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Attracting FDI in middle-skilled supply chains

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Abstract

While popular opinion often pictures FDI flowing in search of lowest-wage, lowest-skilled activities in emerging markets, actual FDI to such countries increasingly addresses medium to high-skilled manufacturing sectors. Such FDI might be called “Quality FDI” that contributes to the creation of decent and value-adding jobs, enhancing the skill base of host economies, facilitating transfer of technology, knowledge and know-how, boosting competitiveness of domestic firms and enabling their access to world-wide markets, as well as operating in a socially and environmentally responsible manner. To attract such quality FDI, host countries need mindfully tailored policies. Recent research offers evidence for strategies in developing countries that successfully turned FDI into such quality FDI.

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Overview

For any reasonable analysis of the impact of foreign direct investment on emerging market economies, FDI flows must be divided into at least five separate industry segments, each with distinctive policy and regulatory challenges. These include foreign investment in extractive industries, foreign investment in lowest-skill, lowest-wage manufacturing industries (“sweatshop industries”), foreign investment in middle-skill, middle-wage manufacturing industries, foreign investment in infrastructure, and the understudied field of foreign investment in service industries.

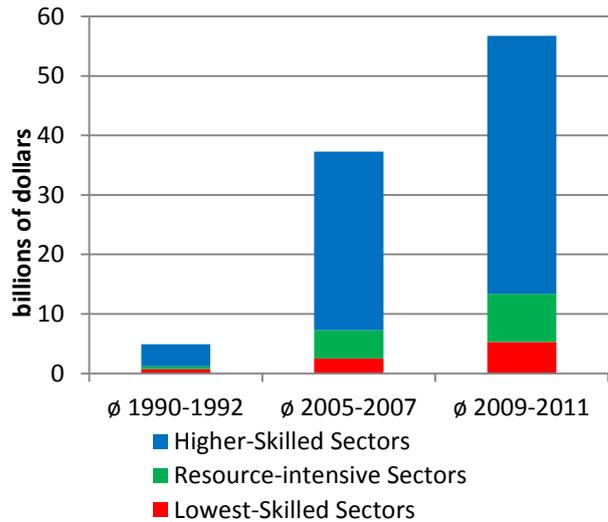
Each form of FDI presents such particular kinds of policy challenges for developing-country host authorities, and generates such diverse impacts on the developing host economy, as to undermine the usefulness of any assessment that does not disaggregate the FDI flows. For example:

- Does FDI in the extractive sector generate substantial government revenues that are managed in a fiscally sound manner (no “Dutch disease”) with reasonable transparency and lack of corruption (no “resource curse”)?
- Does FDI in infrastructure provide reliable electricity, water, and other services to businesses and households with appropriate sharing of foreign exchange risk and demand-fluctuation risk?
- Does FDI in lowest-skill manufacturing subject workers to dangerous health and safety standards, or not, while decreasing or increasing their economic and social agency?
- Does FDI in services crowd “in” or crowd “out” indigenous investment in services, and which outcome is more beneficial for host-country development?

This paper concentrates on FDI in middle- and higher-skilled supply chains such as automotive clusters, electronics clusters, industrial and medical products and the like. The question is under what conditions can FDI in middle- and higher-skill efficiency-seeking manufacturing upgrade and diversify the host production and export base, while generating backward linkages and vertical spillovers?

While popular opinion often pictures manufacturing FDI flowing in search of lowest-wage, lowest-skilled activities in emerging markets, the data show that FDI in developing countries increasingly flows to medium to high-skilled manufacturing sectors rather than to resource-intensive and

Figure 1: Manufacturing FDI Flows to Developing Countries



Source: UNCTAD 2014

low-skilled sectors (Figure 1). And as skill levels needed by FDI increase so do wage levels (ILO 2007, Coniglio et al. 2015). Survey data from FDI in industry sectors such as autos and auto equipment, electronics, chemicals, and industrial equipment -- in comparison to garments and footwear -- show that foreign investors in higher-skilled activities pay their workers *two to three times as much for basic production jobs*, and perhaps *ten times as much for technical and supervisor positions*, in comparison to what is earned by employees in comparable positions in lower-skilled MNC operations.

These FDI flows to middle-skilled manufacturing industries might be called “Quality FDI” that contributes to the creation of decent and value-adding jobs, enhancing the skill base of host economies, facilitating transfer of technology, knowledge and know-how, boosting competitiveness of domestic firms and enabling their access to markets, as well as operating in a socially and environmentally responsible manner. To achieve this, host countries cannot just wait and see what international market forces may bring to them. Rather, they need tailored policies to overcome domestic imperfections that hinder a smooth integration of indigenous and foreign firms into world-wide supply-chain networks. Recent research offers evidence for strategies in developing countries that successfully turned FDI into such quality FDI. The idea underlying the following suggestions is to learn the lessons from past experience.¹

The suggestions

1. **Open up markets and allow for FDI inflows.** Reduce restrictions on FDI. Provide open, transparent and dependable conditions for all kinds of firms, whether foreign or domestic, including: ease of doing business, access to imports, relatively flexible labour markets and protection of intellectual property rights.
2. **Set up an Investment Promotion Agency (IPA).** A successful IPA could target suitable foreign investors and could then become the link between them and the domestic economy. On the one side, it should act as a one-stop shop for the requirements such investors demand from the host country. On the other side, it should act as a catalyzer to the host’s domestic economy prompting it to provide the top notch infrastructure and the ready access to skilled workers, technicians, engineers and managers that may be required to attract such investors.² Moreover, it should engage in after-investment care, acknowledging the demonstration effects from satisfied investors, the potential for reinvestments, and the potential for cluster-development as a result of follow-up investments.

¹ For more detail and background see Moran et al. (2016).

² See, e.g., case studies on the State Development Committee (PDC) of Penang in Malaysia, on the Costa Rican Investment Promotion Agency (CINDE) and on the Motor Industry Development Programme (MIDP) in South Africa (Moran 2014, Barnes et al. 2015). See also Harding and Javorcig (2012) who find that in developing countries targeted sectors receive more as twice as much FDI as non-targeted sectors.

3. **Think carefully about sectors / activities to be targeted.** Investment / location decisions of suppliers may be dependent on those of prime multinational investor into the host economy.³
4. **Put up the infrastructure required for a quality investor:** such as sufficient close-by transport facilities (airport, ports), adequate and reliable supply of energy; provision of adequately skilled workforce, facilities for the vocational training of specialized workers, advisably to be designed in cooperation with the investor.⁴
5. **Strengthen backward linkages from FDI to the indigenous economy.** Allow for the competitive pressure of foreign entrants on their local suppliers in order to raise competitiveness of the latter,⁵ and allow for multiple forms of direct assistance from foreign to domestic firms, in the form of training, help with setting up production lines, management coaching regarding strategy and financial planning, financing, assistance with quality control and introduction to export markets.⁶
6. **Encourage spillovers from FDI to the indigenous economy.** Local firms set up by managers who had started in multinational firms are more successful and more productive than others.⁷ Managers of local firms gain knowledge on new technologies and marketing techniques by studying and imitating their multinational competitors.⁸ Similarly, worker movements from multinational to local firms spread knowledge and skills.
7. **Encourage first-time foreign direct investors.** Foreign firms that are not already part of an extensive network of subsidiaries are more ready to accept linkages to domestic suppliers.⁹
8. **Encourage foreign direct investors from diaspora members.** These are also more likely to generate linkages to domestic firms and contribute to the internationalization of the host country.¹⁰
9. **Provide for access to credit;** reform domestic financial markets. Setting-up a business-friendly financial system helps indigenous firms to respond to challenges

³ See case studies of the Indian automotive market (McKinsey 2001) and of Wal-Mart entering Mexico (Javorcik et al. 2006).

⁴ Same sources as before.

⁵ See, e.g., a case study of Mauritius (Rhee et al. 1990).

⁶ See Javorcik and Spatareanu (2005), Blalock and Gertler (2008), Godart and Görg (2013), Görg and Seric (2016).

⁷ See case study of Ghana (Görg and Strobl 2005).

⁸ See case studies of Czech Republic and Latvia (Javorcik and Spatareanu 2005) and of 19 sub-Saharan African countries (Boly et al. 2015).

⁹ See Amendolagine et al. (2015).

¹⁰ See Boly et al. (2014).

and impulses from foreign entrants, to self-select into supplier status, and to thereby grow and prosper.¹¹

10. **Set up a vendor development program to support the match making process between foreign customer and local supplier.** To strengthen the capacity of the domestic economy, it may offer financing opportunities to indigenous suppliers for required investment on the basis of purchase contracts from foreign buyers;¹² or reimburse the salary of a manager in a foreign plant acting as a talent scout among domestic suppliers.¹³
11. **Shape Export Processing Zones (EPZ) in a way that they spearhead into the domestic economy.** Avoid EPZ regulations discriminating against creation of local supplier relationships. Set up a secondary industrial zone for local suppliers, be it as a geographical site adjacent to formal export processing zones or be it as a legal status allowing for easy foreign-domestic linkages, with, e.g., databanks and “marriage counselors” to assist in supplier selection.¹⁴
12. **Refocus the “Who Is Us?” perspective and address related concerns adequately.** “Us” should be understood as the firms that are most beneficial to the domestic economy irrespective of the nationality of their owners, i.e., the firms that create the highest-skilled and highest-paying jobs, the least-expensive products and the most competitive exports.¹⁵
13. **Be patient and rely on the gradual structural transformation of the domestic economy.** Investors may come in waves, e.g., first, investors in thermionic tubes, valves and transistors, then, in television and broadcasting systems, and finally, in computers, computer peripherals, and data processing systems. Along such avenues, FDI may contribute to diversifying and upgrading domestic production.¹⁶

Notes of caution

1. **Do not insist that all inward FDI be at the most sophisticated technical level.** International firms with middle-level technology can provide benefits and connect up with local suppliers whose capabilities match the foreign firms more closely.¹⁷

¹¹ See Alfaro et al. (2009).

¹² See the the Local Industry Upgrading Program (LIUP) of Singapore.

¹³ See the example of the Singapore’s Economic Development Board (EDB).

¹⁴ See cases of Malaysia versus Mauritius (Moran et al., 2016).

¹⁵ See the argument about pros and cons of Japanese investment in the United States (Reich 1990).

¹⁶ See Amendolagine et al. (2013), and the afore-mentioned case studies of Malaysia, Costa Rica and South Africa (Moran 2014, Barnes et al. 2015).

¹⁷ See Boly et al. (2015), Pérez-Villar and Seric (2015).

2. **Do not confound supply-chain creation with support for SMEs.** Medium-sized and larger indigenous companies are often more apt to link with foreign investors in win-win scenarios than their smaller counterparts.¹⁸
3. **Do not subsidize specific companies.** Public support should take the more general form of creating reliable infrastructure and offering specific vocational training.

The role of external donors and developed countries

1. **There is still a vital role for external donors such as developed countries and multilateral financial institutions in supporting developing countries.** The explosion of international private sector investment flows has not eliminated the need to support growth-and-development programs in developing countries, even beyond emergency aid and pure poverty reduction programs.
2. **Developed countries should improve the functioning of financial markets worldwide,** to enable developing countries harness their FDI. For instance, better financial market institutions even in FDI source countries help overcoming deficient financial markets in host countries, thus increasing FDI flows to developing countries.¹⁹
3. **Developed countries should intensify support for effective FDI promotion of developing countries.** Targeting large investors pro-actively in particular sectors requires specific and expensive expertise on the side of the Investment Promotion Agencies, with a professional staff to be paid at internationally competitive salaries, the costs of which could be borne by external donors. Moreover, developing countries need help in learning how to use IPAs effectively for marketing their countries to multinational investors.

Concluding remarks

The essence of the suggestions is to advocate a light form of industrial policy: a policy that seeks to hitch FDI to development goals and to generate backward linkages as deep as possible into the host economy. The evidence cited here shows that progress in developing countries can be achieved without either substantial levels of protection or large amounts of direct support.

Sometimes there is concern that FDI in lowest-skilled assembly activities may constitute a race-to-the-bottom in poor working conditions. But the effort to use FDI to upgrade and diversify the export profile of host developing countries in middle- and

¹⁸ See UNCTAD (2011).

¹⁹ See Görg and Kersting (forthcoming), Donaubaauer et al. (2016).

higher-skilled manufacturing leads to a *race-to-the-top* in launching host country regulatory reforms, raising host country doing-business indicators, creating public-private partnerships for vocational training, and improving physical and IT infrastructure.

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