Issue paper

Business and investment environment / European Investment Plan (EIP), Financial Instruments

1. DESCRIPTION OF ISSUE / INTRODUCTION

Private investment in the agricultural sector remains unprofitable and risky with regard to investments in other sectors of the economy of African countries.

Subsistence agriculture faces significant distortions in national agricultural markets, which frequently encourage food imports from the world market to the detriment of local production.

Development policies including Agricultural policies are often designed by urban consumers who are far from the realities of small rural producers.

Export agriculture follows international price cycles and must support long-term structural degradation of the terms of trade for products with insufficient value added.

Productivity gains remain low in view of the growth potential highlighted by agricultural research and in comparison with other tropical agricultural production areas (Asia, South America).

Proven climate risks, coupled with often recurrent political risks, phytosanitary risks and commercial and non-commercial risks, affect the private investors' decisions to invest as they tend to have higher investments' return expectations.

Compared to a recognized benchmark of 20% profitability of private investments in emerging countries, the observed returns on agricultural investments in African countries remain much lower, rarely exceeding the 10% internal rate of financial profitability, even if the economic benefits for the national community are higher.

In addition, international private investors tend to use transfer pricing mechanisms to ensure the profitability of their investment.

These mechanisms, well described by UNCTAD (CNUCED) have the effect of reducing the apparent profitability of private investments in the African countries benefiting of the investment, and of transferring profits to international profit centers by optimizing the country's national taxation system where the investment is made.

These mechanisms therefore create distortions in investment decisions and in the rationality of public intervention towards support of private investment.

Finally, the distribution of the added value in agricultural chains is often unfavorable to small producers as compared to the situation in other regions of the world.

Thus, if an Asian farmer receives up to 80% of the added value of the main agricultural value chains, the African farmer rarely receives more than 30% of the added value in a context of low productivity and market distortions.

This low share of the added value attributed to the agricultural producer discourages innovation and investment.

New EU-funded private sector support and financing instruments do not seem to attract significant volumes of investment in the African agricultural sector, even though the sector is in need of significant investment to increase its productivity, distribute income, create jobs, especially for young people, stabilize rural exodus and thus help reducing the migration pressure. In addition, despite a double-digit urban population growth in many countries, most of Africa's population remains rural, and public and private investment should focus more on countryside and rural areas.

2. POINTS FOR DISCUSSION

The vicious circle linking market distortions, climate and political risks, low productivities, low returns on investment and, ultimately, low agricultural investment must be broken.

Sectoral policies (agriculture, rural development, land, land use planning, etc.) should help to improve the context and the business environment in which the investment decision must take place.

Nevertheless, the financial returns in the agricultural sector will remain lower than in other sectors of the economy of African countries (Real Estate, Trade, Services, Food Imports, Telecommunications ...).

So, how to attract private capital to agriculture and agribusiness and how can the new European instruments of support to the private sector be oriented towards the agricultural sector?

The situation is all the more complex as EU financial support to the private sector is channeled through national and regional development banks, for which agriculture is not always a priority sector.

Mechanisms to increase the profitability of private capital through public support in the agricultural sector are well known and have been used successfully in European countries (interest-rate subsidy, investment fund financing infrastructures...) within the framework of a coherent, robust and sustained agricultural policy

Are these mechanisms fully or partially transposable in African countries via national or regional development banks?

The answer must certainly be modulated according to the existence, the effectiveness and the robustness of the national sectoral policies concerned (Agriculture, Rural Development, Land, Territorial Planning…).

In addition to specific instruments to support agricultural investment, the decision to invest also depends on the long-term vision of land tenure development and the transfer of land

and industrial assets. Private investors may accept low profitability in the medium term if there is an “acceptable” risk for a delayed profitability and a capital gain perspective (or at least the absence of capital loss).

In fragile States developing embryonic or ineffective sectoral policies, the new European financial instruments are unlikely to have an impact on the level of private investment in the agricultural sector.

In countries where effective and robust "umbrella" sectoral policies exist, the European instruments to support private agricultural investment must then be sufficiently incentivized (additionality) to convince private investors to invest despite low initial financial returns (or higher but deferred returns) while avoiding creating sectoral or sub-sectoral distortions or "over-subsidizing" private investment.

Quantitative and qualitative analytical methods to respect these principles exist and have been developed at the level of the Commission services (Financial and Economic Analysis, Value Chain analysis, Public Private Partnership assessment’s methods).

These methods aim to verify the financial and economic returns of public and private investments, their inclusiveness and their contribution to real pro-poor growth, their social and environmental sustainability.

The use of these existing methods of analysis should help in the orientation of European financial support in the agricultural sector towards financially viable, economically profitable and inclusive, socially and environmentally sustainable investments.

The challenge is certainly to see the systematic application of this performance analysis kit by the financial intermediaries who, ultimately, implement the European support (national and regional banks for development, financial institutions specifically financing the agricultural sector).

This will require a permanent and effective political dialogue with all stakeholders in support of private agricultural investment (Government, Representatives of the National and International Formal Private Sector, Farmers Organizations and Professional Agricultural Organizations, Interprofessions, Regional and National Development Banks ...).

In this respect, a sectoral approach supported by a mix of Budgetary Aid, allowing a dialogue on the relevant sectoral policies, and a "package" of public and private investment projects, would undoubtedly be an effective solution in countries eligible to Budgetary Aid.

New financial instruments in support of the private sector will not have an impact on the level of private investment in agriculture without effective political dialogue enabling the establishment of adequate sectoral policies to support agriculture and rural areas.

3. READING LIST

-**Council on Smallholder Agricultural Finance(CSAF): 2018 State of the Sector**

https://www.csaf.net/state-of-the-sector/

-**Votre guide pour le Plan d'Investissement Extérieur de l'UE -Novembre 2017**

https://ec.europa.eu/commission/eu-external-investment-plan/what-eus-external-investment-plan_fr

-**Public Private Partnerships in the EU: Widespread shortcomings and limited benefits**

European Court of Auditors 2018 Number 09

https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=45153

-**Providing Value Chain Analysis for improving operations**
https://europa.eu/capacity4dev

-**Manuel d'Analyse Financière et Economique des Projets de Développement**
https://europa.eu/capacity4dev

- **UNCTAD Transfer Pricing**
http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=348