

## CONCLUDING OBSERVATIONS:

### Benefiting more from export expansion

Building export competitiveness is a high priority for both developed and developing countries – for good reason. As Part Two argued, countries that manage to link up to international markets through trade in goods and services can reap gains in employment, income and efficiency. International production systems and increased specialization in many industries provide new opportunities for developing countries. Exports generate foreign-exchange earnings, allow firms in developing countries to enter activities they could not have undertaken solely for their domestic markets, and help them build new productive capacity. Exports can also serve as a monitoring device for economic performance generally.

It is also clear that TNCs play a pervasive and prominent role in international trade and in the export competitiveness of many countries. Current developments in the global economy suggest that this trend is set to continue. Ever more intense global competition, driven by liberalization and technological change, offers opportunities for developing countries seeking to benefit from export-oriented FDI. TNCs respond to competition by cutting costs, increasing efficiency and innovating. As a part of this process, they now cast their nets much wider in search of new locations, increasingly encompassing developing countries.

The world economy is thus in a state of flux. Given the dynamic changes characterizing key export industries and the rising competition among countries and sub-national entities for export-oriented FDI, policy-makers face a tremendous challenge. Just as the firms they seek to attract are forced to make their production systems constantly more competitive, policy-makers too have to address the issue of upgrading. This applies to countries at all levels of development. Even traditionally significant recipients of export-oriented FDI need to keep moving up the value chain to sustain rising wages and to maintain their

competitiveness as an export base.

Moreover, the potential benefits from export-oriented FDI cannot be taken for granted. A number of low-technology industries (e.g. textiles, clothing and footwear) on which many developing countries have relied in the past may have peaked, quota restrictions in the area of textiles and clothing industry are in the process of being phased out and preferential margins are being gradually eroded. Additionally, in some major recipient countries, export production by foreign affiliates remains strongly dependent on imported inputs, with only limited linkages to local suppliers of goods and services. Where economies of scale at the plant level, agglomeration economies, and close interaction between buyers and suppliers matter greatly, latecomers face a difficult task in competing with first-mover locations. Countries that manage to develop dynamic localized clusters of such industrial activity will be in a good position to benefit from inward FDI.

Policies to attract and benefit from export-oriented FDI should take into account changing corporate strategies and the increasingly competitive environment for promoting FDI. And countries (and sub-national entities) need to assess their potential role in the evolving international production systems carefully. There is no universal policy prescription that can be used by all countries, but there are some key factors to consider.

First, more and more countries recognize the need to undertake more *targeted* efforts to promote export-oriented FDI. The main advantage of a targeted approach is to improve the chance of attracting the type of investments that can help meet the development objectives of a country. Successful targeting involves a good understanding of the relative competitiveness of a host country (or a location within it) for specific activities, and a sound analysis of corporate strategies affecting the choice of location. In response to increased

geographical and functional specialization in many industries, countries may find it useful to identify production niches through which they can link up with global value chains. However, effective targeting involves more than just IPAs; it requires a co-ordinated effort by the host-country Government. At the same time, such an effort must be in tune with the industrial policy and overall development strategy of the country and the specific needs of the targeted export activity. Moreover, care must be taken that not all countries aim at exporting the same products, as this would result in oversupply and a subsequent deterioration of the terms of trade.

Second, *access to key destination markets* is a necessary – but not sufficient – condition for attracting export-oriented activities. While multilateral liberalization is eroding the preferential access on which some countries have relied, many regional and preferential arrangements still remain important, such as the European Union and its association agreements, NAFTA, the United States' Caribbean Basin Initiative and AGOA, as well as the various offshore production schemes. While policy-makers need to be aware of any opportunities arising from such arrangements, they need also to understand their limitations. For example, tariff schedules linked to offshore production schemes generally discourage the use of local components and may constrain the upgrading of local operations. Trade preferences provide neither a sufficient nor a sustainable basis for developing competitive export industries (with or without FDI). They need to be seen as affording a temporary window of opportunity that provides the requisite time to strengthen other locational advantages.

Third, in selecting the policy measures to be included in a package for investors, developing countries not only need to identify the most effective ones in a specific context, but also to ensure that they conform with the *international regulatory framework*, notably WTO rules. In this context, the role of export subsidies warrants special attention. The Agreement on Subsidies and Countervailing Measures (the SCM Agreement) stipulates that all export subsidies have to be phased out by the end of 2002, except by LDCs and other countries listed in Annex VII of the Agreement. Even those countries granted an extended transition period are not allowed

to set up new forms of export subsidies and will need to develop appropriate post-transition policy responses. The implications may be particularly relevant for countries using EPZs, as export subsidies are very often an integral part of the incentive package offered in such zones.

This does not mean that EPZs will not continue to play an important role in the overall strategy of countries to promote export-oriented FDI. For example, countries will still be allowed to exempt exports by companies in these zones from indirect taxes (such as sales taxes), border taxes (e.g. consular fees) and import charges. Also, duty drawbacks and duty exemptions will still be permitted. Similarly, advantages in the form of well-functioning infrastructure and streamlined administrative procedures will remain unaffected. Partly in the light of this, a number of countries, including some developed ones, are turning their EPZs into industrial parks or science parks that can act as catalysts for cluster development (see below).

There is a risk of intense competition for export-oriented FDI translating into a *race to the bottom* (in social and environmental standards) and a *race to the top* (in incentives). Such concerns have been voiced especially in the context of EPZs. Successful EPZs should not be judged solely on their capacity to attract FDI or increase exports and foreign-exchange earnings. They should also be assessed by the extent to which they help meet broader economic and social objectives. Countries that pursue more integrated policy approaches for attracting export-oriented FDI – for example by encouraging tripartite representation (employers, workers and public authorities) on EPZ committees, guaranteeing workers' rights (including freedom of association and collective bargaining), and upgrading skills and work conditions – have tended to attract higher-quality FDI. Singapore and Ireland are two examples of countries that have pursued such integrated policy approaches. In both these countries, efforts were made to promote training, facilitate dialogue between labour and management, and provide first-class infrastructure for investors. They have demonstrated that good labour relations and the upgrading of skills enhance productivity and competitiveness.

With regard to the risk of an incentives race to the top, while the SCM Agreement generally prohibits the use of export subsidies, other incentives, especially locational ones, are still widely used in both developed and developing countries to promote export-oriented FDI. Increasing competition for export-oriented FDI risks accelerating the incentives race among competing locations and thus calls for further international cooperation to address this issue. The difference in resources available for public support to private investment also suggests that developing countries will continue to be at a disadvantage in such a race. A reduction of investment subsidies in developed and developing countries should help Governments allocate more resources for the development of skills, infrastructure and other areas that serve to attract export-oriented activities. At the same time, a case could be made for making certain development-oriented subsidies to foreign affiliates non-actionable under WTO rules, for example, if they serve to encourage the provision of technology, technical assistance and training to local suppliers and their personnel. However, to avoid free-riding, firms receiving incentives should be required to commit sufficient resources on a long-term basis.

Fourth, expanding exports is just a means to an end – to promote development. To benefit fully from export-oriented FDI and facilitate an upgrading of export-oriented activities, host countries need also to *encourage linkages* between the foreign affiliates and local suppliers. Export-oriented foreign affiliates – especially if operating in enclaves – often import all or most of their input requirements of components and raw materials, assemble the product in the host country, and then export their semi-finished or finished output. It is partly against this background that linkage promotion has become an increasingly important policy area. Linkages with foreign affiliates are a key channel for the diffusion of skills, knowledge and technology among domestic firms. Whereas a range of policy measures can be considered to promote linkages, the emphasis has shifted towards the use of instruments that address market failures and contribute to building local capabilities. Examples include information provision and matchmaking; encouraging foreign affiliates to participate in programmes aimed at upgrading domestic suppliers' technological capabilities; promoting the

establishment of supplier associations or clubs; the joint provision of training; and various schemes to enhance domestic suppliers' access to finance (see *WIR01* for more details).<sup>1</sup> Meanwhile, as in other policy areas, linkage promotion strategies also need to adapt to the changing nature of corporate strategies. For example, in response to the globalization of the electronics industry, the Government of Ireland has abandoned the idea of promoting linkages only between Irish firms and foreign electronics affiliates present in Ireland and is instead promoting the participation of Irish firms in supply chains of TNCs based anywhere in the world (box VIII.14).

Linkages between domestic suppliers and foreign affiliate buyers can also take place more frequently if buyers and suppliers operate in the same spatial and industrial area. Indeed, the increasingly interdependent nature of policies on investment, trade, technology and enterprise development calls for a more integrated approach to fostering export-oriented FDI and economic development. As the development of infrastructure, business services and specialized skills often involve significant levels of investment, many countries have encouraged the formation of *localized industrial clusters*.<sup>2</sup> Such efforts seek to create conditions that will promote dynamic interaction, learning and competition among all relevant actors. Many countries that have seen improvements in their export competitiveness over the past two decades have hosted agglomerations of mainly foreign-owned producers. Prominent examples include Costa Rica, Ireland, Malaysia (Penang), Mexico, Singapore and a few countries in Central and Eastern Europe. However, not all export-oriented projects are good candidates for becoming nodes of dynamic industrial clusters. The chances of production concentrating in a limited number of locations increase when there are economies of scale at the plant level, relatively low costs per unit of output, low barriers to trade, and the presence of externalities and spillovers.

While the formation of industrial clusters can be spontaneous, resulting from the agglomeration of firms engaged in similar or related activities, increasingly, strategic government intervention can facilitate their creation. Three kinds of effort have been identified as essential for the development

of clusters involving inward FDI (Low, 2001). The first is *investment and business promotion* in a targeted manner (chapter VIII). Policy-makers need to understand the competitive needs of different industries to avoid encouraging investments to the wrong kinds of clusters; cluster diagnostics is therefore fundamental (Peters and Hood, 2000). Furthermore, there is a special need in FDI-based cluster development for close cooperation between IPAs and related government institutions. The second is *institution-building*, which is a complex process. Agglomeration tendencies can be encouraged by the establishment of EPZs, industrial parks and other specialized facilities, often specializing in one or more industries.<sup>3</sup> Such institutions as metrology, standards, testing and quality assurance (known collectively as MSTQ) provide the infrastructure of modern industrial activity. Their importance to

competitiveness is growing with increasingly stringent quality, precision, tolerance and other standards in international markets. Other relevant institutions are those responsible for initiating research, providing access to financial resources, and creating business networks and professional associations.<sup>4</sup> Obviously, depending on the cluster, some institutions will be more important than others. The third element focuses on the *training and upgrading of human resources*. For knowledge-based activities, in particular, training and upgrading of relevant human resources is key. While this aspect is addressed mainly through the education system in general, it is sometimes necessary to make specific and targeted efforts to ensure a sufficient supply of qualified people. Such efforts may involve the establishment of specialized training centres, possibly with the involvement of foreign affiliates.<sup>5</sup> Another

#### Box VIII.14. Promoting supplier transnationalization

To remain competitive as a supplier, firms are increasingly required to supply their outputs at the regional or even global levels. The presence of foreign affiliates in a host economy can be used as a vehicle to facilitate such a transnationalization process of domestic firms.

The transnationalization of local suppliers – by way of either increased exports or FDI – is more likely to occur when domestic collaboration between suppliers and investors is not only high but also involves high-value-added activities. Factors that influence the likelihood of transnationalization include the complexity of the production process, the level of local procurement by foreign affiliates, the autonomy and mandate of foreign affiliates, and the importance of geographical proximity between investors and suppliers (Raines, Turok and Brown, 2001).

Some authorities have taken these aspects into account and designed special measures to benefit from the presence of export-oriented foreign affiliates with a view to strengthening the international operations of domestic supplier firms. In Scotland, for example, Scottish Enterprise has set up a Global Connections Strategy, a key aim of which is to increase the benefits from inward FDI and facilitate the emergence of internationally more competitive Scottish firms. The Strategy covers the activities of Locate in Scotland (the IPA), Scottish Trade International, the Globalisation Team and Scotland Europa (Raines and Brown, 2001).

Source: UNCTAD.

The Irish case is also illustrative. In the latter half of the 1990s, TNCs in the electronics industry increasingly required their Irish suppliers not only to supply their Irish affiliates, but to do so also on a regional or global scale. In response, Enterprise Ireland, the government agency responsible for SME development, set up an “International Business Linkages Division” in 1998 with the purpose of supporting the transnationalization of the Irish supplier industry. The initiative was a joint endeavour with the national export board and offers the following activities (Ruane, 2001):

- Assistance to local companies in finding global partners;
- Encouraging international companies to purchase local companies that could not succeed on their own, and to ensure that local plants can continue to operate in Ireland;
- Assistance to local suppliers engaged in electronics sub-supply to find international markets, often piggy-backing on the parents of affiliates who source locally;
- Assistance to internationally successful Irish suppliers in finding cheaper sources of inputs in Central and Eastern Europe, in areas in which the Irish cost base is threatened; and
- Assistance to successful local companies in transforming themselves from being sub-suppliers to being sub-assemblers.

approach is to attract internationally mobile skills to complement the local skills base. In general, the more knowledge-intensive the activity, the more important it becomes for clusters to attract skills.

The bottom line is that the degree of success of a host country in attracting and upgrading export-oriented FDI, and in reaping development benefits from such investment, critically depends on its ability to develop the domestic resources. Indeed, some of the countries most successful in boosting export competitiveness and leveraging export-oriented FDI practised a two-pronged approach, based on developing domestic capacities while targeting foreign resources. Perhaps the most visible example is Singapore, which implemented a comprehensive strategy to target foreign investors in critical export-oriented and high-technology activities. The broad contours of this strategy include the following elements (Felker, 2002; Low, 2001; Mathews, 1999; <http://www.sedb.com>; Lall, 2000a):

- The establishment of a top agency to oversee FDI targeting, in line with the country's broader development and industrial strategies;
- An evolving package of targeted incentives to encourage TNCs to invest in strategic (typically export-oriented) activities;
- Harnessing the presence of TNCs and partnerships with foreign Governments to develop and upgrade a highly flexible and responsive human resource system;
- The development of world-class infrastructure, including science parks to host foreign research units;
- The establishment of capital investment funds to partner with foreign companies in strategic investments; and
- Targeted support for the development of domestic enterprises, and for suppliers and clusters (box VIII.15).

Other Asian countries, and Malaysia in particular, have followed the Singapore model, but none has been as successful, mostly

#### Box VIII.15. Cluster development: the case of Singapore

In Singapore, the Economic Development Board (EDB) has been the lead agency in cluster development, complemented by a number of important institutions responsible for key areas. Examples include the International Enterprise Singapore, the National Computer Board, the Standards, Productivity and Innovation Board, and the Agency for Science, Technology and Research. In addition, some Government-linked companies have also played an active role.

For example, the electronics cluster, which has evolved from consumer electronics via industrial electronics to semiconductors, has been reinforced by wafer fabrication, undertaken by the Singapore Technologies group, a Government-linked company (Low, 2001). The EDB played an instrumental role in creating three specialized "wafer fabrication parks".<sup>a</sup> Each park is supplied with specialized power and water supply systems and waste treatment facilities, as well as high quality land and ancillary services. Through its Cluster Development Fund<sup>b</sup> the EDB took equity stakes in wafer fabrication jointly with (among other companies) Texas Instruments, Chartered Semiconductor Manufacturing, Hitachi/Nippon Steel, and Philips.

Source: UNCTAD.

<sup>a</sup> The parks are located in Woodlands, Tampines and in Pasir Ris (Mathews, 1999).

<sup>b</sup> This Fund has three purposes: to facilitate investments in strategic projects that enhance core capabilities of local industry clusters, to accelerate the development of local enterprises, and to undertake strategic investments with local companies and TNCs to strengthen Singapore's regional links (Mathews, 1999).

The National Science and Technology Board has played the role of coordinator of R&D activities such as in the establishment of the Centre for Wireless Communications, the Gintic Institute of Manufacturing Technology, the Institute of Microelectronics and the Magnetics Technology Centre (Mathews, 1999).

These initiatives were supported by major efforts to build the skills needed for technology-based industrialization. In 1979, the Government set up the Skill Development Fund, along with a Skill Development Fund Levy of 1 per cent of payroll from employers. Money from this Fund is disbursed to firms that send their low-paid workers to approved training courses. Meanwhile, the university system has been expanded and directed to meet the needs of the country's industrial policy. A Vocational and Industrial Training Board, established in 1979, has trained and certified more than 110,000 individuals since its inception in various fields relevant to industry needs. These and other measures have resulted in an upgrading of skills; the proportion of professional and technical workers rose from 16 per cent in 1990 to 23 per cent in 1995 (Lall, 2000a).

because of an inability to build strong domestic capacities and linkages. The latecomers have yet to fill the gap between the sophisticated nature of their export structures and the rather weak base of domestic skills and technological capacity. While high-technology FDI has not been particularly footloose, it may well place its most dynamic and skill-intensive new technologies elsewhere if old bases are unable to meet growing needs.

In conclusion, the continuous need for countries to move up the ladder and improve the attractiveness of their locational advantages is a challenging task for policy-makers in developing countries, and calls for sophisticated and comprehensive policy approaches. Moreover, given the potential of improved export competitiveness as a vehicle for promoting development, the need of developing countries to preserve sufficient policy space to pursue their development objectives has to be recognized. Finally, although the extent to which developing countries can profit from new opportunities created by the emergence of international production systems depends primarily on their own actions, developed countries can also help in a number of ways. Such efforts include the provision of assistance for the development of institutional capacity, dissemination of information about export-oriented investment opportunities in low-cost locations, and the dismantling of barriers to exports from developing countries. Meanwhile, a rise in protectionism could, in effect, jeopardize the prospects for poor countries to exploit their comparative advantages fully. The growing use of the anti-dumping weapon, increased tariffs on certain products, and the expanded use of targeted subsidies in developed countries all give cause for concern in this context.

## Notes

- 1 Some countries have taken a more comprehensive approach and established specific linkage promotion programmes. Costa Rica, the Czech Republic, Hungary, Ireland, Malaysia, Singapore, Thailand and the United Kingdom have all made special efforts of this kind, either at the national or the regional/local level (*WIR01*).
- 2 According to one definition, clusters are geographic concentrations of interconnected companies and institutions in a particular field (Porter, 1998, p. 58).
- 3 In China, for example, hundreds of industrial parks have been developed with the active support of local authorities. In Shanghai, some of the many industrial parks and special economic and development zones are highly specialized, including the Shanghai AIC Modern Agriculture Park, the Shanghai Chemical Industry Park and the Shanghai Xinzhuang Industry Park. The last focuses on information technology, electric appliance and automotive components, biological medicine and new materials.
- 4 For example, a key element in the cluster-oriented approach of Scottish Development International has been to develop various forums to facilitate interaction and networking between the different actors. Clusters have been promoted in oil and gas, food and drink, forestry, micro-electronics (including optoelectronics), semiconductors, biotechnology, and services such as tourism and software (Scottish Enterprise Network, 2001).
- 5 Many industrial parks and special economic zones in China boast the availability of universities and research institutes in their vicinity that provide training to specialized technicians. The Penang Skills Development Centre in Malaysia plays an important role in putting together training courses contributed by TNCs to upgrade skills in the supplier workforce. In Singapore, public-private cooperation for training is an important part of the Local Industry Upgrading Programme (*WIR01*).