



TOGETHER
for a sustainable future

OCCASION

This publication has been made available to the public on the occasion of the 50th anniversary of the United Nations Industrial Development Organisation.



TOGETHER
for a sustainable future

DISCLAIMER

This document has been produced without formal United Nations editing. The designations employed and the presentation of the material in this document do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations Industrial Development Organization (UNIDO) concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries, or its economic system or degree of development. Designations such as “developed”, “industrialized” and “developing” are intended for statistical convenience and do not necessarily express a judgment about the stage reached by a particular country or area in the development process. Mention of firm names or commercial products does not constitute an endorsement by UNIDO.

FAIR USE POLICY

Any part of this publication may be quoted and referenced for educational and research purposes without additional permission from UNIDO. However, those who make use of quoting and referencing this publication are requested to follow the Fair Use Policy of giving due credit to UNIDO.

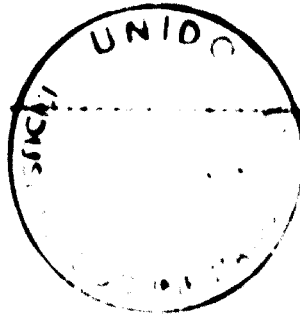
CONTACT

Please contact publications@unido.org for further information concerning UNIDO publications.

For more information about UNIDO, please visit us at www.unido.org

04867

UNITED NATIONS INDUSTRIAL
DEVELOPMENT ORGANIZATION



Distr.
~~RESTRICTED~~
UNCLASSIFIED

FRANCE ENGLISH

THE ROLE OF THE POLICY-MAKER
IN INVESTMENT
DECISION-MAKING

14.73-4375



TABLE OF CONTENTS

	Page
INTRODUCTION	1
I. CURRENT PRACTICES AND PROBLEMS OF THE INVESTMENT DECISION PROCEDURES IN AFRICA	5
II. THE NEED TO INFLUENCE INVESTMENTS	7
III. INDUSTRIAL PLANNING AS AN INSTRUMENT OF THE POLICY-MAKER	9
IV. PRACTICAL STEPS FOR INVESTMENT DECISION MAKING	12
1. Clear concepts of long-term development	12
2. The importance of large-scale investments	13
3. Increasing the number of available projects	14
4. Establishing a system for project evaluation	16
5. Investment Implementation	17
V. CONCLUSIONS	20

INTRODUCTION

1. Investment decisions as a whole constitute probably the most important influence on the future course of economic development of a country. Industrialization is in fact based on a series of investment decisions. There are two complementary ways in which the volume and pattern of investment exerts its influence on the economy:- on the one hand, investment creates new capacity for producing additional output and on the other hand it creates new jobs and purchasing power in the economy. This dual role of investment makes it essential for the country's policy-makers to devise ways and means of influencing investment decisions, so as to be able to steer the economy according to national economic and social priorities.
2. The extent to which, and the form of how, a government can influence investment decisions vary from country to country, depending on the specific economic and political institutions prevailing. In a highly centralised economy, the government usually makes all the important decisions in the sphere of investment planning, while in a market-oriented economy such decisions are typically left to be determined by the forces of the market. Inbetween these two extremes, there exists a variety of economic systems characterised by different degrees of centralisation, where the price mechanism operating through the market is partly allowed to shape investment decisions.
3. Indeed, the first and in certain ways, the most important role of the policy-maker is to delineate the areas where the price mechanism would be allowed to operate and other areas where market signals are deemed to be inadequate or even misleading and direct, centralized decisions have to be taken. Thereby, a delicate balance must be struck to combine the advantages of information flowing through even an imperfect market economy enabling decentralised commercial decisions with the advantage of centralized decisions in nationally important areas.
4. The nature of the problem of investment decisions can be further demonstrated by listing the various basic questions involved:-

- in which branch to invest;
- how much to invest,
- when to invest
- in which form to invest (choice of technology, process, etc.)

The decision to invest in a particular project means a decision on such economic, financial and technological issues which may have a long-term and significant impact on the country's economic development. In as much as the political leadership of the country wishes to influence economic development, it should therefore participate in, or influence the individual investment decisions.

5. This paper aims at presenting the problem of what the policy-maker's role in the investment decision process involves. Although the paper's title refers to investment decisions in general, the actual subject focuses on investments in the industrial sector in African countries. Even in this narrowing-down of the subject, the findings of the paper can only lead to broad and general recommendations.

1. CURRENT PRACTICES AND PROBLEMS OF THE INVESTMENT DECISION PROCEDURES IN AFRICA

6. The majority of African countries recognize the need for an active role of the government in guiding investment decisions in order to ensure a high and sustained economic growth and industrial development.
7. The rationale of this active role of the government is that the small markets, insufficient capital and the lack of skills as well as the inadequate infra-structure constitute too great obstacles for the desired economic and industrial development to be left to market forces alone to overcome. Industrial investments tend to constitute a long-term commitment of the country's resources and development processes and the price mechanism is not considered an appropriate allocational guide for these investments. As a consequence, the policy-maker wishes to influence investment decisions to ensure that industrial development is geared in accordance with the declared objectives and strategic concepts of development. Under the assumption that development planning is the appropriate tool for the allocation of resources and that the plan breaks down over-all objectives and expresses investment intentions, most African countries emphasize the significance of economic and industrial planning.
8. As to current African development plans, the industrial plan objectives and strategic targets are generally rather vaguely expressed. The plans may emphasize labour-intensive (employment creating) industries, agro-based industries, import substitutions, export promotion and utilization of domestic natural resources, but apparently very few countries have systematically formulated a detailed, consistent and long-term strategy for industrial development which can be applied at the level of individual investment projects.
9. In a UNIDO study ('Summaries of Industrial Development Plans', vol. III) to be published shortly, it is noted that the plan documents often even lack a clear distinction about the desired role of the public and private sectors

of investment. The study also reveals that the various components for the formulation of a strategy and for the preparation of a consistent plan are either non-existent or inefficient.

10. It is thus generally assumed that there are difficulties in reconciling strategic targets with the usual individual investment projects:- Firstly, it has shown to be a substantive problem to translate the overall objectives and strategic targets into specific projects and to incorporate investment projects into a programme totally consistent with the overall objectives. Secondly, there are generally too few projects available at the time of plan preparation to allow an application of selection and priority criteria. Thirdly, the private investment decisions may not fol on the policy-maker's objectives, since these objectives are mostly not supported by a consistent policy framework and an effective and operative promotional system at the project level.

11. In African planning reality, it is thus not uncommon that (a) the plan document (of the policy-maker) more or less spells out overall objectives and priority areas for industrial investment, that (b) at the same time and unrelated to these, a number of investment projects are listed which happened to have been identified and conceptualized by the technicians in time for the plan preparation, and that (c) the entrepreneurs - be it a private industrialist, a parastatal development corporation or a public industry - carry out different investments based only on commercial profitability analysis, disregarding external economies, interindustry relations and without giving regard to socio-economic considerations.

12. As a result, the choice of investment projects, their timing and their form may be quite different from what the policy-maker envisaged in his original concept.

II. THE NEED TO INFLUENCE INVESTMENTS

13. In the ECA/OAU Conference of the Ministers of Industry, 1971, the need to better influence investments was clearly recognized. In its Programme of Action, the Conference accordingly stressed the need for African governments to put greater emphasis on solving some of the most significant problems which refer to industrial financing, high capital and operating costs, ownership, employment, foreign influence, etc. Appropriate measures to avoid these problems should be foreseen already at the stage of an investment decision.

14. The recommendation of the Conference is still valid indeed. Too many wrong investments have demonstrated to Africa that even in a developing economy each investment does not necessarily constitute a step toward development. Therefore a thorough selection of investment projects must be carried out, based on socio-economic considerations.

15. In influencing investment decisions, one should consider that only few African countries are large enough to expect, even in the long run, to be able to create a broad industrial structure of their own. Moreover, resources are likely to be scarce for an extended period of time and development must therefore concentrate on selected projects having maximum effect.

16. The policy-maker should consider the following essential elements of an investment decision:-

- Commitment of the country's resources (financial, material, manpower);
- Effects on employment;
- Effects on the distribution of income;
- Foreign exchange effects;
- Long-term effects on the industrial structure of the country;
- Effects on the regional development;
- Effects on the infrastructure (public utilities);
- Effects in regard to domestic versus foreign control of industry;
- Other social implications.

Obviously, the above mentioned effects have the greater an impact on the national economy, the larger the project is in regard to installed capacity. There is thus a greater need for the government to exert its influence, the greater the individual investment contribution is.

17. There are a number of techno-economic alternatives of each project,[✓] the choice of which will have a large impact on the future operation of the plant. These alternatives are:-

- Choice of product mix, (i.e. type specification and quantity of various products to be manufactured),
- Production technology, (i.e. process flow, material inputs, by-products and wastes, type of machinery and equipment, maintenance requirements, and future need for renewal);
- Manpower and skill requirements and organization;
- Location,
- Timing; time table for construction, and operation start.

These choices should basically be left to the technicians. The policy-maker may be instrumental to some extent only in decisions which affect timing and location.

[✓] As stated in an article by Richard Nailon (entitled "A time of crisis for planning"; Modern Government, January/February 1972), a steel project in Venezuela showed 27 alternatives regarding only the staging and phasing of construction of various process options.

III. INDUSTRIAL PLANNING AS AN INSTRUMENT OF THE POLICY-MAKER

18. So far, it has been pointed out that there is a need for a government to establish priority areas for investments and to see to it that the best choice be made among the individual investment projects. Industrial planning has proved itself to be an instrument for translating overall objectives into concrete actions. There are, however, certain constraints to it.

9. The industrial planning process is supposed to function in the following way:-

- (i) Based on an analysis of the existing industrial structure and the long-term prospects, as well as on the determined overall objectives of economic development, a long-term industrial development strategy is formulated by the policy-maker. The strategy determines long-term priority areas of investment and basic criteria for evaluating investment projects.
- (ii) A set of policy measures is formulated for implementing the overall objectives.
- (iii) The policy-maker's strategy is transformed into a medium-term development plan in which quantified targets are set (investment, production, employment, foreign trade, etc.).
- (iv) A large number of investment opportunities are identified. The investment opportunities are systematically analysed by the technicians according to the criteria and other preferences established by the policy-maker. The selected investment opportunities are subsequently developed into a feasibility study and evaluated according to national benefit-cost criteria.
- (v) Based on objectives as to the degree of public ownership and public control over specific branches and on locational and other preferences, the technicians determine the timing and other conditions for investment in the selected projects.

(vi) The selected investment projects are implemented in accordance with the prevailing regulations (policy measures) either by the public sector or by private entrepreneurs. To attract private investment and/or foreign capital, appropriate promotional measures are applied on a selective basis. The contracts for supply of foreign know-how, capital and equipment are reviewed to ensure that the policy-maker's objectives in this regard are fully considered.

20. In reality there are, however, obstacles for introducing and following such an 'ideal' system. These obstacles are of substantive, administrative, organizational and statistical nature.

21. In addition, the policy-maker would have to be completely knowledgeable about long-term potentials and trends and be specific about his objectives to be able to form sensible priorities and preferences and to transmit these to the technicians. In most cases the objectives are formulated only vaguely due to on the one hand the lack of reliable data on the present structure, potentials and trends of the economy and in particular of the industrial sector and on the other hand the short time horizon for a country in rapid political, social and economic transition. As a result of these uncertainties, the government often prefers to refrain from a more precise formulation of a long-term strategy and leaves it to technicians to take an ad hoc approach within a broader policy framework which contains these uncertainties. Moreover, even if the government has determined its long-term goals, there is a problem of how the policy-maker's objectives should be translated into directives for the project planner. If the priorities are not clearly defined in quantified terms, the investment may be implemented in contradiction to the basic objectives of the policy-maker.

22. It should finally be noted that an important requirement for the proper functioning of the planning process is that the government has to its disposal an efficient administrative machinery.

2). In most African countries, the administrative machinery needs to be strengthened to meet these requirements. In many cases even the actual institutions have to be established. UNIDO is currently supporting most African countries in these efforts.

IV. PRACTICAL STEPS FOR INVESTMENT DECISION-MAKING

24. The question arises what practical approach could be recommended for the policy-maker's guidance of industrial investments. If one disregards the specific problems of various countries, certain general recommendations for such an approach can be made as formulated below.

1. Clear concepts of long-term development

25. The long-term industrial development objectives should be part of a consistent socio-economic continuum. The formulation of the objectives should lend itself to the definition in quantifiable terms which would serve as criteria for investment decisions. Better understanding of the long-term effects and commitments caused by investments which are selected in this way should be ensured. The effects of investments should be under continuous surveillance in order to enable a possible adjustment of earlier defined objectives.

26. The policy-maker needs to overcome the problems of uncertainty of future developments and prospects. Clearly, in certain turbulent situations it may be futile to attempt to foresee and gear development beyond two to three years; but generally it seems to be possible to make a stocktaking of the present economic structure, to visualize development for up to ten years ahead and to arrive at some sensible conclusions as to the long-term prospects and problems. Strategic and policy concepts could be formulated based on these findings. The logical sequence of activities to be undertaken could be described as follows:-

- (i) Analyse the present industrial structure, problems and potentials of long-term industrial development in the context of the overall economic development;
- (ii) Based on these findings formulate long-term objectives and strategies for economic and industrial development;
- (iii) Based on the strategy, formulate a plan in which priorities are assigned to specific industries;

- (iv) Review present legal, economic, financial and foreign trade policies and instruments and their effect on the promotion and direction of new industrial investment, on trade and on the operation and efficiency of existing industries; review the institutional and organisational set-up;
- (v) Formulate appropriate policy measures and an institutional set-up for the realisation of the long-term objectives.

27. The actual role of the policy-maker in this process can obviously be focused on items (iv) and (v). This implies a dual responsibility of the policy-maker, i.e., the formulation of the objectives and their implementation. In fact, he will identify the instruments of economic policy that are politically and administratively feasible to use for attaining those objectives. Technicians will carry out the remainder of the tasks.

28. In view of the inaccuracy of available data and of possible rapid changes in the political and economic systems, the long-term concept should be re-considered with each medium-term plan. In this way the strategy could be "rolled forward" based on the feedback of information obtained in the process of implementation.

29. On the other hand, if there is no possibility to formulate clearly defined long-term development objectives as for instance in a specific transitional period, then at least some basic concepts should be established regulating ownership and investment licensing.

2. The importance of large-scale investments

30. The features of the large industries are heavy capital investment, requirements for special skills and technological and marketing (including export marketing) knowledge. The investments involve long gestation periods, greater risk element and long commitments of the economic resources of the country. Generally, a large foreign participation is necessary in order to

supply capital, know-how and equipment. Because of all these properties, large-scale industrial investments are a prominent issue of the long-term strategy.

31. It is in this category of large investments that the policy-maker should have a deciding role. He should ensure that thorough analyses of the long-term effects on the national economy are undertaken and that the possible alternatives and variations of the project are properly examined.

3. Increasing the number of available projects

32. As mentioned above, one of the major obstacles for a proper selection of projects among various possibilities is the fact that generally there are too few pre-investment studies available and sufficiently prepared (open to permit a real choice). In order to overcome this problem, it is important - on the one hand, that a restricted number of indicator areas which are of priority for investments and which should be investigated as to investment opportunities and, on the other hand, that pre-investment studies be undertaken in a systematic way. The systematic preparation of industrial pre-investment studies can be arranged by the establishment of the appropriate institutions. Several African countries have in fact set up Project Studies Centres with UNDP/UNIDO assistance. These centres generally carry out pre-feasibility studies (called opportunity studies also), prepared by economists, industrial engineers, financial analysts, etc.

33. The pre-feasibility studies contain:-

- (a) a description of the market (estimation of demand, supplies and prices and their trends);
- (b) a brief description of the alternative technologies and information on the availability of major inputs;
- (c) tentative estimation of the investment and operating expenditures;
- (d) rough estimate of the commercial profitability.

14. The aim of the studies is to enable a decision⁴-

- (i) whether the objectives of the project idea comply with the objectives of the government;
- (ii) whether the project idea on prima facie grounds, seems to be promising enough to deserve detailed examination;
- (iii) what aspects of the project deserve special attention in the course of further examination.

15. The preparation of a pre-feasibility study thus enables the project sponsor to make a first appraisal of the project and to decide whether further commitment of funds for more detailed project studies should be made. The policy-maker is in the position to make a first screening of the alternative projects. It has been observed in some cases that when a complete feasibility study has been commissioned, based directly on a vague project idea, without previously establishing the viability through the evaluation of a pre-feasibility study, the actual commitment of - often considerable - funds for this study⁴ already meant a de facto decision to invest since it had become politically difficult to revoke the decision. Those projects which prove to deserve a detailed techno-economic feasibility study will pass through the final evaluation and decision stage.

✓ The term "pre-investment study" covers the preliminary selection stage and the formulation stage of a project and comprises the following studies:

- (a) project idea study (pinpointing investment opportunities);
- (b) pre-feasibility study (opportunity study, bankable project study);
- (c) complete techno-economic feasibility study.

✓ of. "Stages of Industrial Project Development", (UNIDO) Industrialization and Productivity Bulletin No. 19, United Nations, New York, 1973

✓ Sometimes these funds constitute up to 10 per cent of the investment funds for machinery and equipment.

36. Thus, with a large number of sufficiently prepared pre-investment studies being available, the government's priorities can be applied in selecting and ranking of different projects and in making the appropriate choice from variations of one particular project.

4. Establishing a system for project evaluation

37. The proper influence of the policy-maker on investment decisions - as described above - is ensured when long-term strategy considerations are translated into project evaluation criteria. Thus, appropriate procedures for national benefit-cost analysis will have to be established in the country. UNIDO has worked out a methodology for project evaluation which shows how national parameters or national weights reflecting the government's goals can effectively be used in a system of social benefit-cost analysis of individual projects.^{5/} Based on this methodology respective national manuals containing specific procedures can be elaborated.

38. The establishment of such a procedure in the country and a determination of the specific national parameters by the policy-maker would be an essential instrument for steering investment decisions in accordance with the objectives. In this context, it appears to be useful to briefly describe the approach laid down in the UNIDO Guidelines.

39. The basic approach of the Guidelines is to evaluate the project in terms of its contribution to the social-economic objectives of the country. This procedure is to be carried out in several steps. The first step is to evaluate the project from a commercial and financial point of view. The next step is to correct those market prices that obviously do not represent the real opportunity costs or values of the resources to the economy as a whole. The prices to look at first are the prices of unskilled labour and the price of foreign exchange. In addition, one may need to correct prices which are controlled by the government such as prices for electricity, water, transportation, and agricultural products.

^{5/} "Guidelines for Project Evaluation", United Nations, New York, 1972, Sales No.: E.72.II.B.11

40. If there is inadequate savings for the implementation of the development plan, the unit of savings should be valued higher than the equivalent unit of consumption. These corrections should be introduced when the flow of costs and benefits are discounted over time, in order to determine the value of the project. The policy-maker has so far determined only the time preference and the relative weight of consumption versus savings through the choice of the discount rate. The critical role of the policy-maker, however, is to determine the project's contribution to other objectives which as a rule are in conflict with the maximisation of aggregate consumption. Policy decisions on income distribution and regional disparity are good examples of this type of conflicting objectives.

3. Investment implementation

41. Besides influencing the investment decision the policy-maker should also make sure that the realisation of the investment projects goes according to his objectives and priorities. Therefore this role would not end with the evaluation of projects and the final decision to invest, but should be extended into the field of implementation.

42. Investment attraction

One of the basic questions is 'who will invest'. This question calls for an examination of the following problem :-

- Is sufficient domestic, private, or public capital available to be raised for the investment project?
- If yes, how can these funds be channelled to the desired investments?
- If no, can domestic capital be generated or raised by measures like relaxed financial controls, stoppage of capital exports?
- Is there sufficient attraction for foreign capital to come to the desired investment?

With other words, if the means of realising the desired investments are not secured, then the selection process of projects and priority setting was futile.

43. If foreign private capital is expected to play a crucial role for the country's development, sufficient provision will have to be made to lay as much emphasis on the promotion of the selected investment projects as on their planning and evaluation. Otherwise foreign capital may be scared away by the restrictions and/or attracted to other countries offering a better investment climate. In this connexion, the problem of the generally prevailing scarcity of properly formulated and evaluated projects should be considered. Due to this problem, the government may after all have to leave the initiative of identifying, preparing, evaluating and implementing investment projects to private entrepreneurs disregarding their compliance with the national priorities.
44. To attract private, foreign capital to selected projects is indeed a difficult task for many African countries. Obviously, private capital is only attracted if there is scope for a reasonable commercial profitability of the project within the policy conditions and if political risks are considered as limited. The country will have to ensure that these conditions are fulfilled and that this fact is made known to potential investors.
45. It is felt that investment promotion is frequently being carried out too passively and on too general a basis. In many cases potential investors themselves are expected to find the projects and to initiate contacts and studies.
46. To make the promotion more efficient, it would be necessary to undertake promotional activities in a more specific way. Each individual project - available in form of a pre-feasibility study - would have to be 'sold' to selected potential investors. Also the application of incentives and other policy measures should possibly be done on a more selective basis. The policy-maker's role in this aspect should be to create the necessary facilities and the concepts for the proper handling of these activities by the technicians.
47. Contracting
After the problem of financing has been solved, one key problem is the formulation of contracts for consultants, civil works contractors and

- above all - for suppliers of machinery equipment. It is understood that the policy-maker cannot be expected to play a direct role in formulating the individual contracts. However, in order - on the one hand - to strengthen the negotiating position of investors and technicians and - on the other hand - to have priorities and objectives for industrial development incorporated into the contractual arrangements, the policy-maker would have to establish certain guidelines for formulating contracts. Such guidelines would have to cover issues like the use of scientific capacities in joint work contracts, association of local consultants with foreign consultants, provision for training of local staff, etc. As to know-how contracts, these should follow certain basic patterns which the policy maker will have to formulate as to payments, export clauses, duration, etc.

48. Feedback

A final basic requirement for an active role of the policy-maker in investment decisions is the feedback of information on the actual performance of established industrial plants. If the policy-maker disregards that information, the subsequent investment decisions may not alleviate prevailing problems but tend to further aggravate these.

49. The role of the policy-maker in this context is to ensure the creation of proper institutional arrangements for this feedback of information and also to review the effect of existing policy measures on existing industries.

✓ This particular problem was discussed at the ICA/UNU Conference of Ministers of Industry, Addis Ababa, 3-7 May 1973. The report of the conference states (p.19) that "in the recent, African investors in the private and public sectors often have experienced an extremely weak position with overseas suppliers of plant and machinery".

7. CONCLUSIONS

50. As a concluding remark, it should be said that it is relatively easy to define the role of the policy-maker in investment decisions on a general basis and also to describe the institutional and data requirements for such a decision-making process. The problem is to apply these findings on an actual case, i.e., to delineate the control functions of the government in a particular country. The determination of the balance between centralized - social, and other curative - decisions on the one hand, and decentralized - commercial and short-range, but often efficient - decisions on the other hand, must be based on a realistic assessment of the country's administrative and managerial capabilities.

51. The basic discussed approaches to define the role of the policy-maker in certain aspects of investment decisions, require above all an efficient institutional set-up, an appropriate administrative procedure and a communication between the policy-maker and the technocrats. The administrative machinery has to cater for a transmission of the pronounced priorities and set of preferences of the policy-maker to the institutions dealing with the selection of investments.

52. There is indeed a danger that detailed and centralized control over individual investment decisions by the government can put too heavy a burden on a weak administrative machinery and can eventually over-bureaucratise and hinder effective industrial development.

53. The institutions generally required to execute the policy-maker's decisions or provide the technical support for these decisions would have to perform the following features:-

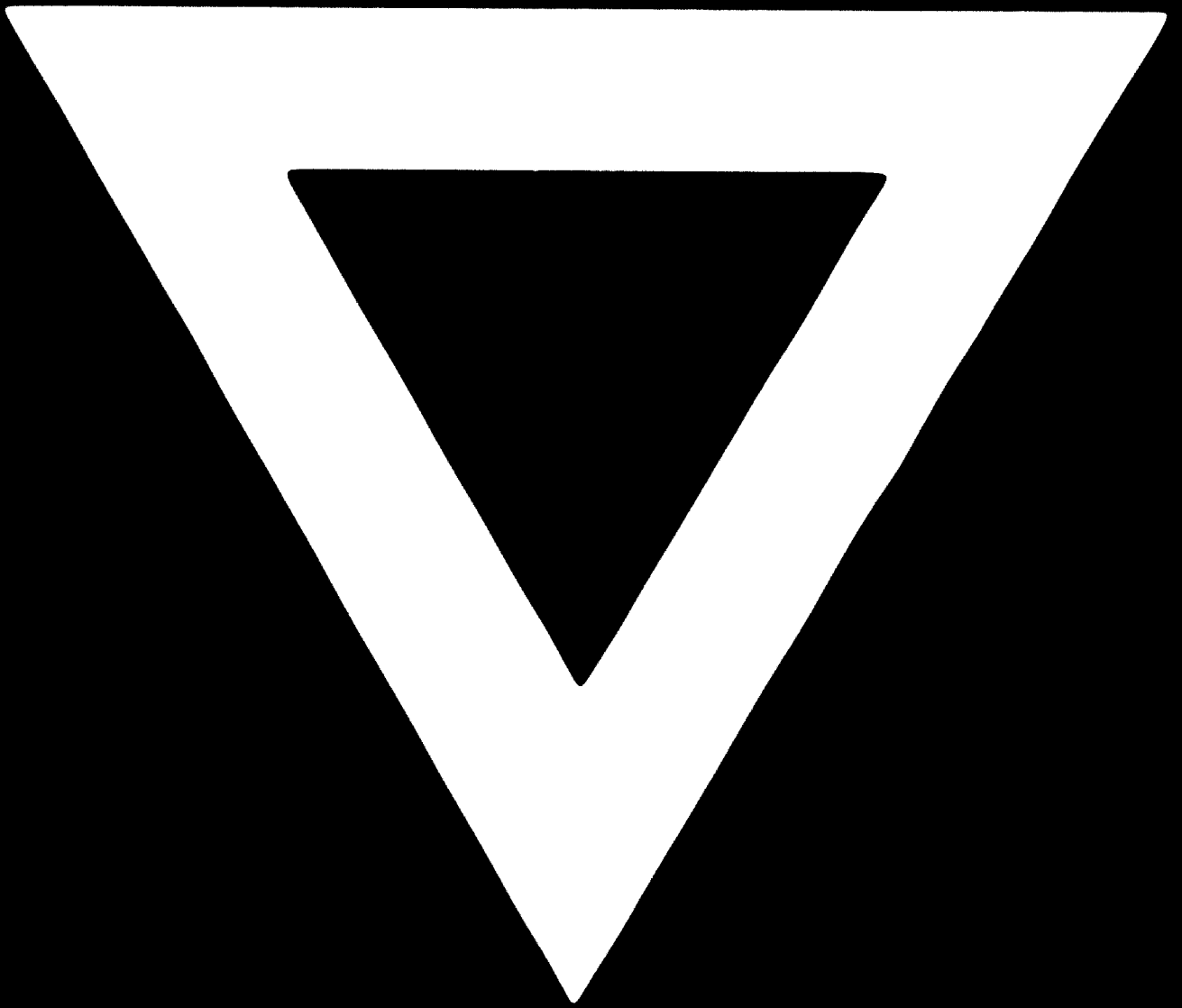
- (a) a macro-economic function which is to prepare surveys, analyses, alternative strategic proposals and plans and programmes. The formulation of policy instruments would also be carried out.

- (b) the identification of investment opportunities especially in high priority branches and the preparation of pre-investment studies;
- (c) industrial project evaluation and - based on the evaluation - ranking of projects for investment promotion;
- (d) investment promotion of the selected projects including rendering information about and applying incentives and other policy measures;
- (e) project implementation including contract negotiation for the project.

These functional parts of the institutional set-up need to effectively communicate with each other to ensure consistency and follow-up of investment decisions.

54. UNIDO could offer its assistance here. Indeed, one of the major roles of UNIDO is to support developing countries in strengthening their machinery for industrial programming, planning and implementation and to assist in defining the most suitable approaches and methodologies in this field. Thus, assistance is presently being rendered to developing countries including most African countries in the fields which were mentioned above, i.e., strategy formulation, industrial programming, sectoral programming, project preparation, and evaluation and investment promotion and implementation.





76. 02. 09