Foreign Direct Investment for Structural Transformation in Landlocked Developing Countries

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Executive summary

Progress towards economic growth and structural transformation in landlocked developing countries (LLDCs) was impeded significantly by the COVID-19 pandemic. Efforts at a broad-based recovery have also largely failed to gain momentum due to challenging macroeconomic conditions. LLDCs thus stand at a crossroads and risk having their development gains wither away and having their structural vulnerabilities further exacerbate.

Against this backdrop, leveraging the potential of the private sector to aid recovery in LLDCs, and provide renewed impetus to the pursuit of the sustainable development agenda and the Vienna Programme of Action has become paramount. One area where the role of the private sector is critical is driving productivity enhancing investment. Investment by and trade with multinational enterprises (MNEs) can provide impetus to efforts for structural transformation in LLDCs. Foreign investment can also lead to a host of positive externalities in the form of knowledge spillovers, human capital development and improvement of the business environment. Integration into GVCs that is contingent on foreign investment is especially important for LLDCs as it can increase their trade linkages and provide opportunities for the higher retention of value added domestically.

The global investment landscape, however, is becoming increasingly challenging both due to long-term secular trends such as regulatory restrictions, automation and the shift towards sustainability. Moreover, grey swan events such as the COVID-19 pandemic and the war in Ukraine are also having significant impact on investment flows. Yet there are also new opportunities on the global horizon which LLDCs need to benefit from. For example, the increasing importance of intangibles, services and knowledge intensive outputs presents an opportunity for LLDCs to sidestep their geographical disadvantages. Similarly, the pressure to build redundancies in supply chains and the shift towards regional value chains is opening up new opportunities for LLDCs to participate in large manufacturing industries such as textiles, pharmaceuticals and electronics.

This report after providing foreign investment trends in LLDCs' during the Vienna Programme of Action review period will present tangible policy options to increase investment flows and harness them for structural transformation. It also includes a case studies of Malaysia's investment promotion strategy that has a significant impact on development and industrialization in the country. Policy options are specifically presented across five dimensions: overcoming trade and transit constraints; proactive investment promotion policies and favorable investment climates; industrial policies; building efficient and dynamic special economic zones and finally integration in global and regiona value chains.

1. Introduction:

Foreign direct investment (FDI) inflows in landlocked developing countries (LLDCs) have been tepid for several years and especially after the adoption of the Vienna Programme of Action. Numerous factors have contributed to this, including, a changing international investment landscape, weak integration with global trade networks, higher competition for investment flows, low productive capacity and uncompetitive investment regulations. The COVID-19 crisis led to a further and severe decline in FDI flows to LLDCs, at a pace even higher than the global average. The impact on FDI in LLDCs was exacerbated by demand-side constraints for commodities and low prices of natural resources during the pandemic. In addition, resource and institutional constraints precluded employing economic support measures for individuals and producers, further inhibiting foreign investment. FDI to LLDCs declined from $22 billion in 2019 to $14.1 billion in 2020, a 35% decline. Although inflows recovered in 2021, by 31 per cent, this recovery was below both the global and developing country average increase in FDI flows (UNCTAD, 2022).

Not only have FDI inflows in LLDCs remained consistently low, but they have also been largely directed towards natural resources with limited investment inflows in manufacturing and services. This has perpetuated natural resource dependency and denied LLDCs the opportunity to leverage the knowledge spillovers and other benefits associated with foreign investment for their structural transformation.

Foreign investment flows can support a sustainable recovery in LLDCs and enhance long-term economic resilience. However, this would be contingent on attenuating the deep structural bottlenecks that have kept investment low and also reorienting it towards dynamic manufacturing and services sectors. Foreign investment played a critical role in the development of many economies that transitioned from low value added to high value-added activities in the last 50 years. Although the global investment landscape has shifted significantly, considerable opportunities still persist for harnessing the role of foreign investment for structural economic transformation. Considering the special circumstances of LLDCs, a proactive approach to attracting efficiency and regional market seeking investment in line with the local contexts and priorities is imperative. Foreign private investment is also increasingly becoming important for infrastructure especially transport infrastructure and renewable energy. Yet LLDCs, despite high needs, have to a large degree been unable to harness foreign investment for infrastructure development.

This report has been prepared against this backdrop and aims to serve a brief guidebook for policymakers in LLDCs on steps that can be taken to increase the role of foreign investment for structural transformation and infrastructure development. This report comes at a crucial time as the post-pandemic development agenda is being devised at the national, regional and global levels. In addition, the UN General Assembly in December 2021 decided to convene in 2024 the Third UN Conference on LLDCs (LLDC-III) which will undertake a comprehensive review of the implementation of the Vienna Programme of Action (VPoA) and formulate and adopt a renewed framework for international support to address the special needs of LLDCs. In light of this, the report presents a detailed assessment of investment

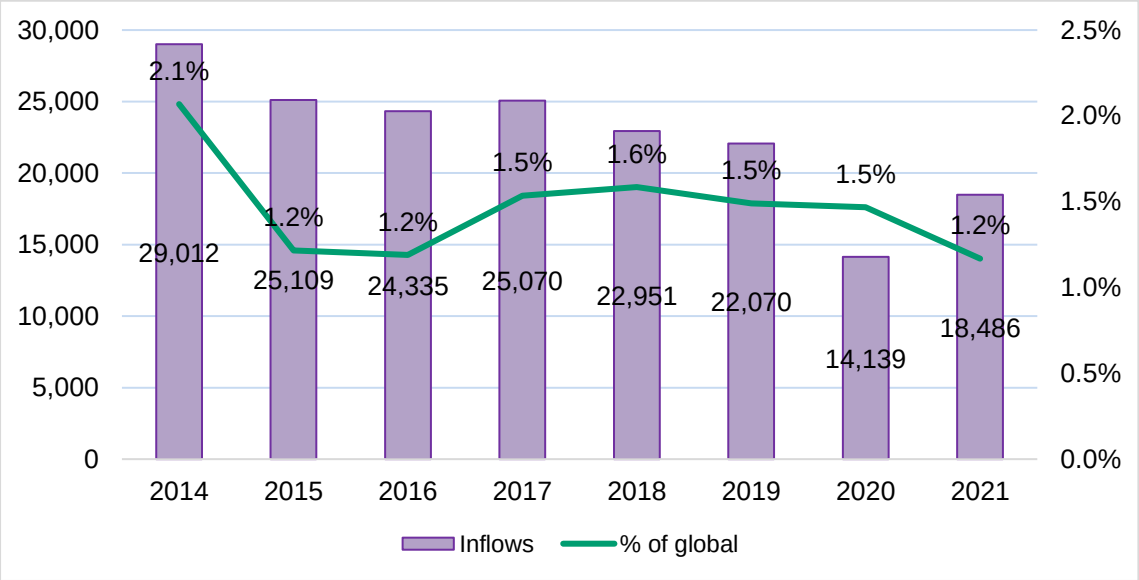
trends in LLDCs in the VPoA review period and suggests wide ranging policy proposals for optimizing broad-based growth generating investment flows that will feed into the preparations for the conference.

2. Investment trends in LLDCs during the Vienna Programme of Action Review Period

Investment inflows in LLDCs during the Vienna Programme of Action (VPoA) review period have mostly been on a downward trend (Figure 1). The highest inflows were received in the year when the VPoA was adopted (2014). In 2021, FDI inflows in LLDCs were $18.5 billion only, compared to $29.0 billion in 2014. While some of the drawdown in investment can be attributed to a slowdown in global FDI flows, LLDCs' share of global investment flows has also been declining, having come down from 2.1% in 2014 to 1.2% in 2021. In 2020, inflows had dropped to less than half of 2014 levels ($14.1 billion from $29.0 billion). Although this was due to the COVID-19 pandemic, the post-COVID investment recovery in LLDCs has also been slower than the global average. This is illustrative of wider structural shortcoming in LLDC economies that inhibit higher levels of investment and restrict their competitiveness as investment destinations.

Another key challenge for LLDCs is that the limited investment flows that they receive are largely directed towards natural resources extraction. On the other hand, inflows in manufacturing and services industries that are crucial for structural economic transformation are limited. This makes investment flows volatile and contingent on demand for commodities. As a result, foreign investment that does come to LLDCs has limited impact on domestic value capture. Amid an increasingly competitive global investment climate in the coming years, it would be crucial for LLDCs to diagnose reasons for low levels of foreign investment and take urgent measures to alleviate these. Some of the key reasons for low and declining levels of foreign investment flows in LLDCs are outlined in the following section.

Figure 1: FDI inflows in Landlocked Developing Countries in the Vienna Programme of Action Review Period (millions of US$ and % of global)



Source: UN-OHRLLS based on UNCTAD data

FDI stock refers to the cumulative and reassessed value of all past FDI inflows. FDI stock data enables an analysis on the evolution of a country's foreign investment position in the long-term. Since FDI inflows can be volatile based on both international and domestic conditions, FDI stock data is beneficial for comparing across countries and country groups. Table 1 shows the evolution of the FDI stock position in LLDCs from the start of the VPoA review period. It confirms that the international investment position in LLDCs despite improving in absolute terms, has deteriorated in comparative terms.

Table 1: FDI Stock in LLDCs

	2014	2015	2016	2017	2018	2019	2020	2021
Current prices in millions of US$	305,966	321,892	348,342	374,048	393,593	409,902	420,583	431,130
Current prices in US$ per capita	675	693	733	768	787	800	801	802
Percentage of world total	1.16	1.21	1.22	1.13	1.2	1.12	1.01	0.95

Source: UN-OHRLLS based on UNCTAD data

It is pertinent to mention, however, that LLDCs are a heterogenous group in terms of FDI inflows. Although some broad investment trends can be delineated across the group there is wide discrepancy within the group. Table 2 provides a comprehensive assessment of investment trends in all LLDCs across the VPoA review period.

Table 2: FDI inflows in LLDCs (millions of US$, 2014-2021)

Country	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Afghanistan	43	169	94	52	119	23	13	21
Armenia	407	184	334	253	267	101	47	379
Azerbaijan	4430	4048	4500	2867	1403	1504	507	-1708
Bhutan	23	6	-34	-10	7	3	1	2
Bolivia (Plurinational State of)	657	555	335	712	302	-217	-1129	594
Botswana	515	379	143	261	286	94	32	55
Burkina Faso	356	232	391	3	268	163	-102	137
Burundi	47	7	0	0	0	1	8	8
Central African Republic	3	3	7	7	18	26	35	30
Chad	-676	560	245	363	461	567	558	562
Eswatini (Kingdom of)	26	41	21	-56	36	130	41	126

Ethiopia	1855	2627	4143	4017	3310	2549	2381	4259
Kazakhstan	8489	4057	8514	4714	3898	3284	3675	3172
Kyrgyzstan	248	1142	616	-107	144	404	-402	248
Lao PDR	868	1078	935	1686	1358	756	968	1072
Lesotho	95	207	159	123	129	36	30	27
Malawi	387	510	116	90	959	55	45	50
Mali	144	276	356	563	467	721	537	660
Mongolia	338	94	-4156	1494	2174	2443	1719	2140
Nepal	30	52	106	198	67	185	126	196
Niger	823	529	301	339	466	717	361	755
North Macedonia	273	240	375	205	725	446	230	606
Paraguay	604	378	505	336	156	225	120	122
Republic of Moldova	342	237	83	152	297	508	150	264
Rwanda	459	380	342	356	382	354	274	212
South Sudan	44	0	-8	1	60	-232	18	68
Tajikistan	451	572	345	307	360	364	107	84
Turkmenistan	3830	3043	2243	2086	1997	2129	1169	1453
Uganda	1059	738	626	803	1055	1274	874	1142
Uzbekistan	809	1041	1663	1797	625	2316	1726	2044
Zambia	1489	1305	663	1108	408	860	-173	-457
Zimbabwe	545	421	372	349	745	280	194	166
Total/average	**29,013**	**25,109**	**24,335**	**25,070**	**22,950**	**22,070**	**14,139**	**18,486**

Source: UN-OHRLLS based on UNCTAD data

Table 2 shows the variance in FDI inflows in LLDCs. Countries like Kazakhstan and Ethiopia attract large volumes of inward investment consistently averaging $5.0 billion and $3.1 billion annually in the VPoA review period. While Kazakhstan traditionally attracted high levels of investment due to its oil and gas reserves, recently some flows have targeted other sectors as well in more dynamic sectors of the economy, including financial services, transport and energy. The country was one of the few in the world that did not witness a drawdown in investment flows during the COVID-19 pandemic and some large investment projects have been implemented in the past few years. For example, Borusan Makina Kazakhstan part of the Borusan Group (Turkiye) has recently established a Components Rebuild Centre (CRC) spanning over 50,000 sq m. that for the production, assembly and assembly of parts of industrial machinery for the Caterpillar brand. The government also maintains an active dialogue with foreign investors through the President's Foreign Investors Council and the Prime Minister's Council for Improvement of the Investment Climate (US Department of State, 2021). In Ethiopia high levels of FDI inflows can be explained by the importance the country has attributed to foreign investment as a key enabler of economic growth and development. In 2019, the country launched the Homegrown Economic Reform

Agenda which listed FDI as a key priority and stressed the need to increase investment levels through further structural reforms. Most FDI in the country is directed towards oil refining, manufacturing, real estate, infrastructure development and renewable energy. Recently, some efforts have been made to liberalize services especially ICT and open them up to foreign investment.

FDI inflows have also been increasing in Mongolia in the VPoA review period. After reporting net negative inflows on average from 2014 to 2016, inflows have averaged $2 billion annually from 2017 to 2021. Mining is the main driver of FDI in the country, but efforts are ongoing to attract investment in energy, agribusiness and transport infrastructure as well. In 2019, the Invest in Mongolia One Stop Service was launched to simplify procedures for foreign investors. Turkmenistan and Uzbekistan are amongst other LLDCs that have received high FDI inflows in the last eight years, averaging $2.2 billion and $1.5 billion, respectively. Investment in Turkmenistan is largely directed at natural gas, oil and petrochemicals with China, the Russian Federation and Kazakhstan being the main investor economies. Uzbekistan has declared attracting FDI a core policy priority and a driver for economic growth. In 2020, the Law on Investments and Investment Activities was enforced which guaranteed the right for repatriation of profits and protection from nationalization. Investment to the country has targeted retail, finance and other services in recent years but efforts are ongoing to attract higher investment in manufacturing.

On the other hand, some of the LLDCs have received extremely low levels of FDI in the VPoA review period averaging as low as a few million US$ a year. Most of these countries have been beset by security challenges and political instability which have deterred foreign investors. In addition, complex regulations and the lack of investor protection also impede FDI inflows to a number of LLDCs. According to UNCTAD (2022), FDI to LLDCs originates mostly from a few key investor countries. With $20 billion, China is the largest investor in terms of FDI stock. Other largest investor economies in terms of FDI stock include Thailand, the Netherlands and Canada.

3. Reasons for low investment levels and natural resource oriented FDI profile

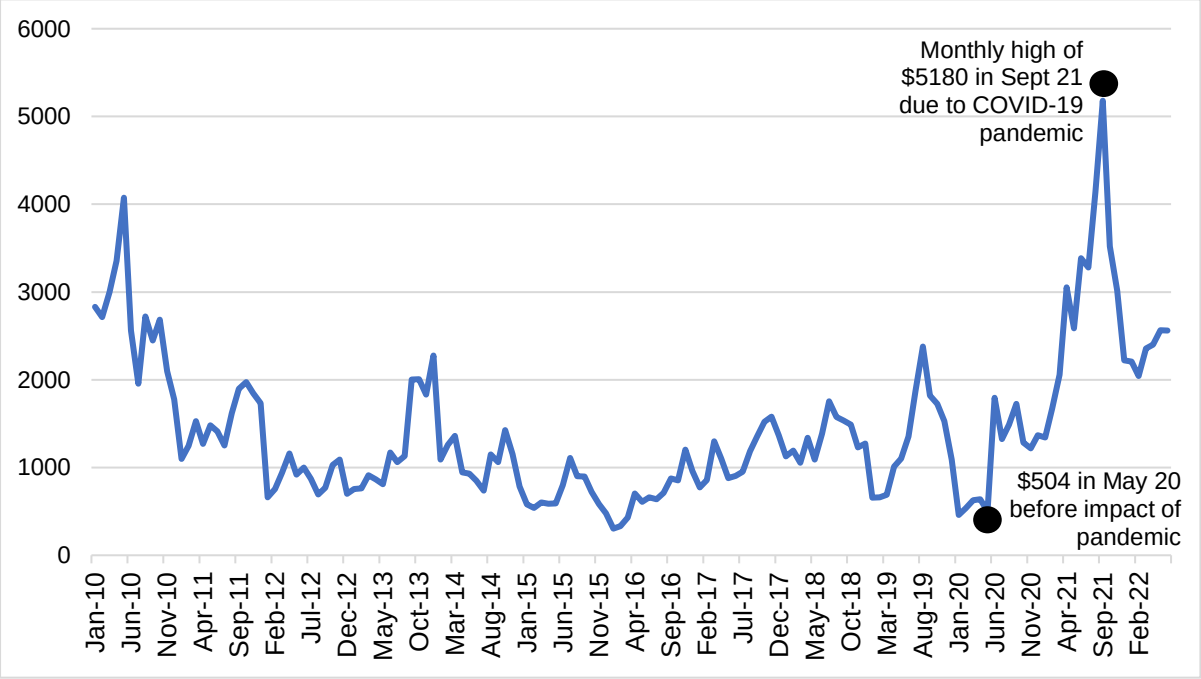
a. Geographical disadvantages and high transportation costs

Geography is a critical determinant of FDI flows. One of the fundamental models on the drivers of FDI, the Ownership, Location and Internationalization (OLI) Model (Dunning, 1980) emphasized that for a firm to invest overseas, the potential benefits had to outweigh the costs of distance due to transportation and acquisition of information. Geography related costs have also been framed as MNEs' liability of foreignness (Hymer, 1976) on account of direct and indirect costs accrued because of cross-national dissimilarity and physical distance. Considering LLDCs are isolated from global shipping routes and have high transportation costs because of both physical distance and transit procedures, they are at a fundamental disadvantage in terms of MNEs' investment decisions. An estimated 80% of total international merchandise trade is estimated to be dependent on maritime routes. Higher distance from global shipping routes thus results in elevated trade costs reducing

competitiveness of exports and increasing the costs of imports. Since MNEs are frequently operating under the networks of global and regional value chains, their exports are dependent on imported intermediate goods to varying degrees depending on the industry. Thus, elevated transportation costs present a two-fold disadvantage for manufacturing exports due to higher costs of both imported intermediate goods and processed exports. This is one of the major reasons that LLDCs have by and large been unable to attract higher levels of efficiency seeking investment over the years.

Global transport and shipping costs trends have a direct impact on LLDCs' export competitiveness and in turn viability as investment destinations. Increasing global transport costs motivate firms to put a higher premium on transport cost efficiency, whereas decreasing costs reduce the relative importance of distance in investment decisions. One promising development for LLDCs was the steady reduction of global freight costs since 2010. For example, the Baltic Exchange Dry Index which measures the cost of transportation of various raw materials including coal, iron ore, cement, grain and fertilizer has come down significantly in the ten years between 2010 and 2020 (figure 2).

Figure 2: Baltic Dry Index, 2010-2020 (US$)



Source: UN-OHRLLS based on data from Baltic Dry Index

However, during the COVID-19 pandemic, shipping costs have gone up considerably reversing the progressive decline that they underwent in the ten years leading up to it. The Baltic Dry Index reached a monthly high of $5180 in September 2021. Although the index came down considerably after that due to pandemic restriction ending, the war in Ukraine is pushing up shipping costs once again. For LLDCs, this can deter higher levels of efficiency

seeking investment and also increase prices of imports used for both consumption and re-exports after processing.

Not all types of foreign investment have an negative relation to higher transportation costs. Horizontal FDI or market seeking FDI has an inverse relation with transportation costs. In other words, high transportation costs can motivate firms to relocate manufacturing closer to consumers. However, market seeking FDI is generally directed towards major consumer markets. Most LLDCs do not offer sufficiently large markets to motivate firms. Another way in which high transportation costs can facilitate investment is through regionalization and near shoring of value chains. Value chain vulnerabilities were particularly exposed during the COVID-19 pandemic leading to calls for shortening and diversifying supply chains. The move towards sustainability is similarly adding pressure for shorter supply chains and greater proximity amongst the different nodes of fragmented production processes. Figure 3 provides an overview of how different types of foreign investment are impacted by low and high transportation costs. The ways in which LLDCs can capitalize on opportunities due to this will be discussed in the policy proposal section.

Figure 3: Impact of transportation costs on different investment types

	Decreasing transport costs	Increasing transport costs
Efficiency seeking investment	Importance of geographical proximity decreases with respect to cost arbitrage opportunities	Proximity becomes important and shift from global to regional value chains in manufacturing industries
Market seeking investment	Incentive to establish subsidiaries closer to consumer markets diminish	Importance of geographical proximity with major consumer markets increases
Resource seeking investment	Importance of regulations and incentives for foreign investors increases compared to proximity	Higher demand for fuel and energy commodities increases investment in oil and gas sector

Source: UN-OHRLLS

b. Low productive capacity

Another major reason for low investment levels in LLDCs is the lack of adequate productive capacities, especially for skills-intensive manufacturing and services activities. Productive capacities refer to the productive resources, entrepreneurial capabilities and production linkages that together determine a country's ability to produce goods and services that will help

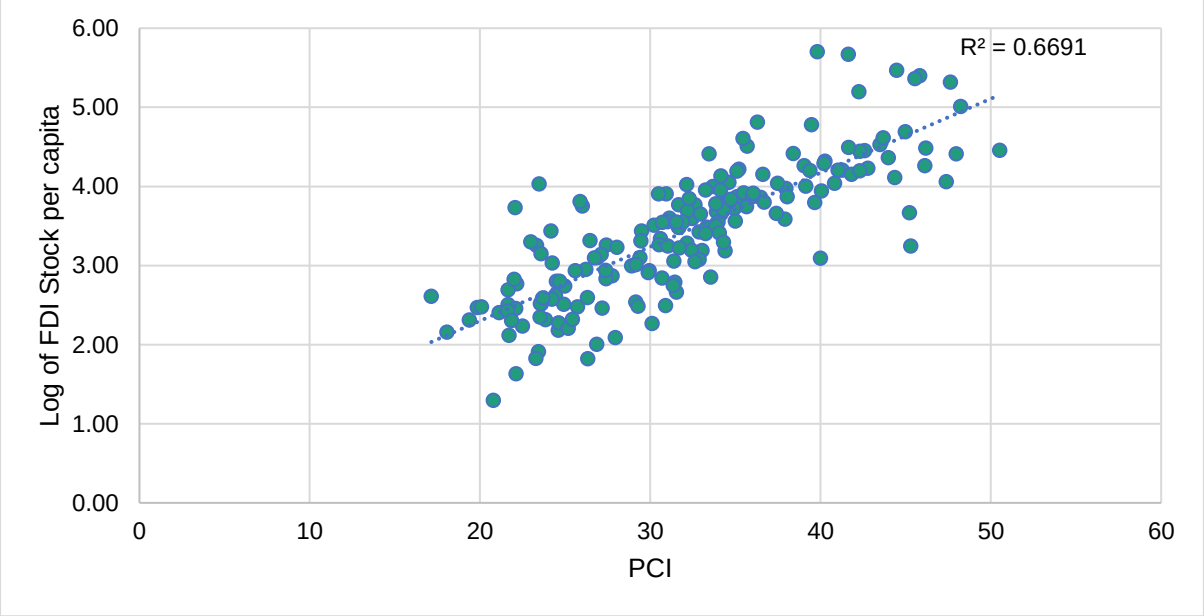
it grow and develop[1]. Human capital, innovative capacity and technical skills are particularly important components of productive capacity as the premium of technology has increased in manufacturing and services industries.

Efficiency seeking investment is likely to flow to destinations that have adequate productive capacity to enable comparative advantage. In the last few decades, the increasing complexity of economic activity enabled by consistent improvements in productive capacity have been a defining feature of countries that have experienced a sustained growth path[2]. In most LLDCs on the other hand, productive capacities have not been enhanced to the degree that could attract high value-added activities. As a consequence, the economies continue be skewed heavily towards natural resources with limited domestic value addition.

Productive capacity enhancement can initiate a virtuous cycle as high productive capacity attracts more efficiency seeking investment which in turn boosts productive capacity further due to the transmission of skills and innovative capacity and the development of stronger links with the global economy. In addition, this could also promote infrastructure upgrading, foster digital technologies and nurture human capital.

Figure 3 shows an analysis comparing FDI stock per capita (log) with productive capacity of all countries in the world using measurements from UNCTAD's Productive Capacity Index (PCI). It shows a significant correlation between the two variables demonstrating the importance of long-term planning of productive capacity development in LLDCs with an emphasis on human capital, transport, energy and institutions for attracting higher FDI flows.

Figure 4: Correlation between FDI and Productive Capacity



[1] UNCTAD (2021)
[2] For example, Wade (1990) argues that the rapid economic development in East Asia in the twentieth century was due to a transition towards increasing productive capacity in sectors of higher value added.

Source: UN-OHRLLS based on data from UNCTAD

c. Unfavorable investment environments

The global climate for foreign investment is extremely competitive with various countries competing with each other for footloose global capital. Amid resource constraints in the aftermath of the COVID-19 pandemic, the competition for cross-border investment flows has intensified even further. As a consequence, and for vulnerable economies, in particular, including LLDCs, foreign investment inflows are contingent upon prudent, comprehensive and well-tailored investment promotion policies and initiatives. Investment promotion policies offer one way to compensate for other investment related disadvantages including geography and transport/transit constraints. These policies do not necessarily imply a race to the bottom in terms of foregone taxes and import duties, but rather a combination of financial and non-financial measures that can improve the investment climate and make it worthwhile for an MNE to invest in a country. Yet in LLDCs there has been insufficient attention devoted to improving the investment climate and enacting forward-looking and dynamic investment policies. Many LLDCs have cumbersome investment regulations that inhibit foreign investors. These include amongst others, foreign equity limitations, stringent screening or approval mechanisms, restrictions on employment of foreign workers, capital controls and land ownership limitations. Other factors that impact the investment environment include fair dispute regulation mechanism, enforcement of contracts and efficient application of investment rules.

The investment climate of a country is also impacted by infrastructure, utilities, public services and business regulations. Transport infrastructure deficits in LLDCs are well documented are a particularly serious impediment for foreign investors due to their special significance in landlocked economies. Similarly, electricity availability and affordability is also a key challenge in LLDCs, especially those at the lower income levels.

4. Enhancing FDI flows to LLDCs and harnessing them for structural transformation

a. Overcoming trade and transit constraints

For LLDCs to become attractive destinations for investment, alleviating trade, transportation and connectivity constraints is paramount. Trade in intermediate goods and by extension efficiency-seeking FDI is highly sensitive to logistical performance and uncertainty in bilateral trade times (World Bank, 2020). For regional market-seeking FDI, connectivity constraints would negate the cost savings that MNEs may accrue by shifting production closer to consumers. In view of rising global transportation costs and the increasing recognition of resilience of supply chains in the aftermath of the COVID-19 pandemic, the urgency for LLDCs to enhance connectivity with the rest of the world and increase efficiency and resilience of trade and transport connections has increased even further.

There are several sources of financing for LLDCs to develop better infrastructure to overcome geographical and transport-related disadvantages. Firstly, LLDCs may be able to promote public private partnerships to leverage the role of the private sector for infrastructure development. Based on local conditions and national priorities, modalities such as build-operate-and-transfer as well as build-operate-and-own can facilitate this. Considering the scale of financing needs in infrastructure in LLDCs, opening up this segment of the economy to foreign investors should also be considered. LLDCs can also avail opportunities of bilateral and multilateral financing in infrastructure. Already many LLDCs have reported major projects being built through financing from bilateral economic partners such as China under the Belt and Road Initiative. In addition, multilateral financing agencies such as the African Development Bank, World Bank and the Asian Infrastructure Investment Bank are also offering financing for infrastructure projects in LLDCs.

The prudent use of emerging technological resources can also aid LLDCs in overcoming some of the transport-related disadvantages. Automation, improved use of logistics data and remote sensing are some of the applications that can enhance LLDCs' connectivity in a meaningful yet cost effective way. There also needs be greater cooperation and closer coordination with transit countries to ensure seamless and cost-effective connectivity to ports.

One key strategy to aid infrastructure development in LLDCs for improved connectivity is to package infrastructure programmes under regional economic cooperation mechanisms. For example, Mongolia is currently benefiting from the development of the China-Mongolia-Russian Federation Economic Corridor that seeks to connect China and the Russian Federation through Mongolia. Infrastructure upgrading projects in Mongolia are already underway to enable it to provide transit to the high expected trade volume between its two large neighboring countries.

b. Proactive investment promotion policies and favorable investment climate

Proactive, open and non-discriminatory investment promotion policies that foster a favourable investment climate are a potent tool available for policy makers to increase FDI flows and direct them to productive industries. As competition for international investment increases, the question for investment policymakers is not if they should intervene, but how.

One of the key concerns for foreign investors when picking a location for investment is having streamlined and simplified investment regulations that offer clarity, enable the swift execution of projects and offer investors legal protection. For LLDCs, it is critical to ensure investment policies are conducive to foreign investment and incentivize investment in manufacturing industries that enable higher domestic value addition rather than resource seeking foreign investment that leads to the export of unprocessed commodities. This can be facilitated through conducting a comprehensive geographical analysis of where setting up manufacturing projects can be most competitive and then providing detailed information to potential investors. In addition, ensuring potential sites for manufacturing projects have access to ports through access to adequate infrastructure, reliable and cost-effective energy and high-speed internet should be made part of broader investment promotion strategies.

Nearly all LLDCs have Investment Promotion Agencies tasked with attracting higher levels of foreign investment. The pandemic has shone light on the need for IPAs to adapt modern and digital tools for investment attraction. Having a comprehensive website that is easy to use, exhaustive in terms of information investors may need and has a list of sample projects that are ready to receive investment is of the highest importance. Secondly, IPA websites should integrate investment license applications, visas and other regulatory processes at one online shop that is user friendly and swift. After the pandemic hit, many countries reported significant shifts to online application processes for investor applications with great success. For example, Benin recently became the fastest place in the world to officially start a business using a mobile phone only. For systems specific to foreign investors, Oman had introduced the 'Invest Easy' online system even before the pandemic hit. The system allows local and foreign investors to request and get all the necessary registration certificates online, with a single form, a single set of documents and a single payment. The system brings together sixty-four services, involving 19 government agencies under one integrated online system.

Another key consideration for the modernization of Investment Promotion Agencies is the need to integrate trade issues with investment issues. Investors should have information on export and import procedures, tariffs, subsidies and trade facilitation measures under a single window rather than having to consult a separate organization. Similarly, regulations on fiscal and custom subsidies need to be consolidated so that investors have one point of contact for conducting business.

According to UNCTAD's Investment Policy Monitor, in the last five years, there were a total of 41 new investment policy measures introduced in LLDCs, encompassing 16 countries. In comparison, at the global level there were a total of 1306 investment policy measures. Although this is encouraging, significant potential to improve the investment climate through targeted investment promotion policies remains untapped in LLDCs.

Table 3: Investment policy measures in LLDCs

Country	Date	Investment Policy Measure
Azerbaijan	1 Jan 2020	Tax exemption period in industrial and hi-tech parks extended
Burkina Faso	30 Oct 2018	New investment code adopted
Bolivia,	1 Jul 2020	Launch of a new exports and investment promotion agency - PROEXPORT
Botswana	22 Oct 2021	Offered tax incentives in special economic zones
Burundi	17 Jun 2021	Amendment of the Investment Code and new investment entity
Ethiopia	7 Sep 2020	Adoption of new investment liberalisation measures
-	2 Apr 2020	New investment proclamation published
	13 Jun 2019	Adoption of Telecommunication Services law
	3 Aug 2018	Advisory Council on Privatization of State-owned Companies Established
	4 Sep 2018	Lifting of restrictions on logistics industry reserved exclusively for Ethiopians
Kazakhstan	21 Jan 2019	Amendment of investment arbitration rules
	2 Jan 2021	Introduction of investment agreements
Kyrgyzstan	11 May 2019	Investors in special economic zones entitled to zero percent VAT
Lao, PDR	12 Aug 2020	Amended Law on Land
Mongolia	25 Feb 2019	Opened its one-stop service center for foreign investors
Nepal	23 May 2019	Minimum threshold for foreign investment introduced
-	4 Jan 2021	Opened agriculture sector for FDI
-	11 Jan 2021	New regulation to prevent delays in the implementation of foreign investments introduced
Rwanda	14 Aug 2020	New Investment Code approved by Cabinet
	5 Feb 2021	New Investment Code enacted
Uganda	1 Jun 2018	Amendment to tax law
-	20 Feb 2019	Adoption of new Investment Code
Uzbekistan	20 Feb 2019	Facilitation and promotion of investment in mining industry
	29 Apr 2019	Uzbekistan privatizes certain State companies
	27 May 2019	Grants new subsidies for hotel construction
	12 June 2019	Adopts its first PPP law
		Creates a new special economic zone and expands the existing one
		Establishes the Foreign Investors Council
		Adopts a comprehensive law on Special Economic Zones

Zambia	29 Oct 2021	Reduced corporate income tax rate and introduced new tax incentives
	1 Jan 2022	The Zambia Development Agency (Amendment) Act 2021 provides new incentives for large investments
Zimbabwe	7 Feb 2020	Investment and Development Agency Act (Chapter 14:37)

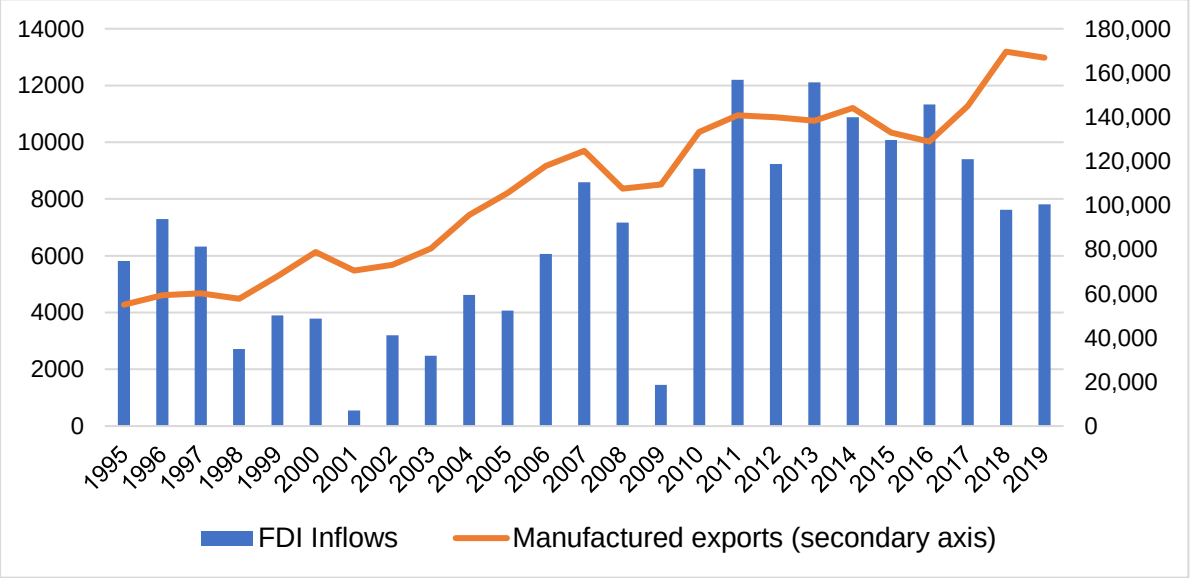
Source: UNCTAD Investment Policy database

Box 1: Learning from Malaysia's Investment Promotion Strategy

FDI in Malaysia has increased steadily since the early 1990s and been a major driver of the country's structural economic transformation. The role of the country's investment promotion agency, the Malaysian Investment Development Authority has been critical role in this. The agency was hailed by the World Bank as "the necessary impetus for purposeful, positive, and coordinated promotional action" for Malaysia's industrial development. The increase in FDI in the country corresponded with a shift from natural resource and labor-intensive industries to ones with a higher focus on skills and technology. This was achieved on the back of deliberate and targeted investment promotion interventions with a particular focus on attracting investors from progressively complex industries. For example, while in the 1990s, a focus was on ensuring investors had access to basic infrastructure, attractive tax rates and efficient public administration, once the country started targeting more technology intensive activities, the focus shifted more to the availability of an adequately skilled labor force and high-quality engineers.

Figure 5 shows how FDI has been increasing in the country steadily since the early 1990s in tandem with exports of manufactured goods (with the exception of years during which the country was facing the impacts of the East Asian economic crisis and the global financial crisis when both FDI and exports were declining).

Figure 5: FDI and Manufacturing Exports in Malaysia, 1995-2019 (millions of US$, current)



Source: UN-OHRLLS based on data from UNCTAD

Today, many of the world's largest MNEs in sectors ranging from electronics, mineral processing, automotives, rubber and food processing have manufacturing facilities in Malaysia. In terms of products, integrated circuits account for the country's largest exports ($65 billion), followed by refined petroleum ($15.9), palm oil ($10.6), semi-conductor devices ($8.7 billion) and rubber apparel ($8.3 billion)[3]. The country is also ranked 25 out of 127 on the Economic Complexity Index, which measures the knowledge intensiveness of an economy in terms of the products it produces.

Today, MIDA continues to offer targeted services to investors to attract investment in a number of high value-added manufacturing and services industries. Although the context of Malaysia is different from most LLDCs, the country offers three key lessons that have broad relevance:

1. Amid a competitive global investment climate, attracting efficiency seeking investment that can drive structural change is contingent on the ability to proactively design and implement targeted, holistic and forward-looking investment promotion policies.
2. Cultivating an investment conducive environment encompassing business-friendly policies, long-term investor protection, availability of supporting infrastructure and a sufficiently skilled labour force, is also a pre-requisite for FDI.
3. Investment promotion policies should be tailored to local circumstances based on domestic productive capacities, natural resource endowments, stage of development, geography and skills of labour force.

c. Industrial development policies

The last 50 years have demonstrated that structural transformation and industrialization do occur on their own but are rather contingent on deliberate and wide-ranging industrial policies. Industrial policies have been defined as 'government policies directed at affecting the structure of the economy (Rodrik, 2004)'. Industrial policies have a direct relation with foreign investment either due to explicit targeting or implicitly due to horizontal interventions that seek to improve the business environment. According to UNCTAD (2018), between 2013 and 2018, 84 countries in the world accounting for more than 90% of global GDP adopted formal industrial development strategies.

For LLDCs, comprehensive, forward looking and nimble industrial development policies are paramount to attract foreign investment and harness it for structural transformation. This report will highlight three particular pillars of industrial development policies that can result in significant development dividends for LLDCs: sectoral targeting, regulatory reforms and energy policies.

[3] OEC, https://oec.world/en/profile/country/mys#:~:text=Exports%20The%20top%20exports%20of,and%20Japan%20(%2415.6B).

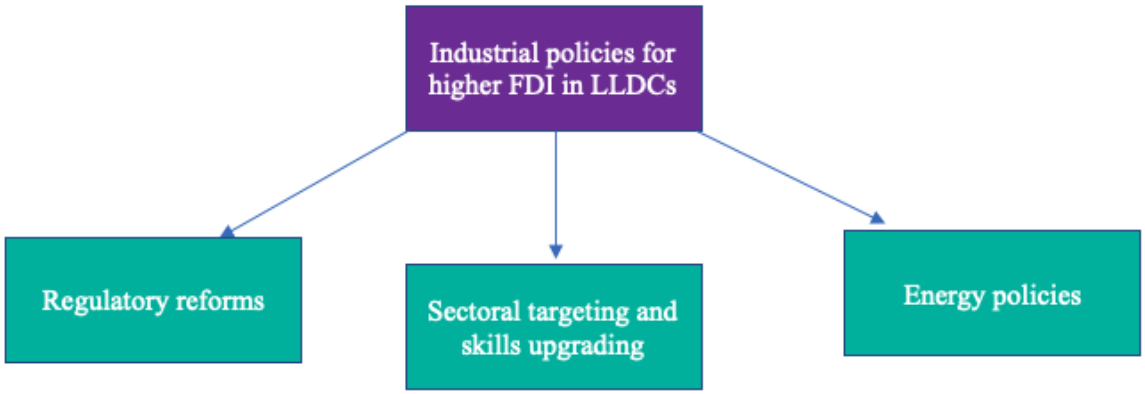
Vertical industrial policies that seek to identify priority sectors are crucial for LLDCs' structural transformation. A significant number of LLDCs are reliant on natural resource commodities, including energy, minerals and agriculture. Based on the specific national circumstances of each country, industrial policies should seek to enhance domestic value addition of commodities and disincentivize their unprocessed export. For example, giving incentives to foreign investors to establish processing facilities instead of extractive facilities only could be beneficial. Within this context, light manufacturing industries such as textiles, foods and beverages, coffee, cocoa and paper products are of particular relevance.

The second key opportunity for LLDCs is to target industries in which intangibles account for a large proportion of value added. These include both services and intellectual property-oriented manufacturing industries, such as pharmaceuticals. In the last few years, intangible outputs are accounting for an ever-larger share of global GDP, a trend likely to accelerate in the coming years due to digitalization, technology advancements and automation. These industries offer LLDCs an opportunity to sidestep their geographical constraints and compete on a level playing field with the rest of the world. Promoting services can also have a knock off impact on manufacturing in LLDCs and broadly improve their competitiveness. Some of the priority services sectors that LLDCs could target include professional services, customer support, telemedicine, information technology, data hosting, blockchain mining etc. To target these industries, however, LLDCs would need to adopt a proactive approach by developing partnerships with the private sector, development partners and specialized organization that can aid in building significantly conducive conditions. Skills upgrading and the honing of technical skills in a targeted manner is a precondition for industrial policies to succeed. Moreover, language skills especially English language skills are extremely important for services industries and knowledge intensive manufacturing industries. LLDCs should therefore adopt a long-term approach on industrial policies by carefully selecting specific sectors and ensuring the availability of workers with adequate skills.

The second key pillar for industrial policies to succeed in LLDCs is regulatory reforms that facilitate foreign investors and improve the business environment. Amid a competitive international investment landscape, regulatory efficiencies are an extremely important component of industrial policy. All efforts must be taken to enhance efficiency, digitalization and transparency of business processes and regulations. Linking industrial and investment promotion policies to preferential trade agreements with developed economies, for example, the American Growth and Opportunity Act and the Everything but Arms (EU) can also deliver profound benefits. Since 17 out of 32 LLDCs are also LDCs, this can be a key incentive for foreign investors. Similarly, countries with regional trade and economic cooperation agreements such as the African Continental Free Trade Area Agreement and the Regional Comprehensive Economic Partnership (Asia and the Pacific) should seek to link industrial policies with investment promotion by attracting investors who seek to benefits from these agreements.

Finally, ensuring access to reliable and cheap energy is fundamental for industrial policies in LLDCs to succeed. Although, the average proportion of population with access to electricity in LLDCs increased from 58.0% in 2019 to 59.5% in 2020, significant more work needs to be done to achieve parity with the global average of approximately 90%[4]. With progressively declining installation costs, renewable energy offers a practical solution for LLDCs to alleviate energy deficits, while at the same time contributing to climate change adaptation and mitigation. Increasing fossil fuel prices directly impact electricity costs especially in energy importing LLDCs and make it difficult for industrial enterprises to be competitive. A long-term strategic approach to integrating energy policies with industrial policies is paramount. Progress towards renewable energy adaptation has been tepid in LLDCs, with the amount of the renewable energy capacity in the total final energy consumption increasing to only 44 per cent in 2020 from 37 per cent in the year 2000, a 7-percentage point increase in two decades[5]. Many LLDCs have high potential of renewable energy generation due to hydel resources and being in high solar irradiation zones. Unlocking these resources should be an urgent priority in all LLDCs for which a proactive approach to developing partnerships with all relevant stakeholders will be critical.

Figure 6: Key industrial policy priorities for LLDCs to attract higher FDI



Source: UN-OHRLLS

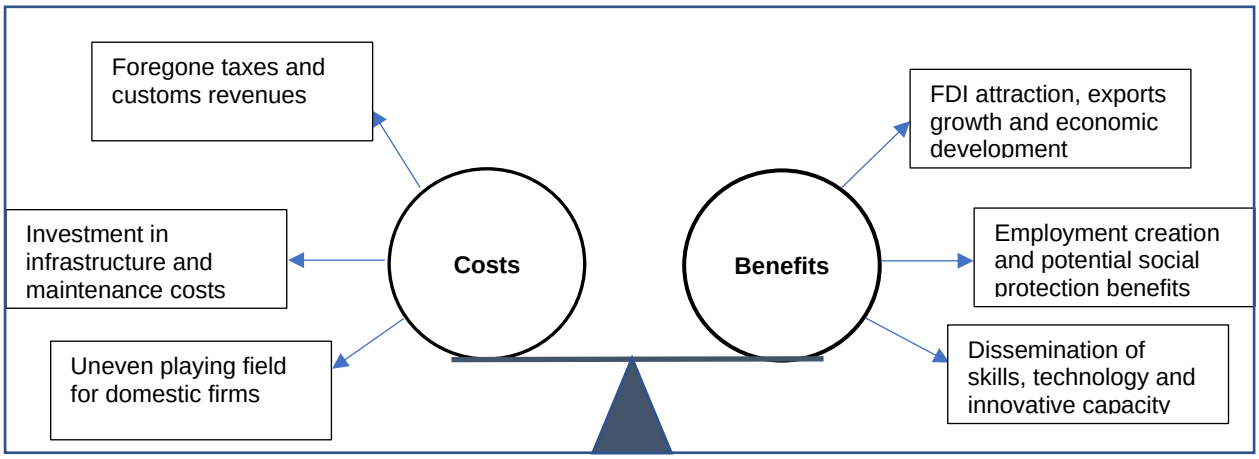
d. Building efficient and dynamic Special Economic Zones

Special Economic Zones, also classified as industrial parks, export processing zones or free trade zones are geographically delineated entities that provide a combination of institutional, regulatory and infrastructural conditions conducive to FDI in a cost effective and targeted manner. The main obstacles for LLDCs in attracting higher levels of investment include inadequate physical and digital infrastructure, complex investment regulations and high distance from ports. One efficient way of circumventing these obstacles is the development of

[4] UN SDG Database
[5] ibid

special economic zones (SEZs). SEZs are also a policy tool for competing with footloose cross-border investment by providing targeted incentives such as tax breaks, exemptions on custom duties and subsidized utilities. SEZ programmes are already underway in most LLDCs. However, in practice not all SEZs are successful, and many suffer from high direct and indirect costs and low occupancy. Despite this, considering structural deficits in LLDCs and geographical disadvantages, SEZs remain a potent policy option to attract foreign investment if planned and operated in a nimble, prudent and forward-looking manner.

Figure 7: Costs and Benefits of Special Economic Zones



Source: UN-OHRLLS

For LLDCs, the foremost consideration in determining the success of SEZs is their location. Zones are often used as a regional planning tool to promote development in underdeveloped parts of the country. However, for zones to succeed, they need to be in close proximity to the most vibrant parts of local economies to ensure adequate supply of skilled labour, development of backward linkages with suppliers and access to support services. For LLDCs, one way of alleviating geographical disadvantages is to develop zones close to border towns with transit countries. If conditions permit, the development of cross-border zones can be especially beneficial. These zones can help LLDCs avoid the direct and indirect costs due to transit and offer investors a shorter route to the ports. For example, Kenya and Ethiopia signed an agreement to convert the Moyle border region into a free trade zone so that firms located in Ethiopia can have unhindered access to Kenyan ports.

Second, policymakers need to ensure that they follow a profit and loss model while developing zones (UNCTAD, 2019). High levels of spending on infrastructure and large amounts of foregone capital due to tax subsidies do not automatically translate into successful zones. A prudent approach that enables zones to benefit from infrastructure already under development with a focus on cost-effective and targeted interventions for zones, such as the provision of high-speed internet and waste processing facilities is likely to be much more effective. One way of marketing zones to MNEs is through the development of adequate ESG standards supported by requisite infrastructure. Due to the increasing recognition of the importance of decent labor standards and sustainable production patterns amongst consumers,

zones that facilitate adherence to requisite ESG standards, will become more attractive for MNEs in the coming years.

Lastly, policymakers should ensure that zones are not developed as isolated economic outposts but deeply embedded with local economic networks and build on the unique specialization of each location and country in terms of natural resources and human skills. Historically, only those zones have been successful that have developed intricate links with the local economy and built on its unique endowments. One option to facilitate this is to allow local firms to be located within SEZs and benefits from the better infrastructure even if they do not have access to other incentives reserves for foreign export-oriented firms.

e. Targeting integration in global and regional value chains

Global value chains which were already being transformed due to a gradual reversal of economic liberalism, the sustainability imperative and accelerating digitalization, have undergone irreversible changes due to the COVID-19 pandemic. This is creating new opportunities and challenges and redrawing the map of international investment and production networks. Two changes are particularly salient and relevant for LLDCs. Firstly, there is a shift towards regional value chains due to the need to build redundancies in international supply chains and increasing ad-hoc and localized trade agreements. This opens up new opportunities for LLDCs especially as many of them are located in close proximity to major international markets and production centers. Second, the adoption of digital tools, technology and automation in production processes has accelerated. As intangibles account for an increasingly large share of global output, this is bringing new opportunities for LLDCs to circumvent their geographical disadvantages. However, to capitalize on opportunities LLDCs need to adjust to the new economic realities with a particular emphasis on sufficiently developing their regional connectivity, digital infrastructure and human capital. Moreover, a proactive approach to engaging with the private sector both domestically and globally would be paramount.

GVC participation and foreign investment have a symbiotic relationship. Higher participation in GVCs encourages higher levels of foreign investment and vice versa. Yet LLDCs currently have a peripheral role in global value chains, and foreign investment is largely natural resource seeking. This results in lower levels of domestic value capture and the limiting of their role as largely forward participants in GVCs, i.e. the providers of inputs for various industries that undergo most of their value addition in other countries.

To increase their participation in global and regional value chains, one key strategy that can be considered by LLDCs is vertical specialization. This would entail ensuring differentiated opportunities for value added in specific industries or industrial processes are on offer for foreign investors. A key requirement for vertical specialization is to have technically qualified employees that have the requisite skills to result in a competitive advantage for firms. Most LLDCs have relatively young populations. Providing young people adequate skills development avenues can unlock the economic potential in these countries and enable a shift to more sophisticated activities that can enhance their participation in GVCs. In

industries where labor and tax arbitrage opportunities are becoming less important on account of automation and policy changes respectively, there will be a shift towards shorter, less fragmented value chains. This is opening up opportunities in large manufacturing value chains that were earlier largely concentrated in a few large economies.

At the same time COVID-19 and the increasing frequency of climate related extreme events is leading to the diversification of value chains. This entails the broader distribution of manufacturing industries to build redundancies and enhance resilience of supply chains. Diversification of value chains will lead to new opportunities for LLDCs to attract FDI in several industries, including resource based light manufacturing, as well as strategically important industries like pharmaceuticals and personal protective equipment. Investors seeking to diversify their supply chains and at the same time maintain production cost advantages may increasingly target new destinations, including LLDCs. There are examples from some LLDCs even before the pandemic. For example, global apparel firms including PHV, and H&M have set up manufacturing plants in Ethiopia in the last few years with the objective of exporting to developed and emerging markets. To benefit from diversification opportunities, LLDCs would need to improve the standard of infrastructure, particularly soft digital infrastructure and integrate spatial planning with investment promotion polices to ensure fast and cost-effective access to ports.

Many LLDCs have recently enhanced regional integration through a variety of initiatives. This includes, for example, the African Continental Free Trade Area Agreement and the Regional Comprehensive Economic Partnership Arrangement. These and other similar regional cooperation agreements are leading to higher intra-regional trade and strengthening regional value chains. A key opportunity for LLDCs in the years ahead is to enhance their participation in regional value chains. Since many regional cooperation mechanisms have provisions for both trade and investment, they are suited for both regional firms as well as international firms that are seeking to make an entry into a specific regional market. For LLDCs cooperation with their transit neighbor to strengthen regional value chains through, for example, common industrial areas, strategic infrastructure development and priority transit facilities can deliver significant development dividends.

5. Conclusion

Investment promotion has been a key policy tool by developed and developing countries alike in the last three decades. Despite realization of the importance of foreign investment by LLDCs, investment levels have been low and on the decline in the Vienna Programme of Action review period. Moreover, FDI flows to LLDCs are largely resource seeking resulting in minimal value capture locally.

Amid resource constraints in the post-COVID-19 environment and slow progress on structural transformation, FDI attraction should be a key policy priority for LLDCs. However, FDI only results in development benefits when it promotes the transfer of production technology, skills and innovative capacity. To enhance the inflows of foreign investment and optimize their impact on development, LLDCs should adopt a proactive

approach. Moreover, the support of international stakeholders including development partners, multinational firms and multilateral organizations is crucial to help LLDCs foster conditions conducive to foreign investment.

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