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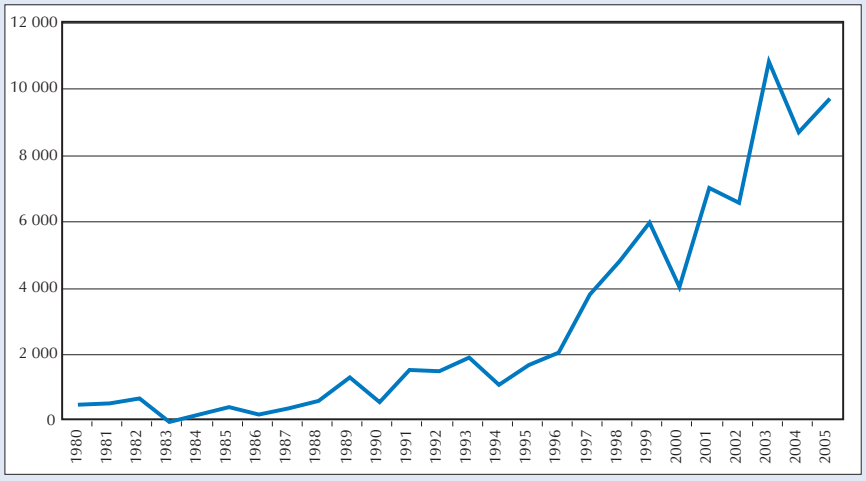
Policy Action is Needed to Leverage more Learning from Foreign Direct Investment

Inflows of foreign direct investment (FDI) into least developed countries (LDCs) have increased markedly since the early 1990s. However, there is little indication that this is helping to close their technology gap with more advanced countries. Over the last two decades the focus in LDCs has been on opening up to FDI in order to reap the benefits of related foreign exchange earnings and job creation. LDCs need to devise policies to leverage more learning benefits from FDI.

Technological catch-up for LDCs requires access to the international knowledge pool, and the ability to learn, master and adapt foreign technologies and thereby benefit from international technology diffusion. It has been argued that one of the main channels for diffusion is FDI. It is generally contended that the arrival of transnational corporations (TNCs) leads to technological upgrading of domestic firms through spillover effects, by means of joint ventures, training, labour mobility, and backward and forward linkages in value chains.

Between 2000 and 2005, annual FDI inflows into LDCs were three times greater than during the preceding decade (see chart). However, this increase has not been accompanied by an increase in innovative capabilities or technological absorption in LDCs. The technology gap between the latter and more advanced countries is as wide as ever. It includes the divide in terms of knowledge, skills and absorptive capacity.

FDI inflows in LDCs, 1980–2005
(Current $ millions)



FDI has the potential to contribute positively to knowledge accumulation in host countries, but realizing that potential is not automatic. Rather, it hinges on a range of conditions, including the type of sector that attracts FDI, the channels through which knowledge is diffused, and the efforts and policies of the host country to harness that knowledge. UNCTAD's research on the sectors most targeted by foreign investors in LDCs indicates that there is little evidence of a significant FDI contribution to technological capability accumulation in those countries, owing to the type of TNC integration into host countries' economies, the sectoral composition of FDI, lack of policy priorities and LDCs' low absorptive capacity.

While data on the sectoral destination of FDI in LDCs are fragmentary, some broad geographical trends can be distinguished. In African LDCs the bulk of FDI is directed to the extraction of oil and other minerals. Asian LDCs most often attract FDI in labour-intensive industries, particularly textile and garment manufacturing. In island LDCs FDI in services is predominant. Mineral extraction industries and textiles and garment manufacturing have

accounted for most of FDI inflows into LDCs over the last 15 years. Those types of FDI have not contributed significantly to the enhancement of technological learning in host countries.

FDI in minerals extraction

Mineral-rich countries, particularly in Africa, have striven since the 1980s to attract larger FDI inflows by radically changing their policies and regulations for the mineral sector. Africa accounted for 66 per cent of total inflows into LDCs in the 1990s, with that share rising to 87 per cent in 2000–2005. The increase is accounted for by a small number of recipients of additional FDI flows. Just four petroleum-producing countries – Angola, Sudan, Equatorial Guinea and Chad – received 56 per cent of all FDI inflows into LDCs during that period.

In African LDCs, typically, the mineral extraction activities of TNCs are capital-intensive, have little impact on employment, are highly concentrated geographically, have high import content and result in exports of their output as unprocessed raw materials. Most of those operations are wholly owned by foreign investors (rather than joint ventures), and a large share of their foreign exchange earnings are not invested in the country. In some cases the arrival of foreign investors displaces small and medium-sized producers to marginal areas, rather than resulting in the establishment of links with them that would permit their technological upgrading. TNC operations tend to function as enclaves. This means that foreign companies are weakly integrated into domestic economies, as they develop few forward and backward linkages in host countries. Some of the main channels for the potential circulation of knowledge between TNCs and domestic firms, namely linkages, joint ventures and labour turnover, are largely absent. The potential of those FDI inflows to contribute to domestic technological capability-building in host countries is therefore very limited.

The changes in mining policy made by African LDCs have neglected wider objectives such as integrating the mining sector into broader developmental objectives, for example through backward and forward linkages or by means of domestic value-added processing of minerals. The goal of generating technology spillovers has generally not been actively pursued, nor has it been an unintended consequence of increased TNC activity.

FDI in low-tech manufacturing

Similarly, Asian LDCs have not been able to leverage much learning from FDI. Their policies have relied extensively on FDI to drive investment, employment and exports in the garment industry, particularly through foreign firms located in export processing zones (EPZs). Governments have focused on liberalizing foreign investment regulation, promoting private enterprise, coordinating investment approvals, facilitating customs procedures and providing basic infrastructure in EPZs to stimulate the growth of the different segments of activities in the value chains.

The surge of FDI inflows into textile and garment manufacturing has caused employment and exports to grow. FDI in garment manufacturing has brought not only capital but also greater access to export markets and links with buyers driving value chains. However, the expansion of TNC activity has not been accompanied by a corresponding development of domestic firms' technological capabilities. This is confirmed by evidence from Bangladesh, Cambodia, the Lao People's Democratic Republic and Myanmar. Local firms have not been able to learn from TNCs and have not benefited from TNC training of workers or from labour movement. Where local firms are important, they participate only in low-value-added activities subcontracted by TNCs.

LDC Governments should formulate and implement strategies to promote local firms' participation in learning and innovation activities, so as to ensure the long-term sustainability of garment operations in the LDCs.

Learning through global value chains

In many industries, the most important channels for the diffusion and acquisition of knowledge are the linkages between suppliers and customers. For small firms in less developed countries, participation in value chains is a means of obtaining information about the needs of markets and gaining access to those markets. However, access to the fastest-growing market segments depends on satisfying the demands of retailers and competing with other suppliers. Frequently, industrial upgrading is associated with a shift from producing for local markets to producing for export markets, which generally have greater demands.

When firms move up the value chain they increase their output of higher-value-added products along the same processing chain. Such upgrading is a broad indicator of increasing technological competence. UNCTAD research shows that LDCs have not managed to significantly upgrade their specialization in global value chains in the past decade. That finding follows from the analysis of 24 value chains that accounted for two thirds of the total merchandise exports of LDCs from 2000 to 2005. Those countries have successfully upgraded in only seven out of 24 value chains, namely in aluminium, iron, artificial fibres, nickel, fruit, cotton and wheat. In all others there has been either downgrading or no change. LDCs' exports have become increasingly specialized at the lower end of the value chains. In quantitative terms, downgrading has been more prevalent than upgrading. In almost all cases, LDCs have increased their specialization in relatively basic products at the lowest stages of processing.

One problem faced by LDC firms is that while buyers and value chain leaders are becoming more and more demanding, they do not necessarily provide support or transfer knowledge and capabilities to firms down the value chain.

The possibilities available to LDC firms for developing their technological capabilities through exports depend not only on the linkages they develop with their downstream foreign customers but also on their technological effort to learn through those linkages. The assimilation and ab-

sorption of existing technologies involve costs and risks at the enterprise level, and there may be a need for policy interventions to facilitate and support learning in small firms. Suggested policy measures are outlined in the following section.

Policy implications

LDC policies to attract FDI have mostly focused on the potential for foreign exchange earnings and job creation, with relatively little attention given to the acquisition of associated knowledge or its successful absorption into domestic production systems. Two complementary types of policy mechanisms are required in order to address those objectives.

First, policy action is needed in order to leverage more learning from FDI by strengthening the integration of TNC activity into the domestic economy. That can be achieved through increasing local participation in TNC activities, and enhancing the potential for diversification and adding value in the home country. Appropriate measures include the following:

- Promoting the establishment of joint ventures with domestic firms when TNCs establish themselves in countries;
- mposing training levies and establishing training centres, particularly those related to clusters centring on a particular type of activity;
- Negotiating with TNCs minimum levels for employment of nationals, so as to foster domestic skills accumulation;
- Reaching agreement with foreign investors on commitments on minimum levels of local sourcing. This should be decided on a case-by-case basis, taking into account the supply capacity of domestic firms. In some cases, efforts to establish local sourcing are pursued by TNCs themselves or through pressure from international financial institutions that co-finance projects;
- Negotiating with TNCs the local further processing of primary products, particularly in the case of natural resource extraction.

Second, policy mechanisms are needed in order to foster the development of local firms so as to enable them to supply both TNCs active in the domestic market and export markets, and to integrate into global value chains. Those mechanisms include the following:

- Facilitating access to capital goods by reducing their total cost to domestic firms. That can be done through trade and fiscal policy mechanisms (e.g. tax rebates, accelerated depreciation);
- Using public procurement as a means of fostering development of small and medium-sized enterprises (SMEs);
- Establishing stakeholder coordination councils to facilitate strong and horizontal interfaces between all critical economic agents (SMEs, other domestic firms, TNCs, and training and research institutions) in order to upgrade and improve the competitiveness of their activities;
- Supporting the development of national standards infrastructures, especially for certification and testing;
- Providing technical assistance to small firms and farms in order to raise their awareness about standards (for example, technical, environmental, safety), so as to enable producers to meet more stringent requirements imposed by domestic and international downstream buyers. This can be done at the cluster level and through collective institutions and joint actions, involving small producers together with buyers, chain leaders and TNCs;
- Adopting enterprise development policies aimed at diversifying economic activity vertically and horizontally around natural-resource-based activities initiated by TNCs (e.g. in mining).

South–South FDI

The increasing share of developing country partners in flows of both trade and FDI of LDCs points to another area of opportunity for increasing the technological capabilities of LDCs. FDI inflows from other developing countries have a greater tendency to take the form of joint ventures with local partners, and to create more linkages, than do inflows from developed countries. Furthermore, given the smaller technological “gap” between LDCs and other developing countries (as compared with developed countries), the impact of technological imports from developing countries on LDCs may be greater, as those imports require less developed domestic absorptive capability.

South–South links should be actively pursued by LDCs as a means of contributing to national technological catch-up. Those links may be established in the context of regional integration schemes or through the joint undertaking of supranational development projects that try to exploit the complementarities of different economies in the same region.

This issue of *LDCR Highlights* is based on UNCTAD, *The Least Developed Countries Report 2007: Knowledge, Technological Learning and Innovation for Development*, chapter 1. The Report is available on the UNCTAD website (www.unctad.org).