series Country Classification," September 2010, http://www.ftse.com/Indices/Country_Classification/Downloads/Sept%202010/FTSE_Country_Classification_Sept_2010_Update.pdf. FTSE includes the following countries in their index: Argentina, Bahrain, Bangladesh, Botswana, Bulgaria, Côte d'Ivoire, Croatia, Cyprus, Estonia, Ghana, Jordan, Kenya, Lithuania, Macedonia, Malta, Mauritius, Nigeria, Oman, Qatar, Romania, Serbia, Slovakia, Slovenia, Sri Lanka, Tunisia, and Vietnam.

has adequate turnover, number of listings and whether it has attracted some foreign investor interest. Other considerations are a market's development prospects and, in particular, whether it is likely to develop the breadth (i.e., listings), depth (i.e., market capitalization and turnover), and infrastructure (i.e., regulatory structure, custody, clearance and settlement) for S&P Dow Jones Indices to maintain regular frontier index calculations."[4]

Finally, there are least developed countries, a classification used by the UN and multilateral development banks. The UN classifies least developed countries as having a low per capita GDP ($900 and below), weak human resource indicators (nutrition, health, education, and adult literacy), and vulnerable economies (unstable agricultural production, trade imbalance, high level of informality, and an underdeveloped market).[5] For the purposes of this chapter, we will focus on countries that within these categories that have seen their investment levels expand rapidly in the last five years but remain at a low level, and those that continue to struggle to attract investment. This will include a majority of countries in sub-Saharan Africa, several countries in Southeast and South Asia, and some in Latin America. When the term *developing country* or *developing world* is used in this chapter, it refers to the following countries (table 1).

Finally, *investment* is a broad term and covers several different areas, including foreign direct investment, equity, loans, and bonds. For the broad swath of emerging market economies, FDI is the largest form of foreign investment, totaling nearly 56 percent of cumulative flows from 2007 to 2012. Equity accounted for 6 percent during the period, bonds for 10 percent, and loans for 28 percent.[6] FDI accounts for such a high percentage of foreign investment in emerging markets because these countries lack more robust financial markets that offer a wide variety of assets for investors.[7] As an example, McKinsey Global Institute estimates that only about half of equity shares in developing countries are freely traded. In comparison, in advanced economies this figure is 85 percent. Ultimately, FDI is important to these countries, not only as a source of finance, but also for the skills and knowledge that it transfers to the local economy. This chapter will focus on the issue of FDI.

Global Financial System since 2008–2009 Crisis

The global financial crisis of 2008–2009 put a severe dent in cross-border capital flows. Even with resurgent stock markets, strong earnings by the large banks, and strong growth in developing markets, cross-border capital flows remain 60 percent below their pre-crisis peak.[8] Data and analysis indicate that emerging market economies weathered the financial

4. S&P Dow Jones Indices, "S&P Frontier Indices Methodology," September 2012, 7, https://www.sp-indexdata.com/idpfiles/emdb/prc/active/methodology/methodology-sp-frontier.pdf.

5. United Nations, "Criteria for the Identification of the LDCs," http://www.un.org/special-rep/ohrlls/ldc/ldc%20criteria.htm.

6. Lund et al., *Financial Globalization*, 35.

7. Ibid., 36.

8. Ibid.

Table 1. The Developing World

Sub-Saharan Africa	*Southeast Asia*	*South Asia*	*Latin America*
Botswana	Cambodia	Bangladesh	Belize
Burkina Faso	Laos	Pakistan	Costa Rica
Cape Verde	Myanmar	Sri Lanka	Ecuador
Cameroon	Philippines		El Salvador
Chad	Thailand		Guatemala
Congo	Vietnam		Guyana
Côte d'Ivoire			Honduras
DRC			Paraguay
Eritrea			Suriname
Ethiopia			Uruguay
Gabon			
Ghana			
Guinea			
Kenya			
Liberia			
Madagascar			
Malawi			
Mali			
Mauritania			
Mozambique			
Namibia			
Niger			
Rwanda			
Senegal			
Sierra Leone			
Tanzania			
Togo			
Uganda			
Zambia			

crisis well and in most instances escaped the contractions that advanced economies experienced. In fact, 32 percent of global capital flows now go to emerging markets—this is up from just 5 percent in 2000. However, there are serious questions about whether these markets can continue to attract financing, especially as advanced economies tighten their regulatory frameworks in order to prevent a repeat of 2008–2009. In response to this regulation, many banks in the United States and particularly Western Europe have refocused on domestic markets and reduced the amount of financing available. Although South–South financing is on the rise (now totaling $1.9 trillion in assets, up from only $300 billion in 2000), the majority of South investment still flows to the global North.[9] As yet the potential for greater South–South investment remains unfulfilled.

9. Ibid., 3–5.

In response to the global financial crisis, the advanced economies have implemented new national and transnational regulations for the financial sector. This includes national legislation such as the Dodd-Frank Act of 2010 in the United States and the United Kingdom's Financial Services Act of 2012. It also included new capital requirements for banks enacted by the Basel Committee on Banking Supervision (Basel III), which, in short, requires banks to hold significantly higher amounts of capital to hedge against potential crises. These regulations have caused many banks to reduce their overseas presence and begin to focus more on domestic lending and investments. It has also forced many banks to eschew riskier investments and either not make investments or seek shelter in stable, safe areas. It is clear that these were unintended consequences of the push for tighter regulations and greater oversight. This may not be optimal for generating greater investment for the developing world, but it is equally clear that politically it will be difficult to alter these regulations in any substantial way.

Looking at foreign direct investment (FDI) provides further depth to this picture. In 2012 there was a total of $1.3 trillion in FDI inflows around the world, which represented a slight decline from $1.6 trillion in 2011. Importantly, for the first time, FDI to the developing world was higher ($703 billion) than to the developed world ($561 billion).[10] This is clearly a result of a continued soft recovery from the global financial crisis, especially in the Eurozone. In spite of these impressive numbers, it is clear that the majority of global capital flows to the developing world are going to very specific markets. For example, the BRICs (Brazil, Russia, India, and China) accounted for $263 billion FDI inflows, or 37 percent of the total in 2012.[11] East and Southeast Asia accounted for $326 billion of FDI inflows, and Latin America for $244 billion; these two regions represented 81 percent of total FDI inflows to the developing world. Meanwhile, regionally Africa attracted $50 billion in FDI (an increase of $6 billion from 2010), and least developed countries brought in $26 billion in FDI.[12] This is a critical fact that donor countries must incorporate into their thinking on how to approach development in these regions.

Although these figures are impressive and show a growing interest on the part of investors for new markets, they mask the fact that many countries continue to struggle to attract investments. Looking at the relative success of BRIC countries in attracting FDI shows that not all are created equal. China still accounts for the lion's share of BRIC FDI, receiving $121 billion last year. India, in contrast, attracted $26 billion in FDI, approximately 20 percent of China's total. This is likely attributable to India's cumbersome foreign investment regulatory framework, which makes it less attractive to investors. In sub-Saharan Africa, the majority of FDI flowed to countries that have significant natural resources, whether minerals or oil and gas reserves. After South Africa, oil-rich Nigeria and Angola received the next highest FDI in 2012. This trend extends to countries that have seen recent discoveries, including Ghana, Liberia, Mozambique, and Tanzania.

10. UNCTAD, *World Investment Report 2013: Global Value Chains: Trade and Investment for Development* (Geneva: UNCTAD, 2012), xiii, http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf. Hereafter *WIR 2013*.
11. Ibid., xiv.
12. Ibid., xviii.

The Enabling Environment

The investment and business climates are generally combined together to create the enabling environment—the measures needed to encourage investment and private-sector development in a particular country. In general, countries that have seen increased investments over the past decade have also combined three important factors:

1. Increased political stability;

2. Improved macroeconomic indicators; and

3. Improved regulatory framework.

This is in marked contrast to two decades ago, when many countries across the developing world were mired in debt, politically unstable, and labored under byzantine regulatory frameworks. This is not to suggest that the problem has been solved—it remains a major issue for increasing access to investment in the developing world. An improved regulatory framework is critical to increasing investment in the developing world, but it is not sufficient. One can have the best regulations in the world on paper, but if they are not enforced or backed up with strong institutions, then they are meaningless.

To provide one example: Tanzania is seen as a "donor darling," receiving on average nearly $2 billion per year in official development assistance from a variety of bilateral and multilateral donors. On the macro level, the country has had impressive GDP growth over the past decade, but GDP per capita remains very low. Other economic indicators are strong, but poverty remains an issue throughout the country. Although the government entities closely associated with planning and development are seen as strong and capable, many of the broader agencies lack the ability to effectively execute policy. The judiciary, in particular, does not provide the effective legal protection necessary to stimulate broader private-sector growth and investment. Further, land tenure remains an unresolved issue in the country as a legacy of its earlier experiment with African socialism in the immediate post-independence years. All of this, along with persistent corruption, continues to hold back Tanzania from achieving its true economic growth potential. In spite of this and a multitude of diagnostics that continually identify these as the key constraints to growth, governance and rule of law remain low priorities for donors in Tanzania. The United States, for example, allocates over 70 percent of its foreign aid in this country (approximately $500 million total per year) to public health programs, with a minimal focus on factors such as governance, rule of law, and regulatory reform.

BUSINESS CLIMATE

The regulatory business climate is defined by the World Bank's *Doing Business Report* (*DBR*) as comprising 10 types of regulations: starting a business, employing workers, getting

credit, enforcing contracts, closing a business, registering property, dealing with licenses, protecting investors, paying taxes, and trading across borders.[13] Although the *Doing Business Report* has always been clear that it deals strictly with regulations that local small and medium-size enterprises must deal with, policymakers across the developing world associate improvements in their *DBR* ranking with the ability to attract greater levels of FDI.

The World Bank's *Doing Business Report* highlights the need to make improvements in the rule of law and governance in order to improve the overall investment climate. Since the *Doing Business Report* was first issued in 2003, countries around the world have made impressive regulatory improvements—nearly 2,000 individual reforms in total. This means that it is now easier to start and register a formal business in Rwanda and many other countries then it was 10 years ago. The *Doing Business Report* measures two broad metrics that affect small and medium-size enterprises (SMEs): the regulatory process that exists to register and start a business, and the strength of legal institutions. The most progress in the last 10 years has been made in the former area, while the least progress has been made in strengthening legal institutions and processes that are needed to support SMEs. This includes areas such as contract enforcement, resolving insolvency, property registration, and the overall strength of the commercial court system.

The *Doing Business Report* examines the firm level, and it is difficult to extrapolate what this means for the macro-level economy. But 10 years of data do demonstrate that the rule of law, institutional capacity, and governance, from an investment climate standpoint, remain weak in many developing countries. Although many of these countries have achieved macroeconomic stability, they continue to lag behind others in attracting foreign direct investment and other forms of finance needed to further grow their economies. It is clear that this nexus of rule of law, governance, and institutional capacity is emerging as the principal impediment to greater growth. A report by New Partnership for Africa's Development (NEPAD) and the OECD notes, "Strengthening judicial systems and the enforcement of regulations are thus central to deepening financial systems. Protecting creditors' and borrowers' rights, enforcing contracts, and putting in place transparent information sharing mechanisms are also prerequisites for financial deepening."[14] All of this remains at the periphery for most bilateral donors, who tend to focus on public health, basic education, and food security.

INVESTMENT CLIMATE

The investment climate is traditionally defined as including the business climate and the following areas: quality of infrastructure, the health system, overall level of education, rule of law, political stability and security, functioning financial markets, trade liberalization,

13. UNIDO and GTZ, *Creating an Enabling Environment for Private Sector Development in Sub-Saharan Africa* (Geneva: UNIDO, 2008), 6–7, http://www.unido.org/fileadmin/user_media/Publications/documents/creating_an_enabling_environment_for_private_sector_development_in_subSaharan_Africa_01.pdf.

14. Karim Dahou, Haibado Ismael Omar, and Mike Pfister, "Deepening African Financial Markets for Growth and Investment," NEPAD-OECD Africa Investment Initiative, November 2009, 25, http://www.oecd.org/investment/investmentfordevelopment/43966839.pdf.

and acceptance of international rules and standards.[15] The World Bank/International Finance Corporation report *Investing Across Borders* (*IAB*) highlights the critical role that the investment climate plays in attracting foreign investment. The report assesses regulations in four key areas and the impact that these have on flows of FDI for particular markets. The four areas measured are: investing across sectors indicators; starting a foreign business indicators; accessing industrial land indicators; and arbitrating commercial disputes indicators. The *IAB* found that restrictive and obsolete laws and regulations impede the flow of FDI; one-fifth of the 87 countries surveyed in the report require foreign companies to go through an approval process before investing. This is worst in regions that are most in need of investment, such as sub-Saharan Africa, where 38 percent of countries surveyed require foreign investment approval, or South Asia, where 40 percent of countries require approval. It further found that red tape and poor implementation of laws create further barriers to FDI, and good regulations and efficient processes and institutions help foster FDI.[16]

REMOVING BARRIERS TO INVESTMENT

There is some evidence to suggest that an improved business and investment climate leads to greater foreign direct investment. Generally, research suggests that there are four different types of FDI: natural-resource-seeking FDI, market-seeking FDI, efficiency-seeking FDI, and strategic-asset-seeking FDI.[17] There is no question that *market size* is important in determining whether to make an investment or not. The largest economy in the world—the United States—is the single largest destination for FDI ($168 billion in 2012), and the most populous country, China, is the second highest recipient of FDI ($121 billion in 2012). However, in reviewing 30 studies of how decisions around FDI are made, the World Bank found that the second most important factor is institutional and regulatory quality (that is, investment climate).[18] The study by the World Bank also found that *market potential* may matter more than market size. This seems to be supported by the fact that the developing world writ large is seen by investors as providing a higher rate of return than advanced economies. Not surprisingly, FDI flows to the developing world were higher last year than to the developed world.

This begs the question of whether targeted investment climate reforms can achieve short- and medium-term increase in FDI. A report by the International Finance Corporation (IFC) in January 2013 found that investment climate reforms in four sub-Saharan countries (Burkina Faso, Liberia, Rwanda, and Sierra Leone) led to increased FDI and job creation in the formal sector. In each country the IFC through the Foreign Investment

15. UNIDO and GTZ, *Creating an Enabling Environment*, 8.

16. World Bank, *Investing across Borders 2010: Indicators of Foreign Direct Investment Regulation in 87 Economies* (Washington, DC: World Bank, 2010), 8–10, http://iab.worldbank.org/~/media/FPDKM/IAB/Documents/IAB-report.pdf.

17. Kusi Hornberger, Joseph Battat, and Peter Kusek, "Attracting FDI: How Much Does Investment Climate Matter?," World Bank Policy Note No. 327, August 2011, 2, http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/327-Attracting-FDI.pdf.

18. Ibid., 2–3.

Advisory Service instituted a series of regulatory reforms that covered areas such as access to business land, construction permits, labor regulation, property registration, and taxation. The IFC estimates that this led to private-sector investment of $5–6 million in Burkina Faso, $11–13 million in Liberia, $44–51 million in Rwanda, and $15–20 million in Sierra Leone. These reforms were implemented over a period beginning in 2006 for Burkina Faso and Liberia and 2008 for Rwanda and Sierra Leone. At a higher level, all but Burkina Faso saw their overall FDI increase dramatically during this period of time.[19] Going further, based on numbers it is clear that countries working to improve their investment climate, along with increased political stability and improved macroeconomic indicators, are gaining more FDI. It seems likely that the reforms and progress of the past two decades have had an impact on where investors are willing to put their money. In 1990 the idea that investors would be flocking to fund projects in West or East Africa was inconceivable. Unfortunately, this is largely a case of causation versus correlation.

Donor Support for Investment

MULTILATERAL DONORS

The World Bank Group tackles investment climate reform through the Facility for Investment Climate Advisory Services (FIAS), which is supported by the World Bank, the IFC, the Multilateral Investment Guarantee Agency (MIGA), and a slew of bilateral donors. In fiscal year 2012, FIAS spent $19.1 million on 46 reforms. FIAS focuses its investment climate reform support on sub-Saharan African countries, International Development Association (IDA) countries, and fragile and conflict-afflicted states.[20] Under its FY 2012–2016 strategy, FIAS is focused on three strategic priorities: (1) fostering enterprise creation and growth; (2) facilitating international trade and investment; and (3) unlocking sustainable investments in key industries, particularly agribusiness and tourism. As targets, FIAS looks to implement 250 investment climate reforms across their priority clients—SSA(Sub Sahara Africa), IDA, and FCS ("fragile and conflict situations"). This work remains relatively small in comparison to the other work the World Bank carries out.

U.S. GOVERNMENT

Most of the U.S. government's investment climate reform work is carried out by the U.S. Agency for International Development (USAID)'s Bureau for Economic Growth, Environment, and Education (E3). Smaller amounts are managed by MCC, the Overseas Private Investment Corporation (OPIC), and the U.S. Trade and Development Agency (USTDA). The Promoting Economic Development and Prosperity account of the State Department and Foreign Operations budget has seven subaccounts, for macroeconomic growth, trade and

19. International Finance Corporation, *IFC Jobs Study: Assessing Private Sector Contributions to Job Creation and Poverty Reduction* (Washington, DC: World Bank, January 2013), 44; *WIR 2013*, 213–214.

20. FIAS, *2012 Annual Review* (Washington, DC: World Bank, 2012), https://www.wbginvestmentclimate.org/results/results-of-our-work/upload/2012-FAIS-AR_Web_final.pdf.

investment, the financial sector, infrastructure, agriculture, private-sector competitiveness, and economic opportunity. In FY 2013, the Obama administration requested $3.9 billion for USAID and State Department economic development programs, with 64 percent going to agriculture and infrastructure. Nearly one-third of the total goes to just two countries —Afghanistan and Pakistan— leaving only $2.6 billion to support all growth activities in the rest of the world. By contrast, the administration requested $8.5 billion for global health and $10 billion for peace and security.[21]

During his recent trip to Africa, President Obama announced that the U.S. government would commit $7 billion over the next five years to help increase investment in sub-Saharan Africa's power sector. This public-sector money would be spread between USAID, OPIC, the Export-Import Bank, MCC, USTDA, and the African Development Fund. The money would be allocated for export credits, technical assistance, risk mitigation, debt financing, grants, and guarantees. The initiative will focus on Ethiopia, Ghana, Kenya, Liberia, Nigeria, and Tanzania. Along with this, the administration has leveraged an additional $9 billion in private-sector investment. This includes:

- General Electric committed to invest in 5,000 megawatts in new projects in Ghana and Tanzania;
- Heirs Holdings committed $2.5 billion in investment and finance to develop 2,000 megawatts;
- Symbion Power will seek to catalyze $1.8 billion in investments to support 1,500 megawatts in Power Africa countries;
- Aldwych International will invest $1.1 billion in building 400 megawatts of wind power in Kenya and Tanzania;
- Harith General Partners will provide $70 million for wind power in Kenya and $500 million in a new fund for African power sector investments;
- African Finance Corporation will invest $250 million in Ghana, Kenya, and Nigeria with the aim of leveraging an additional $1 billion in investments.[22]

This is an ambitious attempt to address the shortfalls that exist in this critical sector. Although it is in the early stages, it does represent a significant shift in priorities for the United States in Africa. Earlier presidential initiatives—in the Bush and Obama administrations—dealt with food security (Feed the Future) or public health programs (PEPFAR and the Presidential Malaria Initiative).

21. See Fiscal Year 2013 Request, "Funding by Sector," http://www.foreignassistance.gov/web/ObjectiveView.aspx?budTab=tab_Bud_Planned.

22. White House, "Fact Sheet: Power Africa," June 30, 2013, http://www.whitehouse.gov/the-press-office/2013/06/30/fact-sheet-power-africa.

Alternative Sources of Investment

In countries where the regulatory framework cannot easily be addressed and the local financial markets will remain shallow, it will be necessary for other institutions to fill that gap. In practice, this will mean development finance institutions (DFIs) such as the United States' Overseas Private Investment Corporation (OPIC) and the World Bank's International Finance Corporation (IFC). DFIs hold much promise, especially considering their rapid growth over the past several years. In the early 2000s, DFIs had assets of $10 billion; that figure is now over $40 billion. This is especially useful for countries where access to financing remains a major stumbling block for private-sector companies looking to expand. SMEs face serious barriers to gaining capital or credit. Banks with a presence in the developing world (either locally owned or Western-owned branches) operate under extremely conservative, risk-averse policies. Lending to an SME is seen as having high costs from a financial and time perspective. This leads banks in the developing world to be more comfortable lending to local governments, securities and real estate firms, and other large businesses with a proven track record. Beyond restricting credit and capital, this frequently strengthens the exclusive nature of many of developing world economies.

The DFI approach is not perfect and indeed has many flaws. In particular, the IFC and OPIC remain risk-averse to moving into more dangerous countries. For example, the top 10 countries that the IFC invested in FY 2012 were: India ($3.9 bn); Brazil ($2.5 bn); China ($2.4 bn); Turkey ($2.3 bn); Russia ($2.2 bn); Mexico ($1.1 bn); Egypt ($1.1 bn); Nigeria ($1.1 bn); Philippines ($1 bn); and Vietnam ($1 bn).[23] This means that the BRIC economies accounted for $11 billion of the IFC's exposure last year. Furthermore, the regional breakdown remains tilted toward Latin America and the Caribbean, Europe and Central Asia, and East Asia, which account for nearly 60 percent of the IFC's commitments in FY 2012.[24] Investments in these countries certainly generate returns for the IFC; they also likely could largely be financed by either the host country themselves or a private-sector entity. OPIC, for its part, struggles under many of the same issues and finds itself investing in areas that may not address the proper shortfalls. OPIC has increased its investments in Africa ($900 billion in FY 2013[25]) but can and should do more.

USAID, for its part, has also begun to explore alternative means of increasing investment in the developing world. In January 2013 it launched the Private Capital Group for Africa, which seeks to facilitate greater investment in Africa. PCGA remains a new concept, but seeks to leverage experience, build partnerships, and foster innovation. PCGA is principally about identifying potential investments, finding investors, and advising on

23. International Finance Corporation, *Fiscal Year 2012 Annual Report* (Washington, DC: World Bank, June 2012), 28, http://www.ifc.org/wps/wcm/connect/2be4ef804cacfc298e39cff81ee631cc/AR2012_Report_English.pdf?MOD=AJPERES.

24. Ibid.

25. Overseas Private Investment Corporation (OPIC), *Fiscal Year 2012 Annual Report* (Washington, DC: OPIC, 2012), http://www.opic.gov/sites/default/files/files/OPIC_2012_Final.pdf.

how to invest.[26] At the end of June 2013, USAID went further and announced that it had partnered with the Abraaj Group and JS Private Equity Management to launch a private equity vehicle for Pakistan. The Pakistan Private Investment Initiative focuses on investing in Pakistani SMEs through two new private equity funds. USAID is seeding these funds with $24 million each, and Abraaj and JS have both agreed to match or exceed these funds.[27]

As evidenced by USAID's new private equity initiative, private equity is increasingly playing a prominent role as a source of investment for developing markets. Since 2002 the amount of private equity invested in emerging markets has grown from $2 billion to $26.9 billion in 2011 (down from a pre-crisis high of $53.1 billion in 2007).[28] Much of this growth has occurred in emerging Asian markets, but sub-Saharan Africa and Latin America and the Caribbean have seen significant growth. As with DFIs, private equity helps to offer access to finance in markets that have little capital available for companies from banks or simply crushing interest rates. Private equity further holds promise for growing companies in the developing world, because it can marry financing with strategic advice and knowledge that improve companies. Once invested, private equity transfers knowledge and skills that improve management teams, help companies think more strategically, and improve financial reporting, health and safety, and other areas. DFIs have been particularly supportive of growing the role of private equity in emerging markets by investing in funds focused on those markets.

Conclusions and Recommendations

Investment across the developing world is on the rise. Even countries that one would not think of as destinations of foreign investment have seen significant interest as the advanced economies of the world continue the struggle to recover from the global financial crisis of 2008–2009. Yet far more is needed. The investment gap in many countries remains significant, especially for critical pieces of infrastructure needed to spur greater growth. It is unlikely that this will be filled by official development assistance, which is taking a hit in traditional donor nations struggling to recover from the financial crisis. Many countries are increasing their own funds through improved taxation, public financial management, and bond offerings, but this will not cover the entire gap. Private sector investment is critical to filling this need.

President Obama recently returned from a trip to three countries in sub-Saharan Africa (Senegal, South Africa, and Tanzania). The focus of the president's trip was on boosting trade and investment between the United States and the African continent. Trade

26. USAID, "Private Capital Group for Africa," January 29, 2013, http://www.usaid.gov/news-information/fact-sheets/private-capital-group-africa.

27. USAID, "USAID Launches Pakistan Private Investment Initiative to Mobilize at Least $150 Million in Private Equity Investment," June 25, 2013, http://www.usaid.gov/news-information/press-releases/usaid-partners-abraaj-and-jspe-150-million-private-equity-pakistan.

28. Emerging Market Private Equity Association (EMPEA), *2012 Industry Statistics*, March 15, 2012, 8.

and investment are what is needed to help these countries and others to achieve lasting growth. This will mean that the United States and other traditional donors must rethink how they approach foreign assistance in the coming years. The focus must shift from the delivery of social goods to helping to create the enabling environment needed for greater investment and the growth of a local, vibrant private sector. Thus, the United States (and in some instances the World Bank) should refocus its efforts on governance, rule of law, regulatory reform, and institutional capacity building.

- *Strengthen Support for Critical Regulatory Reforms.* Although one cannot say with absolute certainty that improved regulations critical for investment lead to greater investment in every single case, it is clear that there is significant correlation. The U.S. government's development agencies can and should do more in this particular area. This will require greater coordination among the agencies involved in this area—USAID, MCC, OPIC, USTDA, and others.
    - *A New Strategy.* Design a new USAID strategy for economic growth. The last comprehensive economic growth strategy was issued in 2008 during the Bush administration. This strategy should highlight the critical role that governance, rule of law, anti-corruption, and regulatory reform can play in achieving long-term economic growth.
    - *Constraints to Growth/Investment.* As part of its compact process, MCC has long utilized a "constraints to growth analysis" to determine how to allocate funds in a particular country. In the recently launched Partnership for Growth, USAID employed a similar process in four countries: Ghana, the Philippines, Panama, and Tanzania. This is a critical process to determine how resources should be allocated, and it should be broadened to include more countries.
    - *Shift Resources Where Appropriate.* In countries where the investment climate (regulatory reform, governance, and rule of law) continues to present a barrier to investment, the United States must shift resources to address these issues. In some circumstances this may mean shifting funds away from public health and other programs. If the United States is serious about creating the conditions for private-sector investment, then it must take the necessary steps to assist partner governments.
    - *Strengthen U.S. Support for World Bank Activities.* The World Bank, through FIAS and the IFC, provides significant support for improving the investment climate across the developing world. The United States does provide some funds to FIAS, but it should increase its support.
- *Continue to Use DFIs to Address Critical Shortfalls.* For many private investors, some countries around the world will remain out of bounds due to their high level of political and economic risk. Even in countries that are attracting higher levels of investment, some entities—specifically small and medium-size enterprises, the so-called "missing middle"—will continue to struggle to attract the investment needed to grow. Development finance institutions such as the World Bank's IFC and the United States' OPIC can help fill these particular needs.

- *Strengthen OPIC's Tools.* OPIC must be reauthorized on a long-term or permanent basis and its mandate expanded and strengthened by increasing its borrowing ceiling, providing it with equity-investing authority, and allowing it to provide first-loss funding. Giving OPIC these tools would bring it in line with the IFC and other DFIs in advanced economies.
- *Carbon Cap at OPIC.* We should revisit the OPIC Carbon Cap for the fifty lowest-income countries. Although the goal of encouraging renewable energy sources is laudable, in some circumstances the market conditions are not appropriate. This is particularly true in low-income countries, where the focus should be on financing solutions that are market appropriate.
- *Refocus on Critical Regions.* Both the IFC and OPIC have shifted significant funds toward sub-Saharan Africa and fragile and conflict-afflicted states, but both could and should do more in areas that continue to attract lower levels of private investment. The UK's DFI, CDC, recently underwent a review of their entire system and decided to refocus their support on sub-Saharan Africa and South Asia.
- *Provide Greater Support to SMEs.* Congress should create an SME line item similar to the long-existing microfinance item in the annual foreign operations appropriations bill to improve SME access to capital. It should further build the capacity of private development finance organizations, such as the Small Enterprise Assistance Fund, by removing policy and regulatory obstacles to SME lending.

- *Expand and Use New Investment Vehicles.* USAID has recently created several new investment vehicles that are meant to encourage greater private investment in the developing world. This includes the Private Capital Group for Africa and the Pakistan Investment Initiative. These are good first steps and represent an effort by the U.S. government to crowd in private investment. The IFC has been a major investor in private equity funds geared toward the developing world; if OPIC had the ability to make equity investments, then it could begin support these funds as well.

3 Procurement: Procurement System Modernization

Conor M. Savoy and Clare Richardson-Barlow

Introduction

Government procurement capacity remains a challenge across the developing world. This is true of middle-income countries like Indonesia and lower-income ones such as Tanzania. The World Bank estimates that the average government in the developing world will spend up to 20 percent of gross domestic product on procurement every year. Worldwide it is estimated that total government spending on procurement amounts to $7 trillion per year, half of which is allocated by local and not national government entities.[1] Traditionally procurement has been undervalued, with procurement specialists being largely treated as providers of a process-oriented office support function that could be implemented by nonprofessionals. There is a growing recognition that a reformed, professionalized procurement system can contribute to good governance by raising government accountability and improving the value of funds expended. Although some of this recognition is the result of outside pressure, much of it is being driven by the rise of a new middle class across the developing world that is demanding more accountability from its governments. A consistent lack of (1) human capacity, (2) modern tools and processes, and (3) clearly outlined laws and regulations poses serious challenges to reform efforts in the area of government procurement.

What is clear, though, is that procurement is a cross-cutting issue that can have an immense effect on broader development issues. For example, finding ways to address the large infrastructure investment gap (estimated to be $93 billion annually) that exists in sub-Saharan Africa is critical for the African continent's continued economic success. One piece that is often absent from those discussions is how governments award contracts to build infrastructure projects (i.e., the procurement process). Furthermore, because many procurement systems are closed to outside competition, procurement reform should form part of the trade agenda. Looking at it from an even broader lens, reform of procurement systems is one way for donor organizations to tackle difficult governance, accountability, and most importantly, transparency issues that are increasingly on the agenda. Part of the problem remains the fact that procurement in many developing countries is a closed

1. Colin Cram, "$3.5 Trillion Global Spent on Local Procurement 'Woefully' Mismanaged," *The Guardian*, October 22, 2012, http://www.theguardian.com/local-government-network/2012/oct/22/colin-cram-local-government-global-procurement.

process that favors political connections over best value or cost. Increasing competition and transparency will drive down cost and ensure best value. The challenges outlined above, especially vested interests and political will, get at the heart of these broader issues. Incorporating procurement reform into this debate is simply one more way in which to address issues that, for many countries, must be addressed before these countries can grow further.

Background

Government procurement is the purchasing of goods and services, including all government expenditures except staff costs and transfer payments, for the benefit of a government agency or other public authority. A well-functioning public procurement system is generally seen as being transparent, competitive, economical and efficient, and fair and accountable.[2] The two types of procurement, large and complex tenders and small-scale procurement, are intertwined, and reform of procurement policies directed at one will affect the other. Small-scale procurement efforts are more common, and were previously identified by a CSIS working group as "a scalable starting point from which to build up the internal structures and human capacity necessary for achieving a workforce and system with the level of sophistication required to manage complex procurements later on."[3]

Many governments have their own rules and regulations regarding procurement policies, and often government procurement rules are written into free-trade agreements (FTAs). The United States, for example, incorporates government procurement obligations into all FTAs so that U.S. suppliers receive fair, nondiscriminatory opportunities in order to compete with FTA partners.[4] This incentive, enhancing access and increasing competition among potential suppliers, is what makes government procurement policies so important. As such, government procurement has had a long history of involvement in the FTA negotiating process. In 1979 the first government procurement agreement, the Government Procurement Agreement (GPA), was established; it entered into force in 1981. The GPA was adopted by the World Trade Organization (WTO) and revised and expanded into the 1996 agreement, which remains the only legally binding agreement in the WTO that focuses on government procurement;[5] the GPA was revised and renegotiated in 2011.[6] Today most developed countries take government procurement into account when negotiating trade issues in FTAs.

The link between government procurement and total spending is significant. The Office of the U.S. Trade Representative estimates that government procurement makes up 15 to

2. World Bank, "Elements That Constitute a Well-Functioning Public Procurement System," in *Country Procurement Assessment Report*, May 23, 2002, 13–14, http://siteresources.worldbank.org/PROCUREMENT/Resources/cpar.pdf.

3. CSIS, "Procurement Reform in Developing Economies," internal memo, March 19, 2012.

4. USTR, "Government Procurement," http://www.ustr.gov/trade-topics/government-procurement.

5. Not all WTO members are signatories of the GPA—it is a plurilateral agreement that members have the option of signing; of the 159 members, there are 15 parties to the agreement and 28 observers, of which 9 are negotiating accession.

6. WTO, "The Plurilateral Agreement on Government Procurement (GPA)," http://www.wto.org/english/tratop_e/gproc_e/gp_gpa_e.htm.

20 percent of a country's GDP (depending on level of development).[7] As much as 50 percent of total government spending is for government procurement, linking suppliers with international markets and vice versa. Many governments take for granted how public money is spent, and the funneling of money back into the local economy by utilizing only local providers can have short-term political benefits. In the long term, however, government procurement can eliminate barriers to market access, opening up small markets to the rest of the world through the elimination of preferential treatments. Implemented correctly, government procurement builds economies; done incorrectly, however, it has the potential to destroy markets and waste resources. Utilizing reforms to government procurement strategies within FTAs can have wide-ranging positive effects on developing economies, and as such can be used as an important development tool. Trade is, in and of itself, one of the most important tools for creating a more prosperous, better integrated global supply chain; likewise, free trade is the key to procurement reform.

Broader challenges to reform of government procurement policies have come from many directions, including increasing commodity prices, the global economic crisis, and the rise of state capitalism. Political opposition to government procurement policies is also an issue, as there is skepticism as to developing economies' ability to compete with goods and services suppliers in industrialized and developed nations. Protectionist policies, in which local or national companies are given large subsidies and the government provides protection against international competitors, affect not only multinational companies, but also small businesses that are not given the opportunity to innovate or grow and expand into other markets. Proponents of government procurement agreements point to increased transparency, market access, and incentives for innovation as the real game-changers that government procurement has to offer. Building stronger procurement capacities within developing and emerging economies has the potential to be an effective tool of development and an outlet of infrastructure investment. Reform of procurement policies, in order to lessen the negative effects, spur development, and increase international trade, are an important step in fully utilizing government procurement as a tool of development by both developed and developing economies.

Procurement Reform

Donors have traditionally supported various procurement reform efforts with the emphasis generally on training of procurement staff and inspection activities, such as anti-corruption procedures or auditing. Much of the work flows through multilateral organizations, such as the World Bank or the Organization for Economic Cooperation and Development (OECD); many bilateral donors, including the United States, have engaged in work to support procurement reform. One of the main projects of the United States' recently signed Millennium Challenge Corporation (MCC) compact with Indonesia, for example, is procurement modernization. Donors have traditionally focused on procurement reform as addressing a perceived lack of training for those implementing procurement. In

7. USTR, "Government Procurement."

reforming their procurement systems, governments face a series of challenges, including the following:

- Lack of technical knowledge and capacity;
- Complexity of issues;
- Type of legal instrument needed;
- Type of procurement organization; and
- Enforcement of rules and regulations.

The source of these shortcomings can generally be traced to the prevailing political mindset that undervalues the importance of procurement and procurement professionals. Addressing this challenge of political will requires an approach that extends *beyond* the current framework of governance. For example, anti-corruption monitoring, which has been a prominent focus of efforts by the international community, has had the unintended consequence of reinforcing the misperception among emerging economies that procurement is a wholly administrative process requiring top-down oversight rather than bottom-up improvement. The dearth of procurement professionals in emerging markets diminishes those countries' ability to truly capitalize on their growth. Procurement decisions based on price points rather than life-cycle costs preempt the creation of the long-term infrastructures and systems needed to support expanding populations and private sectors. Early international efforts to foster workforce professionalization and policy reform, such as the United Nations' Procurement Capacity Development Center in Denmark and the MCC's compact with Indonesia, will require much greater and sustained attention over the next decade.

The World Bank, in particular, has played a leading role in assisting countries in the reform and modernization of their procurement systems. This is undertaken as part of the Bank's overall governance work as well as its work in strengthening the local capacity of government. The Bank tackles specific country-level procurement reform projects and conducts "Country Procurement Assessment Reports" that aid in determining the critical challenges facing particular country procurement systems. In implementing a country-level project, the Bank seeks to "reduce delays, improve quality and ensure transparency in public sector procurement." Further, the Bank seeks to bring broader benefits from procurement reform through "faster and better use of public resources, significant reduction of corruption and increased aid utilization capacity."[8] The Bank has worked with a number of countries to improve their procurement systems; in particular it has an ongoing project in Bangladesh.

On the other hand, exporting U.S. government standards such as the Federal Acquisition Regulation has not worked. For example, following the collapse of the Soviet Union, the

8. World Bank, "Implementation Completion and Results Report on a Credit in the Amount of SDR 3.6 Million to the People's Republic of Bangladesh for a Public Procurement Reform Project," June 25, 2008, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2008/07/02/000333038_20080702024537/Rendered/PDF/ICR6660ICR0P071sclosed0June03002008.pdf.

United States attempted to use the existing U.S. acquisition and procurement framework as a model for the former Eastern Bloc nations. This process failed, largely for the following reasons:

- The bureaucracy tends to measure the process rather than the outcomes of that process. It is important to know what money is being spent on, but the effect of the expenditure is even more important.
- The emphasis on transparency has led to a greater concentration on precision rather than consequences.
- Governments vote with how they spend their revenue, hence they vote for both process and outcome. If the intended consequence is not realized, a perfectly executed process is useless. Procurements are a major part of the economy even if the multiplier effect is minimal.
- The role of life-cycle cost analysis and other practices broadly used in the private sector have been overlooked. Unlike the private sector, governments, with annual appropriations processes, have no time-value of money; hence, spending decisions are often based on single-event, cost-only terms.
- The amount of paperwork and red tape imposed by anti-corruption processes de-incentivizes the very businesses they are supposed to protect.
- Governments usually elevate procedural perfection over outcomes because procurement is seen as an end in itself. The zero-risk tolerance attitude (often promoted by the United States) to developing countries results in the oversight mechanism's being more expensive than the actual operation and is therefore counterproductive.[9]

Tackling these issues in procurement reform is difficult. These six areas call into question many of the fundamental ways in which donors approach reform projects and may require a rethink of how they design projects. The traditional focus on process and regulation has not produced the results needed. Looking at how procurement professionals are trained may hold the answer to addressing lingering challenges.

Other potential areas of reform include the opening of donor countries' markets to products, such as IT services, from emerging economies in order to incentivize governments to refine their procurement platforms and thus stimulate industry. This represents an issue that is often overlooked when discussing procurement reform—that is, how closely linked it can be with the free-trade agenda. Resistance to reform is often rooted in a desire to keep local and national procurement systems closed to outside competition, either to support "buy local" provisions[10] or to maintain some form of an exclusive economic system

9. CSIS, "Internal Discussion on Procurement Reform," May 2013.

10. The United States and other donors are certainly not innocent when it comes to utilizing "buy local" provisions in procurement. Calls for "buy American" remain very powerful in the U.S. Congress and certainly resonate with many Americans.

that benefits a small elite. What is often overlooked in this particular area is that fact that many of these countries receive preferential trade provisions from the United States through the Generalized System of Preferences (GSP). Linking reform of procurement to the broader trade discussion would have immense benefit both for local governments and for worldwide trade and competition.

CORRUPTION AND TRANSPARENCY

It has long been a tacit assumption in development that corruption is inherently part of the cost of doing business in the developing world. This is particularly true of procurement, where one of the biggest challenges is creating systems that are transparent and offer open opportunities to all players. If the process remains opaque and hidden underneath byzantine regulations, the field is immediately titled toward those who have been there before and who have an upper hand because of less-than-reputable means. Such systems only reinforce exclusive economies that maintain power in the hands of the elite. As one author notes, "A procurement system that has loose or opaque rules and which are also poorly enforced provides opportunities for misuse of the contract award process through corruption or other patronage arrangements."[11]

Information technology can offer innovative improvements to the transparency of the procurement process. In particular, e-commerce can offer an ability to better understand the breadth of government procurement. This could include everything from tender announcements, requests for proposals, acquisition and procurement regulations, and announcements of decisions. Moving transactions to an electronic and traceable system has yielded tremendous results in the anti-corruption struggle in other arenas—one need look no further than the immense amount of graft that was eliminated when Afghan policemen began receiving their salaries via mobile banking. There is good reason to believe that this technologically driven progress against corruption can happen with respect to procurement as well.

The private sector can play a critical role in combating corruption, especially in the procurement context. While some companies operating in developing countries have traditionally had a higher tolerance for corruption than donors, they also are keen to eliminate costs and dangers associated with bribes and unreliable investment climates. The World Bank and its private-sector arm the International Finance Corporation take procurement reform seriously within their broader goal of promoting healthy investment climates in developing countries. How recipient countries use World Bank funds for goods and services remains a topic of debate within the institution. The World Bank seeks to utilize countries' own procurement systems wherever possible, but rampant corruption in a system can jeopardize the whole venture.

11. Robert R. Hunja, "Obstacles to Public Procurement Reform in Developing Countries" (paper presented at a joint WTO–World Bank regional workshop on procurement reforms and transparency in public procurement for Anglophone African countries, Dar es Salaam, January 14–17, 2003), 4, http://www.wto.org/english/tratop_e/gproc_e/wkshop_tanz_jan03/wkshop_tanz_jan03_e.htm.

Civil society, in particular, is playing a key role in tackling corruption in procurement. Active civil society, with an independent and informed media presence, can hold government and private-sector actors accountable. In the context of procurement, increasing pressure from civil society groups and journalists for governments to disclose their transactions in publicly accessible portals bodes well for transparency in these systems. Importantly, this pressure is felt even in countries where governance and rule of law are weaker. Global efforts to create an enabling environment for civil society actors in developing countries can thus bear fruit in procurement reform as well.

MCC: THE CASE OF INDONESIA

Since the Asian financial crisis of 1997 and its transition to democracy, Indonesia has emerged as a growing middle-income country. It has seen over 6 percent GDP growth for the last several years, weathered the 2008–2009 global financial crisis well, and continues to attract robust foreign investment. As part of its transition to democracy, Indonesia also underwent a process of decentralization of power. Known as the "big bang," this featured a great deal of power transferred from the central government to the local level. From a budget perspective, this has the effect of moving more than 40 percent of total government expenditure to the local level, making Indonesia one of the most decentralized countries in the world. This has had a profound impact on procurement in Indonesia, by concentrating a large amount at the local level without corresponding improvements in the overall system of procurement. Indonesia's procurement system is not unlike that of other developing countries that must contend with overlapping rules and regulations, an ill-defined procurement track within the civil service, high levels of corruption, and a lack of transparency. A study by the Indonesian Corruption Eradication Commission in 2011 estimated that in 2011 alone almost $15 billion was misused due to corruption or ineptness in the procurement process.[12]

The United States recently signed an MCC compact with Indonesia that focuses on three areas: (1) green prosperity, (2) procurement modernization, and (3) community-based health and nutrition to reduce stunting. Although procurement modernization is the smallest of the three projects ($50 million over the life of the compact), it has the potential to make an impact. The project will focus on building a professional procurement workforce within both central ministries and local government offices. The MCC will only work with a small subset of Indonesian entities (there are over 1,000 procuring entities in Indonesia), but it will seek to seed the new professionals throughout the system. It will professionalize through training and institutionalizing good practices across the system. For the first time, procurement will become a track within the Indonesian civil service. The training program will involve a multi-tiered system that will become more advanced as individuals move through it. Ultimately, the hope is that the training program will be taken over by the Indonesian government, expanded, and made permanent.[13] But it is important

12. MCC, "Indonesia Compact," http://www.mcc.gov/pages/countries/program/indonesia-compact.
13. MCC, "MCC and Indonesia: Investing in Innovation for Sustainable Economic Growth," February 6, 2012, http://www.mcc.gov/documents/press/transcript-2012002104401-indonesia_compact_outreach.pdf.

to keep in mind that the MCC's procurement modernization project in Indonesia remains a work in progress that has yet to produce results that can be measured and evaluated to lead to lessons learned.

Conclusion and Recommendations

For too long, reform of procurement systems has been viewed as a small niche subject unconnected to the broader issues of governance, accountability, and transparency across the developing world. But when one considers that procurement can account for up to 20 percent of GDP, the importance of the issue should come into focus. The combined effects of procurement reform on governance, growth, investment, and transparency are immense, although thus far the development community has not pursued procurement reform in a systemic way. Efforts to date include small-scale projects in a variety of countries where procurement is being tackled as part of broader capacity-building and governance programs. It is clear, though, that in order for procurement reform efforts to be successful, donors will need consistent political support to ensure enforcement and commitment to the reforms enacted.

Many developing countries do not have the market access capacity required for effective procurement; the same government that controls procurement controls market access. The legal framework that exists is usually adequate, but what is missing is enforcement. A responsible procurement system needs a working judiciary, an active civil society, and a free investigative press. There is also a need to identify the link between procurement efficiency and economic development, stressing awareness of the significance of the broad economic impact of procurement. However, energizing the private sector has proved to be difficult, because there is a form of prisoners' dilemma in which no enterprise wants to be the first to disclose its operational details, for fear of losing its competitive edge. Some experts advocate a global professional standard for procurement officials. Because there is no industry standard for procurement and means of measurement, only compliance is emphasized by governments. Hence, a conceptual framework for government efficiency needs to be created, and there is also potential for a procurement performance index.

Further, procurement reform can play a part in the broader trade liberalization agenda. To achieve truly open markets, all sectors—including government procurement—must be open to outside competition. Unfortunately, in many developing countries this sector remains largely closed or at the very least tightly controlled by the central government to protect local industry. Many of the countries that have open markets are parties to preferential trade agreements with the United States, such as the African Growth and Opportunity Act (AGOA), and they reap the benefits conferred upon them. Opening their procurement process to outside competitors on a balanced playing field would help bring them best value and best product. The AGOA and other trade preference programs include conditions that countries must meet in order to gain entry. It is not unreasonable, as a first step, to include a condition on procurement transparency as part of the ongoing renewal of the AGOA.

To begin the process of reforming procurement, the U.S. government should consider the following steps:

- *Put Procurement on the Development Agenda.* This is particularly true for U.S. development efforts, where procurement remains a low priority. Procurement needs to form part of a renewed U.S. commitment to tackling tricky governance issues that are frequently the prime constraint to greater growth. Improved procurement processes will lead to better value, which ultimately will lead to cost savings and free up resources that can be directed toward a country's development.
- *Use Procurement Reform as a Starting Point to Tackle Issues of Corruption and Transparency.* As noted, corruption is an issue that the development community has traditionally shied away from or viewed as the cost of doing business in the developing world. This is changing, and the process remains slow. Procurement is one area that is particularly affected by corruption and offers a useful inroad for donors to begin a larger dialogue about reducing corruption and increasing the transparency of government operations.
- *Monitor the Indonesia MCC Compact Procurement Reform Project as a Potential Model.* The MCC has launched an important effort to reform Indonesia's procurement system. Although still in the early stages, this project holds promise. If it is successful, it should be replicated by MCC and USAID in other countries where procurement reform is a priority (e.g., Ghana and Bangladesh). Where possible, the United States should work with other donors that are already engaged on this topic.

Appendix: Conference Agenda

On October 23, 2013, the CSIS Scholl Chair joined the CSIS Project on Prosperity and Development program to host the "New Development Agenda" conference, which addressed future trends in funding development projects. An annotated conference agenda is included below. The event can be viewed online at http://csis.org/event/new-development-agenda-trade-investment-and-procurement.

Panel: Challenges and Opportunities for Trade and Investment

Scott Miller, *Senior Adviser and Scholl Chair in International Business, CSIS*

- Trade grew at a faster rate than the economy in the last few decades. There has been a trend toward the rejection of central planning.
- There is great potential in the marriage of long-term, stable returns in the developed world and the building of infrastructure in the developing world.
- Local contact requirements remain a trade-distorting subsidy.
- 80 percent of trade by firms involves the exchange of ideas and know-how. By not having a strong intellectual property protection scheme, developing countries forfeit participation in this market.
- The actual creation of jobs will always be a more attractive option than job training programs.

Randy Quarles, *Managing Director, Carlyle Group*

- Bulk of current capital flows come from the private sector, which is a radical change from the 1960s.
- The current total of all official direct assistance (ODA) is about $120 billion. With governments facing fiscal constraints, this number will likely shrink while demand for capital in developing markets will increase.

- The private sector is where the most transformative money is. A billion people have been lifted out of poverty in India and China alone, as a result of their opening to global trade.
- The biggest drawing force for private capital is the potential. Developing markets are growing rapidly.
- Improving the business environment, such as through rule of law, transparent and fair regulations, and the protection of intellectual property, is much more important than physical infrastructure.
- Protection of intellectual property is an increasingly important consideration for firms. IP laws may determine where firms choose to produce.

Karan Bhatia, *Vice President and Senior Counsel, Global Government Affairs & Policy, GE*

- Physical infrastructure is the most important aspect of development.
- Development policy has not kept up with the idea of the private sector working as the driving force in development.
- Better procurement policy is necessary for these markets to reach full potential.
- Traditional trade barriers (tariffs, preferential subsidies, etc.) are increasingly irrelevant as barriers to trade. Twenty-first-century trade barriers include things like local content requirements.
- OPEC and other regulating authorities are not quick enough in their response to global market changes.
- Procurement can slow down transactions, especially when governments lack the capacity for efficient procurement processes.
- Governments need to come to their own conclusion on balancing the protection of their domestic interests with the opening their markets to trade and investment.

Joseph Engelhard, *Senior Vice President, Capital Alpha Partners, LLC*

- Multinational companies account for 80 percent of global value chains. The emerging market only accounts for 40 to 50 percent of the total value added.
- The governments of emerging markets are more focused on short-term results, like reelection. They need to focus on long-term, structural change.

Keynote Address

Caroline Atkinson, *Deputy National Security Adviser, International Economics, Executive Office of the President*

- There is not enough government money to address issues without support from the private sector. We need to change incentives to encourage institutional reforms.
- Aid triggers capital flow but cannot sustain it.
- There needs to be harmonization between the private sector, government agencies, and international organizations toward trade facilitation.
- Facilitating trade should feature removing barriers that slow exchanges across borders.
- The full implementation of OECD regulations could cut trade costs by 10 percent.
- Trade is necessary for development in Africa. States must first focus on integration within the region and the development of the capacity of African firms. Second, they must create an environment that is conducive to investment.
- G20 countries are actively looking to invest in new countries.
- Partnership with the private sector has brought huge progress to food security, nutrition, and electricity.

Panel: Modernizing Procurement Systems

Christopher R. Yukins, *Lynn David Research Professor in Government Procurement Law, George Washington University Law School*

- Corruption costs $200 billion in bribes and $1.5 trillion in lost economic growth due to leakages and trade barriers.
- Corruption and domestic preferences are both trade barriers. Establishing procurement systems can reduce moral hazard risk but can also add to inefficiency in the market.
- Procurement officers are given almost complete agency in procurement, which means sophisticated transparency regulations must be implemented to keep the principals satisfied.
- Corruption can be reduced by training the public and private sectors, as well as creating an understanding that states are participating in an international community with norms and commitments.

Christopher Browne, *Chief Procurement Officer, World Bank*

- To strengthen procurement systems, there must be more transfer of knowledge.
- There is no international standard for procurement.
- If the state is too weak, the bank itself is responsible for procurement.

- In many developing countries, procurement is a complicated, inefficient system. The relevant bureaucracies must be streamlined.
- One approach is to build on existing local systems that work and improve them.
- The prospect of increased trade can be a strong enough incentive to transform procurement.
- More flexibility is needed in the implementation of procurement practices. Data transparency is also crucial for success.

Jean-Marie Meyer, *Senior Director, Program on Procurement Policy, MCC*

- Procurement is underrecognized and underfunded.
- The alleviation of poverty, performance, etc., all ties back to economic growth.
- There are no performance standards for procurement. The focus is on compliance rather than outcomes.
- The MCC was involved in creating in Indonesia a procurement unit that helped them develop the tools and environment for better procurement.
- Procurement needs to be approached like a business, not a bureaucracy.
- Important skills for procurement include record keeping and data management.
- There is a need for technical experts, vendors, and auditors who understand the importance of procurement.
- Procurement should be considered a profession. There are many experts who deal with the financial transaction aspect of PPPs, but not many are versed in the implementation/accountability aspects.

About the Authors

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