



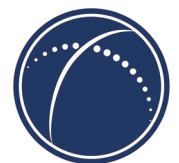
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CHANGE

Scaling Up Investment for Covid-19 Economic Recovery and Jobs in Africa

Connecting best practice
of investment and economic
development

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Executive Summary

Covid-19 is causing countries in Africa and other parts of the developing world to face multiple overlapping crises: the pandemic itself, a wider health crisis, a food security crisis and an economic crisis that is further exacerbated by low commodity prices and a decline in global travel and trade as well as financial flows.¹ As Africa grapples with this new reality and what it means for its economic outlook in the short, medium and long terms, many governments are already planning for economic recovery. In doing so, they seek not only to revive economic growth to be able to handle these overlapping crises but also to deliver economic transformation that can increase the resilience of economies to future economic shocks and of health and social welfare systems to future pandemics and natural catastrophes. And with Africa's population forecast to rise from 1.3 billion today to 4 billion by 2100, pressure is fast rising to accelerate the economic development of the continent in such a way that it creates sufficient jobs and economic opportunity for the rapidly increasing youth population.²

Robust economic recovery plans need to focus on scaling up private investment that can create jobs, sustain livelihoods, widen the tax base to pay for social welfare, increase net exports and strengthen markets for the informal sector. Such investment needs to be facilitated and directed to the areas of greatest impact, for both short-term recovery and long-term transformation.

Covid-19 has reinforced the need for both short-term investment in critical sectors that may underpin economic and political security in many African economies (e.g. medical equipment manufacturing, delivery and logistics, and food), as well as long-term investment in sectors which may be more permanently disrupted by the changing global order (e.g. agro-processing and pharmaceutical drug manufacturing).

As a result of extensive market failures and investment risks across many African economies—which are likely to be exacerbated as a result of Covid-19—the public sector's role in creating an enabling environment to unlock investment is heightened. Job-creating and value-adding investment needs to be underpinned by effective governments that can facilitate investors and create the right conditions to manage risks. Governments play a key role in scaling up investment, whether through running a fair and competitive procurement process for infrastructure projects, ensuring the availability of suitable land and rural roads for agriculture investors, or coordinating a suitable regulatory framework for telecommunications firms. Further, governments also play a fundamental role in creating the right conditions to allow innovative businesses—including small ones—to flourish in conditions of crisis, enabling new sectors to grow as companies respond to the changing market needs.

Yet governments cannot do it alone. Securing the right type of investment at a sufficiently large scale requires the support of investors: development investors (such as development finance institutions and impact investors) and commercial investors with business models that invest in local value addition. Prior to Covid-19, development finance institutions and impact investors in Africa recorded strong returns. In 2018 there were \$18.3 billion worth of assets under management on the continent and, of these, \$12.9 billion were invested at competitive market rates of return.³ Returns on foreign direct investment in Africa have also been robust, averaging 6.5 per cent in 2018, compared to 6.2 per cent in Latin America and the Caribbean, 6.0 per cent in developed countries and 5.3 per cent in South Asia. On this metric, Africa is second only to East and South-East Asia.⁴

In order to maintain these levels of investment in the new Covid-19 reality—and to make investment more transformative and build economic resilience—coordination is needed. Development investors and international development partners should work together with governments on their national economic recovery responses, their development planning processes and their plans to develop key sectors such as agriculture, manufacturing and technology solutions.

This paper argues that to scale up private investment in a way that can support Africa's economic recovery from Covid-19 and deliver economic transformation, these three players need to align their approaches and synchronise their efforts better. It suggests three ways to do this:

- **Governments, development partners and development investors should adopt a more targeted analytical framework to identify which sectors and subsectors to prioritise for development.** This paper suggests such a framework. It prioritises sectors for both economic transformation and private returns. Such analysis should be conducted jointly among these three players.
- **Development finance institutions and development investors should proactively prioritise investment in firms within these sectors, even if returns may be lower than in other areas.** While development finance must sometimes synchronise with purely commercial investor interests in order to leverage additional capital, we argue that development investment could maximise impact by better focusing on the most transformative sectors.
- **Support for both private-sector and public-sector investment facilitation should be substantially increased, especially in light of Covid-19, as a key feature of economic recovery plans.** On the private-sector side this should be for locally present investment intermediaries that can lower transaction costs and reduce information asymmetries. On the public-sector side, facilitating low-capability governments to play their role in enabling private investment is equally essential. Facilitation of both private- and public-sector investment has been under-supported across Africa and both are crucial to secure a step change that can lead to large-scale job creation and continent-wide economic transformation. Facilitation allows investment to be gently and adaptively steered towards the most impactful sectors without resorting to excessive top-down planning or overly centralised industrial policy. This paper sets out a framework for how to facilitate both the private sector and governments to scale up investment in transformative sectors. The implementation of this framework as part of Covid-19 recovery plans—including by development finance institutions, impact investors and development partners, beyond African governments themselves—would go a long way towards delivering Africa's economic transformation.

Introduction

Africa's development challenges are well known. Even in a pre-Covid-19 world, by 2040 the continent was expected to face a shortfall of 50 million jobs and livelihoods.⁵ Seventeen million small- and medium-sized enterprises have unmet financing needs.⁶ At \$38 billion, Africa's share of global foreign direct investment (FDI) is only 3 per cent of worldwide flow,⁷ while the continent accounts for 17 per cent of the world's population and its infrastructure needs amount to \$130–170 billion a year, with a financing gap in the range of \$68–108 billion.⁸ African countries have made little progress in transforming their economies from subsistence agriculture or extractives towards manufacturing and industrialisation,⁹ or towards other high-value, tradeable and labour-intensive industries such as agro-processing, tourism, ICT and other tradeable services.¹⁰

The persistence of these challenges has called into question three long-standing approaches to private-sector development that have largely remained disconnected from each other:

- **First is the approach of development finance and investment.** This has been led by development finance institutions (DFIs), investment intermediaries, impact investors and occasionally donors who run investment programmes. For the purposes of this paper we call these “development investors”. These generally aim to maximise returns through investment projects that pass the investment gates of the investor.¹¹ This has led to a transactional focus in sectors such as energy, finance, real estate, health and extractives. It has also led some actors to increase their focus on upper middle-income countries rather than on the world’s poorest countries.¹² They have most often taken government-related constraints as a given and focused only on barriers that can be addressed by investors or entrepreneurs. Finally, because of limited staff and bandwidth, they are generally reactive—responding to investment proposals and pitches—rather than proactively identifying new opportunities.
- **Second is the approach of nationwide economic development.** This has been led by developing countries’ governments and their donor partners—typically multilateral development actors and bilateral programmes focused on the macroeconomy and non-sector-specific private-sector development. These have focused on generic, cross-cutting business-enabling reforms such as the Doing Business Reforms, large infrastructure investments based on economy-wide growth diagnostics, and increasing openness to trade and macroeconomic stability.¹³ They often focus on generic capacity building efforts or capacity substitution for basic government functions, and have not leveraged the potential of government to address investment market failures and unlock economic transformation.

- **Third is a targeted development approach sometimes taken by development organisations in certain economic sectors,** such as agriculture, tourism, energy and mining. Although market-system development objectives are becoming more common, the approach to these sectors has typically been driven by single issues or challenges rather than from a nationwide economic standpoint. For example, agriculture support has primarily been driven by a focus on food security and basic livelihoods, while extractive development has been driven by good governance or public financial management objectives.

Typically these approaches have been designed and implemented independently from each other, resulting in a disconnect between the development investment community (for example, development finance institutions), the macroeconomic management community (for example, the Bretton Woods institutions) and the issue-based development community (such as the Food and Agriculture Organisation and the World Trade Organisation). While there are increased efforts to address this divide through programmes such as the US government’s Prosper Africa and the UK government’s Manufacturing Africa, the disconnect remains large. In many countries in Africa this may have contributed to an ad hoc approach to firm-level investment transactions, which has often not accounted for sector-level and macro-level reforms.¹⁴ On the other hand, it may have contributed to an inadequate focus on the binding constraints faced by firms in sectors with the greatest scope to deliver economic transformation,¹⁵ with the focus instead mostly on macro-level reforms or on single issues and challenges.¹⁶

There is increased pressure on both development finance and investment institutions¹⁷ and on governments and their economic development partners to scale up their impact.

On the development finance side, this is epitomised by the United States' Development Finance Corporation developing an Impact Quotient¹⁸ and the United Kingdom's Department for International Development requiring CDC – the UK's development finance institution – to maximise impact and secure scale.¹⁹ According to the Center for Strategic and International Studies and the Overseas Development Institute, “while DFIs have always had an economic development mandate, they have previously tended to focus by and large on the financial and investment side of the business. Today they have become firmly focused on achieving bold development goals.”²⁰

On the economic development side, the pressure is characterised by increasingly vocal unemployed youth, increased global migration and pressure on development partners to increase their value for money and taxpayer/shareholder returns. Both sides recognise the importance of private investment to create value, jobs, revenue and exports in-country. Both also recognise the need to build a stronger pipeline of transformational investment projects.

This paper proposes a way to bridge this disconnect. It suggests a strategic and targeted approach to identify sectors and subsectors to invest in—accounting for both investment and economic development criteria—and then provides a framework to step up investment facilitation in the private and public sectors.²¹ It requires a marriage between free-market principles and government intervention in catalysing market activity, fixing coordination challenges and targeting binding constraints in transformative subsectors.²² It also calls for harnessing effective government to strategically underpin private-sector innovation, in a similar way to several subsectors in developed countries.²³

The two traditional silos: the transactional approach of development investment versus national economic development enablement

BARRIERS AND OPPORTUNITIES FOR THE TRANSACTIONAL APPROACH TO DEVELOPMENT FINANCE AND INVESTMENT

Development investors have traditionally sought investment deals with the highest probability of returns wherever they exist. They have historically had “gating” items regarding environmental, social and governance (ESG) standards and development impact, but they have not necessarily prioritised the highest development-impact transactions. This has contributed to the fact that most FDI in Africa—and in developing countries more broadly—is concentrated in natural resource extraction, finance, utilities, real estate, construction and telecoms. There has historically been less of an emphasis on potentially transformative sectors and/or smaller deal sizes.²⁴

Barriers to Frontier Market Investment

One contributing factor is the incentive system whereby the focus on maximising returns²⁵ may have limited the incentive of development investors to build up a local presence and acquire in-country expertise and partners—often a precondition to be able to invest in the most transformative sectors.²⁶ Other challenges are insufficient investment-ready opportunities and high transaction costs.²⁷ These have led to development investors investing in “bankable” transactions wherever they are and whatever they may be. These challenges have likely contributed to a relative underinvestment in developing countries over the long term and to a lack of “scale-up,” particularly in subsectors that multisectoral analyses might define as key for growing the investment pipeline and the economy.

CrossBoundary’s *Investment Facilitation Revisited* report (2019) detailed the barriers faced by investors, recapped in [Figure 1](#) below.²⁸

CrossBoundary categorises the barriers into four types of systemic failures. “Macro-level constraints” reflect the full range of country-level challenges including government failures, infrastructure deficiencies and human capital limitations. These constraints have traditionally received the most attention from development actors and policy advocates, but they can also be considered and prioritised in tandem with transactions.

The second category can operate at both the sector and firm level: “lack of capital for risk/return profile” captures the mismatch between the profile of an investment opportunity and the expectations of available capital. These mismatches can be sector-based (e.g. the low returns associated with rural mini-grids) and/or location-based (e.g. no private equity funding available for a given fragile state). Solutions may include new funds or channels that are closer to market and direct capital appropriately, and/or blended finance vehicles that blend public and philanthropic capital with commercial investors.

FIGURE 1 Investment barriers in frontier markets

		SECTOR LEVEL			
		COUNTRY LEVEL		FIRM LEVEL	
SYSTEMIC FAILURE	BARRIERS TO INVESTMENT	1. MACRO-LEVEL CONSTRAINTS	2. LACK OF CAPITAL FOR RISK/RETURN	3. TRANSACTION COST	4. INFORMATION ASYMMETRY
				<p>A lack of quasi-public goods, worsened by sub-optimal policy decisions and legal barriers, impedes ease of doing business and scares investors:</p> <ul style="list-style-type: none"> - Lack of physical infrastructure (transport, energy, water) - Lack of soft infrastructure (educated workforce) - Poor enabling environment 	<p>The uncertainty, limited liquidity, and returns of investing in frontier markets make it difficult to justify investment and mitigate risk:</p> <ul style="list-style-type: none"> - High perceived risk may discourage actually beneficial transactions - Genuine constraints may mean the risk/return profile is less than that of developed markets

Source: CrossBoundary 2019

Thirdly, and quite commonly, firm-level transaction costs are a major barrier to mutually beneficial transactions. Although they affect investors and entrepreneurs in different ways, they often create a first-mover disadvantage, particularly in new markets and new sectors. Deals are difficult and transaction costs can be disproportionately high compared to the initial investment size, especially for investors looking to enter new markets or sectors with high levels of informality and scarce information. In frontier markets, the cost of each step in the deal process can be substantial, especially when few template transactions exist. Many investors thus opt to stay within their comfort zone of markets and sectors they already know well. The information gaps both firms and investors face typically stem from a lack of bandwidth to undertake due diligence and analysis, a lack of appropriate geographic presence or a lack of expertise.

Finally, investors and entrepreneurs often tend to initially distrust each other, either because less capable firms may have a greater incentive to conceal their underperformance as they seek investment or because investors might have an incentive to deceive unsuspecting entrepreneurs by hiding onerous or unfair terms in the deal documentation.

In Chapter 5, we discuss how investment facilitation can be used to address these transaction costs and information asymmetries to create mutually beneficial transactions, particularly in new geographies and sectors, where bandwidth, expertise and local presence may be limited.

Selection of Investable Deals

The nature of these challenges drives typical investable deals, in the absence of further interventions. In the 2018 SME Ventures report, IFC and CrossBoundary identified four types of companies/projects in which investment funds active in Africa are typically investing.²⁹ These are:

1. Companies with revenues in hard currency, such as travel, unprocessed agriculture and extractives;
2. Companies with insulation from international competition, such as non-tradeable goods and services with high transport costs like logistics, construction, retail and hospitality;

3. Companies with restricted domestic competition (monopolies or oligopolies), such as telecoms, toll roads, energy and other sole-licence businesses;
4. Opportunistic comparative advantage companies, such as extractives or very niche high-value crops with limited development impact, e.g. lychee or teak.

Figure 2 below is a graphic presented in IFC and CrossBoundary's SME Ventures report that presents examples of such investments.

As shown above, investments are typically happening when the business case can be made as a result of hard currency access, natural or artificial competition insulation, or natural resource access. A number of these businesses contribute to value-chain and market-system development and to job creation and value addition. However, because of the nature of these business categories, there is often likely to be underinvestment in sectors that can be more transformative, such as agro-processing, manufacturing and tradeable services. These sectors often have highly competitive markets and possibly a latent comparative advantage that may require higher risk and investment to discover.³⁰ Moreover, without either a robust existing private sector ecosystem or government support, companies in fragile states overwhelmed find they need to vertically integrate to provide basic services and missing portions of the value chain. For example, an agri-processor might find they not only have to have their own electricity supply and transportation fleet, but also provide housing, healthcare, and education for local workers and their families. While this can be quite developmentally beneficial, from an investor perspective it can substantially increase both the capital expenditure required and the reputational risk as they now become responsible for social services in a given area. Similarly, from a "natural" business case perspective there is likely to be underinvestment in small and medium enterprises.

In the worst case, over-emphasis on these classic business success factors could lead to investment in firms that may have negative development effects, such as purely extractive firms, commodity traders and firms that thrive on rent-seeking behaviour.

FIGURE 2 Typical investments by funds in fragile and frontier markets

	Companies with revenues in hard currency	Companies with insulation from international competition (basic goods & essential services)	Companies with restricted domestic competition (monopoly/oligopoly/first mover)	Opportunistic comparative advantage companies
DESCRIPTION	Focus on exports or providing goods/services to international customers in-country. Illustrative sectors include tourism, export oriented agriculture, and mining/oilfield services.	Produce essential non-tradeable goods or produce goods with high transportation costs. Illustrative sectors include logistics, construction, FMCG retail, business services, hospitality, and healthcare.	Provide services that have a restricted license to operate or provide infrastructure that has high capital costs/barriers to entry. Illustrative sectors include telecoms, toll roads, energy, and any other sole licensee business.	Leverage a comparative advantage of the country to build an enterprise with unique advantages. Illustrative sectors include extractives or unusual crops native to the region.
EXAMPLES	<ul style="list-style-type: none"> - Housing and warehouse companies for multinationals - Tourism or business hotels - Vehicle rental or equipment leasing companies 	<ul style="list-style-type: none"> - Healthcare clinics and hospitals - Soft drink companies and breweries - Agro processing - Construction materials 	<ul style="list-style-type: none"> - Telecom or ICT providers - Airport cargo handling company - Project finance for a power or infrastructure project with a bankable off-take agreement 	<ul style="list-style-type: none"> - Tree crops (like cashews) in Mozambique that have comparative advantages for export markets - A teak company exporting from South Sudan - A lychee exporter in Madagascar

VERTICAL INTEGRATION CAN POTENTIALLY ENHANCE ANY INVESTMENT BY REDUCING RISK ALONG UNCERTAIN SUPPLY / VALUE CHAIN

Source: IFC and CrossBoundary, *IFC SME Ventures: Investing in Private Equity in Sub-Saharan African Fragile and Conflict-Affected Situations*, 2018

GIZ—the German development agency—recognises this broader problem and claims that “there is yet great untapped potential to incentivize actors along the investment chain to allocate funds to high impact small and growing businesses and actively manage for impact. Due to reasons such as high perceived risk, disproportionate due diligence cost, lower potential returns, longer time horizons, and unfamiliarity with new business models in unknown markets, capital providers and fund managers are hesitant to place capital into small and growing businesses. Further, once capital with an impact intention is placed, impact is at risk of being sidelined or the scale of impact achieved may fall short of its potential. This is due to mostly traditional incentive structures with a singular focus on financial performance that does not adequately integrate impact considerations.”³¹

Underinvestment has also been highlighted through various reviews, such as one on the UK’s development finance institution, CDC, by the Independent Commission for Aid Impact (ICAI), which recognised progress but pointed out key gaps: “CDC has successfully redirected new investments towards lower-income and fragile states and its priority sectors, though these are largely concentrated in a few countries and in the power and financial services sectors...CDC has faced challenges in finding viable direct investment deals, particularly in Africa.” ICAI went on to note: “In order to accelerate the scale-up of investment and achieve broader development impacts in more challenging markets, CDC should have prioritised much earlier on in the process its country presence expansion in Africa, the development of its geographic and sectoral plans, strengthened its links with DFID country offices and improved its monitoring and evaluation systems.”³²

A common thread here is a growing recognition that while the commercial characteristics of subsector selection are critical to finding investable deals, for development finance investors the larger transformative potential of the subsector should also be a priority.³³

TRADITIONAL APPROACHES TO ECONOMIC DEVELOPMENT PLANS AND THEIR RECENT EVOLUTION

In 2017 the Tony Blair Institute’s *Jobs Gap* paper called the traditional approach to economic development in Africa the generic enabling environment approach. In this approach, countries focus on generic reforms for what are deemed to be prerequisites for rapid economic growth and development, such as the rule of law, property rights and Doing Business reforms.³⁴ This prevailing approach has been applied since the structural adjustment programmes of the 1980s and 1990s. Yet evidence suggests that developing countries that have ignited a long-term process of rapid economic growth—for example in Asia where many countries have succeeded in their structural transformation—have often done so without such preconditions.³⁵

As summarised in the *Jobs Gap* paper, there are multiple disadvantages to the traditional approach. For example, it fails to effectively address the political economy challenges that hold back many economies and states’ capabilities. Moreover, because it treats the private sector as a homogenous sphere made up of firms with the same growth constraints, it often fails to address sector-specific challenges in the sectors that have the most transformative potential. The generic approach also makes the implicit assumption that governments are not “doomed to choose”, yet inevitably, choices such as where to construct an electricity line or a road, will benefit some firms and sectors more than others. Finally, the traditional approach requires widespread government capability because they are trying to implement cross-cutting solutions, but many African countries simply do not have this yet.³⁶

These findings are leading to a gradual revival of modern industrial policy as a complement to typical macro-level efforts.

This policy focuses on developing sectors that have strong market competitiveness potential in large markets at home or abroad, and that have the potential to create jobs and improved livelihoods for large swathes of the labour force. It targets interventions to address binding constraints in sectors with transformative potential. These interventions need to be feasible in terms of both the political economy and capability constraints.

As discussed in the *Jobs Gap* report, this allows for better targeting of all four levels of constraints presented in [Figure 1](#) above—including macro-level constraints.³⁷ It does not mean that macro-level programmes are not important. They are: not least because macroeconomic stability is essential. But it is key to complement them with a sector development agenda—which could also be referred to as a “market-based industrial policy”. Industrial policy has historically been treated as a dirty word, particularly within US development circles, but there is now a growing recognition that a completely hands-off “free-market” approach may result in no private investment momentum being gained for any sectors. Investors and entrepreneurs simply migrate to other markets that have already demonstrated traction or have incentives in place.³⁸

Modern industrial policy seeks to enable and support the in-country and market-based process of cost discovery—whereby an entrepreneur attempts to produce a good for the first time in a developing economy.³⁹ Such an entrepreneur faces considerable risks and cost uncertainty. “Even if the good comes with a standard technology (‘blueprint’), domestic factor endowments and institutional realities will require tinkering and local adaptation. What the entrepreneur effectively does is to explore the underlying cost structure of the economy. This process is one with considerable positive externalities for other entrepreneurs. If the project is successful, other entrepreneurs learn that the product in question can be profitably produced and emulate the incumbent. In this way, the returns to the pioneer investor’s cost discovery become socialized. If the incumbent ends up with failure, on the other hand, the losses remain private. This knowledge externality implies that investment levels in cost discovery are sub-optimal unless the industry or the government find some way in which the externality can be internalized.”⁴⁰

Paul Collier, Neil Gregory and Alexandros Ragoussis similarly note that these pioneering firms face a first-mover disadvantage, and that such firms are critical in fragile countries to generate a disproportionate development impact.⁴¹ Thus, donor support to these firms is serving a legitimate public good.

Countries that have achieved high growth over the past 70 years—such as Japan, Israel, China, Brazil, Bangladesh and Cambodia, as well as states in India such as Tamil Nadu—have done so by marrying export-led market principles with a clear sector focus. In each of these cases, smart industrial policy was essential to set a suitable enabling environment for transformative sectors to develop in a market-oriented manner.⁴² Tamil Nadu—which is one of India’s leading states in automobiles, components, textiles and garments, leather products and pharmaceuticals—attracted these industries through industrial parks, land banks that streamlined access to land, tailored industrial training institutes, the strategic development of the port of Chennai and connectivity infrastructure.⁴³ Incentives on infrastructure access, sales, output tax exemptions, and capital and power subsidies were also used, attracting investors such as Ford. In Africa, countries such as Botswana, Lesotho, Mauritius and, more recently, Ethiopia have followed this path, with some promising early results in textiles and garments.⁴⁴

Why sectors matter

There is clear evidence that specialising in certain products brings higher growth than specialising in others.⁴⁵ This is for three reasons. First are the inherent characteristics of sectors that dictate the extent to which a country has the ability to compete and thrive relative to its peers. Such characteristics are all the more pronounced in the context of the Covid-19 crisis and the investment opportunities it amplifies or reduces. Second is the process of innovation and cost discovery. Countries that produce a set of goods and services that make it easier to innovate and start producing a more advanced set of goods and services tend to develop faster than those that produce goods and services that do not facilitate innovation towards more complex goods.⁴⁶

The third reason is the role of products in the political economy and the extent to which they increase or decrease the commitment of the business to ask the political elite to invest in institutions and inclusive market systems. This is an essential determinant of the extent to which business and political leaders have an incentive to invest in an improved enabling environment for investment.⁴⁷ Hence it is essential to prioritise investment into firms in sub-sectors that align investor and development interests and contribute positively to the political economy. Lant Pritchett and Eric Werker refer to such firms as “magicians” in their market matrix.⁴⁸

The market matrix is a framework that categorises businesses in a country into four groups (see [Table 1](#)) in order to distinguish the types of policy requests they are likely to make to politicians and to government. It recognises that businesses and politicians in developing countries operate on the basis of bilateral deal making rather than by fixed rules that apply equally to all: hence companies support certain politicians, and what they ask for in return matters.

There is often a circular relationship between business and politicians who are responsible for developing institutions and improving the enabling environment for the private sector. These are essential for economic transformation. In the market matrix, companies are categorised based on whether they add or extract value, are net exporters or importers, how many jobs and spillovers they create, and so on.

TABLE 1 Market matrix: Types of private-sector economic actor

	HIGH RENTS	MARKET COMPETITION
Export-oriented	Rentiers	Magicians
Domestic market-oriented	Power brokers	Workhorses

Source: Lant Pritchett and Eric Werker, *Developing the Guts of a GUT (Grand Unified Theory): Elite Commitment and Inclusive Growth, Effective States and Inclusive Development Research Centre working paper 16/12, 2012*

Rentiers—defined as businesses that largely sell to export markets but maintain high rents, typically through the extraction of a resource such as oil, minerals or timber logs—typically extract natural resources, while creating relatively little value in-country as well as few jobs and spillovers. In addition, rentiers typically ask politicians for preferential licences and tax breaks which do not require politicians to invest in institutional capacity and an improved enabling environment for the country as a whole, so long as the resource is able to be exported without interruption.

Similarly, power brokers largely target domestic markets but also make high rents and profits. This category may include banks, telecoms and protected manufacturers and importers in many African countries. While such firms add value to an economy through service provision or local production, their lack of exposure to international—and often also domestic—competition tends to limit quality, innovation and scale. Due to the nature of their business model, they tend to ask governments for preferential licences, preferred access to inputs, including cheap electricity, and high formal barriers for their competitors—to protect their monopolistic or oligopolistic position—or tax breaks. This creates relatively poor incentives for politicians if power brokers fund or support their political

campaign, as they can easily strike a one-off deal without needing to improve the broader enabling environment and rule of law.

Magicians—private-sector actors that export through the production of value-added products—are highly valuable from a development perspective because they generate foreign exchange, have high spillovers and typically create jobs at scale. They often contribute favourably to the political economy because they typically ask politicians for growth-enhancing institutions such as better-funded standards bureaus, more reliable electricity, improved customs procedures for export or improved sanitary and phytosanitary standards. This is because these features are critical for magicians to compete effectively.

Finally, workhorses encapsulate most African micro and small businesses who sell domestically and face high competition. This group includes hairdressers, street hawkers, smallholder subsistence farmers, taxi drivers and market sellers. While they add significant value to the economy, this group often shares limited resources, often among millions of people. As a result they have limited power to transform an economy (other than instances where technology improvements, such as mobile phones and the internet, benefit the vast majority of this group of businesses).

Political power generally lies with firms in the first three categories, and less with workhorses—who are common in African countries and who typically have limited influence with political elites.

Table 2 below presents an example of firms in one country—Malawi—mapped against the market matrix.⁴⁹ You can see that firms can typically be aggregated to subsectors, although it is possible to have a subsector in a country that spans more than one category.

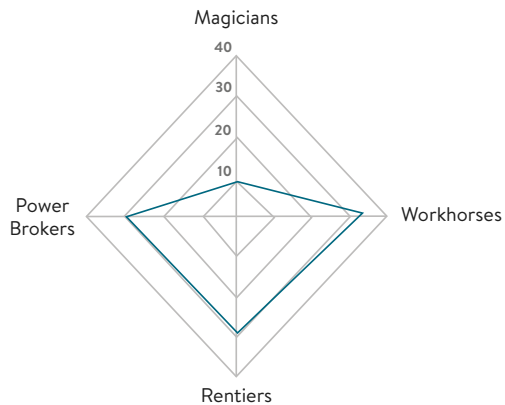
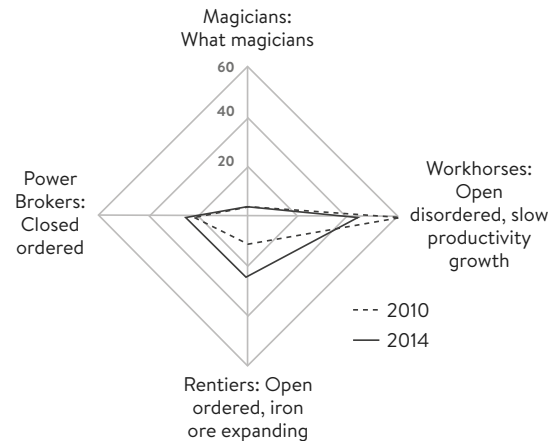
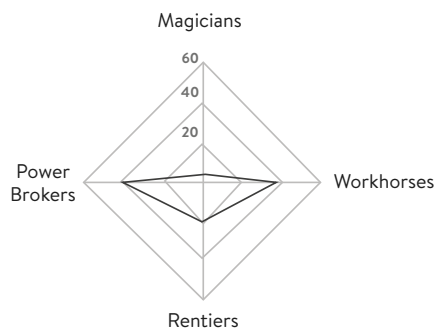
In countries where magicians are weak and rentiers and power brokers are strong, politicians tend to have relatively little political capital to invest in institutional

capacity and an improved enabling environment for new investors. This is the case in Ghana, for example, where in 2014 magicians accounted for 10 per cent of the country's GDP, while power brokers made up 30 per cent (see Figure 3). Many other countries, such as Liberia, Malawi and Rwanda, show a similar pattern regarding magicians.⁵⁰ This is common across most countries in Africa, as many have historically relied on extractive industries (classified as rentiers)—such as those for oil, iron ore, copper, diamonds and timber—or raw agricultural exports such as tobacco, tea, coffee and rubber as important sources of government revenue and elite rents. This means there may be little pressure from the political economy to build the capacity needed for economic transformation.

TABLE 2 Example of firms in a country mapped against the market matrix (Malawi, 2014)

Rentiers <i>(export-oriented, high-rent businesses with typically little value added in-country)</i>	Magicians <i>(export-oriented, high-competition businesses, high value added in-country)</i>	Powerbrokers <i>(domestic-oriented, high-rent businesses)</i>	Workhorses <i>(domestic-oriented, high-competition businesses)</i>
<ul style="list-style-type: none"> - Tobacco buyers (54 per cent of exports), five main buyers - Mining firms (12 per cent of exports) - Tea producers (6 per cent of exports), four main producers - Tourism facilities (3 per cent of exports), two main players - Coffee farms (1 per cent of exports), a few players - Cotton players (2 per cent of exports), 14 ginners (but oligopolistic in their behavior) 	<ul style="list-style-type: none"> - Beverages (juices), one new company, social enterprise - Two agro-processing companies - Numerous small tourism players - Some exporters of groundnuts, rice, pigeon peas etc. (e.g. National Association of Smallholder Farmers of Malawi) 	<ul style="list-style-type: none"> - Certain Manufacturing (8 per cent of GDP) - Farm Inputs (seed, fertiliser) - Beverages (beer, spirits), one main company - Dairy (four main companies) - Sugar (4 per cent of exports), one main processor - Oil Seeds (8 per cent of exports), five major players - Construction (5 per cent of GDP) - Financial services (7 per cent of GDP), 12 commercial banks but three largest banks own approximately 65 per cent of total bank assets 	<ul style="list-style-type: none"> - Millions of maize smallholder farmer households, 80 per cent of population - Some 250,000 smallholder tobacco farmers - Some small manufacturers of various products e.g. beverages, assembly, food processing, plastics, pharmaceuticals - Numerous informal retailers and distributors, close to 800,000

Source: Jonathan Said and Khwima Singini, *The Political Economy Determinants of Economic Growth in Malawi*, Global Development Institute working paper 40, University of Manchester, 2014.

FIGURE 3 Market matrix in various countries (percentage of GDP)**GHANA 2014****LIBERIA 2010, 2014****MALAWI 2013****RWANDA 2013**

Source: Lant Pritchett, Kunal Sen and Eric Werker, *Deals and Development: The Political Dynamics of Growth Episodes* (Oxford and New York: Oxford University Press, 2019)

This shows that sectors matter for nationwide economic transformation, as much as they do for investment and development finance. For investment to take off in Africa at a transformative scale, it is essential to align the political economy: in other words, the vested interests of companies need to align with those of government and of development partners, so that the barriers to invest in magician subsectors can be removed. The combination of a lack of modern—typically export-oriented and market-based—industrial policy on the one hand, and lack of strategic development finance and investment on the other, is an important reason why there remains underinvestment in Africa and therefore a lack of economic transformation.

In order to significantly increase the amount of private investment into Africa—in particular into

African SMEs—such that it can allow nationwide transformation and development impact, sectors and subsectors need to be prioritised by governments and their development partners, as well as by development investors. It is important to prioritise subsectors that can support an improved enabling environment for other subsectors; those that can strengthen the capacity of the political economy and of the government to deliver such an enabling environment. This is key for economic transformation. In the next chapter we set out a framework for governments, development partners, development financiers and investors to identify priority subsectors in a way that can drive both economic transformation and investment returns. We then set out a framework for how to support investment into these sectors and subsectors.

How to select sectors for development impact

Even when sector views have been taken, siloed approaches in the past have resulted in confusion and wasted efforts as investors and donors talk past each other. A donor comes up with an overly specific top-down country development strategy, specifying that their funds must be used only to support smallholders in the sorghum value chain in the northeast portion of the country, for example, and then wonders why no development investors can align investments to their goals. On the other hand, development finance institutions with limited bandwidth find that they can often only be reactive to the entrepreneur's business plans that make their way to their home offices, rather than proactively seeking to put risk capital to work in transformative sectors.

How then should development investors and economic policymakers in Africa prioritise sectors for investment? To move towards strategic investment that can both satisfy investor requirements and support economic recovery from Covid-19 and the development of transformative sectors, we propose a framework for identifying productive sectors that meet the objectives of both investors and policymakers.

The framework is based on a two-step process:

1. Identify the sectors and subsectors with greatest transformative potential, as well as attempt to understand and respect the government's existing priorities and political economy/power implications of the sectors.
2. Apply investment criteria to the sectors and firms within them.

The first step of the framework covers only what we call productive sectors: those whose primary developmental benefit is the direct creation of decent jobs, sustainable livelihoods and incomes, net exports and fiscal revenues at scale. For the purposes of this exercise, we do not include enabling sectors—those such as energy, financial services and transport services whose primary developmental benefit is their ability to enable productive sectors—while recognising that if these are key constraints (and they usually are) for productive sectors, it makes sense for investors to prioritise them as well (the US government's Power Africa programme is one recent successful example).

We strongly recommend that national economic development actors—predominantly governments themselves—and development finance institutions and investors carry out this analysis together rather than separately as historically has been the case. Joint analysis is important wherever possible to allow for joint buy-in and common understanding of priorities, challenges and how to address them.

STEP 1: SECTOR PRIORITISATION FRAMEWORK

We propose a framework for sector selection that builds on two sector selection methodologies: the Malawi National Export Strategy 2013–2018 developed by the government of Malawi with support from the United Nations Development Programme (UNDP) and Imani Development in 2012;⁵¹ and the Liberia Agriculture Transformation Agenda 2016–2017 sector selection framework developed by the government of Liberia, with the support of the Tony Blair Institute for Global Change, and as published by USAID in its Liberia Development Conference 2017 Anthology.⁵²

The proposed framework for sector prioritisation comprises an assessment of six factors for each sector under consideration. The factors are:

1. Profitability
2. Resource base and economic feasibility
3. Market size
4. Product innovation
5. Political economy and political feasibility
6. Firm capability in outbound country

Under this conceptual framework, all of the first five factors need to be present for a sector or subsector to drive the greatest development impact, while at the same time deliver sufficient investor returns. We suggest for the analysis to be applied at subsector level first, before being aggregated at sector level. The first step of framework is to assess whether the subsector allows for a realistic and manageable path for **sizeable profits** to be made. There must be a strong business case. Second: is the **resource base and economic feasibility**—which spans natural, human and financial resources—large enough, both for scale and for job and sustainable livelihood creation? This includes assessing the economic feasibility of addressing constraints (e.g. does a country have sufficient skills, or suitable soils for a certain crop?). Third: is the **size of markets** in which the subsector competes or would compete large enough to accommodate numerous producers at a national scale? Fourth: does the subsector allow scope for downstream and upstream **product innovation** in-country as per the Economic Complexity Index? The fifth criterion is the **political economy**. This has two aspects. First, is there or can there be sufficient political capital to address the binding and major constraints faced by the subsector? Second, would the subsector support a positive evolution of the political economy, defined by an improved demand for political leaders to invest in institutional capacity and an improved enabling environment?

Finally, development investment that is sourced from a country DFI or an intermediary with specific source-country expertise should also consider the **capacity of companies in the source country** in order to maximise knowledge and capital transfer to the recipient country. Sectors should be assessed for each of these, using the questions set out in [Figure 4](#) below. Sectors and subsectors should be ranked according to the most affirmative answers.

FIGURE 4 Criteria for sector and subsector selection

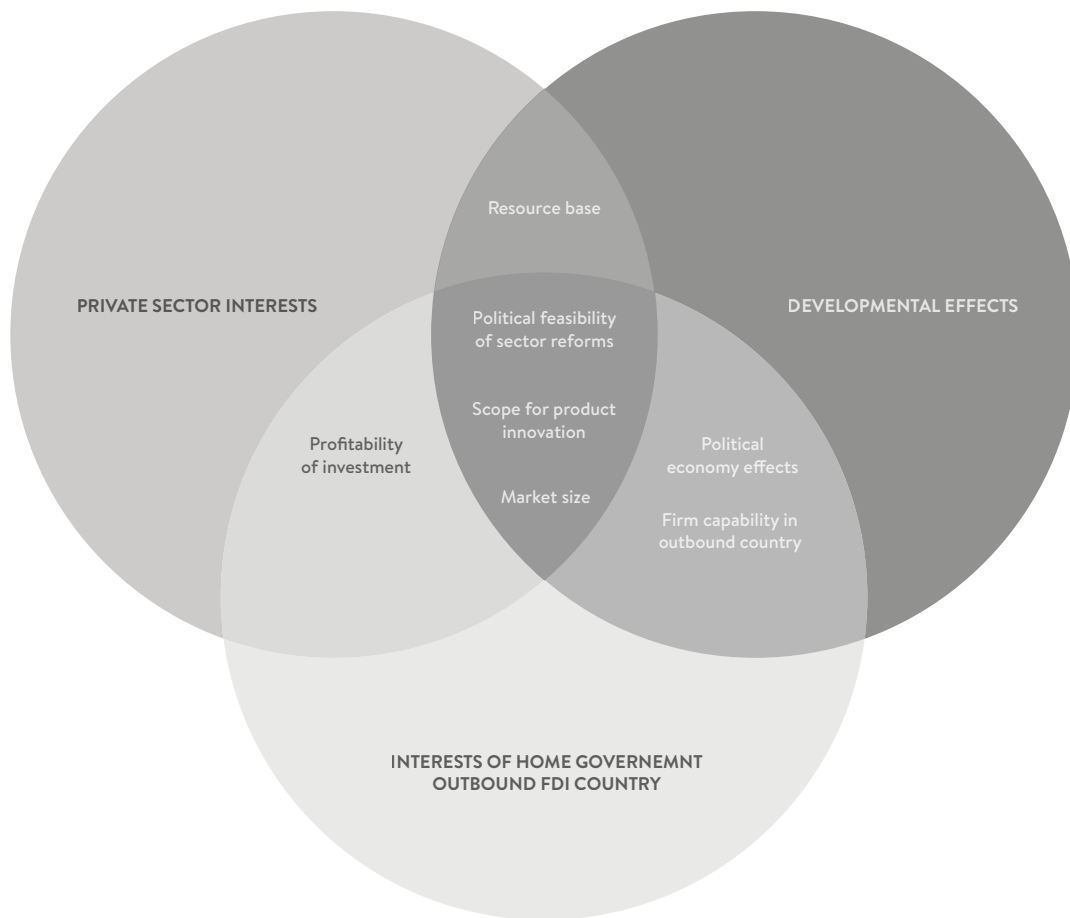
<p>1</p> <p>Profitability</p>	<p>Can private businesses make (or have a strong probability to make) a significant and sustained profit, and hence a significant return on their investment, by competing domestically, regionally or globally without the need to be protected from international markets?</p>
<p>2</p> <p>Resource Base</p>	<p>Is the local capacity to produce to respond to market demand big enough, in terms of land, labour, inputs to production and capital? What is the opportunity cost of investing in unlocking production capacity in this sector vs in other sectors? What level of hard and soft (e.g. regulatory environment) infrastructure investment is needed and is it feasible?</p>
<p>3</p> <p>Market Size</p>	<p>Is the target or potential target market size large enough to allow profitable scale to be achieved, and to allow for multiple businesses to operate successfully? Can the market actually be accessed? How many jobs and livelihoods can the sector sustain at potential?</p>
<p>4</p> <p>Product Innovation</p>	<p>Is there scope for cost-discovery innovation, i.e, for downstream or upstream product innovation to allow to a better positioning on the Atlas of Economic Complexity?</p>
<p>5</p> <p>Political Economy</p>	<p>Are the typical policy asks of businesses in the sector conducive to institution building and an improved enabling environment for business in general? Is fixing the binding constraints to investment into that sector politically feasible or potentially politically feasible and if so what's the path to political feasibility?</p>
<p>6</p> <p>Outbound country capability</p>	<p>What firm capacities – that are looking at expanding their markets – does the outbound investment country have?</p>

Source: Tony Blair Institute for Global Change and CrossBoundary

Prioritising sectors and subsectors on the basis of these factors should drive an increase in the quantity of suitable investment opportunities. This is because if they succeeded, these sectors would ease the macro-level and sector-level constraints presented in Figure 1 of this report, many of which many DFIs and investment intermediaries take as untouchable. For example, by being profitable, having a large resource base, tapping

into a large market, driving innovation and improving alignment of the political economy, they increase the capacity for governments to mobilise tax revenue, recruit skilled staff and carry out politically challenging reforms. In addition, these criteria allow for a balancing of interests between the private sector, developmental effects (and the interests of the government) and the interests of outbound FDI countries.

FIGURE 5 Venn diagram of the criteria for sector and subsector selection by interests of key actors



Source: Tony Blair Institute for Global Change and CrossBoundary

What might the application of this framework for sector selection look like in practice? The first four criteria were applied for the Liberia Agriculture Transformation Agenda sector prioritisation exercise, which aimed to rank ten subsectors. It was published in the USAID Liberia Development Conference Anthology 2017. The table below is a summary of the results, and it shows how different subsectors were ranked against five of the economic factors of success: profitability, resourcing,

market potential and scope for product innovation (proxied as “national scale”). Using estimates for job creation is valuable in giving a sense of development scale for each sector, thus allowing a suitable comparison between subsectors. Other sector-wide indicators such as net export potential or tax revenue potential can also be used. This analysis excluded a political economy analysis (criterion 5). Base tables for criteria 1 to 3 are presented in the Annex.

TABLE 3 Application of sector prioritisation framework to Liberia’s agriculture sector in 2017

Rank	Product/Sector	Profitable Enough? (Criterion 1; see Annex A1)	Enough appropriate resources? (Criterion 2, see Annex A2)	Big enough reachable market? (Criterion 3, see Annex A3)	Job and livelihood creation at national scale? (Criterion 4)	Potential jobs and livelihoods that could be sustained (Criteria 1–4)	Suitability for inclusive economic diversification in Liberia (Criteria 1–4)
1	Ribbed smoked sheets rubber and rubber processing	Yes	Yes	Yes	Yes	270,000	High
1	Crude palm oil	Yes	Yes	Yes	Yes		High
	Refined palm oil	Yes	Yes	Yes	Yes	160,000	High
	Soaps and cosmetics	Yes	Yes	Yes	Yes		High
3	Grade 1 cocoa	Yes	Yes	Yes	Yes	135,000	High/Medium
4	Aquaculture	Yes	Yes	Yes	No	31,000	Medium
5	Marine fish	Yes	No	Yes	No	44,000	Less suitable as resources few for scale
6	Tomatoes	Yes	Yes	No	No	11,000	Less suitable as market size too small for scale
7	Lowland rice	No	Yes	Yes	No	Current 250,000	Not suitable as profitability too low
8	Technically specific rubber	No	Yes	Yes	No	Current 50,000	Not suitable at low prices

Source: Jonathan Said, “How Liberia Can Diversify its Economy for Inclusive Growth”, 2017.

Note: Liberia’s workforce in 2017 was approximately 1 million.

In terms of criterion 5—the political economy—two elements should be studied:

1. The political capacity that government has to set a sufficiently workable enabling environment for each sector; and
2. The impact of the sector on the political economy.

With regard to the former, we recommend using a political economy analysis framework, many of which are available through the work of organisations such as USAID, ODI and others.⁵³

With regard to the latter, we recommend using the Deals and Development framework developed by Effective States for Inclusive Development, which essentially categorises businesses in terms of their policy demands, as presented in Chapter 3 of this report.⁵⁴

In the annex, we present another variation of the framework—the Cluster Prioritisation Method used for Malawi’s National Export Strategy 2013-2018 (NES).

STEP 2: INVESTMENT CRITERIA

Having identified priority subsectors based on what will drive inclusive economic growth, the next step is to apply investment criteria—as per each organisation’s own investment guidelines and codes of responsible investing—to firms in the top-ranked subsectors and to key enabling sectors. How many of the top ranked subsectors to take forward depends on their size and scope, and the requirements of the DFI or intermediary.

The IFC and CrossBoundary set out a number of criteria of success for development finance organisations and intermediaries investing in small and medium enterprises. Their focus is on fragile and conflict-affected situations, but these criteria likewise apply to other low-income countries, particularly in Africa.

The overarching criteria are:

1. **Seek a gross return of 15–20 per cent IRR (internal rate of return).** Funds that target anything lower are typically not sustainable or investments would not be in companies deemed to have sufficiently high-growth and job-creating potential. In addition, fund-management fees are typically high in more difficult markets, due to the high costs of operation and typically small fund sizes. Therefore a net return of 5 to 10 per cent is considered a good performance.
2. **Ensure investment’s impact on development.** This requires strong impact metrics and aligning to well-known and understood impact frameworks is essential. Two tools are typically used: Impact Reporting and Investment Standards (IRIS) and Global Impact Investing Rating System (GIIRS). However, most of these indicators are direct effects, such as jobs created, taxes paid and percentage of women employed/on the board. A gap remains when it comes to indirect effects, such as impact on value-chain development or on economic transformation. This gap can be addressed by using market-systems approaches to measure the contribution of a firm to market-systems (or subsector) development and second, by using the six criteria in [Figure 4](#) to assess the likely contribution ex-ante (and actual contribution many years after investing) to broader economic transformation.

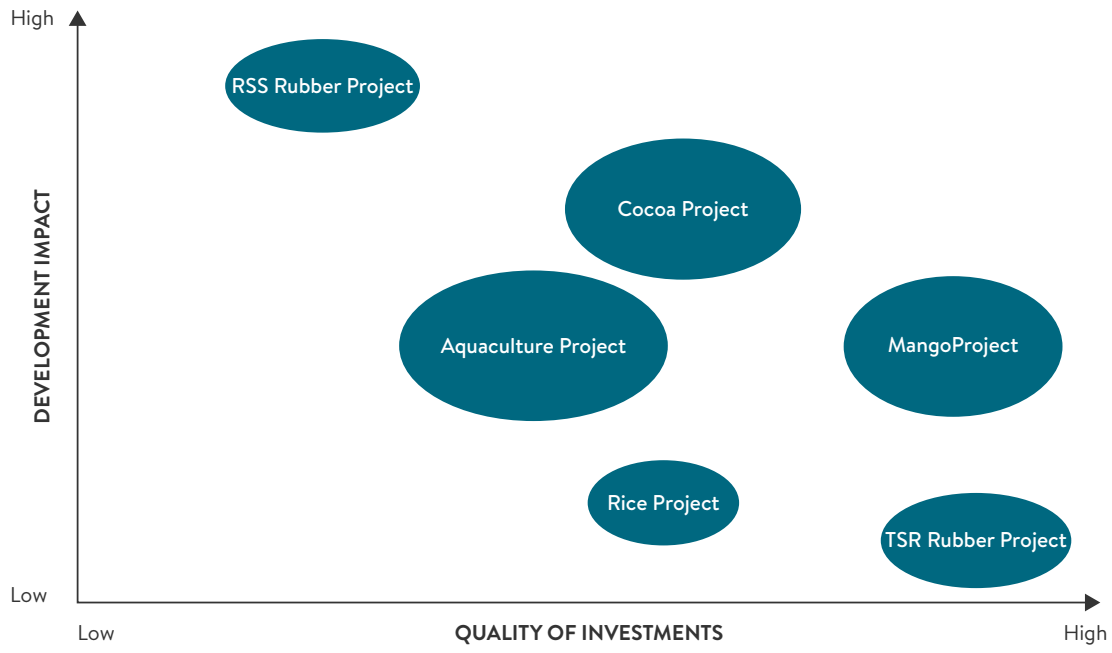
Using these criteria, various considerations can be assessed such as whether:

- a. A firm can be categorised as “catalytic”, “first mover” or “pioneering” in discovering or commercialising an innovation in a country. Are products that the firm is producing already produced in country? Is a firm accessing new markets for a country? Is a firm making it easier for downstream or upstream diversification by a country?
- b. A firm’s success would likely lead to a more closed, captured market or would likely support other entrants to the market. This question would need to be caveated by third factors, such as whether subsectors naturally have high fixed costs for entry.
- c. A firm’s success would likely improve the alignment of the political economy (for example, by disrupting the dominant position of a firm enjoying a captive market) for developmental outcomes. While recognising that there are many factors at play, one can make an assessment of whether a business model is likely to lead the owners to ask politicians to maintain the status quo or for an improved enabling environment for businesses as a whole. The market matrix is a useful tool that can be used for this.

Finally, we recommend combining the outcome of both steps into a graph like the example below. In this illustration, as per the findings of the framework applied to Liberia, an investment in ribbed smoked sheet (RSS) rubber would be more beneficial than an investment in technically specified rubber (TSR), despite the former being a much harder project from an investment standpoint and delivering lower financial returns to the development investor. This shows the importance of assessing both criteria.

We are not asking the reader to agree fully with our method or examples outlined here—the criteria for sector selection can be adapted as desired. We are, however, strongly advocating for a jointly driven Venn diagram approach that explores considerations of investability, transformation, donor/host priorities and political economy to prioritise sectors of mutual advantage.

FIGURE 6 Illustrative mapping of development and investor criteria



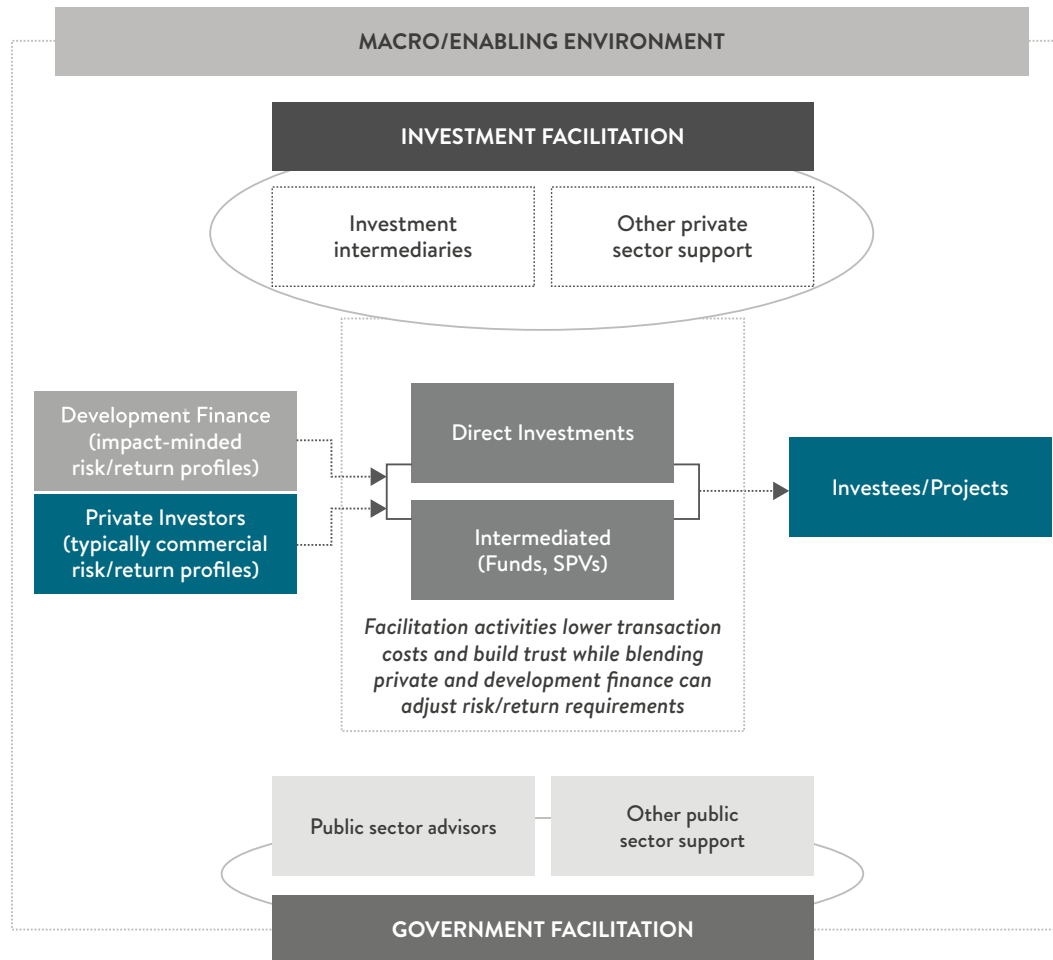
Source: Authors. Size of bubble indicates size of outbound-country firm capability

Framework to scale up high-impact investment

How can barriers to development finance and investment be addressed? We believe that market-based industrial policy is the missing link here, reflecting the disconnect between typical interventions under the development finance investment approach

and typical interventions in the national donor plans. This section shows how a market-based sector development approach can serve as the connective tissue for the list of typical interventions presented in this figure.⁵⁵

FIGURE 7 Private and public investment facilitation ecosystem



Source: CrossBoundary 2019

Removing barriers to scaling up investment in highly transformative sectors in fragile and low-income countries in Africa requires coordination across five key actors that make up the investment system:

1. **Investors and investees/project developers**—there can be no investment transactions without a buyer and a seller.
2. **Third-party financiers, like development finance, funds and banks**—these are critical to provide suitable capital and absorb some of the risk.
3. **Investment intermediaries**—these are critical to pull the investment together, manage the investment process and bring SME investees to bankability. They include providers of key services such as legal, transaction advising, accounting, business development, due diligence, market assessors and so on.
4. **The government**—key to address the enabling environment for transformational sectors (such as provision of infrastructure, licences, regulatory framework, financial-sector development, market development, investment promotion and skilled labour); to provide incentives, de-risk and ensure business development support; to solve government-based problems around transactions; and to provide aftercare support.
5. **Facilitators for government to enable investment**—by definition, governments in fragile and low-income countries are weak and have limited capacity to carry out the above functions effectively. Furthermore, governments are effectively a system of ministries and agencies, not one single agency, creating a coordination problem. Hence governments need to be facilitated to provide the right type of firm-level support to investment transactions as well as to address sector-level and macro-level issues.

In this chapter we focus on the role investment intermediaries and government facilitators should play. These can be essential channels for development partners seeking systemic impact to work through (as opposed to working with individual investors or entrepreneurs on a one-off basis).

We suggest that the most valuable approach is a coordinated one that provides support to both investors and capital-seeking entrepreneurs on the one hand (via investment intermediaries) and to governments on the other (via government facilitators).

DONOR-SUPPORTED INTERMEDIARIES AND INVESTMENT FACILITATION

The main value of investment intermediaries is in addressing high transaction costs and information asymmetries that are typical in shallow markets. Intermediaries can economise on information costs and lower transaction barriers for a wide set of investors—closing the gap between gross and net returns—and shepherd an economically beneficial transaction to a close. Both investors and entrepreneurs face higher fixed transaction costs for potentially mutually beneficial transactions. These barriers—which include obstacles in initiating, managing and completing a transaction—often put first movers in new subsectors or geographies at a disadvantage. The steps required to complete a transaction in fragile and frontier markets can be costly, discouraging investors from deviating from subsectors and geographies they know well.

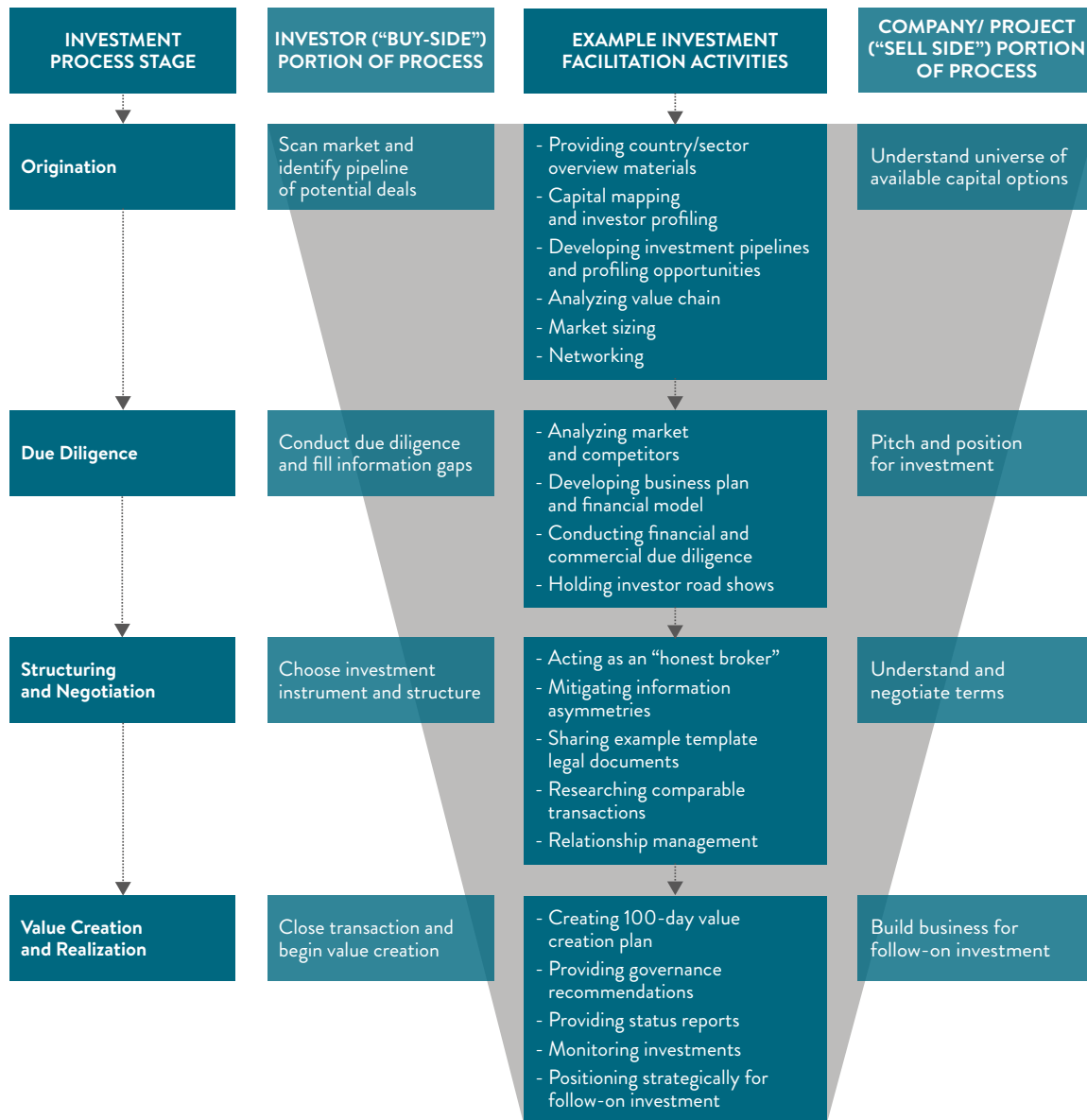
Information asymmetries—lack of general expertise, specific data and/or analysis to inform a commercial decision—underlie many transaction costs. The perception and reality of large information asymmetries, often stemming from eroded social capital, exacerbate the distrust that can prevent parties from closing a deal. These distortions arise during the due diligence process and may impact the investor and entrepreneur in different ways. Reducing this asymmetry between the parties may require additional bandwidth, expertise and local presence from neutral intermediaries to broker trust and facilitate an investment.

Figure 8 provides CrossBoundary’s summary of investment facilitation activities provided to the investors (including third-party financiers, such as development finance institutions) and to the company or entrepreneur.⁵⁶

The investment facilitation activities at each stage in the process are meant to reduce the transaction cost barriers which pose direct obstacles to initiating, managing and completing the transaction process.

These transaction cost barriers may differ for investors (“buy side”) and entrepreneurs (“sell side”) at each point in the investment process:

FIGURE 8 Private-sector investment facilitation process and transaction cost barriers



Source: CrossBoundary 2019

1. Origination—Investors need to understand and scan a new market for opportunities, then source/originate deals from that market; entrepreneurs must understand the available capital sources (debt, equity, concessional capital, grants) and then connect with capital providers.
2. Due diligence—Investors must conduct diligence on individual deals; entrepreneurs must create pitch materials and position themselves for the best available investment.
3. Structuring and negotiation—Investors must choose the appropriate structure and negotiate the deal; entrepreneurs must understand and negotiate the deal terms, often across the table from more experienced investors.
4. Value creation and realisation—Investors must plan for operational improvements and eventual exit; entrepreneurs must implement the post-investment value creation plan and preserve flexibility for future investors.

Private-sector investment facilitation is most successful when the intermediary has a permanent geographic presence. This local presence can help reduce information asymmetries between the investor and the company, while also contributing to the development of local institutional knowledge and reputation of credible third-party advisors. As this knowledge increases, transaction costs decrease, and intermediary productivity increases, thus contributing to a more robust intermediary ecosystem.

For example, in frontier markets of francophone West Africa, such as Mali, investors are hungry for information, but it is simply unavailable: the advisors that would normally provide reliable market data do not exist. To support investment in Mali, CrossBoundary’s local investment facilitation team worked closely with the Netherlands-based impact investor Cordaid to provide detailed information and analysis at the country, sector and individual investment level. This work, coupled with the team’s long-standing local presence, ultimately contributed to the investor being able to make three investments in Mali, despite having never visited the country before engaging with CrossBoundary.

Furthermore, the investor has stated they now have a strong pipeline of additional potential investments in Mali, demonstrating that there are benefits once the initial first-mover disadvantage is overcome.

There is also a role for development partners to use investment facilitation to accelerate capital into essential businesses or sectors and to restructure existing payment obligations to ensure that businesses and sectors are able to withstand unforeseen demand-driven crises, like Covid-19.

Investment intermediaries can help to quickly re-direct new sources of capital to sectors which may serve as a critical underpinning to economic and political security. Furthermore, if a company is facing challenges in meeting existing payment obligations, donor-funded investment facilitation can serve an ‘honest broker’ role by re-aligning incentives between existing investors and the company as a neutral intermediary.

GOVERNMENT FACILITATION FOR INVESTMENT AND SECTOR DEVELOPMENT

What does government facilitation for investment look like? We use the principles of modern industrial policy (which we call market-based industrial policy⁵⁷) and the experiences of the Tony Blair Institute, CrossBoundary and other organisations that provide public-sector investment advisory support to countries across Africa to provide a framework for setting this out.⁵⁸

In [Figure 9](#) we extend the four-step investment process presented in [Figure 7](#) above to seven steps so that it reflects the activities governments need to undertake to be able to play their role in scaling up investment in transformative sectors.

The steps are:

1. Sector planning and coordination
2. Enabling environment for priority sectors and subsectors, which can also provide incentives that drive investor/entrepreneur origination
3. Project origination and planning

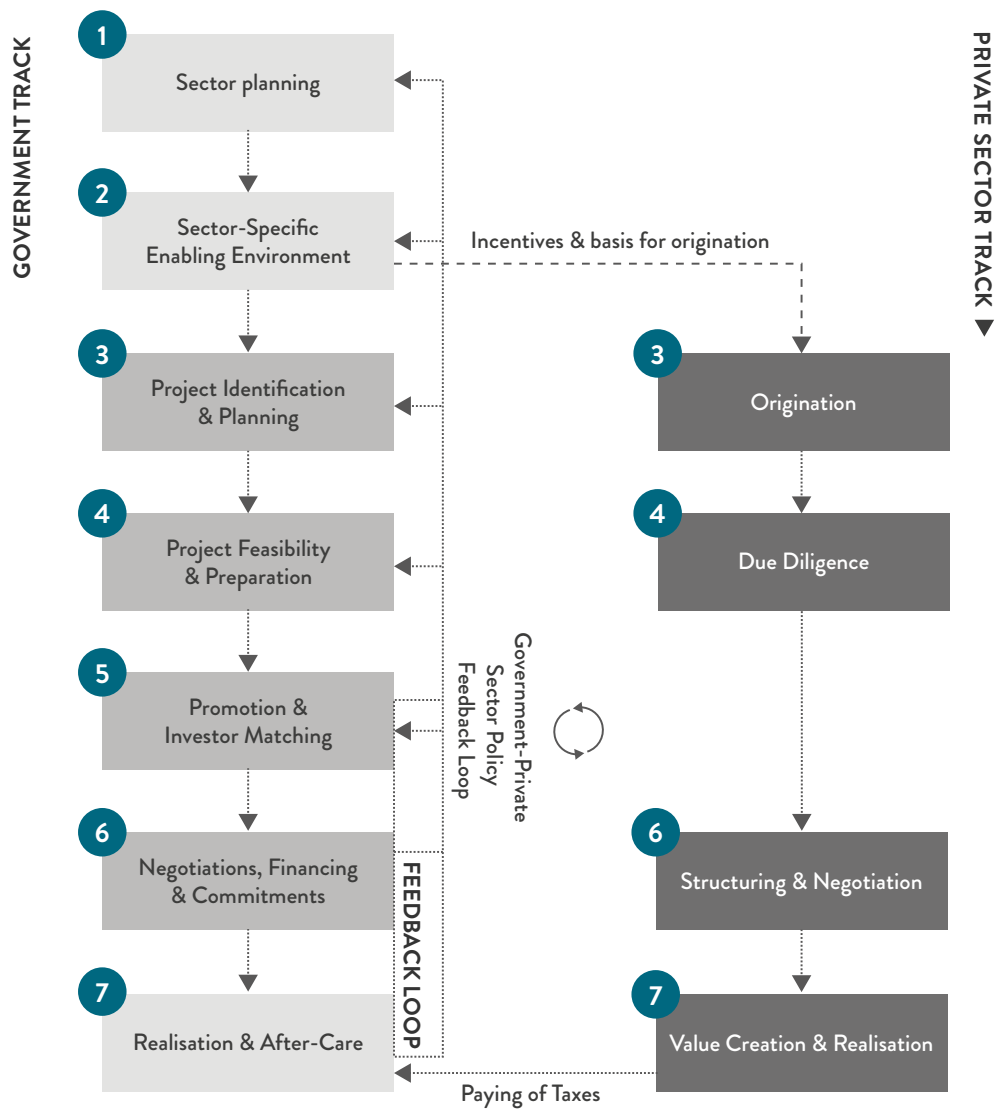
4. Project feasibility and preparation
5. Promotion and investor matching
6. Negotiations, financing and commitments—we include government commitments needed to bring deals to a close, e.g. a final concession on land or tax
7. Realisation and aftercare—we have added aftercare to speak to the ongoing need for governments to ensure a suitable enabling environment for investors to create value
8. Finally, we include a feedback loop from realisation back to sector planning and enabling environment, and of course the payment of taxes by the successful investment back to the government.

We recognise that in practice these steps might not happen in sequence. A case where sequencing was essential was Ethiopia, where the government could not push hard on investment promotion in textiles and apparel until plans for Hawassa Industrial Park were finalised and construction commenced. Without this, investors might be sceptical about whether a park would actually materialise. But in other cases there may be parallel efforts across the various stages. For example in Ghana, the government conducted

investment outreach in 2019 to Renault, as part of its industrialisation agenda. With Renault signing an initial MoU to invest and other automotive firms being targeted, this sparked the need for a working group on subsector planning to address various constraints. Often the feedback loops are constant across the various steps. Another challenge is about getting the timing right. For example, in the case of industrial parks as a mechanism to provide a sector-specific enabling environment for investment, if a government started steps 3–6 too soon, investors might not be interested because the infrastructure is not there yet. But if it started these steps too late, it might be stuck with an empty, expensive industrial park that may not meet investor specifications. These issues all add additional levels of complexity that governments need to handle, and further point to the importance of government facilitation for investment.

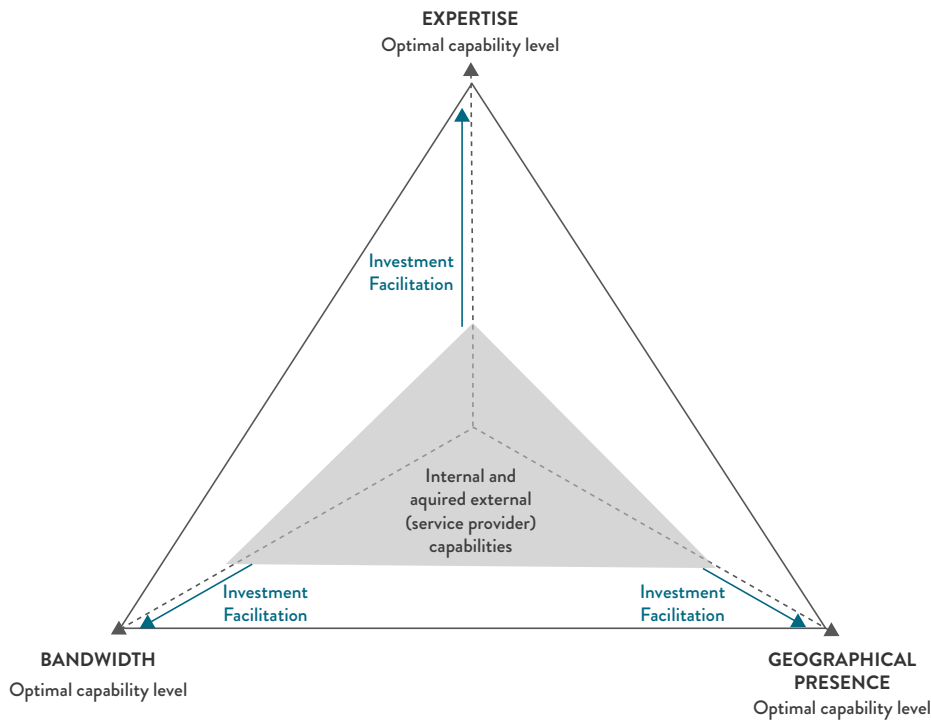
We next explain the role of facilitators⁵⁹ for government's role in enabling investment in each of these steps and the activities involved. This is based on our collective experience as well as on the model presented by CrossBoundary in [Figure 10](#), which shows expertise, bandwidth and geographical presence to be three essential factors needed to bring transactions to a close. In this chapter we apply this framework to the government.

FIGURE 9 Government investment facilitation cycle, with the private-sector investment cycle



Source: Tony Blair Institute and CrossBoundary

FIGURE 10 Helping investors and entrepreneurs with the capabilities needed for a transaction to a close



Source: CrossBoundary

1. Sector and subsector planning and coordination

Sector planning and coordination⁶⁰—which is key to market-based industrial policy—is the activity of setting out a long-term vision and direction of travel for a sector as a whole⁶¹ and then analysing and planning how that vision will be achieved, through the public and private sectors both playing their roles. As argued in the *Jobs Gap* paper⁶² and shown in the Tony Blair Institute’s *Missing Links*⁶³ paper, as well as in case studies of countries that developed, such as Israel,⁶⁴ this is required to allow different parts of government—not least the presidency, the finance ministry and the relevant sector ministry (or ministries) and agencies—to coordinate, plan for, resource and deliver the enabling environment needed by private actors to invest and flourish. This is also essential to enable the government system to sequence problem solving on the public-sector side of transactions, through a process of identifying, ranking and addressing sector-level and firm-level binding constraints.⁶⁵

Because government capability in the world’s poorest countries is weak, there is not the capacity

in governments—be it political, institutional or organisational—to fix all the bottlenecks that hold back investment, such as building or repairing roads to a project site, connecting affordable electricity, setting business-friendly regulations, developing a suitably skilled labour force, enabling technological learning, ensuring imported inputs and exports get through customs and ports quickly, providing licences for staff and for the business and so on.

Therefore, having a strong and sufficiently coordinated sector plan at the government level in sectors and subsectors identified in the sector prioritisation process is a first step to allow the government to align its focus and resources. Sector planning includes putting in place a suitable and fit-for-purpose regulatory framework for each sector and subsector.

This activity is often carried out by line ministries and agencies (such as ministries of agriculture, departments of industry, SME development agencies, industrial parks or SEZs agencies, ministries of transport, ministries of energy and so on), but often needs to be coordinated by a central function, such as a presidency, a ministry or department of economic planning (normally attached to a ministry

of finance), a ministry of industry and trade or a development board/council. It is often not carried out by investment promotion departments. Yet because of limited political, institutional and organisational capability, this requires facilitation by neutral third parties, and scaling up the capacity of governments to conduct sector planning is essential to scale up project pre-pipelines and pipelines.

2. Enabling environment in priority sectors and subsectors

This relates to the government addressing firm-level and sector-level barriers to investment by reducing and managing sector-wide transaction costs and incentives sufficiently for businesses to be able to operate and flourish in prioritised sectors and subsectors. It is the natural extension to sector planning and the result of a coordinated industrial policy. Implementation gaps require facilitation by neutral third parties, just as the planning and coordination functions of sector planning do. This can fall under a range of different implementing agencies, further highlighting the need for facilitation. Providing guidance to governments on how to do this effectively—without cutting one-off deals that benefit one or a handful of firms in a way that leads to a situation of abnormal market power—is also essential.

3. Project identification and planning

Governments need support to work with project developers to package projects, be they greenfield or brownfield. Investment promotion agencies (IPAs) are most often tasked with this. Project developers—which can include SMEs, large businesses (though such businesses typically need less government support) or public-sector organisations (such as a ministry of finance privatising a state asset)—often need support by an IPA given various information asymmetries. In turn, IPAs often need facilitation to undertake this task and to take projects to bankability. Expanding the capacity to undertake project identification is essential to increase the number of bankable projects and scale up project pipeline development. For example, in investment facilitation programmes in South Sudan and Mali, CrossBoundary placed one of their investment professionals half-time in the IPAs. One of the individual's seemingly simple tasks was to sort

through the agency's stack of accumulated business cards and proposals, to identify those investors who had approached the country and were actually credible, as opposed to those who had no resources or were simply trying to sell something. The existing staff simply did not yet have the business networks to determine credibility or do reference checks.

4. Project feasibility and preparation

This activity is often carried out by private developers or a ministry or agency in the case of a publicly financed project or privatisation. Government facilitation in Africa is often needed in the latter case to drive through public procurement processes. However, also in the case of private project development, government facilitation is often needed insofar as government-owned data, information and commitments are needed to allow completion of project feasibility assessment.

5. Promotion and investor matching

This is an essential activity that governments need to undertake in order to scale up investment in transformational sectors in Africa. Information asymmetries between investors and investees mean that a central hub of information is needed to match investments that might otherwise go unaddressed. This includes the act of marketing investment opportunities that have been properly prepared and screened in sectors whose broader enabling environment is being addressed. Investment promotion agencies play this critical function in most countries, although in many developing countries they lack the capacity to play this role effectively. This is often partly because of common problems of weak institutions and staff quality across developing-country governments, but often also because the role of such agencies is still relatively new in Africa, and hence they do not tend to be given sufficient political authority. In recent decades, the primary form of investment promotion was more reactionary (with firms making unsolicited investment bids, rather than being approached as the result of a government economic transformation agenda or industrial policy). These were typically rentier or power-broker firms who could strike a deal with a senior government official and require relatively little government coordination. Relatively little investment facilitation

by government was actually needed. As the push towards job creation and industrialisation increases, investment facilitation is becoming more proactive (to target firms the government wants) and also more complex, because attracting magician firms requires more government analysis, support and coordination across multiple ministries and agencies. Therefore, this requires increased capabilities in investment promotion agencies and ministries of industry and trade. This is being increasingly recognised across governments in Africa but remains fairly new, and the past legacy remains something that needs to be contended with.⁶⁶

6. Negotiations, financing and commitments

Depending on the nature of the transaction, this step can be labour-intensive for the government. If it is a direct party to the transaction, then it requires significant coordination and senior management time, both of which are in scarce supply. It may also require the mobilisation of third-party financing, which in itself needs facilitation and is best accomplished in tandem with a neutral facilitator with some independence from the government (so it can serve as an honest broker). Even if the government is not a direct party, often government commitments of some sort—such as negotiating final concession agreements, ensuring approval of various regulatory agencies and licensing bodies, ensuring availability of government-provided assets such as land and infrastructure—often require extensive attention and focus. In government systems with weak institutional capabilities and limited political capital, this often needs facilitation by a neutral third party that can work with key government champions to solve the problems necessary to achieve deal closure.

7. Realisation and aftercare

This is a highly labour-intensive step for the government and is another major component of market-based industrial policy. Investor aftercare is essential so that the government can address problems faced by investors in operating their businesses that fall within its remit. Once investment happens, all sorts of obstacles and issues will inevitably arise in countries with weak markets and institutions. Ongoing support for investors, not least pioneer investors, in transformational sectors is important.

This is for two reasons: first is for them to succeed in their business and the development impact. Second is to allow for a feedback mechanism back to sector planning and to the enabling environment steps. IPAs and relevant line ministries in Africa typically have even less capacity for aftercare than they do for project development, matching and negotiation—thus showing the need for government facilitation in this step.

8. Feedback to sector planning and enabling environment

This is not a step in the process but a feedback loop to the first steps. This is important because the link from aftercare (and also from transactions that fail to close) back to sector planning is essential. Understanding where existing investors and businesses—including pioneer firms—need further support and learning about how the process of investment actually went is essential for the government to learn how to better play its role in facilitating investment in transformational sectors. The organisation of sector-specific public-private working groups that bring together businesses and government officials from different ministries and agencies to address sector constraints is one tool that can speed up this process.

Crucially, the feedback loop does not only happen at the end of the process, but *throughout* the process. The ongoing collaboration between investors, investees, intermediaries and governments (supported by their facilitators) serves as a permanent feedback mechanism that gradually allows information asymmetries to be addressed in all directions. This feedback loop is extremely valuable, particularly for governments, who otherwise typically lack sufficient exposure to investors and businesses to know how to create an improved business-enabling environment for transformative sectors.

An example of how this all works in practice is the pharmaceutical sector in Ethiopia. In 2016 the government developed initial plans to establish a pharmaceutical manufacturing hub. It assigned a large amount of industrial park hectareage to the sector in Kilinto. Efforts have been led by the Ethiopian Investment Commission (EIC) and the Industrial Park Development Coordination (IPDC) as well as the

Ministry of Trade and Industry. In the sector-planning exercise, these agencies needed support for sector and market analysis to identify the business case and how a viable sector might operate in Ethiopia. They then needed support to reach out to an initial group of target investors to identify a few that could anchor investments and provide guidance on the requirements to invest (both in the industrial park and beyond).

Due to limited bandwidth and expertise, these agencies also needed external facilitation to develop and maintain the relationships with these potential investors, so that they could respond to their requests and requirements and return to them with feedback to maintain their interest and, crucially, move conversations on to project identification and feasibility. In parallel, as the promotional materials were being updated by the EIC, and the IPDC worked on the development of Kilinto Industrial Park, the agencies lacked bandwidth and required support to build a pipeline of up to 200 potential greenfield investors (as of January 2020), with a target of 500 for the rest of 2020—an activity requiring extensive, labour-intensive outreach. With the support of an external advisor, a series of investment promotion events also took place, and more are in the pipeline.

With external support, extensive work is also being conducted to convert prospective investors already in the pipeline. Twenty firms—pharmaceutical manufacturers, mostly from Asia—have signed memoranda of understanding (MoUs) with the government indicating their intention to invest in Ethiopia. These MoUs lay out the obligations of the investors and the government. As of the start of 2020, efforts were underway to complete the remaining steps to allow them to start project implementation. External support is also needed to secure MoUs from additional firms. Given the scale of this task, as of January 2020 external support was still needed by EIC to identify targets, evaluate proposals against specific criteria, and consistently follow up as investors reach their decision to invest. Some handholding for the government is also necessary to allow it to meet its obligations under the MoUs, including to coordinate action across different ministries and agencies.

Such facilitation is also important in the infrastructure sector, not just in FDI. USAID Power Africa’s Senior Advisors Group project, in which the Tony Blair Institute embeds long-term advisors in ministries of energy or in electricity utilities, provides a good example. These advisors complement the work of standard Power Africa transaction advisors by providing support across all of steps 1 to 7 of the public-sector energy investment cycle. While the transaction advisors are focused purely on the technicalities of a deal, the long-term embedded advisors linked the technical aspects to the political and institutional context, and to the process to develop the sector as a whole. Anchoring transactions in that process enables deals to be closed under terms that raised their chances of success and value creation. This allows learning feedback loops for institutional strengthening. Because they are funded by USAID through Power Africa, the long-term embedded advisors have the independence they needed to be fully objective with government counterparts and build trusted relationships with them, enabling them to add expertise to government during the investment cycle.

Conclusion:

Towards a twin-track framework for private- and public-sector investment facilitation and sector transformation

This report identifies a disconnect in Africa between development finance investors on the one hand and African governmental efforts—backed by their donor partners—to drive economic development on the other. We suggest that in order to support Africa’s recovery from Covid-19 while at the same time scaling up investment in transformative sectors in Africa such that it can deliver development and resilience to future shocks, it is essential to bring together the latest insights from investment facilitation in difficult markets with market-based industrial policy. Doing so would enable governments with weak institutional capacity to provide a suitable and focused enabling environment for investors and businesses by addressing not only macro-level challenges to investment but also sector-level and firm-level ones.

We make a case for why sectors matter and propose a framework for identifying which sectors and subsectors to prioritise for investment, using criteria that work from a development investment perspective as well as from an economic development perspective. This framework has all the more relevance as a result of Covid-19 and the ongoing sectoral shifts—some negative, such as a medium-term decline in mobility and consumption, and some positive, such as the rapidly increasing pace of digitalisation.

Finally, we provide a framework to scale up high-impact investment, showing that in order to increase transformative investment, facilitation is needed both on the private-sector side—between the investor, investee and impact-minded financiers such as development finance institutions—and on the public-sector side. Adopting this framework as an integral part of Covid-19 recovery plans is essential.

We conclude by proposing how this might work in practice. We propose a twin-track approach that includes both private-sector and public-sector facilitation of investment. In both instances, facilitation needs to be based on a long-term adaptive management approach, so that support can be contextualised and drive a strong long-term relationship between the facilitator and the counterparts.

Facilitators also need to be independent: they need to be funded in such a way that they are able to provide objective advice to their counterparts, whether in the private or public sector.

While specific skills, such as specialised investment banking or legal expertise, will be needed at critical stages of the process, it is important for these to be complemented by long-term advisors who can better understand the country context in terms of politics, markets, institutions, organisations and people, and who can add bandwidth and expertise to counterparts—particularly for entrepreneurs and government officials.

This paper has sought to highlight the importance of development finance institutions and development partners recognising the value of such long-term investment facilitation to both the entrepreneur and to the government—as a mechanism to scale up their impact in fragile and low-income countries in Africa. It is needed now more than ever.

Annex

TABLE A1 Criterion 1 of sector prioritisation framework applied in Liberia in 2017:
Profitability assessment, pre-tax profits, current prices (in US\$)

	RUBBER		OIL PALM		
	Ribbed Smoked Sheets	Technically Specified Rubber (20)/ Firestone model	Crude Palm Oil	Refined Palm Oil (Olean & Stearin) inc Cooking Oil	Soap
<i>Unit</i>	<i>1 metric tonne</i>	<i>1 metric tonne</i>	<i>1 metric tonne</i>	<i>1 metric tonne</i>	<i>Bar of soap</i>
Revenue at current market prices: \$	\$1,600	\$1,500	\$800	\$1,600	\$0.24
Cost of Production Estimates, \$ per unit					
Coverison cost inc energy & packaging	\$150	\$800	\$100	\$250	\$0.06
Total farming cost			\$422		
Farmer income inc. farm labour, land prep etc.	\$717	\$344		\$700	\$0.08
Fertiliser	inc. above	inc. above	inc. above		
Stems/Seeds	inc. above	inc. above	inc. above		
Agro-Chemicals					
Irrigation					
Feed Cost					
Fry Cost					
Fuel					
Extension Services	inc. above	inc. above	inc. above	inc. above	
Post-harvest storage	inc. above	inc. above	inc. above	inc. above	
Transportation	\$196	\$263	\$47	\$93.50	\$0.003
Export costs: quality certificate, freight, fees etc.	\$141	\$132	\$71	\$141	
Marine fish export taxes					
Overheads and taxes	\$71	\$71	\$36	\$36	
Total Cost of Production	\$1,276	\$1,611	\$675	\$1,220	\$0.14
Profit, \$ per metric tonne (or bar of soap for 'soap' column only)	\$324	-\$111	\$125	\$380	\$0.10
Potential MT (or bars of soap) per hectare per year	1.1	1.1	3.8	3.8	24,720
Profit \$ per hectare per year	\$343	-\$118	\$473	\$1,435	\$2,398

Source: Jonathan Said, "How Liberia Can Diversify its Economy for Inclusive Growth", 2017.

COCOA	FISH		RICE	VEGETABLES
Grade1/ Premium	Aquaculture	Marine	Lowland, Milled & Pacakaged Rice	Tomatoes
1 metric tonne	1 metric tonne	1 metric tonne	1 metric tonne	1 metric tonne
\$3,360	\$3,500	£2,000	\$700	\$720
		\$130	\$19	
		\$127	\$420	
\$777				\$143
\$492			\$141	\$19
\$85			\$31	\$25
\$54				£24
				£180
	\$1,760			
	\$100			
		\$60		
\$92	\$92			\$20
\$38	\$200	\$200		\$38
\$196	\$196	\$98	\$33	\$40
\$297	\$297	\$297		\$64
		\$400		
\$150	\$150	\$150		\$32
\$2,181	\$2,795	\$1,462	\$644	\$584
\$1,179	\$705	\$538	\$56	\$136
0.6	333		2	25
\$707	\$235,017	na	\$112	\$3,390

TABLE A2 Source: Criterion 2 of sector prioritisation framework applied in Liberia in 2017: Estimation of supply-side (resource base) and demand-side (market size) potential

	Non-Tyre Rubber Products	Tyres	Crude Palm Oil	Refined Oil & Cooking Oils
A. Supply Side: Estimation of production potential				
Current hectareage allocated to crop	76,000	76,000	54,500	54,500
Hectareage potential	200,000	200,000	209,600	209,600
Tonnage potential	211,768	211,768	792,298	522,917
Soap bar production potential (million soap bars)				
Potential sales worth of production potential, \$ million at current prices	\$338.8	\$317.7	\$633.8	\$836.7
Total gross profit potential (exc smallholder farmer incomes) to investor, \$ million	\$68.6	-\$23.5	\$99.1	\$198.5
B. Demand Side: Estimation of Market Size				
Year for market size data	2015	2015	2014	2014
Market size in Liberia				
Imports by Liberia, \$ million	\$7.5	\$7.9	\$0.0	\$60.0
Domestic Sales of local production, \$ million	\$0.0	\$0.0	\$3.4	\$0.0
Total domestic market size, \$ million	\$7.5	\$7.9	\$3.4	\$60.0
Market size in ECOWAS				
Imports by ECOWAS (hence export opportunity for Liberia), \$ million	\$403.5	\$645.0	\$1,728.7	\$2,838.6
Global market, \$ million				

Source: Jonathan Said, "How Liberia Can Diversify its Economy for Inclusive Growth", 2017.

Soaps	Cocoa beans, powder & butter	Catfish, Tilapia for Supply Side; All fish for Demand Side	Marine fish for Supply Side; All fish for Demand Side	Rice	Tomatoes
54,500	60,000	100	na	230,000	2,500
209,600	240,000	1,000	na	400,000	7,500
	144,000	333,333	30,500	800,000	187,500
5,181					
\$1,243.5	\$483.8	\$1,166.7	\$61.0	\$560.0	£135.0
\$502.6	\$169.8	\$235.0	\$16.4	\$44.8	\$25.4
2014	2015	2015	2015	2015	2015
\$8.3	\$0.0	\$34.5	\$34.5	\$9.7	\$0.1
\$8.9	\$0.0	\$12.1	\$12.1	\$161.0	\$1.8
\$17.2	\$0.0	\$46.6	\$46.6	\$170.7	\$1.9
\$483.6	\$48.7	\$1,354.5	\$1,354.5	\$2,441.7	\$4.2
	\$20,176.0				

TABLE A3 Source: Criterion 3 of sector prioritisation framework applied in Liberia in 2017:
Suggested target market per product

SUGGESTED TARGET MARKET	
Non-Tyre Rubber Products	ECOWAS for non-tire rubber products; Sri Lanka, Thailand, for ribbed smoked sheets
Tyres	ECOWAS; US/Global for Technically Specified Rubber
CPO	Domestic & ECOWAS (where can capture large market share)
Refined Oil & Cooking Oils	Domestic & ECOWAS (where can capture large market share)
Soaps	Domestic & ECOWAS (where can capture large market share)
Cocoa beans, powder & butter	Global (E.U, US, China)
Catfish, tilapia	Domestic & ECOWAS (where can capture large market share)
Marine Fish	Domestic for shallow water fish; Global (EU, USA, China) for deep water fish
Rice	Domestic & ECOWAS
Tomatoes	Domestic & Cross-border/ECOWAS

Source: Jonathan Said, "How Liberia Can Diversify its Economy for Inclusive Growth", 2017.

Finally we present a second variation of the sector prioritisation framework: the cluster prioritisation method from the Malawi National Export Strategy 2013–2018. This was composed of six levels of analysis to capture the economic factors, as follows:

1. Product space analysis (called trade and market analysis). This identified the market size and product innovation potential of various subsectors (defined as product clusters). It used the Economic Complexity Index.
2. Stakeholder and expert interviews. This allowed the capture of local knowledge and insight across all five economic factors.
3. A review of all existing value-chain analyses conducted by various players. This allowed an analysis of profitability and market-size potential, as well as the identification of various transaction costs.
4. A competitiveness analysis based on trade price comparisons with competitor countries, using Comtrade.¹⁰ This contributed to the profitability analysis by serving as a cost proxy. This should be complemented by a business profitability analysis, as per [Table A2](#) above.
5. A resource analysis. This captured the resource base. In the Malawi National Export Strategy this focused predominantly on soil suitability for various crop based subsectors, since it was a predominantly agrarian strategy.
6. A risk analysis, to capture various risks such as macroeconomic instability and political economy challenges.

[Table A4](#) below presents the outcome of this prioritisation used for Malawi's 2013–2018 National Export Strategy.

TABLE A4 Outcome of Malawi National Export Strategy 2013–2018 cluster prioritisation method

FINAL RANKING AND SCORES						
Final Shortlisted Clusters	Ranking, including Resource Analysis	Ranking, excluding Resource Analysis	Score including Resource Analysis	Score excluding Resource Analysis	Development Contribution/ Spillovers	Ability to Compete
Weightings					80%	50%
Coffee	11	11	55%	50%	38%	46%
Dairy products	4	4	67%	66%	71%	59%
Groundnuts & products	1	7	69%	65%	65%	70%
Pulses products	9	10	61%	54%	45%	49%
Maize & products	3	2	67%	66%	71%	67%
Oil seed products	2	5	68%	66%	67%	68%
Rice	10	9	56%	55%	48%	41%
Soyabean products	5	8	65%	59%	63%	54%
Sugar cane products	7	6	63%	65%	68%	63%
Wheat products	8	1	62%	66%	80%	51%
Manufacturing	6	3	63%	66%	79%	69%
CRITERIA SCORES						
Final Shortlisted Clusters	Demand Trend	Is Value Addition Reachable?	Likelihood of ongoing stakeholder dialogue	Favourable Resources and Resource Impact		
Weightings	40%	20%	40%	80%		
Coffee	48%	83%	67%	70%		
Dairy products	68%	76%	58%	70%		
Groundnuts & products	66%	52%	65%	80%		
Pulses products	55%	89%	61%	80%		
Maize & products	52%	77%	66%	70%		
Oil seed products	75%	83%	43%	75%		
Rice	63%	94%	58%	60%		
Soyabean products	55%	64%	61%	80%		
Sugar cane products	63%	88%	54%	55%		
Wheat products	66%	78%	53%	50%		
Manufacturing	63%	72%	36%	53%		

Source: Malawi National Export Strategy 2013–2018, Annex 9.

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- 66 Assessment based on the Tony Blair Institute's presence in centres of government across 14 countries in Africa as of 2019.
- 67 www.trademap.org.

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