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Creating Sustainable Cooperation Strategies with Africa: A Glance at Development Aid and FDI

Western development policy has been undergoing a significant change. For many years, official development assistance (ODA)[1] from rich donor countries has been the main source of income for many developing countries. In recent decades, other capital flows – predominantly foreign direct investment (FDI) and remittances – have become equally or more important for some of them. FDI increased about tenfold from the early 1990s to the early 2000s but has fluctuated strongly in recent years. For the least developed countries (LDCs) in Africa, the economic importance of ODA has declined significantly since the beginning of the 2000s, yet it remains a more relevant and stable source of external funding than FDI (see Figure 1).[2]

It is not yet clear how the Covid-19 pandemic will affect ODA budgets and private investments. The crisis will certainly lead to tensions and likely to restrained spending, as most countries in the world are experiencing a drop in economic activity. In a statement issued in April 2020, the Development Assistance Committee (DAC) recognizes the importance of ODA, particularly in the light of the Covid-19 crisis, and commits itself to working toward protecting the development aid budgets of DAC donor countries (OECD 2020b) and help the most vulnerable who will suffer the most from this crisis.

The article begins with a description of the role of development aid and the complexity of the international aid system. While aid strengthens the public sector, investment increases the private sector, which could grow local enterprises and entrepreneurship and ultimately stimulate innovation. Thus, the article next looks at the increasing importance of foreign direct investment for Africa and highlights its potential to promote economic development. The article concludes with an outlook that stipulates the conditions under which both aid and foreign investments can be successful in the future.

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[1] Developing aid is provided by governments, international organizations, NGOs, and other private foundations and organizations, such as the Gates foundation or OXFAM. This article focuses on aid flows of the first two. For the purpose of simplicity, official development assistance (ODA) will be used synonymously with "aid" throughout the article.

[2] According to the World Bank, remittances are an even more important source of foreign funds for LDCs (World Bank 2014a).

THE ROLE OF DEVELOPMENT AID

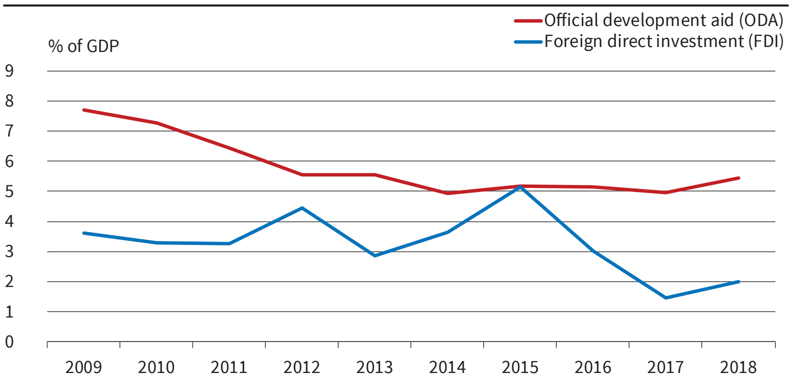
ODA is a key element of the global development industry. It is defined as "government aid to promote the economic development and welfare of developing countries" (OECD 2020b) and is provided bilaterally from donor to recipient countries or channeled through an international organization, such as the UN or the World Bank. According to the UN, developed countries should devote 0.70 percent of their gross national income (GNI) to aid (OECD 2020b).

The Development Assistance Committee (DAC) coordinates aid donors and currently comprises 30 countries committed to promoting development cooperation, economic growth, and improving living standards in the world's poorest countries (OECD 2020c). In 2019, aid from DAC donor countries increased by 1.37 percent from 2018 and almost reached the 2016 peak of USD 155.6 billion (OECD 2020b).[3] In 2018, the greatest share of flows went to Sub-Saharan countries (23 percent), followed by South and Central Asia (12 percent) and the Middle East and North Africa (12 percent) (OECD and DAC 2020). Total ODA from DAC countries combined as a percent of GNI slightly fell to 0.30 percent in 2019 from 0.31 percent in 2018 (OECD 2020b). Figure 2 shows the development of ODA flows by DAC donor country in recent decades.

Figure 3 illustrates the largest aid donors worldwide in terms of US dollars, with the United States,

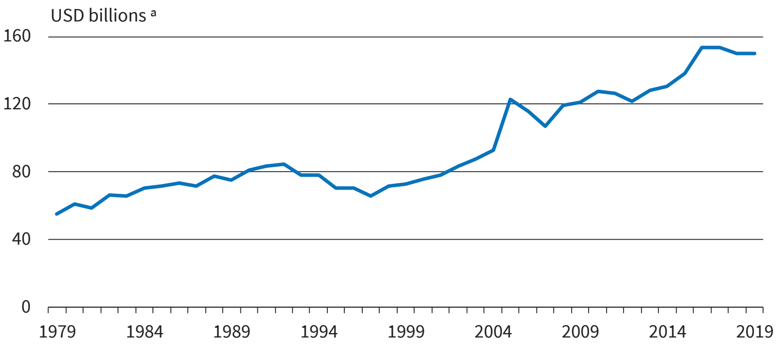
[3] The figure corresponds to a net ODA of USD 150.1 billion. In contrast to net ODA, the newly constructed grant equivalent figure takes principal and interest payments into consideration (OECD 2020c).

Figure 1
Economic Significance of ODA and FDI in African LDCs



Source: OECD Statistics (2020); UNCTAD Stat (2020). © ifo Institute

Figure 2
Net ODA by DAC Countries



ᵃ Constant prices, 2018 as base year.
Source: OECD (2020b).
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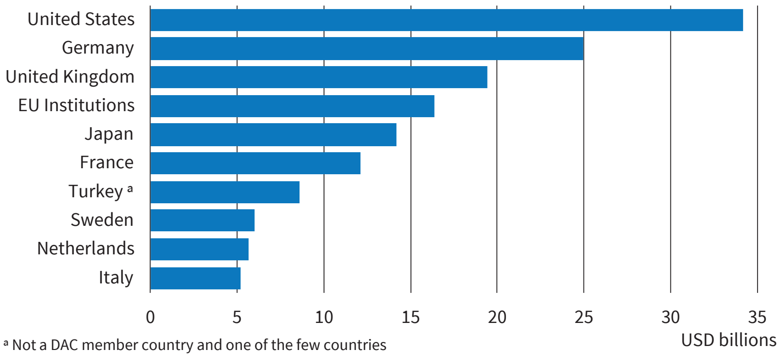
Figure 3
Top 10 ODA Donors (Grant Equivalents), 2018



ᵃ Not a DAC member country and one of the few countries with an ODA to GNI ratio exceeding the UN target of 0.70%.
Source: OECD Statistics (2020).
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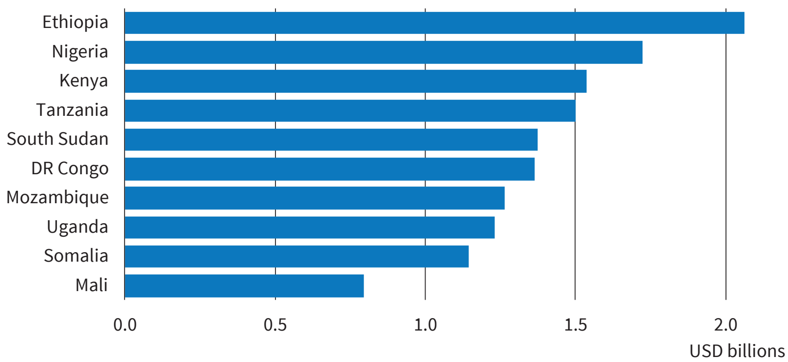
Figure 4
Top 10 ODA Recipients in Sub-Saharan Africa, 2018



Source: OECD Statistics (2020).
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Germany, and the United Kingdom in the lead and aid from EU institutions in fourth place. While the average contribution of DAC countries was below the UN target of 0.70 percent of GNI in 2019, five DAC member countries (Denmark, Luxembourg, Norway, Sweden, and the UK) as well as one non-DAC country (Turkey) met or exceeded the UN target (OECD 2020a).

More than 80 percent of all aid flowing to Africa goes to Sub-Saharan Africa (OECD Statistics 2020). In 2018, Ethiopia, Nigeria, and Kenya were among the main aid recipients (Figure 3).

In order to promote the development of less developed countries, aid is allocated to various purposes. Figure 5 shows for which sectors (lines) and other purposes (bars) aid has been provided in the last decade. Over half of all aid flows into social infrastructure – primarily education and health – or economic infrastructure. Social infrastructure also includes initiatives in the areas of water supply and sanitation, government and civil society (including matters related to conflict, peace, and security), as well as programs and policies targeting the general population and reproductive health.

Due to large infrastructure investments, Ethiopia has managed to reduce its dependence on agriculture and become more productive. Aid has thus helped to reduce the national poverty level (Woldekidan 2015). Also in Mozambique, aid has played an important role for economic development (Orre and Rønning 2017). It has contributed to growth, the development of key national institutions, and has been partially successful in the social sector. However, the country entered an economic crisis in 2016, which has further weakened government structures and accountability mechanisms. Despite the country's dependency on aid, aid has not contributed sufficiently to poverty reduction in the past (Orre and Rønning 2017).

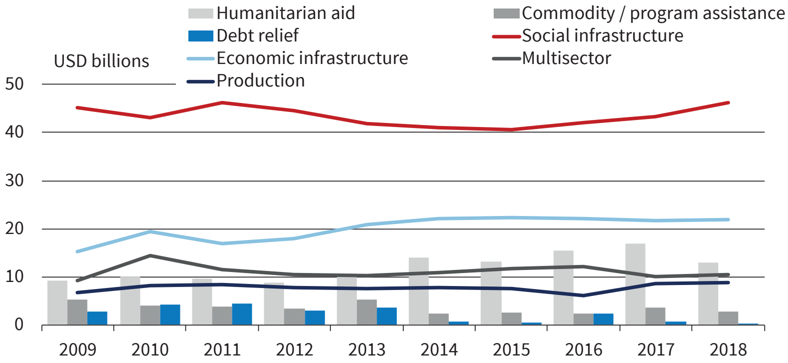
UNDERSTANDING THE DYNAMICS OF AID

The modern development aid industry involves many agents, and despite many efforts, aid has not yet led to the anticipated results for many countries. Hundreds of bilateral and multilateral organizations direct aid to developing countries, often through several agencies and in various projects and activities. However, an international strategy is largely lacking (Haan 2009). Moreover, recent partnerships between public and private organizations have contributed to the complexity of the aid system. This has partially changed with the Millennium Development Goals (MDGs) of 2000, which provide the international community with a framework for setting targets and measuring progress. Nevertheless, the goals, aid activities, and programs as well as the measurement of success often vary from country to country (Haan 2009).

The use of aid and aid relationships have always been a deeply contested topic which gives rise to a strong divide within the academic community and policy world. At the heart of the debate is the question of whether aid is an effective instrument for development (e.g., Brett, 2016; Easterly, 2006; Sachs 2005).

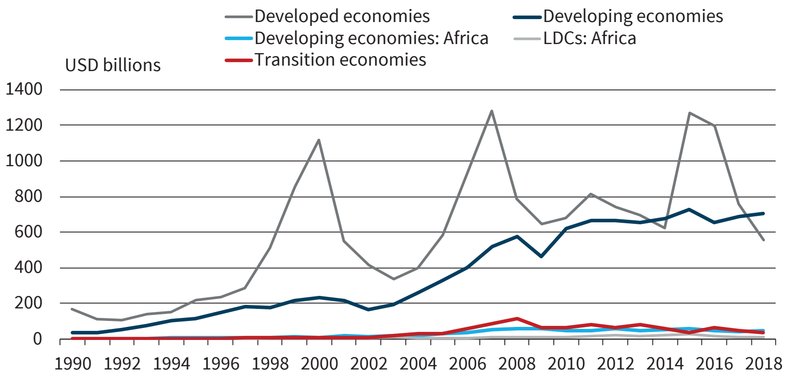
In principle, the discussion is split between three camps (Haan 2009). Those in favor of aid believe that economic development requires substantial initial investment. Aid should therefore be scaled up and overseen by international organizations such as the UN (e.g., Sachs 2005). The opponents of this approach criticize that aid is not transferable from one coun-

Figure 5
Development Aid [a] by Sector and Means



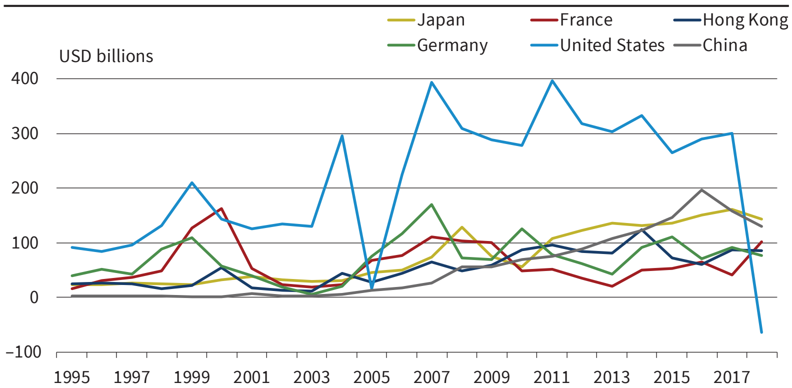
[a] Excluding aid flows that could not be allocated to a specific sector or purpose.
Source: OECD Statistics (2020). © ifo Institute

Figure 6
FDI Inflows in Developed, Developing and Transition Economies



Source: UNCTAD Stat (2020). © ifo Institute

Figure 7
Outward FDI over Time



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try to another, and that instead development must be "homegrown" (Easterly 2006). A growing group in between focuses on how aid is provided and emphasizes the need for better evaluation (Haan 2009). Esther Duflo and Abhijit Banerjee, among others, believe in fighting poverty step by step and translating research and data into policies (see, e.g., Banerjee and Duflo 2011). This approach rests on the idea that a new understanding of poverty is needed and implementing change on a small scale may be more feasible than implementing change through large investments.

To better understand the complexity of the aid system, it is worth investigating what can happen in recipient countries when aid flows in. The size of the public sector increases without any notable increases in productivity or output, which could entail more opportunities for rent-seeking and corruption (Easterly 2006). The recipient government may treat aid as an alternative source of revenue and thus reduce its dependence on taxes, potentially causing the government to respond less to its population and more to its donors. While aid strengthens the public sector, investments flow into the market and grow the private sector. Private sector investments can be investments in local firms or investments in entrepreneurship; the latter is a key driver for innovation. Strengthening of market mechanisms through investments rather than empowering political systems through aid can be beneficial when corruption and limited accountability structures prevail in a country.

INCREASING IMPORTANCE OF INVESTMENTS

Foreign direct investment takes place when an investor buys shares of an existing local enterprise or establishes local business activities in another country, for example by building a subsidiary of the parent company. Investors usually exercise a high degree of control, reflecting the long-term interest in the recipient economy. FDI can be provided in the form of capital, knowledge, or technology (UNCTAD 2007). Unlike development aid, FDI stimulates the private sector, potentially benefiting local businesses without direct government assistance.

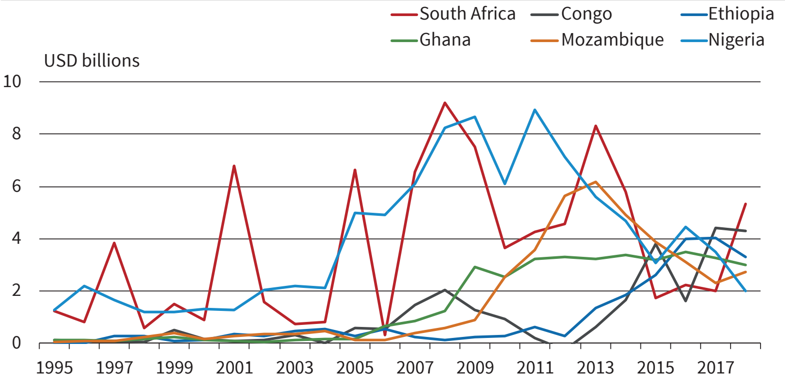
Figure 6 illustrates the development of inward FDI in different regions. The largest share of FDI flows goes into industrialized countries, where it has fluctuated with the economic situation since the 1990s. A general upward trend can be observed in developing countries. Especially in Africa and LDCs, however, FDI flows remain stable at a modest level. In contrast to aid, the majority of FDI to developing countries does not appear to flow to Africa. According to Velde (2006), FDI has always been concentrated in a few developing countries. Part of this may be reflected by weak institutions (e.g., Busse and Hefeker 2007) and in the inability to create the necessary infrastructure and business environment that FDI needs (Velde 2006).[4]

Figure 7 shows the world's largest sources of FDI in 2018. The US, usually the main investor in FDI, has negative FDI outflows in 2018 due to a tax reform and repatriations by US multinationals. Given their strong post-colonial ties, France and Germany are traditio-

[4] Gossel (2018) outlines the discussion on the relationship between FDI, corruption, and democracy and points to three different conclusions: corruption attracts FDI, corruption deters FDI, and FDI is attracted to less corrupt but less democratic countries.

Figure 8

FDI to Sub-Saharan Africa: Selected by Largest FDI Inflows in 2018



Source: UNCTAD Stat (2020). © ifo Institute

nally among the largest foreign investors in the world and in Africa. Other important FDI investors in recent decades have included Japan, Hong Kong, and China. China's FDI increased substantially – more than 50 percent – between 2013 and 2017 (UNCTAD 2019).

Despite strong fluctuation, South Africa is one of the most significant recipients of FDI (see Figure 8). In the 2000s, Nigeria also received significant investments. The country is trying to reduce its dependence on oil and integrate itself into global value chains by expanding its manufacturing sector. Changes at the country level included the merging of trade, industry, and investment, reflecting Nigeria's intention to effectively coordinate these key sectors and improve its trade and investment environment (Lloyds Bank 2020).

Inward foreign direct investment in Mozambique peaked in 2013, then dropped and increased again from USD 2.3 billion in 2017 to USD 2.7 billion in 2018 (see Figure 8). Investments of multinationals had only a limited positive impact on overall employment and poverty levels because FDI was mostly invested in sectors in which the majority of the population is not active (Orre and Rønning 2017). Instead, most of the investments went into existing projects for gas exploration and production and intra-company transfers, such as loans from parent companies to subsidiaries already located in the country (UNCTAD, 2019). In general, Mozambique, which is abundant in natural resources, is characterized by fragile political institutions, high levels of corruption, a lack of private property rights on land, and a low quality of public services (Orre and Rønning 2017). These are all factors that hinder foreign investments and the beneficial allocation of such investments in the country's economy.

Despite various attempts by some African countries to diversify economic growth away from natural resources, FDI for new projects still flows largely into extractive industries and construction (see Table 1). However, there are examples of FDI flowing into other sectors. In Sudan, for example, where FDI grew by 7 percent in 2018, small investments were made into innovative sectors, for example in a car-sharing agency in the capital city with plans to expand in the coming years. However, also in Sudan, the bulk of investment continues to go into oil and gas exploration and agriculture (UNCTAD 2019).

THE ROLE OF FDI FOR DEVELOPMENT

FDI can boost growth, competition, and productivity, and has the potential to contribute to Africa's integration into the world economy. Moreover, spillover effects can provide local workers and companies with technology and knowledge, making private sector investment an attractive component of future cooperation between European firms and firms in developing countries (World Bank 2014b). However, sustainable FDI demands free markets and liberal political systems, free of corruption.

In order for this to succeed, general and specific policies must be implemented to make FDI work for development and the right conditions must be created to enable "sustainable" investments. Policies should strengthen local human capital and technological skills (Velde 2006). Moreover, cooperation must take place on an equal footing and move away from the mere extraction of raw materials toward more productive investment (Velde 2006).

Europe and Africa should therefore work closely together to develop a comprehensive framework for foreign direct investment that benefits both home and host countries (World Bank 2014b). To this end, both partners should be autonomous and recipient

Table 1

Five Largest Announced Greenfield FDI Projects in 2018 in African LDCs

Host economy	Industry segment	Home economy	Estimated capital expenditure (USD million)
Ethiopia	Petroleum refineries	US	4,000
Angola	Oil and gas extraction	Italy	2,236
Mozambique	Natural, liquefied, and compressed gas	US	1,400
Malawi	Commercial and institutional building construction	China	668
Zambia	Industrial building construction	Egypt	668

Source: UNCTAD (2019).

countries should be involved in the decisions concerning how FDI is used and into which sectors it flows. In addition, the local population should be included and bottom-up approaches facilitated. Development aid could support the development of regulations and institutions that encourage private sector entrepreneurship and investment, e.g., how easy it is to set up a business, obtain loans, etc.

Regardless of the type of capital flow, flows should be context-specific, involve the destination country, and empower the local population. This can have a positive feedback effect on the political structure and institutional layout. Strengthening the capabilities of the excluded class will automatically lead to a participatory approach and institutional design. This initiates a smooth process toward greater accountability in the political structures, which may be more realistic than promoting a direct regime change (Brett 2016).

SUMMARY

We have looked at recent trends in development aid and private-sector investment, more specifically FDI. While aid flows have been stable but highly contested over the years, FDI in developing countries has increased many times over in recent years, albeit more hesitantly in the least developed countries in Africa. While aid in Africa flows predominantly into health and education, the focus of FDI remains on the extractive sector. Its extension to other sectors has the potential to take the cooperation between African and European countries to a new level, with countries on both continents becoming equal partners. Sustainable FDI requires strong institutions, liberal markets, and the strengthening of local communities; these are key factors for a favorable business climate and fundamental to the development of sustainable strategies for future cooperation, investment, and economic development. Perhaps aid can help create the conditions that FDI needs.

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