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Maximising the impact of FDI on domestic industrial capabilities and job creation

In brief

- The prospective benefits from FDI for a host country, in terms of spillovers for technology transfer and quality upgrading, are not automatic or guaranteed.
- Governments need to play a proactive role to harness these benefits by linking multinational corporations (MNCs) and local suppliers through market enhancing measures to reduce informational asymmetries and develop local industrial capabilities.
- In contrast, market distorting policy instruments to bolster local suppliers versus their international competitors have proved expensive, in terms of time and opportunities lost, and difficult to implement.
- Drawing on LSE Professor John Sutton's ongoing work from the Ethiopian Investment Commission and Tanzanian Local Content Unit, this note argues that good FDI policy should focus on mitigating the constraints to local participation in global value chains by creating an enabling environment, fostering linkages between foreign and local firms, and deepening domestic firm capabilities.

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Introduction

Developing countries are often confronted with the policy challenge of deepening domestic industrial capabilities and creating jobs while opening up to Foreign Direct Investment (FDI). This is particularly relevant as these countries seek to industrialize, by broadening their industrial base to encompass a higher degree of sophistication ('middle manufacturing') which requires upgrading technical know-how and working practices to attain higher quality standards.[1] The arrival of multinational corporations (MNCs) provides an opportunity to deepen local value addition through technology transfer and knowledge spillovers to domestic firms operating in the same sector, or through supplier relationships. Empirical assessments suggest that vertical supplier relationships, rather than horizontal intra-industry interaction between MNCs and local firms are more conducive for generating positive externalities through backward linkages.[2] In other words, there is a higher likelihood of quality escalation of local firms when it is in the interest of MNCs to buy high-quality and low-price intermediate inputs from them.

FDI in services can also play an important role for the transfer of know-how, and quality improvement.[3] Increased access to competitively priced services can spur the development of domestic firms that intensively use backbone services such as telecommunications, transportation, and retail distribution as inputs in their production process. Hoekman and Shepherd (2015) use firm-level data in the EAC region to show that improvement in services productivity contributes to an increase in manufacturing productivity and merchandise exports. Moreover, in line with the promotion of vertical supplier relationships in FDI for general manufacturing and resource sectors, local sourcing for FDI in services such as tourism and retail can help to spur the development of local manufacturers and service-providers. For example, international hotels can be encouraged to source consumables such as textiles locally if they are made aware of the range of products and services available.[4] Supermarkets may also find it cheaper to source products locally provided their suppliers can meet the required quality and food safety standards, and provide a consistent source of supply. Such linkages can provide an impetus to local packaging and agro-processing firms, in addition to creating market demand for farm products.[5]

The participation of local firms within Global Value Chains (GVCs) is, however, constrained by many factors, including informational asymmetries, low productivity, labour force skills deficits, and inability to achieve economies of scale or to adhere to required quality standards. To maximize the benefits from FDI inflows, governments need to play a proactive role and adopt appropriate

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1. Sutton J. (2015), "Can Sub-Saharan Africa Industrialize? Lessons from History", Africa Growth Forum Public Lecture, International Growth Centre, June 2015.
2. Javorcik, B. (2004), "Does foreign direct investment increase the productivity of domestic firms? In search of spillovers through backward linkages," The American Economic Review 94 (3), 605-627.
3. Sutton, J., Jinhage, A., Leape, J., Newfarmer, R., & Page, J. (2016). Harnessing FDI for Job Creation and Industrialisation in Africa. IGC Growth Brief Series 006. London: International Growth Centre.
4. Shepherd, B. (2016), "Uganda: Improving Export Performance by Improving Policy Focus."
5. Gollin, D. (2016), "Agricultural Transformation and Urbanization: Challenges for Uganda."

policy instruments. Sutton (2015) posits that are two government agencies that are well positioned to play this role – investment promotion agencies (for general manufacturing and services), and local content units (in the case of resource-rich countries). While these agencies operate in very different contexts, they both seek to leverage their local knowledge of industrial capabilities, constraints and up-gradation possibilities, and match these to the requirements of incumbent/prospective investors.[6] These institutions promote local firm integration in GVCs through relationship building and matchmaking, or market friendly measures for promoting local sourcing, and should be differentiated from mandatory local content requirements (i.e. 'x% local content rules'). Value added mandates tend to artificially divert demand toward domestic producers (often with insufficient technical and business capabilities) at the cost of international competitiveness and tend to discourage investors from entering the host country market.[7] In practice, these regulations have often been less successful, as they are easily circumvented by MNCs and do not account for the need to hone local industrial capabilities in order to create an implementable and non-distortionary pattern of firm integration.[8] Percentage requirements for local content are also potentially incompatible with international trade agreements.[9]

Strengthening investment promotion agencies

Investment promotion agencies (IPAs) play an important role in attracting FDI by providing potential investors with relevant information and valuable customer services.[10] They aim to attract FDI through exposing the competitive advantages of the host country and meeting investors' needs, as well as catering to the profit-maximising strategies of investors.[11] This contributes to overcoming information asymmetries, which pose a significant barrier to international capital flows. Consequently, the work of IPAs is a cost-effective way to reduce transaction costs faced by potential international investors.[12] Indeed, investing in investment promotion yields significant returns: when considering IPAs worldwide, a 10% increase in investment promotion budget has been associated with, on average, a 2.5% increase in FDI.[13]

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6. In practice, it is often easier for Governments to promote local sourcing in the case of resource-seeking FDI vis-à-vis general manufacturing/service related FDI as the process of dialogue between Govt. and foreign investors is a natural part of the contracting process for such investments. These existing channels enable Governments to voice local content concerns and achieve quick gains through timely and proactive engagement (Sutton, 2016).
7. Shepherd, B. (2016), "Uganda: Improving Export Performance by Improving Policy Focus", Forthcoming.
8. Sutton J. (2014), "Gains from the Natural Gas: Local Content and Tanzania's Industrial Development", Seventh Gilman Ruthinda Memorial Lecture, Bank of Tanzania, June 2014.
9. Nwapi, C. (2016), "A survey of the literature on local content policies in the oil and gas industry in East Africa", University of Calgary, School of Public Policy Technical Paper, Vol. 9, Issue 6, April 2016.
10. Miskinis & Byrka, "The role of IPAs in attracting FDI."
11. Ibid.
12. Harding, T. & Javorcik,B. (2013). "Investment Promotion and FDI Inflows: Quality Matters," CESifo Economic Studies, CESifo, vol. 59(2), pages 337-359, June.
13. Miskinis & Byrka, "The role of IPAs in attracting FDI."

Typical investment promotion activities include information dissemination, investment generation and facilitation, image building, and developing links between foreign investors and domestic suppliers.[14] However, the World Bank's Global Investment Promotion Benchmark (GIPB) initiative finds that IPAs vary vastly in the quality of services provided, in terms of information provision (e.g. through the investment agency website) and handling of investor queries. This is significant, especially in light of evidence that the quality of IPA services matters for FDI inflows to the country,[15] and that investment promotion is effective mainly in developing countries.[16]

IPAs across the world also serve the function of coordinating investment incentives, i.e. legislative measures aimed at stimulating investment. Such incentives include tax holidays, preferential tax rates, preferential loans, grants, infrastructure access etc. Granting such incentives exclusively to foreign investors to subsidize the inflow of investment is typically justified as a correction for the market failure to reflect the potential benefit from knowledge spillovers and technology transfer. Bloomstrom and Kokko (2003), however, caution that such incentives are difficult to implement on account of problems with 'picking winners', lack of transparency, difficulty of quantifying the benefits from externalities, and coordination problems with competitor countries seeking to attract FDI. Academic research attributes an important role for IPAs as providers of targeted information and services for investment facilitation, but does not substantiate the role of providing tax and fiscal incentives for FDI.[17] This note consequently focuses on the role of IPAs for market creating mechanisms such as information provision and handling of investor issues.

In order to promote improvements in the quality of investor facilitation in developing countries, it is important to learn from best practice, and design appropriate institutional arrangements and processes. Wells and Wint (2000) argue that IPAs that are awarded quasi-government status are more effective than IPAs that are constituted within government, or as private entities. This allows the agency to hire professional staff, independent of government recruitment procedures and pay-scales, and to maintain a link with government in order to effectively relay feedback from investors to relevant government agencies. Additionally, IPAs created by an act of parliament (which is relatively hard to alter) tend to be more successful than those established through e.g. a government decree that is more readily alterable.[18] To be effective, it's vital that IPAs establish strong relationships with other agencies and ministries whose cooperation is needed to implement investment promotion efforts.

Sutton (2015) suggests that relationship building is a key to the success of IPAs, judging from past successes in Ireland, Finland and Singapore. The Ethiopian

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14. Ibid.
15. Harding, T. & Javorcik,B. (2013). "Investment Promotion and FDI Inflows."
16. Harding, T. & Javorcik, B. (2011). "FDI and Export Upgrading," Economics Series Working Papers 526, University of Oxford, Department of Economics.
17. Tuomi, K. (2012). "Review of Investment Incentives: Best Practice in Attracting Investment", IGC Working Paper, June 2012.
18. Dimitrie Cantemir Christian University, "Investment promotion tools."

Investment Commission (EIC), an autonomous government agency responsible for trade and investment promotion in Ethiopia, provides an interesting case of efforts to develop high quality investor facilitation services in an emerging economy.

The case of Ethiopia[19]

The Ethiopian Investment Commission has established a Relationship Building Programme, consistent with international best practice, which seeks to move away from the culture of firefighting, and instead engage with investors (that are significant employment creators) on a continuous basis. This enables the EIC to deal with issues in a timely manner and to avoid crisis situations. The dynamic programme has developed careful routines and procedures, such as a two-tier meeting structure (fortnightly meetings to discuss live issues, and quarterly meetings to conduct a comprehensive review of all firms and issues), and tracking mechanisms to ensure that all issues, on a company-by-company and problem-by-problem basis, are resolved in good time. The implementation of this programme over the past two years has helped to improve investor relations, which may motivate MNCs already operating in the country to bring their next investments to Ethiopia.[20]

The EIC looks to support the integration of local firms into the supply chains of MNCs, including retailers (e.g. H&M, Unilever) and major food processors (e.g. Nestle, PepsiCo). International supply chains for retailers and food processors, however, require high standards with regard to product uniformity, traceability, supply consistency, food safety, etc. The integration of local firms into these supply chains will consequently entail substantial investments to raise their business practices and quality standards to the required level, but will yield important benefits for local firm capabilities and increase access to international markets (whether as suppliers or direct exporters). This highlights the importance of government regulations and enforcement of production quality standards. The EIC uses its advantageous position as a coordinator between MNCs and domestic industry to bring together potential business partners. By providing forums for dialogue, the EIC helps prospective international lead firms to understand the capabilities and constraints of local suppliers. On the other hand, local firms (prospective suppliers) who engage in dialogue are also able to understand the constraints of MNCs, in terms of health and safety standards, technical and business requirements. This mediation function of the EIC offers a low resource-intensive option to promote business partnerships that can easily be emulated by other countries. The EIC, and IPAs in other developing countries, also have the potential to collate comprehensive archives of market information, guides to doing business in-country, and information on potential local suppliers/partners which can further support local participation in GVCs.

19. Case study sourced from John Sutton's (LSE) ongoing work with the Ethiopian Investment Commission & Sutton, J (2015), "Can Sub-Saharan Africa industrialize?"
20. However it remains to be seen how investors will respond to ongoing social and political tensions in the country.

Strengthening local content units

A local content unit (LCU) operates in a resource-rich country and serves to promote a feasible pattern of coordination with MNCs and integration of local firms into the supply chains of MNCs over time, with due consideration given to the existing capabilities of relevant domestic firms. It is important to note that although LCUs may start in the natural resource sector, their scope extends to a broad range of sectors as other associated opportunities arise (e.g. construction, food and beverages, business services). The responsibilities of an LCU include shaping dialogue with MNCs regarding local firm integration and encouraging the development of potential domestic suppliers' capabilities. The latter function is sometimes achieved through the creation of an associated enterprise development centre, which serves to impart technical and business training to local firms, particularly mid-sized firms. Training can be provided to firm staff either through courses run at the enterprise development centre, or by seconding an expert to a local firm for a period of time.[21] Enterprise development centres could, in principle, be co-funded by governments, MNCs and donors.[22] Only firms that undertake this training are conferred 'approved vendor status' to enable them to bid for contracts in the relevant supply chain and to become the first tier subcontractors to MNCs. Such training normally runs for 1-2 years, and therefore it is necessary to start training local firms well ahead of MNCs requiring the goods and services that local firms are to provide.[23] Many countries have missed out on maximising opportunities to integrate local firms into supply chains by failing to start training programmes early enough.

Capacity development programmes for the domestic labour force are also arranged through negotiations between LCUs and MNCs for the institution of 'shadowing schemes' whereby MNCs agree to recruit local individuals to work alongside regular employees and 'learn the job by seeing it done'.[24] Sutton (2014a) cautions that the creation of a successful shadowing scheme requires a realistic assessment of parameters such as the source(s) of financing for the scheme, the number of shadowing positions to be created, targeted technical background of potential recruits, etc. Moreover, it is important to institute a shadowing scheme from the very onset so that this is built into the contracts of incoming MNCs, as these companies are unlikely to concede to terms such as co-financing after the finalization of a contract. One of the most important aspects of developing local firm capabilities is to mesh the training and education of university graduates by, for example, ensuring that the curricula of local universities reflects the skills and expertise needed by the local labour market.[25] Curricula changes will take several years to achieve results and therefore these developments need to be initiated well

21. Sutton J. (2013) "A Local Content Unit for Tanzania."
22. Ibid.
23. Ibid.
24. The most successful example of a shadowing scheme was in Columbia where engineers initially engaged as shadows in MNCs, formed small companies that entered the same supply chains & displaced the former international suppliers.
25. Sutton J. (2013) "A Local Content Unit for Tanzania."

ahead of relevant skills and expertise being needed.[26]

Ideally, local content units comprise a small, well-qualified team of 8-10 persons and are housed in a relevant government ministry with institutional backing from other ministries.[27] It is vital that the LCU staff have a comprehensive understanding of the local business environment and of the capabilities of local firms so that they can fully negotiate the scale, pattern and nature of local firms' engagement in different supply chains.[28] Sutton's (LSE) ongoing work in Tanzania offers some insight into the process of LCU development in sub-Saharan Africa, from which lessons can be drawn for other countries.

The case of Tanzania[29]

The discovery of off-shore gas reserves in Tanzania has produced a unique opportunity for domestic job creation and business development, conditional on the integration of local firms into potential supply chains. As the supply chain is built up over time, opportunities will emerge for partnership between foreign and local firms in the sector of construction, followed by business and general services, and subsequently in engineering. Efforts by the Government of Tanzania to build up a pyramid of contracting relations between a prospective international lead firm, a local lead sub-contractor, and smaller local firms (that are contracted by the local lead sub-contractor), will help to maximize the impact on domestic job creation.

Tanzania has allocated responsibility for local content management to the Planning Unit under the Office of the Prime Minister (following consultations with relevant stakeholders). The Unit is working to develop its knowledge of local companies and has convened meetings with domestic construction firms to assess which firms have the ability and interest to engage with the supply chain. Meetings with multinational gas firms and their lead foreign construction firms are ongoing. A key outcome of the engagement process will be to agree on training arrangements for local SMEs in construction in order to qualify as 'approved vendors'. The institution of training programmes will, however, be costly, and is an area for potential donor support (to complement financing from MNCs and the government) that can reap critical dividends.

The Tanzanian government's pro-active role for instituting local content management at an early stage will prove to be critical for the success of the programme going forward and is an important lesson for other countries.

26. Ibid.
27. Ibid.
28. Sutton J. (2013) "A Local Content Unit for Tanzania."
29. Case study sourced from John Sutton's ongoing work in Tanzania, Sutton, J. (2014a), "Gains from the Natural Gas, and Sutton J. (2013) "A Local Content Unit for Tanzania."

Conclusion

This note emphasises that the prospective benefits from FDI for a host country, in terms of spillovers for technology transfer and quality up-gradation are not automatic or guaranteed. Governments need to play a proactive role to harness these benefits by linking MNCs and local suppliers through market enhancing measures for the reduction of informational asymmetries and development of local industrial capabilities. In contrast, market distorting policy instruments to bolster local suppliers versus their international competitors have proved expensive (in terms of time and opportunities lost) and difficult to implement. Drawing on ongoing work from the Ethiopian Investment Commission and Tanzanian Local Content Unit, we argue that good FDI policy should focus on mitigating the constraints to local participation in GVCs by creating an enabling environment, fostering linkages between foreign and local firms, and deepening domestic firm capabilities.

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