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BUILDING PRODUCTIVE CAPACITIES IN DEVELOPING COUNTRIES

Note by the UNCTAD secretariat*

Executive summary

Ongoing reforms in developing countries have not always yielded expected benefits in terms of successful integration into the global economy. Enterprises in many developing countries are often unable to respond to emerging opportunities. As a result, it is now widely recognized that benefiting from globalization requires a complementary set of capacity-building policies to address the supply-side constraints faced by local firms. Overcoming such constraints involves sustained development efforts and enhanced official development assistance (ODA). At the same time, foreign direct investment (FDI) can contribute to productive capacity development when combined with policies promoting productive investment, technology transfer, enterprise development and the consolidation of productive chains. This note identifies policies to strengthen the contribution of FDI to capacity building, and underlines the need to enhance the linkage between ODA and FDI.

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INTRODUCTION

1. Globalization brings both opportunities and challenges for developing countries. Some countries have done well in building competitive advantages and integrating into the global economy, but many others, particularly LDCs,[1] have had difficulty in attracting foreign investors and responding to opportunities in export markets, in spite of ongoing liberalization of trade and capital flows both at home and abroad. There is need for complementary measures.

2. Policy changes concerning foreign direct investment (FDI) have been unprecedented in scale. According to UNCTAD's annual surveys for the *World Investment Report*, since 1991 Governments have enacted over 2,000 policy measures designed to make their economies more attractive to foreign investors, compared with only 150 more restrictive measures. Investment authorities formerly charged with screening investors and imposing performance requirements have often evolved into investment promotion agencies. Governments have also signed 2,392 bilateral investment treaties, 2,559 double taxation treaties and 212 other international investment agreements. As a result, foreign investors generally enjoy roughly the same treatment wherever they invest.

3. These policy changes have had an impact on FDI flows: developing country inflows as a share of GDP have been three times as high over the past decade as they were in the previous two decades. As a share of global flows, however, the improvement is less than one would expect given the relatively greater liberalization which has occurred in developing countries. The share of FDI stock for the least developed countries (LDCs) remains at one per cent of the global total, although in relative terms FDI plays a more significant role.[2] Even more than the quantity of FDI flowing to developing countries, there are concerns about its quality and the related issue of its sustainability. While the reasons for this disappointment are complex and sometimes country-specific, it is now generally recognized that a lack of supply-side capacity in developing countries is a crucial factor.

4. Against this background, and as decided at UNCTAD XI (São Paulo, 2004), a key objective of UNCTAD's work "is to assist developing countries, in particular LDCs, to design and implement active policies for building productive capacity and international competitiveness, based on an integrated treatment of investment, corporate responsibility, technology transfer and innovation, enterprise development and business facilitation (including transportation and ICT), competitiveness, diversification and export capacity, to sustain a high level of growth and promote sustainable development" (TD/412, São Paulo Consensus, para. 49). This note focuses on the investment, technology and enterprise aspects of capacity building. Other aspects, particularly logistics services, trade and transport facilitation and ICT applications, are taken up in separate UNCTAD Expert Meetings (13 July 2006 and 16-18 October 2006).

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[1] UNCTAD (forthcoming), *The Least Developed Countries Report 2006: Developing Productive Capacities*.
[2] The share of LDCs' FDI stock as a percentage of GDP was 24 per cent in 2004.

I. SUPPLY-SIDE CAPACITY CONSTRAINTS

5. Many developing countries find themselves uncompetitive in the industries in which they may otherwise have comparative advantage; production costs are high, product quality is low, and delivery to market is slow and unpredictable. The core problem is often not in the enterprise but in the economy. The challenge is to raise total factor productivity, which means an approach that goes beyond raising productivity in individual enterprises or industries, and rather addresses the broader and more comprehensive task of raising productivity at the country level. There is need for capacity building and policies that make the economy as a whole a competitive location for production, and enable all enterprises in the economy to contest world markets on a par with firms from more developed economies.

6. Supply-side capacity constraints are economy-wide impediments faced by firms to respond to market demands, innovate, increase productivity and be competitive in domestic and foreign markets. Supply-side capacity constraints reflect the overall underdevelopment of an economy and manifest themselves in various forms:

- Inadequate regulatory environment (i.e. laws, regulations, agencies);
- Weak public sector institutions (e.g. education, training, technology support);
- Small private sector (i.e. shortage of entrepreneurs and skilled professionals, particularly in banking and supplier services);
- Limited resource base (i.e. human, financial);
- Poor and inefficient infrastructure (i.e. roads, ports, utilities, telecommunications).

7. Tackling these supply capacity constraints requires capacity building across a wide range of areas. For example, with respect to trade there is a need for appropriate support for trade policy formulation at the national level, as well as for effective participation in the WTO (including in relation to accession, where appropriate) and bilateral and regional agreements**.** There is also need for complementary institution building, particularly the establishment of efficient procedures and institutions for import/export, insurance, payments, customs clearance and, for a number of landlocked countries, transit arrangements. There is further need to build up the transport network, namely roads, railways, air, sea and inland ports, and pipelines. While building hard infrastructure may entail major expenditure, building soft infrastructure (policies, procedures and institutions) is often more difficult.

8. Similarly, with respect to investment, there is need for appropriate capacity building support for formulation of an attractive policy framework and an excellent regulatory environment, and the establishment of efficient institutions for investment promotion. In countries where the domestic private sector is small (and characterized by a high share of firms operating in the informal economy), there is need for programmes for entrepreneurship development and enterprise support.[3] In most countries, there is need for human resource development and dynamic national systems of innovation linking institutions of science and

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[3] UNCTAD (2005). Expert Meeting on Enhancing Productive Capacity of Developing Country Firms through Internationalization, 5-7 December 2005, Chairpersons Summary (TD/B/COM.3/EM.26/3), and OECD (2006). SME Survey Glossary on " Removing Barriers to International Markets". http://www.oecd.org/dataoecd/47/54/35772896.pdf (3 July 2006).

technology with the productive sector. Of course, infrastructure, particularly reliable power supply, is essential for productive activity.

A. Regulatory environment

9. Building productive capacity ultimately depends on investment by private enterprises, including foreign firms, and their ability and willingness to do so is in large part a function of the regulatory environment in which they operate.

10. The UNCTAD Investment Policy Reviews of over 20 developing countries suggest that specific FDI regulations (i.e. rules governing entry and admission of foreign investors and the standards of treatment for foreign affiliates) have increasingly become a less important impediment to FDI inflow, reflecting the overall trend of liberalization of FDI regimes across developing countries. At the same time, a pervasive impediment is the set of general operating measures affecting all business, including FDI (but not designed explicitly for foreign investors). Thus, cases of poor or discriminatory treatment of foreign investors are now less frequent. But this is less often the case for the general regulatory environment and government administration of business regulation. The range of general standards and policies which impinge on investment activity is illustrated in table 1.

Table 1. General standards and policies which influence investor behaviour

Policy area	Constraints
Fiscal	Uncompetitive high tax regime with significant interpretation difficulties. Inadequate tax treaty network.
Revenue administration	Widespread avoidance, arbitrary and/or corrupt assessment.
Exchange control	Volatile, access difficult. Non-market exchange rates.
Land and labour	Rigid anti-market controls with uncompetitive statutory requirements. Land titles not fully bankable.
Competition policy	Pervasive private and public monopoly.
Expatriate work and residence permits	Severe labour market tests. Arbitrary and unpredictable treatment.
Sectoral regulation	Uncompetitive rules or uncertainties for investors as to rights or obligations.
Intellectual property protection	Poor legal regime and/or widespread abuse.
Environmental regulation	Inadequate legal guidance to investors on obligations and liabilities.
Corporate governance and accounting standards	Substantial gaps and uncertainties.
Rule of law	Slow or unpredictable commercial justice system. Insecure legal and personal environment.

Source: UNCTAD, "Effectiveness of foreign direct investment policy measures" **(**TD/B/COM.2/EM.13/2), 22 April 2003**.**

11. Although Governments have adopted more business-friendly investment policies, the day-to-day implementation of policies and practices can discourage investors. In particular, weak capacity to administer laws and regulations in a transparent and predictable manner is often at the core of governance problems. There appears to be general awareness and acceptance of the problem: one indicator is high degree of acceptance by Governments of the recommendations of the UNCTAD Investment Policy Reviews. At the same time, it is acknowledged that solutions require long-term institutional capacity building. The experience

of the UNCTAD programme on Good Governance in Investment Promotion (GGIP) suggests the usefulness and cost-effectiveness of e-regulations and client charters (a best practice pioneered in Asia) to improve the functioning and service-orientation of institutions. Investment promotion agencies can also play an important policy advocacy role within government, a topic to be taken up in a separate UNCTAD Expert Meeting to be held in Geneva on 23–24 November 2006.

12. Enforceable property rights, an independent judiciary, an active competition policy and adequate regulation all contribute to an environment where firms can feel confident about the policy regime in place. In contrast, complex rules applied in a non-transparent manner allow greater scope for the exercise of discretionary power by the civil service. The World Bank Investment Climate Assessments and Doing Business Reports list bureaucracy and red tape as two of the most important obstacles to investment in many countries.

13. An active competition policy, regulation and authority are important for the success of privatization programmes and strategies to shift productive activity from the public to the private sector. UNCTAD has a programme of policy advice and capacity building in this area and supports the Intergovernmental Group of Experts on Competition Law and Policy, which provides a forum for the exchange of experiences and the conduct of voluntary country peer reviews of competition policy, complementary to the UNCTAD Investment Policy Reviews.

14. A robust private sector financial reporting system is also important for an efficient functioning of markets. Small and medium-sized enterprises (SMEs) are denied access to credit due to lack of reliable financial statements that banks and other credit institutions require them to present as part of loan applications. Larger enterprises that provide potential investors, domestic as well as international, with reliable and globally comparable financial reports gain a competitive advantage in attracting investment. Thus, strengthening the institutional as well as technical aspects of the private sector financial reporting infrastructure — such as accounting and auditing standards — should form an integral part of productive capacity building strategy. The Intergovernmental Working Group of Experts on International Accounting and Reporting Standards (ISAR) at UNCTAD has been providing a suitable forum for member States to deliberate and develop consensus on strengthening their corporate reporting infrastructure, including through capacity building through technical cooperation projects.

15. A sound national insurance and reinsurance market is essential for investment and trade activity, but many developing countries lack diversified insurance products and regulatory capacity. UNCTAD provides assistance to countries to develop the requisite insurance legislation and regulatory authority. In addition, accession of countries to the WTO and participation in the GATS negotiations has led to requests to assist countries in the formulation of national insurance policies.

16. At the regional level, the New Partnership for Africa's Development (NEPAD) introduced the Investment Climate Facility for Africa, which is a new private-public partnership focused on improving the continent's investment climate. It aims to make Africa a better place to do business by removing obstacles to domestic and foreign investment and by promoting Africa as an attractive investment destination. It is supported by NEPAD and endorsed by African Heads of State. The ICF is an independent trust with strong African representation on the Board of Trustees. It is managed according to business principles.

NEPAD also introduced a peer review mechanism to support investment regulatory frameworks reforms in Africa.

B. Absorptive capacity

17. Even relatively advanced developing countries with a growing manufacturing base have difficulties in exploiting new export opportunities, in assimilating technology transfer and in capturing the spillovers from subcontracting and related trade and investment linkages. At the enterprise level, absorptive capacity is strongly dependent on interactions with the firm's environment, e.g. the availability of educated persons with management and engineering skills, the quality of basic public services and advanced infrastructure (universities, diversified financial sector, specialized research an training institutions, etc.) and the underlying incentive system of the institutions involved. In LDCs, the private sector may be small and embryonic, and some of the core support institutions may not exist. Improving absorptive capacity consequently entails efforts across a wide range of areas, from entrepreneurship and enterprise development to technology and education policy.

18. Educational policy is a centrepiece of all strategies to increase absorptive capacity. The case of India's success in the IT industry (and, increasingly, other high-tech sectors like biotechnology) has been driven largely by targeted educational policies. Investments in management capabilities are probably as important as those in technological skills. TNCs in India and Malaysia, for example, have little difficulty in recruiting excellent managers and engineers.

19. Market-oriented intermediaries, such as business development services (BDS), are important. The expansion of developing country firms is hampered by numerous internal obstacles within firms themselves, including a lack of entrepreneurial and management skills, limited access to and high cost of financing, the absence of business development support services, and difficulty in obtaining information on market opportunities.[4] Availability of finance is identified in many business surveys as the most important factor determining the survival rate of firms in both developed and developing countries. After that, there is need for BDS, including training consulting, technical and managerial assistance, marketing, physical infrastructure and policy advocacy.

20. In view of the importance of stimulating the creation and strengthening of entrepreneurs in developing countries and of moving from the informal to the formal economy, there are many national and donor-driven SME programmes. The most effective programmes are part of a holistic and coherent policy framework that takes into account the complementary roles of the Government, the private sector and the donor community. This holistic approach aims to develop horizontal policies to set up a business-enabling environment and a positive investment climate.

C. Infrastructure

21. Weak infrastructure raises the cost of doing business. Lack of roads, inadequate port facilities and poor telecommunications networks add to logistical problems and also hamper the ability of firms to follow demand conditions in distant markets. The detrimental effects of poor infrastructure on production costs, transport costs, exports, poverty alleviation and

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[4] UNCTAD (2005). *Improving the competitiveness of SMEs through enhancing productive capacity* (UNCTAD/ITE/TEB/2005/1).

development more generally have been well documented.[5] They are aggravated in landlocked and post-conflict countries. For example, an UNCTAD study on landlocked countries found that "on average [landlocked developing countries] spend almost two times more as a percentage of their export earnings for transport (and insurance services) than the average spent by developing countries in general, and three times more than the average spent by developed countries".[6] In parts of Africa, it is more costly to trade goods with neighbours than with Europe.

22. Foreign direct investment can contribute to infrastructure development. However, this requires opening up sectors to FDI – power, transport, banking, insurance. Where this has happened, FDI has been forthcoming for power generation, telecommunications and the development and management of ports. Private investment in infrastructure has been facilitated by public-private partnerships (PPPs) and by complementary public investment and official development assistance (ODA).

23. Almost half of all FDI in infrastructure in the past decade was in telecommunications. It was attracted by policy liberalization, in particular privatization of state-owned enterprises. Successful investments were accompanied by government measures to introduce competition in telecommunication services and the creation of independent regulatory agencies. South-South investment has been important in infrastructure development.

24. Privatization and various forms of PPPs were intended to relieve Governments of financial and institutional constraints in building infrastructure capacity and providing infrastructure services. In many cases, private participation has been accompanied by substantial improvements in both service and access. In spite of considerable initial interest, however, PPPs in infrastructure are now well below their 1997 peak in value terms. Experience of over two decades of PPPs suggests that many "infrastructure projects are either not commercially viable at all, or not profitable unless they charge fees which severely inhibit universal access".[7]

25. Experience has also demonstrated that while private participation can relieve Governments of major capital expenditures, it also places increasing demands on the institutional capacity of Governments to regulate the sector, monitor the performance of private partners concerning their contractual commitments, and establish an effective competition authority. An appropriate and well-functioning regulatory environment in infrastructure can help mobilize local and foreign investment.

26. Aside from regulatory and privatization-based issues, competitiveness benchmarking is required to ensure that infrastructure projects will be most effective in reducing capacity constraints. The Kenyan IPR recommends benchmarking each backbone service against the quality and cost of such services in the strongest regional competitor (South Africa), establishing targets relative to the benchmark and giving priority to investors' needs.

27. Building or rebuilding infrastructure is a long-term development goal to be financed by a combination of public funds, private investors and the donor community. Recent

[5] World Bank (2003). *Private Participation in Infrastructure in Developing Countries: Trends, Impacts, and Policy Lessons*.
[6] UNCTAD (2003). *FDI in Landlocked Developing Countries at a Glance*, p. 2.
[7] Stiglitz and Charlton (2006). *Aid for Trade: A report for the Commonwealth Secretariat*, p. 26.

initiatives include the proposal to establish an Africa Infrastructure Fund and an international infrastructure consortium.

28. Improvement of soft infrastructure can be cost-effective and speedy with the application of information technology (IT). For example, low-cost IT-based management systems developed by UNCTAD to facilitate trade and transport include ASYCUDA (Automated System for Customs Data) and ACIS (Advance Cargo Information System). Other types of soft infrastructure support include assistance in the negotiation of transit trade agreements in Central Asia and Africa, and UNCTAD's assistance to establish and maintain the regional Motor Transport Agreements in West Africa and the COMESA region of East Africa, which enable significant interregional trade. Programmes to eliminate the soft barriers to regional trade and investment and promote regional cooperation, such as the Silk Road Initiative for Central Asia, can help create the large markets critical to attract investment in hard infrastructure.

29. Technological infrastructure is relevant for enterprise competitiveness. Examples include business incubators, industrial and S&T parks, and productivity centres. Every stage of an infrastructure project, from planning through maintenance, involves assessing and applying a wide range of technologies and management techniques, and therefore has potential for incorporating learning and capacity-building components.

30. Countries emerging from civil strife or conflict situations face particularly acute constraints in rebuilding institutional capacity and infrastructure. While investments have often been quick to resume in areas where payoffs can be relatively quick (e.g. mobile phone services focused on urban areas), the main challenge for post-conflict countries is to attract sustainable investment. Domestic political and social factors are the prime elements in rebuilding institutions and entrenching peace and stability, but investment can play a role as well. For example, the introduction of corporate social responsibility principles and employment practices that avoid tensions between groups is important. The UNDP and UNCTAD Invest in Peace Initiative was designed to promote investment as a tool to entrench peace and stability in post-conflict countries. The Rwanda IPR, for example, suggests ways to rebuild human capital, which was heavily affected by the genocide in 1994.

II. POTENTIAL OF FDI IN BUILDING PRODUCTIVE CAPACITY

31. UNCTAD XI highlighted the role of investment, including FDI, in building national supply capacities that are both central to development and essential to exploit opportunities offered by the multilateral trading system.[8] Paragraph 37 states: "Foreign direct investment (FDI) offers the potential to utilize foreign savings and to transfer knowledge and technology, upgrade human resources, boost entrepreneurship, introduce new production and management techniques and stimulate enterprise learning through linkages between foreign affiliates and domestic enterprises". However, policies directed to attracting FDI should complement efforts to build domestic capabilities and improve the general investment climate, creating a foundation for a vibrant domestic private sector.

[8] São Paulo Consensus (TD/412), annex on multi-stakeholder partnerships.

A. Export competitiveness through FDI

32. Building productive capacity encourages trade and investment which, in turn, contribute to the process whereby that capacity is developed. Internationalization helps to build capacity, whether it involves exports, outward investment or links with foreign investors in the local economy. "Exporting feeds back into the capacities that underlie competitiveness: it exposes enterprises to higher standards, provides them with opportunities for easier access to information and subjects them to greater competitive pressures, thereby encouraging domestic enterprises to make more vigorous efforts to acquire new skills and capabilities."[9] Exports also provide for economies of scale for relatively small home markets in many developing countries.

33. However, as the experience of many developing countries has shown, encouraging exports and promoting inward and outward investment will not necessarily by themselves bring about sustainable capacity improvements. Nevertheless, together with government policies which attack the broad problem of weak capacity and which provide targeted support for the internationalization of local firms, they can provide a strong impetus to local firms to improve competitiveness.

34. Part of the export growth of successful developing countries has been based on better exploitation of existing advantages (natural resources, lower costs), while part has relied on creation of new advantages (skills, technological capabilities, etc). The development of export competitiveness may require investment in capabilities of various kinds: procurement, production, engineering, design, marketing and so on. TNCs may play an important role in building these capabilities. Not only are TNCs involved, directly and indirectly, in two thirds of world trade, including both intra-firm and third party transactions, but "all the signs are that the export role of TNCs in host countries, through both FDI and non-equity arrangements, will grow further".[10] TNCs contribute to host country exports both by establishing affiliates tied to international production networks and through contractual arrangements with local suppliers, which go beyond traditional arm's-length relationships. Even for basic commodities, such as coffee, cocoa, tobacco or tea, TNCs tend to control marketing, transport and distribution.

35. The role of TNCs in global trade is not just a result of outsourcing by parent firms in order to supply the home market more cheaply. Under the African Growth and Opportunity Act (AGOA), which affords duty-free access to the United States market for most African products, textile and garment firms from Asia have invested in Africa to export to the United States. Indeed, most of the rapid increase in exports under AGOA from the relatively few African countries which have taken advantage of preferential access have come about through FDI by TNCs. The prominent role of TNCs in world trade defines in part the nature of the challenge facing developing countries as they seek to build productive capacity and improve export competitiveness.

36. Foreign investors can help to overcome barriers to exports. TNCs often engage in a range of supplier development activities, including assistance with product design, component sourcing, inventory management, testing, packaging and outbound logistics.

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[9] UNCTAD (2002). *World Investment Report: Transnational Corporations and Export Competitiveness, p.xx.*
[10] UNCTAD (2002). *World Investment Report: Transnational Corporations and Export Competitiveness*, p. 118.

Through its affiliates in LDCs, a TNC can help suppliers with financing and provide technology. Through partnerships with foreign investors or TNC customers, developing countries can overcome non-tariff barriers in the form of phytosanitary and sanitary standards, as seen with certain agricultural and horticultural exports from Africa. TNCs, through their corporate social responsibility programmes, can also assist suppliers in meeting legal requirements and consumer demands by providing guidance on improving environmental management and labour practices. These supplier development activities have been documented in successful Asian export economies.[11]

37. Export-led development is not just a question of expanding total exports. It also involves diversifying exports both by product and by market and upgrading the technological and skill content of export activity in order to increase domestic value added and thereby national income. Export growth based on TNCs is not necessarily evidence of rising export competitiveness. If TNC-based export production is not accompanied by improvements in domestic firms' supply capacity, there is always a risk that those exports will disappear if the TNC leaves. Horticultural exports from Senegal, for example, declined 80 per cent after the investor who had developed them left.[12] This risk is particularly acute when the investment is undertaken to take advantage of timebound preferential access as under AGOA. Anecdotal evidence suggests that some investors are already scaling down operations in anticipation of the end of liberal rules of origin under AGOA after 2007.[13]

38. The sometimes ephemeral nature of certain TNC exports means that lasting improvements to host country export competitiveness will only come about through strategic investment promotion, involving targeting FDI and a commitment to maintain the position as a prime location for investment and to retain existing investors while moving up the value chain. To ensure sustained progress, domestic firms must participate in this process. To this end, UNCTAD helped prepare investor-targeting strategies in Kenya and Peru, aimed at strengthening the investment promotion agencies and their interaction with stakeholders. The development of linkages between the foreign affiliate and local firms is also of paramount importance.

B. Linkages

39. Linkages arise when foreign affiliates of TNCs form relationships with local firms that go beyond those of traditional arm's-length suppliers. They include backward linkages with suppliers, linkages with technology partners, forward linkages with customers and other spillover effects. Strict requirements on quality and delivery times imply that the TNC affiliate must often work closely with local suppliers by providing training, quality control management, technology transfers and even financial assistance. In the best of cases, "[a] dense network of linkages can promote production efficiency, productivity growth, technological and managerial capabilities and market diversification for the firms involved…[which] can in turn lead to spillovers to the rest of the host economy and contribute to a vibrant enterprise sector".[14]

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[11] World Bank (2005). *World Development Report*, p. 65.
[12] Agarwal, Manhoman and Jozefina Cutura (2004), *Integrated Framework for Trade-Related Technical Assistance*, World Bank Operations Evaluation Department, p. 48.
[13] The *IPR of Kenya* (UNCTAD/ITE/IPC/2005/8, p. 87) cites the example of Sri Lankan apparel companies in Kenya that have made no investment commitment beyond 2007.
[14] UNCTAD (2001), *World Investment Report: Promoting Linkages*, p. xxi.

40. As highlighted by UNCTAD, the existence of linkages between foreign and domestic firms depends on the implementation of policies that increase domestic investment and facilitate technology and skill transfer, giving priority to improving the quality of local suppliers; attracting TNCs whose corporate strategy may lead to local supplier development; and the existence of firms able to meet TNC standards of production. The enabling environment also includes the development of a skilled labour pool through education and training programmes and a continuing public-private sector dialogue on programmes for effective enterprise development. Business associations also have an important role to play in facilitating and enhancing the formulation of linkages.

41. Foreign affiliates participate in linkage programmes when it is technically viable and commercially profitable to do so. A successful programme will benefit both foreign and local firms and contribute to enterprise development more generally. In the past, host Governments relied on more coercive policies to create linkages, such as local content requirements, restrictions on the number of expatriate managers, and even mandatory technology transfer provisions. The approach has in general shifted to working with the private sector, where government policies consist of removing obstacles to greater interaction between foreign and domestic firms. These obstacles include both the "information gap" on the part of both buyers and suppliers about linkage opportunities and the "capability gap" between the requirements of foreign affiliates and the supply capacity of local firms. Experience gleaned from UNCTAD's first-hand experience in assisting countries has been consolidated in a roster of good practices (box 1).

42. The experience of the most successful host economies in terms of promoting linkages demonstrates that TNCs can play a major role in capacity building through programmes developed by the host Government. A number of innovative approaches to creating linkages have been undertaken by TNCs such as Hitachi, Intel, Motorola, Philips, Toyota and Uniliver, to name but a few. These innovative approaches did not spring up spontaneously (UNCTAD, 2005).[15] For example, Singapore's Local Industry Upgrading Programme (LIUP) is generally considered to represent the state of the art in linkage promotion. Foreign firms are encouraged to enter into long-term contacts with local suppliers and to assist them in upgrading their products and processes, for example by seconding TNC staff. In Malaysia, the Government has used a mixture of fiscal incentives to encourage TNCs and training for local firms (for example through the Penang Skills Development Centre).

Box 1. UNCTAD Roster of good practices in developing TNC-SME linkages

- Encouragement, initiation and support of linkage-promoting programmes;
- Support of linkage activities by internal TNC systems;
- Providing funding and access to markets;
- Facilitating access to finance;
- Providing feedback, coaching and mentoring;
- Encouragement of human development;
- Contribution to technology transfer;
- Support of clustering, networking and other forms of cooperation;
- Encouragement of seeding;
- Support of exporters, agricultural producers and gender balance;
- Promoting linkages with non-business entities.

Source: UNCTAD (2006). Business Linkages Programme Guidelines, UNCTAD/ITE/TEB/2005/11.

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[15] UNCTAD (2005). *Improving the Competitiveness of SMEs through enhancing productive capacity*.UNCTAD/ITE/TEB/2005/1.

43. Not all developing countries have been as successful at embedding foreign TNCs into the local economy through linkages. As with trade liberalization, encouraging TNCs to invest will not necessarily by itself bring the benefits of linkages. Several countries have prospered on the back of proactive linkage programmes, but for most others the evidence of linkages from inward investment has often been scarce. Many of the supply constraints that impede local firms' exports also make it difficult for the same firms to sell to foreign affiliates producing for the local markets. These constraints include a lack of financial and administrative resources and poor quality control and inventory management.[16]

44. Reviews of linkage programmes that have not been successful usually identify the lack of support mechanisms to assist potential supply companies to achieve the standards required by the purchasing companies as the prime reason for failure, along with a lack of human resource development and managerial training to work with new technologies and to develop the skills necessary to move into international markets, and insufficient access to financing to make it possible to acquire new capital equipment and training or to expand as required. One of the goals of Empretec, the integrated capacity-building programme of UNCTAD, is to help arrange mutually beneficial links between national and foreign companies. Since 1988, the Empretec programme has enhanced individual entrepreneurial capabilities for over 80,000 entrepreneurs in 26 countries. In general terms, the programme identifies promising entrepreneurs; provides them with training aimed at strengthening their entrepreneurial behaviour and business skills; assists them in accessing beneficial links with larger national and foreign companies; and puts in place long-term support systems to facilitate the growth and internationalization of their ventures (box 2).

Box 2. Features of Empretec centres

EMPRETEC emphasizes the need to establish a one-stop shop, which provides under one roof access to appropriate training and advisory and information services through a small team of highly qualified trainers and business counsellors. The professionally staffed Business Centres (BCs) assist entrepreneurs in developing and implementing their business plans, securing financing, getting their new ventures under way, and most importantly networking and partnering on a national and international level. Furthermore, the BC provides access to networks of local and regional service providers that cover other services not available in the BCs. The Centres have introduced a common Management Information System. According to preliminary results, participants in the programmes have received bank loans, implemented business plans, developed exports and received follow-up support. In Chile, for example, more than half the participants confirmed that they had increased product quality and profitability. In Uruguay, Proex Empretec assisted participating companies to make them export-ready, and 74 per cent of those assisted created an export department.

Source: Empretec Chronicle, 2004.

45. Another programme is Enterprise Africa, a regional initiative of the UNDP Africa Bureau designed to provide a regional framework for facilitating and coordinating private sector support activities in Africa and to increase indigenous African entrepreneurship. For example, Enterprise Uganda, established on the Empretec model, is a hands-on programme established in partnership between the Government, UNCTAD and UNDP to support SMEs to enhance their productivity, growth and competitiveness and to promote linkages with TNCs through supply chain development. In 2005, Kinyara Sugar Works Ltd (KSWL) and

[16] UNCTAD (2001). *World Investment Report: Promoting Linkages*, p. 173.

Enterprise Uganda signed a business linkages deal to support Ugandan sugarcane farmers for 24 months. Under the deal, co-financed by KSWL, assistance will be provided to help with quality improvement, the consistency of supplies, honouring of contracts, corporate governance and business ethics, among others. Enterprise Uganda will also help produce a three-year business plan to consolidate corporate governance and upgrade business and management skills.

C. Technology and skills

46. In a liberalized and open economy, competitiveness increasingly depends on the ability to incorporate new technology and management practices. The ability to acquire, diffuse and master technologies as well as to innovate can be achieved in many ways. One way is by establishing links with TNC innovation networks, thereby enhancing technological capabilities, which in turn will improve the export competitiveness of the host country.

47. As with FDI and linkages more generally, a key determinant of the development impact on a host economy is its absorptive capacity; the quality of local capabilities and institutions becomes a prime determinant of the ability to attract and use foreign resources. The experience of successful developing countries in absorbing technology suggests the following policy approach: "[i]n some form (and to varying degrees), they have actively sought to attract technology, know-how, people and capital from abroad. They have invested strategically in human resources, typically with a strong focus on science and engineering, invested in infrastructure development for R&D (such as science parks, public R&D labs, incubators), used performance requirements and incentives as part of the overall strategy to attract FDI in targeted activities, and strategically implemented [intellectual property rights] protection policies."[17] Intellectual property, investment and related laws are important elements of an enabling framework in key industries, such as pharmaceuticals. UNCTAD is providing advice and capacity building to selected developing countries on how their policies could be structured to take advantage of flexibilities available to them under international treaties and thereby develop local supply capacities in the pharmaceutical sector.

48. FDI can directly increase technology stocks by providing machinery and equipment, as well as technical assistance and know-how. It is an efficient way of transferring technology, since it often involves commitments by the investors in terms of skills, information, and brand name technologies, in additional to capital. However, to enhance the benefits from FDI, it is important to generate interactions with firms in related industries, technology institutes, universities and business development centres. Where information flows are particularly dense, clusters emerge with collective learning in the group as a whole. Governments, business associations, and investment and export promotion agencies can facilitate cluster development.

49. Policy measures to facilitate cluster creation include the establishment of free trade zones, multi-facility economic zones, incubators and technology centres. In Uganda and Kenya, the establishment of a multi-facility economic zone was initiated as a follow-up to the IPR. Technological interactions also occur with other countries. A recent initiative at the multilateral level aims to build a network of centres of excellence, offering greater learning opportunities to participants. In 2005, UNCTAD, in collaboration the United Nations

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[17] UNCTAD (2005). *World Investment Report: Transnational Corporations and the Internationalization of R&D*, p. xxx.

Commission on Science and Technology for Development (CSTD), launched a project designed to select existing outstanding centres of excellence in developing countries and use them as regional hubs of learning that can pool resources with one another and conduct joint research in areas of importance to developing countries.

III. HORIZONTAL AND VERTICAL POLICIES TO BUILD CAPACITY

50. Strengthening domestic supply capacity requires efforts across a wide range of areas that contribute to building an attractive investment environment. Horizontal measures are those that have a bearing on the entire investment climate. As such, they are cross-sectoral and affect all investors in a non-selective manner. They relate in particular to taxation, infrastructure, red tape reduction, labour and skills development, intellectual property protection, competition policy, finance, private sector development and other measures that impact the overall competitiveness of an economy. Vertical measures, on the other hand, target individual industries, groups of industries or even individual firms.

51. The rewards of these long-term reforms may materialize years after they have taken place. The recent strategy adopted by the Government of Ghana concerning productive capacity building demonstrates the breadth of issues that must be covered in order to improve domestic capacities. This strategy has been developed by the Government of Ghana in partnership with stakeholders, including the donor community. Aid has been pooled in one basket fund, which has facilitated strategy implementation and monitoring (box 3).

Box 3. The Government of Ghana's supply-capacity-building project

According to the Government of Ghana, export-led and domestic-market-led industrialization depends primarily on developing supply capacity. It is therefore imperative for Ghana to develop sufficient and competitive production capacity to take advantage of market access opportunities. The policy prescriptions developed by the Ministry of Trade include: providing a stable macroeconomic environment; promoting strategic investment projects (for both foreign and domestic firms); facilitating access to credit; supporting strategic sectors; encouraging the establishment of credit reference agencies; identifying and promoting opportunities for economically beneficial linkages along production and supply chains in new and existing productive sectors; establishing serviced industrial and agricultural estates; simplifying land acquisition and assuring security of land tenure; providing well-maintained and competitively priced infrastructure throughout the country; promoting efficient and sustainable energy use; committing substantial resources to technical education and training in response to private sector needs; promoting enhanced management training, including quality assurance and total quality management; encouraging technology improvement through fiscal incentives; and disseminating technical and scientific developments throughout industry.

Source: Ghana Ministry of Trade, Industry and Private Sector Development.

52. Developing countries, especially LDCs, that have embraced horizontal policies and are committed to improved governance are confronted with a huge task but are hindered in their efforts by limited resources and capacity. As shown by Ghana, the effectiveness of horizontal policies is enhanced when there is coordination and stakeholders' participation in policy development and implementation. A result-oriented framework and strong monitoring and evaluation mechanisms are also required.

53. In Colombia, the Compite programme is designed to promote interaction among enterprises, local and national government, trade unions, and civil society in order to build a competitiveness culture. It has developed vertical and horizontal structures comprising: five national committees each focusing on one aspect of competitiveness; regional agreements which examine how sectors can better integrate themselves vertically and how to tackle bottlenecks in the supply chain; provincial councils designed to tackle problems at the local level; an information exchange system on productivity experiences; and a Facilitating Node to coordinate the different parts of the programme.[18]

54. Experience suggests that horizontal measures work best when investors' views and needs are incorporated into the programme. This is particularly relevant for technology policies. Without investors' input, developing countries with a tradition of fostering a strong science base have not always been able to translate this scientific capacity into skills formation, technological change, competitiveness and economic growth. To do so requires a national system of innovation with interactions between key agents in the production system.

55. Several countries for which Investment Policy Reviews were undertaken have a long history of government support for scientific research, such as Tanzania, Egypt and Peru. The IPR of Egypt (p. 14) finds that the country boasts a ready supply of educated and specialized personnel, a network of R&D institutions, some well-focused industrial R&D and a long tradition of government commitment towards, and financial support for, science and technology institutions. But at the same time, in common with both Tanzania and Peru, this scientific base has done little to build the innovative capacity of local firms. Weaknesses include: inefficient management structures; inadequate resources; weak links between R&D institutions and industry; ineffective and non-motivating funding policies; and a relative isolation of science and technology institutions from larger socio-economic activities.

56. In some cases, technology centres, incubators, industrial parks and science parks have been useful policy instruments, especially for developing clusters, promoting collective efficiencies, reducing fixed costs and sharing services. In other cases, the interaction with research institutes and the creation of business service centres has permitted research and other specialized services to concentrate on areas relevant to the cluster economy. For example in Colombia, the technology centres are designed to operate not just as R&D laboratories but as providers of industrial extension services, favouring the acquisition of innovative technologies and providing assistance in marketing and finance. Several policy instruments to promote SMEs have also facilitated SME access to business development services and to finance, as well as access to technology and innovation. Such policies have been particularly effective at the cluster level.

57. Vertical policies apply to particular industries, and according to a recent study by the European Union, generally favour manufacturing.[19] Vertical policies are now evolving into targeting new activities, rewarding entrepreneurs against measurable outcomes, providing support for a predetermined start-up period, and supporting activities in a value chain rather than in specific sectors. For example, the new Industrial Policy of Brazil introduced in 2004 contains a mix of both horizontal and vertical measures. The latter target four innovation-

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[18] UNCTAD (forthcoming). *Investment Policy Review: Colombia*.

[19] Jordi Gual and Sandra Jódar (2006). "Vertical Industrial Policy in the EU: An empirical analysis of the effectiveness of State Aid", paper presented at the European Investment Bank Conference on An Industrial Policy for Europe?, Luxembourg, 19 January 2006.

intensive activities singled out as strategic options (microelectronics, software, pharmaceuticals and capital goods), which will benefit from institutional support in the form of facilitated access to credit and other incentives.

IV. IMPLICATIONS FOR DEVELOPMENT ASSISTANCE

58. To sum up, capacity building touches on almost all areas of development policy and hence requires a multi-faceted approach to development assistance. The growing recognition of the role that trade and FDI can play in building domestic supply capacity, along with the fact that many developing countries are only tangentially linked to the global economy, has led to calls for an enhanced programme of Aid for Trade. By assisting developing countries to benefit from market access abroad, it is hoped that technology flows and other feedback mechanisms will translate into improved competitiveness of local firms. UNCTAD has traditionally played a leading role in providing such trade-related assistance.

59. The notion of Aid for Trade has been proposed as a way of jump-starting the development process by creating a virtuous circle between trade and domestic capacity. The analytical work of UNCTAD on SMEs, linkages and export competitiveness suggests that improvements in capacity can be generated through targeted programmes to support SMEs and by linkages with TNC networks. In essence, domestic sales to TNCs perform the role of exports in terms of building local competitiveness. As a result, any aid directed at building supply capacity for exporting must consider how to encourage further FDI in developing countries and how to foster linkages in order to build supply capacity.

60. Much of the analytical research and technical cooperation undertaken by UNCTAD reflects this holistic view of trade and FDI policies. The recent strategy adopted by Ghana concerning production capacity is imbued with this approach. Its aim is to provide assistance to develop supply capacity to fuel both export-led and domestic-led industrialization. Similarly, UNCTAD's Investment Policy Reviews provide advice that goes beyond a simple assessment of the policy environment for foreign investors, including both policy recommendations and strategic suggestions for investment promotion. The development of domestic industry or service networks that would be able to link effectively with international production networks also requires the promotion of entrepreneurship and enhancing competitiveness at firm level through technology and business linkages. This calls for using ODA more effectively to support developing countries' efforts to undertake a wide range of proactive measures to support an integrated approach to promoting trade and investment for development.

61. Existing mechanisms include the Integrated Framework for Trade-related Technical Assistance, a multi-agency, multi-donor programme to assist LDCs to expand their participation in the global economy, as mandated at the 1996 WTO Singapore Ministerial Conference. As part of this process, the Framework finances diagnostic trade integration studies to examine a country's potential and major bottlenecks hindering improved trade performance. UNCTAD participates in the diagnostic studies, which often also include investment climate assessments.

62. A parallel mechanism in capacity building has been established for Africa under the Joint Integrated Technical Programme to build trade and trade-related capacities. The Programme is implemented jointly by the International Trade Centre, UNCTAD and the

WTO and aims, inter alia, to improve trade policy formulation and the implementation of WTO agreements, strengthen the capabilities of African countries in trade negotiations, and provide reliable technical information on standards and quality.

63. The Group of Eight has committed itself to support investment climate improvements as part of the Africa Action Plan. The Investment Climate Facility of NEPAD was also launched in June 2006 with a seven-year mandate to improve the investment climate throughout Africa. In addition, implementation of the recommendations of the United Kingdom's Commission for Africa would provide a significant boost to capacity building.

Questions for discussion:

- *What are the principal supply-side constraints facing local firms in individual developing countries? What impact have they had on exports and on FDI? What are company experiences and best practices to deal with such constraints?*

- *Which areas of enterprise and investment policy could most benefit from technical assistance in terms of providing an incentive for TNCs to help local firms to build capacity?*

- *What are the implications for development assistance? Can investment be a useful component of Aid for Trade? What role can international organizations play in strengthening local institutions to support supply capacity programmes? Is there scope for South-South cooperation?*

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