T20 Policy Brief

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Task Force 04

TRADE AND INVESTMENT FOR SUSTAINABLE AND INCLUSIVE GROWTH

Redefining Investment: Leveraging FDI's Potential for Mitigating Inequality under the AfCFTA

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Abstract

This policy brief discusses the impact of Foreign Direct Investment (FDI) within the African Continental Free Trade Area (AfCFTA) on reducing income inequality across Africa. It emphasises the AfCFTA's goals of promoting economic integration and highlights the necessity of directing FDI strategically to alleviate the pronounced spatial disparities within and between African countries. The analysis focuses on the dual potential of FDI, influenced by targeted location conditionalities, to either diminish or amplify existing inequalities, particularly in regions with varying socio-economic statuses. The brief advocates for investment in regional value chains and human capital development as essential strategies for ensuring an equitable distribution of FDI's benefits, especially to marginalised communities and regions. It also highlights the need for G20 engagement in building sustainable infrastructure, stressing the importance of project bankability to ensure effective FDI utilization. This approach seeks to transform FDI and FTAs into instruments of equality, aligning with global efforts towards a more inclusive future. The ultimate goal is to leverage the G20's influence to ensure FDI under the AfCFTA contributes to reducing income disparity and fosters sustainable development across Africa.

Keywords: African Continental Free Trade Area, Foreign Direct Investment, income inequality, regional value chains, human capital, G20, economic integration.

Diagnosis of the Issue

Global inequalities present significant challenges to sustainable development, with disparities evident across various dimensions, such as geographic regions, nations, and socio-economic groups. Africa, despite its potential, has the highest number of the world's poor and faces pronounced intra-regional inequalities. The introduction of the African Continental Free Trade Area (AfCFTA) aims to address these challenges by creating a unified market for goods and services. This initiative opens new avenues for Foreign Direct Investment (FDI) that could play a pivotal role in reducing inequalities. FDI, within the AfCFTA framework, is essential for driving economic growth, enhancing industrial capacity, and creating job opportunities. By strategically directing FDI towards sectors that are crucial for the economic empowerment of a wider population, the AfCFTA can facilitate a more equitable distribution of economic benefits. This approach not only aims to increase intra-African trade but also ensures that FDI contributes effectively to addressing the continent's deep-rooted inequalities.

Inequalities are on the rise. Although data from the 2022 World Inequality Report (Chancel et al. 2021) shows that the gap between the average incomes of the richest 10% and the poorest 50% of countries has reduced from 50 times to less than 40 times, this is still a large disparity. It also shows that inequality within countries has been on the rise as the gap between average incomes of the top 10% and bottom 50% of individuals within countries has nearly doubled. In addition, sub-Saharan Africa is among the most unequal macro-regions, second only to the Middle East and North African (MENA) region.

A potential implication of the high levels of global inequalities has been described as the “end of development” by the 2024 Global Risks Report (World Economic Forum 2024). This report draws attention to the growing gaps between developed and developing economies due to newer technologies such as Artificial Intelligence, challenges linked to climate change, as well as demographic shifts and geopolitical dynamics. The prediction is that these challenges will affect investment inflows into the developing world and adversely impact labour markets, thus hindering economic mobility and contributing to stalled global prosperity. Two things that are pitched as measures for mitigating this risk are increased trade and investment in developing regions such as Africa.

Africa has already embarked on a journey of improving the way it trades with itself and the world, in the form of the AfCFTA agreement. The agreement consists of measures to reduce, over time, tariff, and non-tariff barriers in an effort to grow intra-African trade and drive industrialisation. Although the agreement was officially flagged off in January 2021, negotiations of its constituent protocols are still ongoing and are at various stages of completion (Tayo 2023). Meanwhile, it can be said that the agreement is in a quasi-implementation stage, as an interim trading arrangement referred to as the Guided Trade Initiative was launched in October 2022 with an initial eight countries and is expected to be expanded this year to include up to 30 countries. This increases the urgency of mobilising foreign direct investment to help scale production and productive capacity in Africa in response to the AfCFTA. Although Africa has a hard time attracting FDI, the single market that is anticipated through the AfCFTA will strengthen the business case for investing in Africa. This is due to the shift from fragmented individual African markets to an integrated free trade area. While the AfCFTA presents opportunities for development and reduced inequality through FDI, managing it effectively is crucial (Tayo, 2023). Misdirected FDI and FTAs risk aggravating disparities across Africa. Historically, unregulated FDI and FTAs have sometimes led to a concentration of wealth and opportunities in certain sectors or regions, leaving behind vulnerable populations and exacerbating income and social inequalities. Strategic and inclusive investment is necessary to benefit all Africans and support broad-based economic impact, particularly in sectors like sustainable agriculture, renewable energy, and digital infrastructure. Ensuring FDI under the AfCFTA drives equitable growth involves prioritising impactful sectors and fostering local capacity and technology transfer for sustainable progress.

Strengthening the link between FDI and sustainable development is a challenge that does not only face African countries, but also the developing world at large. This policy brief will put forward actionable recommendations for the G20 towards this objective and then will discuss possible outcomes of implementation scenarios.

Recommendations

The African Union's recent inclusion in the G20 and the ongoing Compact with Africa (CwA) initiative provide a strategic platform for aligning FDI with the goals of the AfCFTA. This alignment is crucial for directing investments in ways that foster equitable growth and sustainable development across the continent. The recommendations presented here aim to leverage the CwA framework, advocating for enhanced cooperation between G20 countries and African nations.

A study by UN Habitat (Kaur et al. 2018) examined the links between FDI and income inequality in Africa. The study found that FDI generally led to an increase in income inequality in host countries, but when factors such as absorptive capacity, human capital, the level of technology and the quality of institutions were controlled, FDI led to a reduction in income inequality. Other studies have observed varying effects of FDI on inequality but still emphasise the importance of the above factors for positive outcomes (Nguyen 2023; Wang et al. 2023, 805-820; Yuldashev et al. 2023; Kaulihowa and Adjasi 2018, 250-265). This section will draw from some of the findings from these studies.

Sector and Location: Leveraging conditionalities for inclusive value chains

Another mediating factor that determines the effect of FDI on inequalities is the mix of sectors and specific locations that receive the inward investment. In the context of the AfCFTA, this relates to local and regional value chains that are promoted for inward investment.[1] Value chains comprise sectors and locations and are typically used as a tool

[1] The AfCFTA has selected priority value chains that include automotive, leather, textiles and apparel, pharmaceuticals, some agriculture products, among others. Read more:

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for distributing the gains from free trade. Given that the AfCFTA is made up of state parties at varying levels of industrialisation and with different productive capacities, regional value chains are key to including African economies of different sizes. Local value chains are also used as a tool for addressing spatial inequalities within countries. The implementers of the AfCFTA recognise this and have identified priority value chains that span across the continent, while national industrial policies seek to embed rural areas into production and trade processes.

Where the G20 needs to come in helping to bring these value chains to life by mobilising investment. For these investments to help address inequalities, they will need to be coupled with conditionalities (Mazzucato and Rodrik, 2023). These conditionalities can help direct and incentivise FDI into the sectors and locations that have been determined as crucial for addressing inequalities. The manufacturing sector in Africa generates the largest number of jobs per volume of inward FDI - six jobs per million USD - and FDI into this sector has been found to significantly reduce income inequality (Kaur et al. 2018). This sector is also important due to its potential for linkages with other sectors, including agriculture, services and hi-tech (Kaur et al. 2018). G20 collaboration, in this instance, will mean working together with African governments to design the right kinds of conditionalities and incentives that ensure that FDI into the AfCFTA contributes to addressing inequalities.

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https://www.undp.org/sites/g/files/zskgke326/files/migration/africa/AFCFTA-Futures-Report-2021_Which-Value-Chains-for-a-Made-in-Africa-Revolution_GOLD-DRAFT_21_11_2021.pdf.

Skills and technology development should be at the centre of FDI projects

The profile of skills available in an economy's labour market and its level of adoption of new technology are some of the factors that determine whether FDI inflows will reduce or exacerbate inequalities (Kaur et al., 2018). The absence or insufficiency of these skills and technologies is often behind decisions not to invest in particular African economies. Regarding skills and technology development as part of the "lifecycle" of an FDI project can help incentivise the deployment of the right initiatives. FDI high-technology sectors may require the presence of specialised labour and technological capabilities. Viewing the absence of these as an investment opportunity is the kind of pivot that foreign investors need to make. Although the provision of education and capacity development services, as well as research and development, may not be regarded as highly profitable ventures that capital can be mobilised for, there is currently some scope for this through leveraging geopolitical infrastructure funds. These funds include the European Union's Global Gateway and the G7's Partnership for Global Infrastructure Investment, which include grant components that are targeted at investment for development.

Skills and technology development are typically regarded as spillover effects of FDI inflows to an economy. However, the proposal here is to integrate them into the sequence of activities that might precede large-scale investment in a location. These "pre-investment" projects can be geared towards preparing a location for greenfield investment, thus increasing their absorptive capacities. As a practical illustration, implementing this approach in the growing automotive value chain will require:

- Targeted advocacy to embed or strengthen the tertiary curriculum on automotive engineering, automotive design, supply chain management, advanced manufacturing, sustainability engineering, robotics and automation etc. This can be done by funding the creation of research centres and specialised scholarships within universities in countries that are projected to be part of the automotive cluster, such as Ghana. Capacitating these centres with highly qualified instructors can be done in innovative ways such as visiting lectureships or e-learning.

- Strengthening skills and certifications centres in areas such as Quality Control to meet the standards that will be required for large scale automotive investment.
- Supporting efforts towards eased movement within the continent to facilitate labour mobility.[2] This will be crucial for concentrating specific skills in growing clusters (Mlilo et al., 2023).

The evidence is clear that human capacity development is an important lever for ensuring FDI is a tool that helps to address income inequalities. A study on the impact of foreign direct investment on income inequality in some Asian countries found that the general positive effect was deepened by the presence of human capital (Yuldashev et al., 2023). The African Union's inclusion in the G20 provides an avenue for the negotiation and deployment of these measures.

Peer-learning: Sustainability, bankability and increasing absorptive capacity

A third and final recommendation for the G20 borders around peer learning on key issues, including the absorption, design and implementation of sustainable and bankable FDI projects. The implementation of the AfCFTA will need to be accompanied by significant investment in trade and production infrastructure, as well as in production facilities. However, there is a reported surplus of available capital compared to financially viable African infrastructure projects (Lakmeeharan et al., 2020). This crisis of

[2] A framework for this is the African Union’s Protocol for Free Movement.

"bankability" is also a threat to geopolitical infrastructure funds that are playing a growing role in development financing (Pleeck and Gavas, 2023). Secondly, the challenge of environmental and social sustainability is one that does not face African countries alone, but the entire G20 and even the global economy. Managing energy transition measures to ensure that they reduce and not exacerbate inequalities is another avenue for peer-learning within the G20. The deployment of FDI into the development of strategic minerals in African countries must not mirror historical imbalances and dependencies and will thus require the intervention of the G20. Thirdly, the only way FDI can be used as a tool for addressing inequality under the AfCFTA is if African countries are positioned to absorb this investment. G20 members, such as the European Union, have extensive experience in trying to improve absorptive capacity in some of their member states through measures such as cohesion funds. Knowledge exchanges on the successes and failures of deployed approaches will improve the position of African countries.

Scenario of Outcomes

Implementing recommendations to use FDI under the AfCFTA to reduce income inequality introduces varied potential outcomes. The following scenarios examine these outcomes, considering both positive impacts and challenges. They highlight the critical trade-offs in aligning economic growth with equitable development across Africa.

1. Sector and Location: Leveraging Conditionalities for Inclusive Value Chains

Scenario: Following the adoption of conditionalities targeted at fostering inclusive value chains, FDI flows into sectors critical for equitable growth, such as sustainable agriculture and renewable energy. This investment uplifts rural communities by creating jobs and enhancing agricultural productivity, which feeds into regional value chains, reducing food import dependency.

Contradictions and Trade-offs: However, focusing investment on these sectors might initially divert attention and resources from urban industrial sectors struggling with underemployment and high levels of urban poverty. The trade-off here involves balancing the immediate needs of urban industrial sectors with the long-term benefits of strengthening rural economies and sustainable practices.

2. Skills and Technology Development at the Centre of FDI Projects

Scenario: Investments in education and vocational training programs prepare the workforce for the demands of incoming FDI projects. Enhanced skills in technology and sustainability attract green industries, leading to the establishment of eco-friendly manufacturing hubs that offer higher wages and improved working conditions.

Contradictions and Trade-offs: The concentration of FDI in high-skill areas could exacerbate income inequality in the short term, as those lacking access to education or training may find themselves further marginalised. Moreover, the focus on technology-driven sectors might overlook traditional industries that still employ a significant portion of the population, potentially leading to job displacement without adequate re-skilling programs.

3. Peer-Learning: Sustainability, Bankability, and Increasing Absorptive Capacity

Scenario: Through peer-learning initiatives, African nations adopt best practices in project design and implementation, enhancing the bankability and sustainability of infrastructure projects. This attracts a higher volume of FDI directed toward initiatives that not only promise returns but also align with the continent's sustainable development goals.

Contradictions and Trade-offs: The emphasis on sustainability and bankability may prioritise projects that cater to the interests of foreign investors over local needs, potentially overlooking smaller, community-focused projects that address local inequalities. Additionally, the adoption of international standards might challenge local governance structures, requiring significant adaptations to meet these new benchmarks.

Conclusion

This brief has explored the role of FDI within the AfCFTA in addressing income inequality, emphasising strategic investment and policy adaptation as keys to equitable growth. The G20's engagement in supporting these efforts is crucial. As African development becomes a central project for global prosperity, there is a collective call to action for the G20 nations to prioritise and amplify their support for the AfCFTA's objectives. Strengthening FDI's impact on reducing inequalities within Africa is not just a regional priority but a global imperative.

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