



What should be the Role of FDI in African Development Strategies?

Reviewing Theory and Historical Experience

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Abstract

This paper explores lessons from the academic literature on the conditions required for a country to maximize the benefits from FDI for industrialization. We first outline the different modalities of FDI and the empirical evidence on their benefits. This is followed by discussions of Chinese investment in Africa, the 'Flying Geese' theory of economic development, and the political economy of FDI, all of which emphasize the importance of the institutional context and the power relations within which foreign investment takes place. In conclusion, we argue for some principles which should guide the conduit of FDI policy, including its consistency with national economic objectives, the imperative to attract the most beneficial type of investment, and the creation of organizations that can maximize the transfer of capabilities from foreign to domestic firms. Following these principles will be essential for African economies, given their low stock of productive capabilities and a correspondingly greater scope for FDI to contribute to the continent's industrialization.

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1. Introduction

The role of foreign capital is a crucial item in the checklist of any national leader with an industrialization agenda. Among the different types of capital inflow, foreign direct investment (FDI) has traditionally been considered the one with a more direct impact on the productive structure of the recipient country. However, there is no consensus on how exactly FDI-related policies should fit with other economic policies in the pursuit of industrialization. This piece reviews research that is relevant for clarifying this question. The literature on FDI is somewhat fragmented; in particular, there is a disjuncture between research in economics that uses quantitative methods and qualitative research in political science and international relations. The central argument of this piece is that the two streams offer complementary insights on the conditions necessary for maximizing the contribution of FDI to industrialization in an African context.

Our strategy for navigating the relevant literature consists of starting off by outlining some conceptual distinctions between types of FDI, followed by a review of quantitative empirical research. To illustrate the theoretical and empirical findings of this research, as well as to see how it matches up with recent African experience, we then turn to the burgeoning literature on Chinese investment in Africa, which has received a lot of attention in recent years. Thinking about Chinese investment brings up additional questions. One of them concerns the validity of the 'Flying Geese' theory of economic development, which has a long history, but has resurfaced in recent years in the wake of developmental success in Asia. We confront this theory with writings that engage more critically with the practice of Japanese FDI in Asia, and with a literature that questions the generalizability of the Flying Geese paradigm by comparing the role of FDI in Asia and Latin America. These analyses tie in to older debates on the political economy of foreign investment in developing countries, which we revisit in order to establish the different roles that FDI can play according to the local circumstances. The final section summarizes the main conclusions from the literature and outlines the priority areas for government policy on FDI, which include setting up agencies dedicated to attracting foreign firms and ensuring their efficient operation, as well as creating linkages with domestic producers. More generally, foreign investors need to be seen primarily as *tutors*, and FDI policy must be consistent with a government's economic strategy.

2. The Theory of FDI

2.1 Conceptual Distinctions

In theory, in a world of perfect markets and perfect information, the nationality of firm ownership should not matter (Amsden 2009). In the presence of market failures, however, there might be compelling reasons to provide incentives to attract foreign investors. These include (Hanson 2001; Alfaro 2017):

- Information asymmetries between domestic and foreign investors, which prevent foreigners from investing in projects for which they are better-suited.
- Intra- or inter-industry productivity spillovers, which can be caused by the introduction of new technologies, management practices, or marketing techniques; increases in competition; or the acquisition of skills by local workers.
- Forward linkages, whereby foreign investors provide cheaper goods to downstream producers¹, allowing the production of more complex goods (Rodriguez-Clare 1996).
- Backward linkages, whereby foreign investors' increased demand for goods produced upstream allows a greater variety of specialized inputs to be produced (Rodriguez-Clare 1996).
- Backward and forward spillovers, where the presence of a more productive foreign firm leads to increased productivity among its suppliers or buyers.
- The transfer of a share of the rents earned by multinationals through their global market power to the local economy.
- Access to international production networks.

FDI can also come in different **types**. 'Greenfield' FDI can be distinguished from 'brownfield' FDI in that the former involves setting up new facilities, while in the latter existing enterprises are acquired. In brownfield investment, the cutoff point at which an ownership share is deemed sufficient for an investor to have a considerable say over a firm's decisions is somewhat arbitrary, but the US Department of Commerce sets it at 10% or above (although papers such as Arnold and Javorcik (2009) use a threshold of 20%). An additional distinction can be made between **horizontal** and

¹ A 'downstream' producer, relative to any given firm, is one that use that firm's outputs as inputs. Conversely, an 'upstream' producer, relative to a firm, is one that produces the goods that the firm uses as inputs. A forward linkage is therefore a linkage between a firm and the buyer of its products, and a backward linkage is a linkage between a firm and its supplier.

vertical FDI. Horizontal FDI takes place when an entire production process is replicated in the recipient country, while vertical FDI consists of individual parts of the value chain being relocated. Lall and Narula (2004) note that horizontal FDI is more desirable than vertical FDI because it brings a wider range of activities to the recipient country, with a greater potential to introduce capabilities.

A related distinction of great importance for the study of FDI is between the different **motivations** of investors. The literature generally classes FDI into four categories based on investor motivations (Dunning 1991; Dunning and Narula 2000; Lall and Narula 2004):

1. Natural resource-seeking
2. Market-seeking
3. Efficiency-seeking
4. Strategic asset-seeking

The first two categories are self-explanatory. Efficiency-seeking investment aims to achieve lower production costs, and consequently will relocate to areas where low wages, a good business environment and/or high productivity permit this. Strategic asset-seeking investment is a less common category in the developing world, involving overseas investment as a means of acquiring new technology or know-how (ie. 'capabilities'). Meyer (2015) cites the Tata group's acquisition of the British firms Corus Steel, Tetley Tea, and Jaguar Land Rover as examples of this category. Efficiency-seeking investment is normally seen as the most desirable type of FDI in developing countries, since it is generally linked to export success and technological upgrading. However, Lall and Narula (2004) note that market-seeking FDI can be associated with a higher proportion of the value chain being relocated to the host country, particularly when it has a large market and well-developed local capabilities. In these settings, it might allow host countries to impose relatively demanding conditions on investors in terms of capability transfer. Conversely, most commentators see few benefits coming from natural resource-seeking FDI, and it has often been associated with 'enclave economies' that provide little benefit to the recipient country. Unfortunately, as we will see below, natural resource-seeking FDI has historically been the most common type of FDI in Africa.

A final distinction of import when discussing FDI concerns the **sector** where the investment occurs. If we believe the development of some sectors can offer greater benefits than others for a developing country, then attracting FDI to the right industries can be of high strategic significance. Sectoral characteristics that could

matter might include skill intensity, employment intensity, or the degree to which it can help offset balance-of-payments pressures.²

2.2 Empirical Evidence on Spillovers

Much of the research on FDI has focused on empirically identifying spillovers. There is some conceptual confusion in the literature, which often conflates spillovers with linkages. Building on Hirschman's (1958) original formulation, Rodriguez-Clare's (1996) provides a theoretical restatement of the concept of 'linkages', the existence of which requires three conditions: (1) a wider variety of specialized inputs enhances production efficiency; (2) the proximity of supplier and user is essential for many of these inputs; (3) the size of the market limits the available variety of specialized inputs. Under these conditions, it is possible for forward and backward linkages, as defined in the previous section, to arise. However, most of the research – such as Javorcik's (2004) seminal study – focuses on capturing productivity increases in upstream or downstream sectors, which technically do not qualify as 'linkages'. Since there is little research concerned with the appearance of new goods in upstream sectors (but for an exception, see Alfaro and Rodriguez-Clare 2004), or the production of more complex goods in downstream sectors, we brush these questions aside and proceed to surveying the evidence on productivity spillovers.

There is mixed evidence on the horizontal (within-sector) productivity spillovers of FDI. While Aitken and Harrison (1999) find that increases in foreign equity participation improve plant performance, though the effect is only robust for plants with fewer than 50 employees, their results show that it reduces the productivity of domestically owned plants in the same sector. Overall, FDI has a negligible impact on a sector's productivity. They interpret this as evidence that the increased productivity of the acquired firm is compensated by competitors losing market shares and facing a decline in productivity³, as their fixed costs are spread over a smaller market. Results similar to Aitken and Harrison's are obtained by Lopez-Cordova (2002), Damijan et al. (2003), Bwalya (2006) and Kugler (2006). On the other hand, studies such as Blomstrom and Wolff (1994), Borensztein et al. (1998), Sjöholm (1999), Djankov and Hoekman (2000), Gorg and Strobl (2002) find positive horizontal spillovers from FDI.⁴

² For a more in-depth treatment of sectoral selection in industrial policy, see Dercon, Lippolis and Peel (2018).

³ This requires the assumption that production is subject to increasing returns to scale, so that a reduction production results in a fall in productivity.

⁴ For a more comprehensive review of the literature, see Harrison and Rodriguez-Clare (2010).

Some contributions investigate how horizontal spillovers from FDI change with time. Hu and Jefferson (2002) provide evidence from China's electronic and textile industries suggesting that in the short run, FDI reduces domestically-owned firms' productivity through market stealing, but in the long run both the market stealing effect on domestically owned firms and the productivity-enhancing effect on firms acquired by foreign investors lose statistical significance, indicating a convergence in productivity levels between domestic and foreign-owned firms. Similar results are obtained by Liu (2008). Using data on Romanian manufacturing firms, Merlevede et al. (2013) also find that foreign entry negatively affects local firms' productivity, but with time this is replaced by a permanent positive effect.

The mixed evidence on horizontal spillovers can be contrasted to the much stronger evidence on vertical (upstream or downstream) spillovers. Using data from Lithuania, Javorcik (2004) finds evidence of FDI spillovers to upstream firms, but not downstream. Alfaro and Rodriguez-Clare (2004) find similar results using data from Brazil, Chile, Mexico, and Venezuela, as does Kugler (2006) with Colombian data. Du et al. (2012) also find evidence of upstream spillovers, as well as downstream. Similar results are found by Blalock and Gertler (2008). Lin et al. (2009) differ from these contributions, finding that FDI in Chinese manufacturing firms generates spillovers downstream, but upstream spillovers only take place when investors are not from Hong Kong, Macao, or Taiwan. In one of the few studies on Africa, Bwalya (2006) finds significant upstream spillovers from FDI in Zambian manufacturing firms, although he does not investigate whether there are downstream spillovers. Managi and Bwalya (2010) present evidence from Kenya, Tanzanian and Zimbabwean firm-level data indicating the presence of both horizontal and vertical spillovers (in this case upstream) for Kenya and Zimbabwe, but not for Tanzania. Finally, adding a time dimension to the study of vertical spillovers, Merlevede et al. (2013) find the surprising result that vertical productivity spillovers are much more short-lived than horizontal spillovers, only lasting up to 2-3 years after a foreign firm has entered a downstream industry.

Taken as a whole, empirical studies suggest that there are vertical spillovers from FDI, and that these most often appear upstream. The evidence on vertical spillovers is generally stronger than that on horizontal spillovers, a conclusion in line with that of other surveys such as Crespo and Fontoura (2007), Smeets (2008), and Harrison and Rodriguez-Clare (2010). This is further supported by Havranek and Irsova's (2011) meta-analysis of the literature, where they collect 3626 estimates of FDI productivity spillovers and find that the average upstream spillover is economically significant and that downstream spillovers are positive and statistically significant, but small. Meanwhile, Havranek and Irsova (2013) find that horizontal spillovers are on average zero, but that they tend to be positive when the technological gap between investors and recipients is small, and when investment takes the shape of joint ventures.

2.3 Other Empirical Evidence

The empirical FDI literature also investigates the effect of **type of acquisition** on productivity. Du et al. (2008), Hu and Jefferson (2002) and Lin et al. (2008) all find that in China, joint ventures with foreign investors obtain both higher productivity levels and higher productivity growth, as do Bartel and Harrison (2005) and Arnold and Javorcik (2009) in Indonesia. Javorcik (2004) explicitly compares spillovers from greenfield and brownfield investment, finding that the latter are greater. The same results are obtained by Kugler (2006). Javorcik and Spatareanu (2008) find that projects with shared domestic and foreign ownership generate larger vertical spillovers than fully foreign-owned subsidiaries. They attribute this finding to the ability of the local partner to use the knowledge gained from the foreign partner in its other activities, as well as the greater likelihood that they will rely on local input suppliers. Moreover, anticipating this, foreign investors are more likely to introduce less advanced technologies, which actually facilitates technology transfer to the recipient country (more on this below).⁵

Although there is reason to believe that other theoretical distinctions between types of FDI also matter, these are not equally amenable to quantitative investigations as productivity spillovers, and therefore have been studied less. On the impact of FDI according to the sector, Alfaro (2003) finds that FDI in manufacturing boosts growth, while the effect of FDI in services is more ambiguous, and primary sector FDI negatively impacts growth. Focusing on sectoral characteristics, Alfaro and Charlton (2013) find that FDI leads to higher growth in value added in industries that are more skill-intensive and rely more on foreign capital. Moreover, using policymakers' subjective perceptions of the desirability of FDI in different industries, they find that industries specifically targeted by investment promotion agencies do indeed generate greater growth benefits.

2.4 Absorptive Capacity

⁵ These results are contradicted by papers such as Neto et al. (2010) and Harms and Meon (2011). Looking at the question at a higher level of aggregation, they find brownfield investment to have a negative effect on growth in developing countries and greenfield investment to have a positive one. However, Alfaro (2015) notes that these results must be interpreted with caution, as they suffer from problems with data availability and selection bias of different types of investment.

Instead of assessing the effects of type of FDI, the literature has placed greater emphasis on investigating how host country characteristics influence the benefits provided by FDI. Foremost among these is the transfer of productive capabilities to the recipient economy. Understanding which country characteristics are most important for harnessing the positive impacts of FDI matters not only due to its policy implications, but because there are indications that having these characteristics allows countries to attract the 'best' kind of FDI (as we will see in the next section). The term used to refer to these host country characteristics is 'absorptive capacity', and it can basically be defined as the ability of the host country to benefit from foreign investment.⁶ Although this definition might seem somewhat circular (in fact, this near-circularity is at the root of the difficulties many developing countries face in benefitting from FDI) it is useful to distinguish between four **components of absorptive capacity**, following Narula (2004):

1. **Basic infrastructure:** eg. roads, railways, power supplies, human capital with basic skills.
2. **Advanced infrastructure:** eg. universities, research institutes, banks, insurance firms.
3. **Firms' absorptive capacity:** eg. multinational and domestic firms "with appropriate human and physical capital to internalize technology flows."
4. **Formal and informal institutions:** eg. competition policy, investment promotion and targeting schemes, promotion of collaboration between economic actors.

Narula claims that at each stage of development, different components of absorptive capacity become more important. At low levels of development, the biggest gains come from improvements in basic infrastructure and appropriate formal and informal institutions. Later on, advanced infrastructure becomes the priority policy target, eventually followed by a more pressing need to increase firms' capacity to innovate. These policy recommendations are not too dissimilar from those proposed by Gelb et al. (2007) in their analysis of binding constraints to firm growth in African countries. They note that at low levels of income, firms tend to see basic infrastructure, macroeconomic stability and access to finance as the main constraints on their operations. Firms in lower middle-income countries are more concerned with problems of governance and low administrative and bureaucratic capacity. Finally, the greatest concern of firms in middle-income countries is a shortage of skilled labour. Comparing these two accounts suggests that there can

⁶ Narula and Marin (2003) define absorptive capacity more fully as "the ability to internalize knowledge created by others and modifying it to fit their own specific applications, processes and routines."

be important complementarities between policies for improving absorptive capacity and other areas of industrial policymaking.

The empirical evidence appears to confirm the importance of absorptive capacity for taking full advantage of FDI. Alfaro (2016) lists factors that have been found to matter, including the institutional environment, human capital, local financial market development, market structure, trade openness, labour market policies, and ease of entry and exit⁷. The technological level, both domestic and foreign, can also matter. On the one hand, a greater technological gap between local and foreign firms increases the opportunities for technological transfer; on the other hand, a technological gap that is too wide might create insurmountable obstacles. The institutional environment can also affect the extent to which FDI will provide linkages to the rest of the economy; for example, Volpe Martincus and Gallo (2009) find that the level of institutional development (proxied by the World Bank's rule of law index) affects the diversity of input sourcing relationships. As a result, countries with more developed institutions will obtain more widespread benefits from FDI.

2.5 Attracting FDI

Even though FDI – at least FDI of the right type – might be desirable, it might not necessarily be forthcoming. Most of the research on FDI determinants tends to use cross-country regressions, which are not entirely convincing means of establishing causality. We can still interpret their results as correlations that help us identify factors associated with higher FDI inflows:

- Infrastructure and the rate of return on investments (Asiedu 2002)
- Openness to trade (Edwards 1991; Asiedu 2002)
- Natural resources
- Institutional quality, normally understood as a composite of various political and social indicators such as government stability, protection from expropriation, lack of conflict, lack of corruption etc. (Schneider and Frey 1985; Wei 2000; Asiedu 2006; Alfaro et al. 2007; Busse and Hefeker 2007)
- Government size (Edwards 1991)
- Human capital (Noorbakhsh et al. 2001)
- Investment promotion agencies (Harding and Javorcik 2011)
- Historical legal origins (Alfaro 2007)

⁷ For references see Alfaro (2016) and Smeets (2008).

Despite the multiplicity of factors found to be associated with FDI inflows, we can group them under two categories: the investment climate and economic potential. There is a generally held view among the business community that Africa is a continent with great economic potential, let down by a poor investment climate (eg. McKinsey Global Institute 2010; McKinsey Global Institute 2016). Asiedu's (2002) interpretation of her empirical findings lends some credence to this view. Using cross-country regressions, she finds that while infrastructure development and higher rates of return on capital promote FDI to non-African countries, they have no impact on flows to Africa. In addition, trade openness has a weaker impact on African than non-African countries. She attributes the lack of responsiveness to rates of return to the high risk of policy reversal in many African countries, which in the presence of sunk investment costs may render investment too risky, irrespective of its rate of return. Similarly, trade openness is less effective in attracting investment to Africa than elsewhere because of the risks of policy reversals. Finally, infrastructure is found to be ineffective because the majority of FDI in Africa is natural resource-seeking, and Asiedu's measure of infrastructure development (telephones per 1,000 inhabitants) is of little relevance for extractive industries, which usually operate in remote areas and, due to their very high returns, can build bespoke infrastructure. Complementing her earlier findings with a panel of 22 African countries over the period 1984-2000, Asiedu (2006) finds that natural resources and large markets are the strongest pull factors for FDI, but that these can be offset by political stability, low corruption, good infrastructure, low inflation, an efficient legal system, an educated labour force, and openness to FDI.

Although we must interpret these results with caution, as cross-country regressions do not credibly eliminate the threat of omitted variable bias, Asiedu's findings underscore some of the stylized facts on foreign investment in Africa. The finding that large markets and natural resources to be the most important factors in bringing foreign investment to the continent clearly indicates what the main investor motivations are; still little investment in Africa is efficiency-seeking. Moreover, although there is evidence of FDI in manufacturing, a sector generally recognized as a growth catalyst, this proportion is still much lower than in Asian developing countries. In 2016, 4% of greenfield FDI inflows to Africa went to primary sectors; 21% went to manufacturing; and 75% to services. By contrast, in developing Asia, the corresponding figures were 2%, 38%, and 60% (UNCTAD 2017). There are reasons to believe that the gap between manufacturing in the two regions exists not only in terms of quantity, but also of quality. As we will see in the next section, where we discuss Chinese investment in Africa, it seems like the majority of foreign manufacturing investments in Africa are market-seeking, and there is little evidence of investments targeting insertion into international value chains outside of Ethiopia.

3. Experiences with FDI-led Industrialization

3.1 Chinese Investment in Africa

Since the onset of China's 'going out' policy in 1999, there has been a massive increase of Chinese presence in the African continent. China's forays into Africa involved a scale-up of diplomatic relations, increased funding of development projects (as well as 'prestige' projects such as stadiums and government headquarters), loans to governments, increases in Chinese migration to the continent, and a massive growth in Chinese investment. By the mid-2000's, particularly after President Hu Jintao's hosting of forty-eight African leaders at the 2006 Forum on China-Africa Cooperation (FOCAC) in Beijing, the international media had taken note of the new Chinese involvement in Africa.⁸ Since then, portrayals of China-Africa relations in the Western media have frequently been negative, depicting it as a resource-grabbing power, uninterested in promoting the good governance practices cherished by the Western-led international community. However, scholarly accounts have questioned this stereotyped vision, revealing a more variegated landscape of Chinese presence in Africa, involving a greater plurality of actors than the standard view of a purely state-led strategy (Allen 2007; Allen et al. 2008; Brautigam 2009).

The significant geopolitical implications of China's renewed engagement with Africa notwithstanding, in this piece we focus on Chinese FDI. In many quarters, Chinese FDI into Africa has been heralded as a stimulus to African industrialization, while elsewhere the continuity with longstanding patterns of African relations with the external world has been emphasized (Clapham 2008). For our purposes, a discussion of Chinese investment can shed some light on the possibilities of FDI-led industrialization in Africa, illustrate some of the theoretical points made in the previous section, and help form an assessment of the 'Flying Geese' theory of economic development, which has frequently been invoked in conjunction with pro-Chinese stances. This discussion also benefits from the extensive research conducted through the China Africa Research Initiative (CARI) hosted at the Johns Hopkins SAIS.

At first glance, taking into account the research discussed in the previous section, the allocation of Chinese investment seems to hold more promise for African recipients than that of traditional external actors, since it is comparatively less focused on enclave extractive industries. Eom et al. (2017) compare the sectoral allocation of the stock of American and Chinese FDI in Africa. They find that for both countries, mining investment is the single largest category, but while 66% of the American FDI

⁸ China has a history of funding development projects in Africa since the Mao era. In any case, the scale of previous China-Africa relations pales in comparison to the recent engagement. For an overview of the history of Chinese aid to Africa see Brautigam (1998) and Brautigam (2008).

stock is in mining, the corresponding figure for Chinese FDI is 28%. Meanwhile, construction constitutes a sizeable portion of Chinese investment in Africa, at 27%, while it forms a negligible fraction of US investment. Chinese investment in manufacturing is also much more significant, at 13%, compared to a US figure of 7%.

The amount of Chinese FDI in construction is perhaps the most striking difference between the two countries. Chinese construction companies have increasingly penetrated the African market on the back of new Chinese-financed development and infrastructure projects (Alden 2007), as well as through competitive tenders for projects financed by multilateral organizations such as the World Bank (Farrell 2016). Available research suggests that some of the common myths surrounding the activities of Chinese construction companies in Africa, such as the belief that they do not hire locals, or that the quality of their work is inferior, are misguided (Corkin and Burke 2006; Farrell 2016). Farrell (2016) finds that the quality of projects executed by Chinese and Western construction companies are not statistically different, and that the negative perception of Chinese contractors might be linked to the greater variance among Chinese firms. The report from the Centre for Chinese Studies (2006) also finds that their adherence to social and environmental standards actually depends on the local degree of enforcement, a conclusion backed by Chen's (2016) case study of wind farms in Ethiopia.

Although construction projects, particularly in much-needed African infrastructure, can provide a developmental impulse, construction has not traditionally been considered on par with manufacturing in terms of capability transfer, the central role of foreign investment in developing countries' industrialization.⁹ Nonetheless, there is some scope for capability transfer, either through the training of local workers or joint ventures with local construction firms. While there is some evidence of skills transfer from Chinese contractors to African workers (Corkin and Burke 2006; Wissenbach and Wang 2016), joint ventures with local construction companies are almost non-existent due to the dearth of local construction capabilities (Corkin and Burke 2006). In fact, Farrell (2016), citing Zhang and Gutman (2015) notes that African companies won a smaller proportion of civil works contracts in 2013 than in 1995, indicating that the development of construction capabilities is still lagging.

Manufacturing is often heralded as key sector for developing country governments to target. The relative ease with which simple manufacturing industries such as textiles and garments allow workers to gain the skills needed to function in a modern economy make it "the quintessential escalator for developing economies" (Rodrik 2016). There has historically been little foreign investment in African manufacturing

⁹ See Dercon, Lippolis and Peel (2018) for an articulation of the centrality of capabilities for thinking about development. Hobday (1995) provides an insightful case study of the institutional mechanisms through which East Asian firms managed to absorb foreign technology in the electronics sector.

besides simple consumer goods industries for the domestic market. In view of this, the greater propensity of the Chinese to invest in manufacturing has been received with optimism in some quarters (eg. Sun 2017). The dominant narrative drawn upon by those bullish on Chinese investment in Africa is the 'Flying Geese' theory of economic development, which posits that economies sequentially move into more complex industries as their labour costs rise, and in parallel transfer their lower-skilled industries abroad to countries where labour is cheaper (Akamatsu 1962; Kojima 2000). We discuss the Flying Geese theory in the next section, but first we briefly review the existing evidence on Chinese manufacturing investment in Africa.

Despite the recent surge in optimism over the prospects of Chinese investment playing a catalyzing role in the development of African manufacturing, a closer look at conditions on the ground reveals them to be quite sobering. The work of Brautigam (2009) and that of her collaborators at the Johns Hopkins SAIS CAIR discuss many examples of Chinese direct investment in Africa including studies on Ghana (Xiaoyang 2016), Madagascar (Chen and Landry 2016), and Nigeria (Chen et al. 2016). Almost invariably, interviewed investors cite the lack of competition in servicing the recipient country's market as their main motivation. Despite Lall and Narula's (2004) claim that market-seeking investment can be valuable because of the relocation of a larger part of the value chain, this does not seem to be happening in Africa, although there are local variations. Backward linkages have largely failed to materialize: most investors either source unprocessed raw materials locally, or they import most raw materials and just assemble goods locally to avoid import duties (Chen et al. 2016; Xiaoyang 2016). A second channel through which FDI can benefit the recipient economy, skills transfer, appears to hold more promise. Overall, Chinese firms provide little formal training to its African workers, who occupy mainly low-skilled positions and learn on the job, although there are some exceptions (Chen et al. 2016; Sun and Qi 2017). A similar situation holds with regards to joint ventures. There are some examples of joint ventures successfully leading to skills transfer, as in the Nnewi auto parts cluster (Brautigam 2009; Chen et al. 2016), but these seem to be the exception rather than the rule.

The case studies also indicate some reasons for the limited transformative role played by Chinese manufacturing investment so far. The value chain is cut short because of the lack of local firms producing the inputs required by Chinese manufacturers. Even when such firms exist, they are perceived as producing goods of inferior quality. To be sure, manufacturing FDI could in theory provide the stimulus for the creation of such industries, giving rise to backward linkages. In practice, however, such linkages seldom appear, due to the lack of manufacturing experience and expertise. Of course, there are exceptions, and John Sutton's research (Sutton and Kellow 2010; Sutton and Kpentey 2012; Sutton and Olomi 2012; Sutton and Langmead 2013; Sutton 2014) shows that many African traders spot opportunities for import substitution and

go on to establish manufacturing enterprises. Still, although there is no reliable basis for assessing the rate at which backward linkages appear, these instances seem to be few and far in between.

Lall's (2005) case study of Taiwanese investment in Lesotho's apparel industry offers a clear illustration of many of the limitations of ethnic Chinese investment as a spur to industrial development in Africa. He notes that even fifteen years after the installation of the first garment factory, no local competitors or suppliers had emerged. In contrast, large numbers of local producers came into being just a few years after the garment industry was set up in Bangladesh, and similar reactions occurred in other developing countries. Lall does not provide an explanation, but hints at a mix of the poor training offered by firms, barriers to entrepreneurial activity due to local culture or institutions, and deficiencies in capital markets, elements that also appear in more recent work on Chinese investment in Africa. Lall explains the lack of adequate training as partly due to the motivations of investors in Lesotho, who mostly sought to take advantage of preferential trade status through AGOA and were therefore seen as 'footloose' and lacking incentives to transfer skills locally. Low educational levels of the local population are an additional obstacle, as are cultural and linguistic differences between the Taiwanese and the Basotho, leading to poor overall labour relations. Although the recent wave of Chinese manufacturing investment in Africa does not have the same motivations, poor labour relations, the predominance of Chinese workers in skilled positions, and a perception that local workers are unproductive are a recurring point in such analyses¹⁰. Moreover, elsewhere in Africa, political instability still discourages large-scale investment, as in Chen and Landry's (2016) case study of Madagascar.

The elements singled out by the case studies are constitutive of weak absorptive capacity, and are in line with the theoretical and empirical findings of the economics literature. Of course, it is hard to generalize based on case study work, particularly if it does not have an explicit comparative dimension. It also is important to note that Chinese manufacturing investment in Africa still has a relatively short history. Nevertheless, empirical research on China-Africa economic relations gives grounds for treating the optimistic predictions of narratives inspired by the Flying Geese theory with greater scepticism. In the next section we discuss the theory more closely, and inquire on what it has to offer to those preoccupied with African development strategies.

¹⁰ Rounds and Huang (2017) explicitly compare labour relations in American and Chinese firms in Kenya, finding that although there is no general difference between investors of the two nationalities that transcend the characteristics of the type of investment, language issues complicate labour relations in Chinese-owned firms.

3.2 The Flying Geese Theory of Development

The Flying Geese theory of development has a relatively long pedigree in the study of Asian economic development. The theory was first articulated by the Japanese economist Kaname Akamatsu in the 1930's, but was only published in English in the 1960's (Akamatsu 1961; 1962). According to Kojima (2000), the theory was popularized by Raymond Vernon's 'Product Cycle' theory (Vernon 1966) and by the economist and former foreign minister of Japan Saburo Okita. More recently, it has been incorporated by Justin Lin as a core component of his 'New Structural Economics' (Lin 2012). The theory has also been picked up optimistically by advocates of Chinese investment in Africa (eg. Sun 2017) as a stylized description of the East Asian development model.

The Flying Geese theory, at least in its present formulation¹¹, posits that the evolution of countries' industrial structures display regularities over the course of development. When a country first enters the international economy, it specializes in exporting the least complex goods, mainly in the primary sector. At this initial stage, all other goods are imported. As the economy's purchasing power increases, it becomes profitable to produce consumer goods for the domestic market due to economies of scale. The expansion of the domestic industry eventually allow a shift into export of consumer goods (presumably because of lower costs in the developing country when compared to more advanced industrial nations). At the same time, the expansion of the consumer goods industry precipitates an increase in imports of capital goods, which later on undergo the same cycle of import substitution followed by exports. With rising wages, the economy eventually reaches a 'tipping point' where it is not profitable to produce the simplest goods anymore. At this stage, firms make use of their accumulated capital and know-how to invest in countries with lower wage costs, thereby promoting a replication of the Flying Geese pattern in the new location.

At first glance, this stylized depiction of the Flying Geese theory seems to capture the principal features of the East Asian development experience. One can discern a cascading process, whereby Japan was the first Asian economy to catch up with the West, followed by the 'first tier' Newly Industrialized Economies (South Korea, Taiwan, Singapore and Hong Kong), the ASEAN-4, mainland China, and then the remaining South-East Asian countries. At each stage, the development of local manufacturing was fostered by investment from a nation further along the path, and each country in turn moved through a similar sequence of industries.

Despite this apparent conformity, a closer inspection of the Flying Geese theory reveals a number of theoretical and empirical shortcomings that cast doubt on it. In

¹¹For our purposes we are interested in the Flying Geese theory in its current formulation. See Kojima (2000) and Kasahara (2004) for studies on the theory's evolution.

the first place, the mechanism through which a country transitions from importer to producer of a good is largely unexplained. This is far from being an automatic process; if anything, competition with more advanced importers is likely to constitute a serious obstacle to the development of indigenous industry, as demonstrated by the history of developing economies imposing protectionist measures as a means of promoting domestic industry. Moreover, Kasahara (2004) notes that many countries do not undergo the import-substituting stage at all, since they begin to industrialize by performing simple assembly activities. This seems to have been the case among the ASEAN-4 countries and China, while the earlier experiences of South Korea and Taiwan were closer to the Japanese prototype, where industrialization first involved import substitution. In addition, in many industries rapid technological progress may create significant entry barriers for latecomers (Bernard and Ravenhill 1995; Kasahara 2004).

Perhaps a more fundamental point concerns the increasingly fragmented nature of contemporary manufacturing production, organized around 'global value chains' (Gereffi 1994; Neilson et al. 2014). In this context, it makes little sense to assign an entire industry to a particular country; in practice, there is an international division of tasks, with higher-value added activities tending to be located in richer countries (Cattaneo et al. 2013). In the case of East Asia, Japan has traditionally been at the top of the hierarchy, and commentators have long noted the existence of a 'Japan-centred' regional trading network (Cumings 1984; Bernard and Ravenhill 1995). In fact, Cumings notes that the presumed regularities of the Flying Geese theory owe more to the specific historical and geopolitical context of Northeast Asia than to a generalizable theory of development. In the case of Japan, these include institutional features such as concentrated industrial conglomerates (the *zaibatsu*); labour docility; its monetary isolation, which reduces the influence of foreign lenders; the predominance of debt over equity finance, which enhances flexibility; a low provision of social welfare; and the exploitation of female labour, which together facilitate a smooth process of industrial restructuring. Due to colonization, South Korea and Taiwan share some of these features, as well as more autonomous states and pre-existing commercial links with Japan.

Bernard and Ravenhill also point to a misunderstanding on the nature of the commercial networks linking the Asian countries. The last stage of Akamatsu's theory does not ever seem to take place, as Japanese firms do not exit 'mature' industries. Instead, they transfer the more labour-intensive activities to poorer countries, while ensuring that they maintain their dependence on Japanese technology, resulting in a 'hierarchy of production', with Japan at the top, South Korea and Taiwan below them, and Southeast Asian nations occupying a lower tier. The experience of the latter has been particularly distinct, as they never underwent an import-substitution phase, or developed indigenous capital goods industries. But even the experiences

of South Korea and Taiwan have differed significantly, as they began to compete in the world economy at a later stage, and climbed the industrial ladder on the basis of learning and low labour costs, as opposed to Japan's innovation prowess from a very early stage of 'catch-up' industrialization (Bernard and Ravenhill 1995, p.190). A further context-specific factor that influences the East Asian division of labour is the presence of networks of ethnic Chinese entrepreneurs (Chen and Chen 1998). Despite Machado's (1999) claim that ethnic Chinese do not exert an influence comparable to Japan's on Southeast Asian nations (at least at the time of writings), case studies of Chinese investment overseas frequently point to the presence of co-ethnics as an important spur for entering new markets (such as in Brautigam (2009) and related work from the Johns Hopkins SAIS CARI).

It is not our aim here to provide a comprehensive review of Asian interstate economic relations. Instead, this discussion serves to highlight the context-specific nature of processes that have been generalized as regularities of economic development. Lin's (2012) is the latest example, as he superimposes jargon from neoclassical and structural economics onto the Flying Geese theory to create a 'New Structural Economics'. Instead, we see that the arrangements underpinning East Asian industrialization are largely a function of power relations, as manifested through the actions of states and corporations. Analyzing the workings of such power relations is fundamental for explaining the roles played by foreign capital in different developmental trajectories, as will be shown in the next section.

4. The Political Economy of FDI

Critiques of the Flying Geese theory of development resonate with a more recent literature on the governance of global value chains. This literature notes the increased fragmentation of global value chains and the varied nature of buyer-supplier relationships, each implying a distinct distribution of power between the two participants to the relationship (Henderson et al. 2002; Gereffi et al. 2005; Altenburg 2006). Although it is beyond the scope of this paper to discuss the intricacies of value chain governance, it suffices to note that it is fraught with conflicts and dynamic elements, while being subject to change depending on technological improvements, changes in commercial strategies, changes in consumer demands, competitive pressures, changes in market structure or improvements in supplier capabilities. In view of this, a static, over-generalized theory such as Flying Geese is of little analytical value, and runs the risk of seriously misrepresenting actual processes. A further relevant factor is the presence of asymmetric power relations. For instance, Ravenhill (2014) comments on East Asian car manufacturers' power to demand that their suppliers open up their books for them if they want to be part of

the production network. As a result, suppliers' margins end up being dictated by the lead firm. In sum, there is no one standard relationship between foreign investors and domestic firms, or a standard pattern of regional economic organization, but a range of location- and sector-specific configurations. One would naturally expect these variables to influence the degree to which FDI leads to linkages or productivity spillovers, but these considerations have not been taken up in the quantitative empirical research described above, although it is likely that they would help account for the variations in empirical results.

Against this backdrop, public entities are crucial players in directing an economy's insertion in global value chains, and in ensuring that the engagement of foreign firms favours the domestic economy. This point is evidenced by Neilson's (2014) account of international institutions' application of global value chain frameworks in Indonesia. He notes that in their efforts to strengthen agricultural and agribusiness value chains by collaborating with a 'lead firm' (most often an international investor), these agencies were unconcerned with the distributional consequences of their interventions, which tended to favour foreign investors and those domestic producers most capable of complying with the foreign buyer's standards. His account also testifies to the crucial role played by the state, or state-like institutions, in constructing value chains, setting the terms for foreign investors to enter the local economy, and in erecting institutional structures that are conducive to upgrading the capabilities of local firms, allowing them to move to higher value-added activities along a value chain (Ravenhill 2014). Once more, these observations call for greater attention to the institutional context in which buyer-supplier relationships are immersed and their consequences in terms of productivity spillovers.

The role of the state – and of politics more broadly – in directing an economy's type of engagement with foreign investors is illustrated by Schrank's (2003) account of ruling elites' rejection of a Flying Geese-type model in the Dominican Republic in the 1960's, which he generalizes to a large portion of the non-Asian developing world. This rejection occurred in spite of the USA's desire to promote the country's growth through investment in labour-intensive manufacturing from neighbouring Puerto Rico. Schrank attributes the unwillingness of Joaquin Balaguer's government to implement such a model in the Caribbean country to the 'patrimonial' logic of local politics, which incentivized rulers to use state resources as a means of buttressing their power, rather than engaging in any kind of transformative economic programme. He argues that a rationalization of economic policies and the creation of a potentially hostile private sector were seen as threats to the patrimonial state's long-run power.¹²

¹² For a related discussion, see Lippolis and Peel (2018).

The latter point harks back to a broader debate in development studies on the political economy of foreign investment. Although debates on dependency theory in social sciences have now mostly been overcome, some scholars still claim that elites' nationalist orientation matters for development. Kohli (2009) forcefully argues for the virtues of nationalist states that are autonomous from both global constraints and other internal sources of social power. In a broad comparison of development patterns in Asia and Latin America, he notes that such states were much more present in the former region, which enabled them to use foreign investment to satisfy their own domestic needs. By contrast, foreign investors, and the Western government backing them, had much more power over Latin American polities, which in addition tended to be ruled by elites generally uninterested in extending the benefits of economic development to the bulk of the population. He traces these differences to the post-WWII political discontinuities with the colonial order experienced by Asian states, which were not mirrored in Latin America. These ruptures allowed for the emergence of powerful states not beholden to the interests of foreign powers or 'comprador' elites.

Despite Kohli's emphasis on the specific geopolitical circumstances leading to nationalist capitalist development in post-WWII Asia, this does not mean he downplays the importance of other social, political and economic factors in determining the relative degree of autonomy or dependence in developing country states. In fact, Kohli's (2004) study emphasizes some of the long-term determinants of state formation. His broader concerns are also displayed in other writings that are part of a cottage industry in Asia-Latin America comparisons¹³. These studies highlight regional differences in social, political and economic factors. Stallings (1990, p.30) provides a concise list some of the determinants of the different roles played by foreign capital in East Asia and Latin America:

historical-structural variables such as colonial heritage, domestic political power relations, geographical location, and resource availability. Policy choices on mobilization of domestic savings, promotion of local capital, selective use and regulation of foreign capital, and sequencing of development strategies have also been important.

This multiplicity of factors might lead to perplexity among policymakers, since macro-structural variables such as colonial legacies or domestic political power relations are at best hard to change (not to mention geographic location or resource availability). This is a similar implication as besets research on the long-term determinants of development such as, most famously, the work of Acemoglu and Robinson (2012). For Africa in particular, there would be little cause for optimism, as the region's common characterization as "extraverted" (Bayart 2000) and populated by "gatekeeper states" (Cooper 2002) makes the emergence of nationalist,

¹³ See Sachs (1985), Evans (1987), the contributions to Gereffi and Wyman (1990) and Birdsall and Jaspersen (1997), Hein (1992), Kay (2002) and Elson (2013), among others.

autonomous states unlikely. However, we believe the pessimistic outlook implied by these considerations is not in order. Although institutional legacies cannot be changed and they limit what may be achieved within any given context, skilled political operators have the capacity to navigate domestic power relations and bring about favourable policy outcomes.¹⁴ This observation mirrors Jerven's (2015) critique of how too much of an emphasis on long-term determinants blinds us to the drivers of variations in growth in the short- and medium-term. In the next section we combine political economy factors with the broader discussion in this piece to spell out policy implications with regards to FDI.

5. Policy Implications

In the sub-sections below, we outline some of the policy implications of the literature discussed above. We believe that a correct handling of FDI has to be structured around two poles, which we discuss in the two next sub-sections. The first consists of efforts to attract the best possible kind of FDI (ie. that which will yield the greatest benefits for the recipient economy). The second pole involves maximizing the benefits generated by FDI, focusing on the role of capital markets and social networks. The third subsection discusses how public agencies responsible for handling FDI can be moulded around these two principles, before outlining our final conclusions.

5.1 Attracting the Right Kind of FDI

Based on the discussion in the first section of this review, it is clear that FDI can have beneficial impacts on developing countries. Not only does it provide investment – and consequently employment – that might not otherwise be forthcoming, but it may also be a source of productivity spillovers. It can potentially also lead to the emergence of new industries in upstream or downstream sectors, although there is less evidence on this matter. More generally, FDI adds to the stock of productive capabilities in the recipient economy. Given the centrality of such capabilities to industrial development, FDI can thus promote growth.¹⁵

However, not all types of FDI are created equal. FDI tends to be more beneficial if it is efficiency-seeking, if it is in manufacturing industries with a slight technological edge over currently existing ones, and if it is a joint venture between local and foreign

¹⁴ See Lippolis and Peel (2018) for a more in-depth discussion of this point.

¹⁵ See Dercon, Lippolis and Peel (2018) for a more in-depth account of the relationship between growth and capabilities.

investors. Countries differ in their ability to attract the best kind of FDI, which requires good conditions for doing business and a sufficiently productive workforce. However, absent a history of industrial investment, governments lack the resources, institutional capabilities and motivation required to create a good business environment, while the workforce remains unaccustomed to industrial work. The result is a sort of 'catch-22': in order to attract new industrial investment, a country must have a prior history of industrial investment. We can observe this logic in action in the African continent, where efficiency-seeking FDI is still very scarce, and most foreign investment is either resource- or market-seeking, despite the grandiose claims of advocates of the "Flying Geese" theory. One antidote for these structural difficulties is the sort of large-scale state-led industrialization effort pioneered by Ethiopia in the African continent, which has managed to attract foreign efficiency-seeking investment in recent years. But even there the success of the state-led industrialization drive is less than guaranteed¹⁶.

An alternative for countries that are still unable to attract efficiency-seeking investment, despite their best efforts, is to capitalize on market-seeking investment. This sort of investment tends to enter less technologically-advanced industries, but investors still have an edge over local producers due to technical or organizational know-how or the ability to source inputs internationally, as evidenced for example by the accounts produced by the Johns Hopkins SAIS CARI. Structurally, these investors occupy a similar position to the medium and large-scale entrepreneurs described by John Sutton's Enterprise Maps, as they are "islands of high productivity in a sea of smaller low-productivity firms" (Gelb et al. 2014). Gelb et al. (2014) offer an insightful angle through which to think about the matter. They see development as a matter of "*diffusion*, wherein the economic agents driving the high productivity parts of the economy actively extend the reach and scope of their businesses until they encompass the bulk of the economy". We can also think of the diffusion of industrial capabilities across firms as an additional avenue for development. Seen through this optic, market-seeking investment can be a useful way of increasing the stock of capabilities in an economy, and the spread of these capabilities can in turn provide a stepping stone for eventually attracting efficiency-seeking investment. If the recipient economy is to fully benefit from this market-seeking investment, however, we need to think of how to foster the diffusion of capabilities. Here is where absorptive capacity plays a crucial role.

5.2 Increasing Absorptive Capacity

As discussed in this paper, most components of absorptive capacity are relevant to other areas of industrial policy, such as improvements in basic infrastructure, human

¹⁶ See Oqubay (2015) for a comprehensive account of industrial policy in Ethiopia.

capital, government effectiveness etc. Insofar as these improvements are themselves constitutive of 'development', there is not much new to say¹⁷, and poor countries are likely to encounter substantial difficulties in implementing this agenda.

Here we take a different approach to the issue and try to understand what measures can increase the diffusion of industrial capabilities within a given economic and institutional setting. If we distinguish between the two avenues for capability diffusion identified above – the growth of leading firms and the economy-wide spread of productive capabilities – we can argue that the latter is the most desirable from an economy's long-term perspective, since it avoids the concentration of capabilities within a narrow subgroup of society. In the first place, excessive reliance on foreign investment makes an economy more vulnerable to fluctuations in both global and domestic economic conditions, since – borrowing Hirschman's (1972) terminology – foreign investors are more likely to exercise the 'exit' than the 'voice' strategy. They are also less likely to develop long-term relationships with other national firms, for example by not participating in local business councils, or by choosing to source their inputs overseas.

Andrew Schrank's work also underscores the importance of investors' social embeddedness in preserving the competitiveness of a given region. He notes that the decision of Cibao Valley producers to enter international markets for garments and to upgrade production were motivated by threats to their business model posed by the inability to enjoy the advantages conferred by protective tariffs, or the reduction in competitors' costs following the signing of NAFTA, as well as to the resources that these elites were able to access through their social networks (Schrank 2003; 2005; 2008). We are made to reach the conclusion that had these investors not been socially embedded, they would probably have fled towards a lower cost location. Generalizing this point, it is possible to express a preference for local capital, as opposed to 'footloose' foreign investors, as long-term developmental agents, albeit tempered by a realization of the potential benefits of foreign investment.

In our view, the decisive factor for the creation of an able domestic business class is the distribution of productive capabilities. Although this still is an incipient area of research, our reading of the literature suggests that there are two key determinants of the rate at which productive capabilities diffuse across the economy. The first is the quality of capital markets. Even if an aspiring indigenous entrepreneur has acquired the skills to create his own industrial venture, the inability to obtain a loan can be a binding constraint on his investment. Xiaoyang (2016) makes this point when discussing the reasons why Ghanaian entrepreneurs are often unable to capitalize

¹⁷ Policy recommendations on these aspects have been put forth elsewhere. For a synthetic policy brief see Sutton et al. (2016)

on the skills learned in Chinese-owned factories. Access to finance, together with knowledge of the market, is also cited by Sutton as a source of the competitive edge enjoyed by traders when setting up manufacturing businesses in African countries (Sutton and Kellow 2010). A similar conclusion is reached by Moore's (1997) survey of the literature on capitalists in developing countries, where he notes that access to finance is one of the key advantages enjoyed by ethnic minorities that tend to dominate developing country business environments. Finally, a number of quantitative studies on firms in developing countries have attested for the significance of capital constraints as binding constraints on firm growth (Gelb et al. 2007; Dethier et al. 2010; Aterido and Hallward-Driemeier 2010; Aterido et al. 2011; Dinh and Clarke 2012; Harrison et al. 2014). Nonetheless, when commenting on the importance of properly functioning credit markets, one must keep in mind the difficulties in fixing market failures in credit markets. As discussed by Besley (1994), while there may be plenty of good reasons for intervening in credit markets, finding interventions that manage to overcome the market failures that justified them is often extremely difficult, so a large degree of caution is necessary before attempting to fix this problem.

A second factor in the development of productive capabilities is the role of social networks. As discussed in this piece, the literature has found that joint ventures between foreign and local investors are a source of productivity spillovers, as are contacts between foreign buyers and local suppliers. These constitute two types of social exchange enabling the transmission of knowledge from foreigners to locals. There is reason to believe that these forms of contact do not exhaust the possibilities of productive social exchange; for instance, some accounts mentioned by Moore (1997) find that many successful African businessmen either began their careers as employees of European companies, or had studied in the UK or US. We can also interpret the findings of Sutton's Enterprise Maps through this lens, since traders are foreign-oriented by default. Brautigam's (1997) account of the Nnewi auto parts cluster in Eastern Nigeria provides additional support for this view. She notes how trading experience, combined with longstanding ties to Asian producers, endowed local investors with the required knowledge for setting up manufacturing businesses. Brautigam (2003) finds a similar mechanism in play in Mauritius which, given its much more extensive ties with Chinese business networks, is an even clearer success.

These considerations naturally bring forth the question of what it takes to make such synergistic relationships between foreigners and locals work. This is still an underresearched area, but an incipient literature explores the determinants of the diffusion of technology and management practices. Atkin et al. (2017) and Giorcelli (2017) show that contact between developing country manufacturers and firms in more advanced countries can lead to an effective transmission of knowledge and consequently better firm outcomes. One limitation of these papers is that they deal

with simple dyadic relations; in contrast Fafchamps and Quinn (2016) and Cai and Szeidl (2017) deal explicitly with the role of social networks in transmitting business practices.¹⁸ The first paper responds to the question of why the best management practices do not diffuse from firm to firm, and hypothesize that it may be linked to the segmented nature of social networks in countries with a short history of manufacturing, where knowledge about best practices may remain isolated in closed social groups (mirroring the explanation put forth by Ramachandran et al's. (2009) study of Africa's private sector). These "closed social groups" usually consist of minority ethnic groups that tend to dominate business, such as Asians in East Africa and the Lebanese in West Africa, but the explanation is easily transferrable to thinking about foreign investment.

Fafchamps and Quinn's experiment links managers of manufacturing firms in three African countries, thus creating exogenous variation in social networks. They find that practices such as VAT registration and having a bank current account diffuse along these networks, but find no evidence of diffusion of labour management practices, relations with clients and suppliers, or innovation. Admittedly, the limited extent of the treatment prevents the formation of any strong conclusions, but Cai and Szeidl's (2017) experimental work on Chinese manufacturing firms further supports the relevance of networks for the diffusion of firm practices. They find that participation in regular meetings between managers of different firms improved a number of firm performance indicators including growth, revenue, profit, inputs and management. Importantly for the point being made here, firms obtained greater benefits from associating with higher-capability peers, suggesting there is much to be gained by connecting local and foreign investors.

5.3 FDI Agencies

There is still a lot to be understood about the factors that lead to fruitful collaboration between local and foreign investors and what role the state can play in helping to structure these relationships. One interesting strand of recent policy research has looked at the role of public agencies in facilitating the operation of foreign investors and in the promotion of buyer-supplier relationships between local and foreign firms. The main kind of organization responsible for these tasks are Investment Promotion Agencies (IPAs). As discussed above, Harding and Javorcik (2011) find that IPAs can be effective in attracting FDI and directing it towards government priorities. Expectedly, the *design* of IPAs matters for their effectiveness (Harding and Javorcik 2012). Sutton (2017) extracts lessons from the experiences of countries such as

¹⁸ See Fafchamps and Quinn (2016) for a summary of the literature on the ways in which networking can inform different aspects of running a business.

Finland, Ireland and Singapore, as well as the recent Ethiopian experience. Some of the best practices in IPA design include:

- Establishing 'one stop shop' operations allowing prospective investors to obtain all necessary licenses in a single location.
- Creating an organizational culture where the aim is to help firms circumvent any unnecessary obstacles to job creation.
- Assigning each company deemed of sufficient significance to one contact person at the IPA, who takes care of all issues pertaining to that firm.
- Organizing monthly meetings where progress is checked and action points are identified.
- Periodically checking with firms on the state of their operations and on any requirements they might have, rather than simply waiting until a problem arises.

Based on existing research, Sen and Logan (2016) make additional recommendations such as establishing IPAs with 'quasi-government' or private status (ie. not as part of the public bureaucracy), preferably through an act of parliament rather than executive degree. IPAs also play the important role of matchmaker by helping multinationals obtain a more accurate picture of the capabilities and constraints of local suppliers, while at the same time helping local firms understand the requirements of multinationals.

The last function is shared by what Sutton sees as the IPA's 'sister' institution: the Local Content Unit (LCU). If IPAs have the mission of attracting prospective employers to the host country, the mission of an LCU is to maximize the benefits derived from investors that would come anyway. Most of the time these consist of investors in natural resources, or other service sectors such as hotels or construction. Key to this endeavor is to refrain from local purchase rules that specify what percentage of certain goods, or what percentage of value added needs to be bought locally. Steenbergen and Sutton's (2017) explanation deserves to be quoted in full:

Firstly, it is easy to circumvent such policies through creative accounting practices and deceptive statistics (Sutton 2014). They are difficult for governments to enforce and raise administrative costs considerably. Secondly, this policy (does) not explicitly address...two constraints to improving local content use...namely information asymmetries and quality-constrained local suppliers. Instead, it would force producers to use higher-cost and lower-quality domestic inputs, creating market inefficiencies that would thus *reduce* (emphasis in the original) the overall productivity and competitiveness of the export sector (Spray, 2017).

Instead, LCUs should be responsible for 'match-making' services, suggesting potential local suppliers for large foreign firms, which will often be unaware of existing

industrial capabilities in their destination country. In addition, LCUs can engage in capacity-building to help domestic firms achieve the quality standards necessary to supply foreign firms.¹⁹

6. Conclusion – Changing Attitudes Towards FDI

Based on the discussion above, we can identify a set of guiding principles for the conduct of FDI-related policies:

1. FDI should be promoted **only as a means of furthering domestic economic objectives** and not be a target in and of itself.
2. Besides job creation, the **transfer of productive capabilities from foreign to domestic firms** should be seen as the key contribution of FDI to the recipient economy.
3. Countries should try to attract **efficiency-seeking investment**, which is more likely to help them achieve international competitiveness.
4. In the absence of efficiency-seeking investment, **market-seeking** or **resource-seeking** investment can be beneficial, provided it brings capabilities that are absent in the recipient economy.
5. Improving **economic fundamentals** will ensure greater benefits from FDI. These include infrastructure, education, and other factors associated with the ease of doing business.

Some of the key policies required to put these principles into effect include the creation of IPAs and LCUs, credit channels for entrepreneurs with experience in foreign firms (again, paying attention not to overestimate what policy can do to correct credit market failures), and general improvements in the business environment, as well as bespoke policies tied to specific strategic sectors.

Some commentators have argued that the spread of Global Value Chains (GVCs) has changed the way we should think about FDI. Cattaneo et al. (2013) list four required paradigm shifts in the analysis of industrial policy: from the country level to the global, or regional, level; from thinking about industries to thinking about tasks and business functions; from seeing the relevant economic assets as endowments or stocks to seeing them as flows; and from a public-centred view of obstacles to trade and competitiveness to a greater awareness of private obstacles.

¹⁹ See Steenbergen and Sutton (2017) for a more detailed treatment of LCU design.

Even though these are very relevant points that rightly redirect our attention when discussing industrial policy, they are unlikely to obviate the need for strategic policies at the country level, since it is where the bulk of decision-making power still rests. This is not to deny the importance of these changes in the global economic geography. For instance, while they open up opportunities for firms to specialize in niche tasks in the global economy, it is possible that GVCs reduce the scope for linkages, since the tendency for one part of the value chain to bring about the emergence of another part is lessened due to reduced trade costs. Instead, competence in tasks, or capabilities, assumes a much greater relevance, reinforcing one of the central tenets of our framework. In any case, a plethora of policy publications on the implications of GVCs notwithstanding, more research is needed in order to understand how they change the impact of FDI on developing countries. For the time being, the intricacies of the analysis of global value chains are unlikely to be very relevant for the modal African economy, which still needs to develop the right 'stepping stone' capabilities before being able to enter these production networks.

A second aspect of the changing global context that must be taken into account is the evolution of the Asian division of labour. Even if the Flying Geese theory is not a perfectly accurate description of reality, as it assigns rule-like behavior to economic relationships that are much more contingent, one of its merits is opening our eyes to how industrialization in one country largely depends on the opportunities offered by the global context. Although it often has a propagandist flavor, the literature inspired by the Flying Geese theory alerts us to the opportunities being opened up for Africa as low-skill manufacturing industries seek cheaper bases from which to operate. We are thus reminded that FDI attraction does not only depend on the receiving end. China's increased activity on the African continent can therefore represent an opportunity and, given the right political conditions, it can be channeled to promote industrialization.

A final thought concerns the role of politics in the attraction and management of FDI. Politics rules in the conduct of industrial policy, and FDI policy is no exception. The political requirements for an adequate use of FDI coincide with those of other areas of industrial policymaking, including in areas such as bureaucratic effectiveness, firm capabilities, political incentives, and a shared vision.²⁰ The last of these is a particularly salient point, given the still widespread view among many African citizens, politicians and policymakers of foreign investors as 'exploiters'. As shown by the research on China-Africa relations, these coarse nationalistic views often stem from misperceptions, and though occasionally justified, they cannot do justice to the positive contributions that FDI can make to developing economies. Even the literature on the Latin American experience recognizes that FDI has often made substantial contributions to economic development (Ferraz et al. 2011). Thus, one

²⁰ See Lippolis and Peel (2018).

major policy prescription is bound to involve attitudinal changes ensuring that foreign investors are seen as “tutors”, rather than mere “tenants” (Schrank 2008). Local agents should act neither with unjustified suspicion, nor with subservience, but charting a middle path not too dissimilar from the ‘embedded autonomy’ held to constitute the basis of developmental success in the Asian ‘tiger economies’ (Evans 1995). Foreign investors are as profit-oriented as any, and the government’s focus must remain on the benefits for the receiving country, forming the nationalist and autonomous development strategies that have been so successful in the past.

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