



EMBEDDING FOREIGN DIRECT INVESTMENT

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1. Introduction

The attraction of Foreign Direct Investment (FDI) is one of the principal economic development activities of regional governments and development agencies, which make extensive use of marketing and promotion and investment incentives to influence foreign investor location decisions. Success in attracting FDI can potentially release many local development benefits. As well as the direct additional employment and output in the foreign affiliates themselves, there are multiplier effects associated with local purchasing of materials and services and local spending of wages and salaries and a series of wider effects including technology transfer, upgrading the efficiency of local suppliers, competitors and customers, contributions to local infrastructure, improved labour force skills and so on.

However, these local development benefits will not come about automatically. Indeed foreign investment policies have often been strongly criticised for having relatively few spin-off benefits for local businesses or the local competitive environment, because of the 'truncated' or 'branch plant' nature of much of the investment attracted. Thus, it is often argued that compared to operations in the home country, foreign affiliates attracted through marketing and investment incentives are associated with 'financial leakage', have relatively few technology spin-offs, local purchasing or sales linkages or strategic collaborations and are relatively vulnerable to closure decisions made by headquarters overseas. This is why a number of pioneering economic development agencies in OECD Member countries have been developing programmes to better embed foreign investors in regional economies.

One part of the effort to better embed foreign investors involves attempts to attract higher quality investment by targeting operations that are more knowledge-intensive, have greater managerial autonomy and have mandates to sell products in several countries. These types of enterprise are likely to have greater local spin-offs than traditional 'branch plant' operations. A second aspect, which is the main focus of this paper, is to develop programmes to better integrate foreign investors into regional networks of firms and institutions. Such programmes tend to work in two ways. Firstly, efforts are made to increase the scale of local linkages of foreign affiliates, both by encouraging foreign affiliates to increase their local linkages and making them aware of the opportunities to do so and by working with local firms and institutions to bring them up to the standards required by foreign investors.

Secondly, efforts are made to influence the nature of the relationships between foreign investors and local firms and institutions towards deeper collaborations, which are more likely to yield positive spin-offs, for example by encouraging tutoring of local suppliers by foreign investors. The development of such programmes reflects an increasing recognition that policies for the attraction of foreign investment must be accompanied by policies for its long-term embedding of FDI in regional economies.

This paper seeks to explain why it is important to increase the embedding of FDI in regional economies, describe what sorts of policies regional governments and development agencies can use to assist embedding and make recommendations on how such policies can be most effective. The paper also briefly outlines work currently underway at the OECD to analyse and compare policies for embedding FDI in case study cities and regions.

2. The importance of embedding FDI in regional economies

Overcoming the problem of 'branch plant' FDI

A traditional criticism of foreign investment policy, especially in developing countries, has been that it does little to capture the value added of the investment in the regional economy. This is because many multinationals have traditionally operated globally-integrated business models, with subsidiary roles often limited to that of 'branch plants', which serve only a local market or have just one function in a vertically integrated supply chain. Foreign investment of this kind is criticised on various counts, including finance, technology, linkages and vulnerability to closure.

- In terms of finance, foreign investment is often criticised for 'financial leakage' out of the host region through the remittance of earnings and profits back to the parent company and use of transfer pricing to reduce taxes paid in the host region.
- In terms of technology, foreign investors are accused of not making available their technology to potential users outside the firm, either directly, through linkages with indigenous firms, or indirectly via the demonstration effect. Another issue is the appropriateness of the technology transferred, with the argument put forward that multinationals do not adapt their process technology for use in developing countries to make it more appropriate to a low-skilled labour environment.
- In terms of linkages, it is often argued that there is little sourcing of materials and services locally, and so positive spin-offs for local suppliers are limited, whilst there are often few forward sales linkages or strategic collaborations in the regional economy.
- In terms of vulnerability to closure, the fact that a foreign affiliate is often a replica of another operation elsewhere within the parent group and that overseas headquarters often have a wide choice of possible locations for any investment, leads many commentators to the view that foreign operations attracted by investment incentives are relatively vulnerable to closure.

The actual benefits to a host economy from attracting a foreign investor depend on how it behaves in terms of the above factors.

Evidence suggests that subsidiaries with greater strategic independence are less likely to be associated with problems such as financial leakage, limited technology transfer, limited local linkages and vulnerability to closure than those that are associated with low local management autonomy carrying out simple assembly or production for local markets (Birkinshaw and Hood, 1998). It can also be argued that relatively knowledge-intensive investment is less likely to be associated with the above-mentioned branch plant economy problems if the local business environment provides suitable conditions for such operations to thrive. In order to improve the impacts of FDI, it is therefore important to adopt policies to improve the quality of the FDI attracted. This can be achieved through better targeting in marketing, promotion and incentive provision and making improvements in the quality of local business environment in terms of local skills, infrastructure, technology base and so on.

It is also increasingly recognised that in order to achieve the degree of reinvestment, technology transfer, local linkages and business retention desired from foreign investment, regional governments and development agencies need to encourage greater embedding of foreign affiliates in regional economies. Promoting the links between FDI and networks of firms and institutions in host regions will not only strengthen domestic industry and provide it with links to global markets and technologies, but will also help foreign enterprises to experience a high productivity environment conducive to their retention in the region.

Involving foreign investors in regional collective learning processes

With the shift towards the knowledge economy, a new territorial development paradigm is emerging in which regional growth processes are increasingly seen to be driven by innovation. This in turn is considered as the output of a collective endeavour, rather than something carried out by individual firms or universities (Cooke and Morgan, 1998; Storper, 1997). Thus one of the most effective mechanisms for collective learning is inter-firm networking and networking between firms and institutions, and this should provide a focus for public policy. Foreign affiliates can play an important role in such collective learning processes, particularly through promoting the diffusion of best practice production processes and technologies through their supplier chain networks and developing collaborations with colleges and universities.

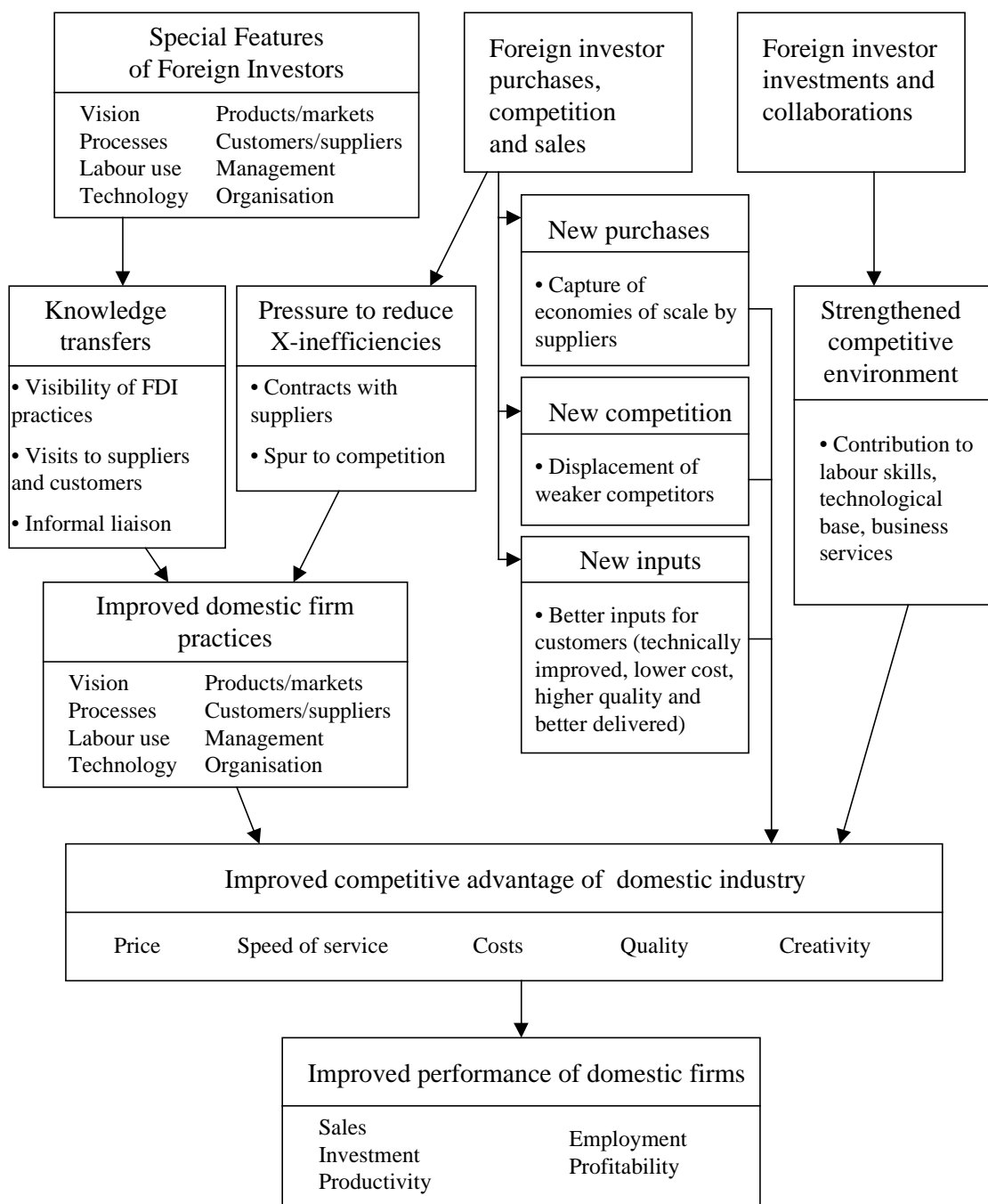
Cooke and Morgan (1998), for example, cite the case of Wales, in the United Kingdom, where restructuring away from coal and steel dependence has been led by substantial foreign investment. There are indications that in Wales the FDI sector is becoming more embedded locally, with some foreign plants increasing local purchasing and tutoring suppliers. For example, some Japanese foreign investors are acting as tutors to SMEs in localised supply chain networks. Here organisational innovations such as placing suppliers' engineers in customers' plant, using supplier associations to disseminate 'best practice' among their members and jointly agreed conventions, like open book accounting, to share the profits of inter-firm collaboration achieved joint problem solving and continuous improvement in price, quality, design and so on. Cooke and Morgan argue that there are similar processes of collective learning in other regions, such as Baden Wurttemberg in Germany, where the small firm sector tends to be linked vertically to large firms through inter-firm networks favouring innovation.

Embedding foreign investment can therefore be seen not just as a way of countering past problems of 'branch plant' type investment, but also as a key component of the new paradigm of regional development strategies aimed at responding to the knowledge economy through regional collective learning.

The potential spin-offs from embedding FDI

Figure 1 sets out a simple conceptual model of how foreign investors may be expected to transmit wider effects of spin-offs to domestic industry (Potter, Moore and Spires, 2002).

Figure 1: Transmission of wider effects of FDI to domestic industry



Firstly, foreign investors are assumed to have certain special features, or firm-specific advantages, including efficient and leading operating practices and technologies, which enable them to compete successfully with domestic firms in host economies. Exposure of domestic firms to these special

features may lead to knowledge transfers through indirect demonstration effects or direct collaboration, if local industry is capable of absorbing this knowledge (Dunning, 1993).

Secondly, the model points to the importance of direct foreign investor purchases, competition and sales. These put pressure on suppliers and competitors to reduce inefficiencies because of demanding suppliers contracts and the competitive spur. They also permit suppliers to capture economies of scale, displace weaker competitors and provide customers with new inputs of better quality, greater technological content, better delivery or lower prices.

A third potential transmission channel relates to a wide range of investments and collaborations by foreign investors that may improve the general competitive environment for business. For example, labour trained by foreign investors may move to other local firms, research collaborations with local universities and colleges may have spin-offs for other firms, and foreign investor demand may stimulate growth of local business services. Together these mechanisms would appear to have the potential to improve the competitive advantage and performance of domestic industry.

Empirical evidence supports the notion that foreign investment can be harnessed for regional development strategies focused on innovation and knowledge transfer. In particular, FDI can help improve innovation and efficiency in domestic industries in host regions through their relationships with local customers, suppliers, competitors and institutions.

A number of econometric studies have been carried out, which attempt to relate productivity measures for host country firms or industries to the extent of foreign ownership in the host country. These are useful for identifying whether there is an impact, although they do not provide much information on how impacts come about. Blomstrom et al (2000) provide a good review of the available evidence in this respect. For OECD countries, the econometric evidence is fairly consistent in showing that the productivity of domestically-owned firms is positively related to foreign presence. However, for developing countries, the studies tend to produce more mixed results. Thus, whilst a number of studies document that foreign investor presence promotes higher productivity in host country sectors, other studies point to limited or no significant efficiency spillovers. However, one consistent finding is that the capability of host country firms to absorb foreign technology is an important determinant of the magnitude of identified benefits. This suggests that embedding policies need to work on the capacity of domestic firms as well as the conduct of foreign firms.

Survey-based approaches can provide more evidence on how impacts occur from foreign firms to domestic industry. One of the few major surveys undertaken, in the United Kingdom (UK), identifies the effects on the operating practices and competitiveness of suppliers, competitors and customers linked to foreign investors (PACEC, 1995). This survey showed that 42% of suppliers, 18% of competitors and 30% of customers considered their link with a foreign investor operating in the UK to have had a strong impact on their operating practices. The improvements in operating practices also fed through to the competitiveness of domestic firms, together with the increased volume of purchases from suppliers, better product inputs for customers and the contribution of foreign investors to the local competitive environment. Some 47% of suppliers, 13% of competitors and 39% of customers reported a strong impact on their competitiveness, for example in terms of price, marketing and promotion skills, speed of service, cost advantages, product design, product quality, specialised expertise or products, flair and creativity and responsiveness to client needs. The survey also gives information on the transmission mechanisms that led to impacts on the practices and competitiveness of domestic firms as a result of their link with foreign investors. This suggests that the most important channels for transmission of impacts included the demonstration effect resulting from the improved visibility of foreign firm practices and technologies and the informal sharing of views and ideas. Contractual arrangements and visits to and from the foreign investor were also important, as was

general networking between foreign investors and domestic firms through conferences, seminars, supplier groups and so on.

Given these potential benefits, it is useful to try and encourage linkages between foreign affiliates and domestic firms and to try and strengthen processes of the demonstration effect, sharing of views and ideas, foreign investor participation in local networks and so on.

3. Policies that regional development agencies can pursue for FDI embedding

Table 1 sets out some key features of policies for embedding FDI, based on the practices of leading regional development agencies in various OECD countries.

Table 1: Key features of regional embedding policies in OECD countries

<i>Aftercare and retention</i>	<ul style="list-style-type: none"> Monitoring foreign investors for problems or expansion opportunities Identification of potential local suppliers and collaborators Recruitment and training assistance Presenting case for new investment to corporate HQ Information, incentives and support to adapt and expand premises Minimise adverse effects of rationalisation Improvement of local business environment (education, skills, communications, technology base etc.)
<i>Long-term embedding</i>	<ul style="list-style-type: none"> Local supplier development programmes Support for joint research with local universities or firms Provision of customised training programmes for foreign investors Identifying local partners for joint ventures / strategic alliances Cluster building initiatives Labour mobility Corporate spin-outs

One of the major areas of policy intervention is that of aftercare and retention. Data indicate that in recent years the proportion of new FDI flows accounted for by reinvestment or expansions has increased significantly. This shift, together with concerns to counter the possibility of relocation or closure by attracted projects, has led agencies to introduce new policies for aftercare and retention. This is especially important in the current global downturn and context of multinational restructuring.

Aftercare and retention involves the provision of a range of services to foreign investment projects once they have begun operations in a region, in order to facilitate their successful start-up, retention and eventual expansion. These services include identification of potential suppliers, help with recruitment and training, support to expand and adapt premises and so on. There are a number of key questions that agencies need to address in putting such programmes into place. Firstly, agencies need to consider how to organise the structure of delivery. Provision might be organised through a network of local offices, for example, or alternatively through centralised regional offices. Often provision is organised through one-stop shops or first-stop shops with a single nominated contact person for each client. This implies a need for strong partnership working between all the organisations involved in problem-solving for the foreign investors and the introduction of new co-ordination mechanisms. Secondly, agencies need to make a choice about whether delivery should be proactive (with staff arranging visits and meetings with foreign investors) or reactive (with enquiries dealt with through standard call centres). A more proactive approach would involve some intelligence gathering on management changes and issues in key foreign investors. Thirdly, agencies need to consider whether to address only local facilities or whether also to address corporate headquarters abroad. Fourthly, agencies need to decide how far they should simply signpost to existing private sector provision or whether direct public provision of advice and assistance is required.

A second major area of policy intervention is that of long-term embedding. Policy for long-term embedding of foreign investors overlaps to some extent with policy for aftercare. However, with embedding, the emphasis is more on achieving the maximum long-term spin-off from foreign investment, whereas the emphasis of aftercare tends to be mainly on facilitating retention and expansions. Some of the most developed projects seek to integrate foreign investors in supplier development and supplier chain initiatives. For example, a number of agencies operate programmes to identify potential local supply sources for foreign investors, which otherwise might not be aware of their presence. Certain initiatives go further than this by encouraging foreign investors to support supplier development by participating in supplier groups, best practice seminars and so on. Other embedding initiatives focus on encouraging collaborations between foreign investors and local universities and colleges or other firms to help improve the local skills base and local research and innovation capacity, provision of customised training programmes for foreign investors and identification of potential joint venture or strategic alliance partners locally. FDI is also often involved in cluster building policies. Clusters are geographic concentrations of firms and institutions in related industries, including competitors or rivals, sophisticated customers, a thick bed of suppliers and firms in related industries and specialised factor pools, including skilled labour and local research, development or design facilities (Porter, 1990). Where foreign investors are located in such clusters it can be argued that their productivity is likely to be higher. They are therefore likely to be more willing to collaborate with other local firms and organisations to support the cluster, because they are likely to benefit themselves from such collaboration.

In order to illustrate the sorts of approaches that are being used, it is useful to give some specific examples of embedding programmes and how they work. The cases of ‘Source Wales’ (UK), ‘Supply Network Shannon’ (Ireland), and the ‘National Supplier Development Programme’ (Czech Republic) are presented briefly below.

‘Source Wales’, Welsh Development Agency, United Kingdom

In recent years the Welsh Development Agency has expanded its attention beyond the simple attraction of FDI towards integration of that FDI with indigenous firms and stimulating networks so that both foreign and local firms can develop an interactive learning capacity (Cooke and Morgan, 1998; Izushi, 1999; Morgan, 1996). As part of this effort the ‘Source Wales’ programme was

launched in 1991 as an innovative business support programme with the virtue of supporting FDI projects and indigenous firms at the same time. Essentially, 'Source Wales' combines a scheme to increase local purchasing by foreign investors and other major firms operating in Wales with a programme to improve the capacity of local suppliers to respond to large firm demands. Thus, as well as identifying potential local supply opportunities to foreign investors, the Agency provides development services to potential suppliers, including a series of best practice, awareness raising and benchmarking programmes designed to help suppliers become 'world class'. The programme includes the creation of over 20 supplier associations, often headed up by major foreign investors, which tutor potential suppliers in world class production techniques. Through this programme the Welsh Development Agency has established itself as an effective intermediary in the supply chain, whilst foreign investors have become closely involved in various sector-focused technology forums and collaborative training projects.

'Supply Network Shannon', Shannon Development, Ireland

Whilst Irish industrialisation has been heavily dependent on the attraction of FDI for many years, since the beginning of the 1980s there has been a policy shift towards promoting the indigenous sector. This shift reflected emerging concerns about weak linkages between the foreign-owned and indigenous sectors and a feeling that Ireland was becoming a 'dual economy'. At the regional level, the Shannon Supply Network, operated by Shannon Development, is a good example of efforts to better embed foreign investors with local firms (OECD, 2001). Shannon Development is the economic development agency for an underdeveloped rural area in the west of Ireland with a population of 400,000 people. It operates a major export zone (Shannon Free Zone) and technological park, which have helped attract major foreign investors. In order to increase linkages between foreign investors and local subcontracting firms, Shannon Development is sponsoring "Supply Network Shannon".

Key components of the Supply Network Shannon initiative are:

- A supplier directory to encourage local sourcing. This is a Shannon Development publication with free entry to supplier companies. Approximately 60 companies are profiled and 2000 copies circulated to regional, national and international buyers.
- A Supply Network website with information on network events and member contact details by company and sector listings.
- Support for business clusters. Companies are encouraged to group together in order to benefit from consultancy work on group strengths and weaknesses and the development of projects on common issues such as production, waste, teamworking, procurement, quality management and finance.

The 'National Supplier Development Programme', Czech Republic

CzechInvest, the foreign investment promotion agency of the Czech Republic, introduced its Supplier Development Programme in 1999 to support the country's supplier base and to link it to foreign affiliates. The Supplier Development Programme consists of three elements (UNCTAD, 2001):

- Collection and distribution of information regarding the products and capabilities of potential Czech component suppliers, so as to enable foreign manufacturers to shortlist

and contact potential suppliers. The profiles of potential suppliers are available through CzechInvest's website. Approximately 1000 firms were listed in 2001.

- Matchmaking, comprising three elements: (i) “Meet the Buyer” events between foreign investors and potential Czech suppliers. The sessions focus on identifying the type of components and services that foreign investors are considering subcontracting. (ii) Seminars and exhibitions organised with and for Czech suppliers and foreign affiliates. (iii) Taking forward concrete proposals to potential foreign investors, indicating potential suppliers in the Czech Republic.
- Upgrading of selected Czech suppliers. Suppliers are selected according to predefined criteria in high-technology industries, such as electronics, or for selected engineering firms supplying to a wide range of industries. The selected firms produce an upgrading plan, tailored to their individual capacities and requirements. The upgrading process usually includes consultancy and training support in such areas as the utilisation of technology, general management operations, quality control and organisational change.

4. Key success factors for FDI embedding programmes

Whilst many FDI embedding programmes are relatively new and detailed evaluation evidence is not yet available, an assessment of the experience to date of various regional development agencies in OECD countries suggests that effective policy for embedding foreign investors should stress the following factors:

- A proactive approach towards embedding foreign investors.
- Development of clear objectives, a strategy and an action programme for the embedding policy.
- Integration of FDI embedding initiatives with wider regional development initiatives.
- Good working relationships between regional governments and development agencies and key managers and decision-makers in foreign investors.
- Development of mechanisms to handle contacts with and feedback from foreign investors (e.g. one-stop shops).
- Use of an account management system for key foreign investors, giving access to a team of staff with different specialisms.
- High quality account managers.
- Strong partnerships between all the organisations involved in the problem-solving involved in aftercare and embedding of foreign investors.
- Assessment of the costs and benefits of the policy and alternatives and feedback into future policy design.

5. The OECD inward investment and local development study.

The OECD Local Economic and Employment Development (LEED) Programme is currently undertaking a study called 'Inward Investment and Local Development' to explore the issue of how local and regional development agencies can better embed foreign investment in local economies. The objective is to make recommendations on policies for the attraction, retention and long-term embedding of foreign investment in case study cities or regions. Six case studies are to be undertaken by a team of OECD staff and international experts between 2002 and 2004. Cities and regions in OECD Member or non-Member countries are invited to apply to participate in this series of reviews. For information on how to participate, contact Jonathan Potter at OECD (email: <jonathan.potter@oecd.org>).

Key advantages for a region of participating in the review series are:

- Identification of model programmes and innovative policy instruments and operational arrangements that could be adapted or transferred from other countries.
- Recommendations from the OECD expert panel on how to improve local policies and operational arrangements in the light of both evidence on international best practices and an assessment of specific local conditions.
- Increased international recognition for the most successful policies operated by local agencies, which may serve as models for agencies in other countries.

6. Conclusion

The key message of this paper is that FDI policies focused simply on marketing and promotion and provision of investment incentives are not sufficient to gain the full wider benefits possible from FDI or to secure the retention of attracted projects. Instead, policy needs to become much more pro-active, involving initiatives for aftercare and the integration of foreign investors into the host region economy. With the long-term shift to a globalising knowledge economy and the current short-run global downturn in FDI flows, it is not enough to simply focus on attraction of foreign investors. It is also critical to retain those foreign investors already attracted and to better exploit their presence for knowledge transfers to domestic enterprises.

FDI embedding policies can help to retain attracted investments, encourage reinvestments, and link foreign investors with local firms and institutions. They are also likely to improve the overall regional competitive environment, helping to promote long-term endogenous development, with a consequent reduction in future reliance on marketing or incentives to attract foreign investment. Indeed, foreign investment policy should not be seen as independent from regional development policy more generally. Instead foreign investment programmes should be seen as a part of a wide range of instruments to build regional competitive advantage, including the development of infrastructure, human resources and entrepreneurial networks, so that foreign investors are not divorced from the regional economies that host them.

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