(Conference Draft)

Inclusive Industrialization:

An analysis of the interplay between FDI and SME promotion policies in SSA

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2017 Law and Development Conference

Cape Town, South Africa
September 2017

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I. INTRODUCTION

In 2015, the United Nations General Assembly, seeking to balance "the three dimensions of sustainable development: the economic, social, and environmental", adopted the 2030 Agenda for Sustainable Development.[1] Through Goal 9 of the Sustainable Development Goals ("SDGs"), countries committed to "…promote inclusive and sustainable industrialization…".[2] The use of the word "inclusive" in this context indicates that industrial development must be all encompassing, i.e., it must include all countries, all businesses, and all people, and offer equal opportunities and an equitable distribution of benefits of industrialization to all stakeholders.[3]

Growth and development of small and medium enterprises (SMEs), as well as their integration into international value chains, is a key element of inclusive industrialization. Indeed, this is expressly recognized in goal 8 of the SDGs, which highlights the importance of "policies that …encourage the…growth of micro, small and medium-sized enterprises"[4]. Likewise, Sustainable Development Goal 9 aims to promote "the integration [of small-scale industrial and other enterprises] into value chains and markets".[5]

However, while SMEs constitute over 95 percent of most SSA economies, industrial strategies that are exclusively focused on developing these businesses will not, by itself, enable a country to industrialize and move its production up on the value chain. Any effective industrialization strategy in SSA must also involve attracting Foreign Direct Investment (FDI) – the engine of economic growth in developing countries. Indeed, the Addis Ababa Action Agenda ("AAAA") – an integral part of the 2030 Agenda for Sustainable Development – "recognize[s] the important contribution that direct investment, including foreign direct investment, can make to sustainable development, particularly when projects are aligned with national and regional sustainable development strategies".[6]

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[1] United Nations General Assembly, *Transforming Our World: the 2030 Agenda for Sustainable Development*, UNGA Resolution 70/1 (25 September 2015) UN Doc A/RES/70/1, preamble.
[2] *Ibid.*, Goal 9.
[3] Li Yong, *Inclusive and Sustainable Industrial Development*, available at: https://isid.unido.org/about-isid.html, accessed 6 August 2017; the term "sustainable" refers to the importance that industrial growth does not generate negative environmental impacts. This is not the focus of this paper, however.
[4] United Nations General Assembly, (2015), *supra* note 1, Goal 8.3.
[5] *Ibid.*, Goal 9.3.
[6] United Nations, General Assembly *Addis Ababa Action Agenda of the Third International Conference on Financing for Development*, UNGA Resolution 69/313 (27 July 2015), para. 45.

Much has been written about policy options SSA countries can consider to attract FDI, or to encourage the growth of SMEs. Likewise, there exists a large volume of literature that analyzes how FDI can encourage the growth of SMEs through spillovers, the creation of FDI-SME linkages, and through value chain integration. Indeed, it is largely assumed – provided that certain conditions are in place – that attracting FDI positively impacts a host country's domestic economy, including its SMEs. However, what remains relatively unexplored is whether policies aiming to attract FDI could undermine the objective to include SMEs in a SSA country's industrialization strategy, and, conversely, whether policies aiming to encourage FDI-SME linkages could inadvertently hamper FDI. For instance, can generous tax reduction packages offered to foreign investors in two-thirds of SSA countries negatively impact growth opportunities for SMEs? Likewise, in what situations do local content requirements dissuade foreign investors from making an investment? And are SSA industrial policies proactively addressing any tensions between FDI and SME promotion policies?

This paper explores the interplay between FDI and SME promotion policies, focusing on two sets of popular policies that are typically associated with attracting FDI and encouraging SME-FDI linkages: investment incentive packages, including Special Economic Zones (SEZs); and local content requirements, respectively. It finds that SSA countries industrial policies are predominantly tailored to attracting FDI, which risks creating an unequal playing field for domestic enterprises, including SMEs. Moreover, this paper demonstrates that mandatory local content requirements can, in certain situations, dissuade foreign investment from entering the country.

In addition, this paper demonstrates that many FDI and FDI-SME promotion policies are potentially inconsistent with the disciplines of the World Trade Organization (WTO) – in spite of the fact that SDG Goal 17.10 aims to "promot[e] a universal, rules-based, open, and non-discriminatory and equitable multilateral trading system under the World Trade Organization…".

It follows that SSA governments aspiring to generate inclusive industrialization through adopting a dual FDI/SME promotion strategy must be conscious of the potential trade-offs between these objectives, and design their policies accordingly. At a minimum, SSA governments cannot afford to adopt policies that provide benefits to larger investors, at the expense of domestic SMEs. Indeed, doing so would be a recipe for *exclusive*, as opposed to *inclusive*, industrialization.

This paper is structured as follows: *first*, it provides a brief historical overview of the trends in SME and FDI policies in SSA; *second*, it demonstrates how investment promotion policies generate an unequal playing field for SMEs, and analyzes their WTO-consistency; *third*, it describes how, and in what situations, local content requirements may negatively impact foreign investors. It also analyzes the WTO-consistency of investment promotion policies. *Fourth*, this paper explores various policy options that SSA countries could consider to attract FDI while not discriminating against SMEs, and to promote the growth of domestic SMEs will minimizing the deterrence effect on FDI.

Where relevant, this paper draws upon the experience of a number of SSA countries, including Tanzania, Rwanda, Kenya, Ghana, Botswana, and Nigeria, and Asian countries, including China and Malaysia. These examples are merely illustrative of a general point made in this paper. None of the references to country-specific situations should, however, be considered as a comprehensive overview or account of the industrialization process, outcome or policy packages adopted in these countries.

II. BACKGROUND

A. Trends in SME/FDI policies in Africa

The role of SMEs and FDI policies in SSA countries has largely corresponded to the dominant ideological underpinnings of SSAs different industrialization phases. Between 1960-1970, post-independence, SSA countries aimed to protect their domestic industry against foreign competition and reduce dependence on imported products through import substitution industrialization (ISI).[7] To this end, many SSA countries adopted import tariffs, import quotas, exchange-rate controls, production subsidies, and overvalued currency. FDI was heavily restricted, and local content requirements were adopted in an attempt to channel investment away from import-heavy, low value-added, foreign-controlled industrialization towards domestically-controlled industrialization.[8] As noted by an UNCTAD report:

> [t]he combination of economic fluctuations due to commodity price swings (especially the price of oil) and the rapid expansion of the state's role in the economy created a powerful disincentive against long-term foreign

[7] C. van der Ven, "Trade, Development and Industrial Policy in Africa: the case for a pragmatic approach to optimizing policy coherence between industrial policy and the WTO policy space", Law Dev Rev 2017; 10(1): 29-80 (2016), p. 36.

[8] UNCTAD, "Local Content Requirements and the Green Economy, (2014), available at: http://unctad.org/en/PublicationsLibrary/ditcted2013d7_en.pdf, p. 5.

> investment, particularly for small and medium-size enterprises (SMEs) who could not afford access to political elites.[9]

To strengthen domestic industrial participation, this period witnessed an increase in SME-focused policies, such as grants, subsidized credits, and fiscal benefits, as well as SME-specific. For instance, Tanzania established a SME agency in 1966; Cote d'Ivoire adopted a ministry to promote SMEs in the 1970s[10]; and in the 1970s, Ghana established a number of institutions to assist SMEs, including providing financial and technical support, little was done at the time.[11]

A radical SSA industrial policy reversal took place in the mid-1980s, when it became increasingly clear that the ambitious targets set by ISI remained unrealized.[12] The disappointing results of ISI were due to a number of different factors, including inefficient, unsustainable and inward-looking industrial sector, whose growth potential was confined by the domestic market.[13] Pressured by the World Bank and the International Monetary Fund, SSA countries began to adopt export-oriented policies, also known as structural adjustment policies. Such an export-oriented outlook typically included the adoption of exchange-rate devaluations, tariff reductions, the removal and/or reduction of quantity restrictions, production subsidies eliminations, and the adoption of export and investment promotion policies comprised of export compensation schemes, and import duty and VAT remissions.[14]

During this time, most SSA countries adopted investment promotion policies and put in place special economic zones ("SEZs) and/or export processing zones ("EPZ").[15] For instance, in 1996, Kenya established its first EPZ; in 1994, Ghana adopted its Investment Promotion Act, and in 1995 an EPZ; and in 1997 Tanzania adopted an Investment Promotion Act in 1997. However, few SME-promotion policies were put in place. While SMEs and the informal sector comprised most of the private business activity in SSA, the private sector development strategies "were skewed towards the needs of large-scale businesses, including foreign

[9] Ibid.
[10] C. Soludo, O. Ogbu, H.J. Chang, *The Politics of Trade and Industrial Policy in Africa*, (2004) pp. 310-320.
[11] J.A. Peprah, A.O. Mensah, N.B. Akosah, "Small and Medium Sized Enterprises (SMEs) accessibility to public procurement: SMEs entity perspective in Ghana", European Journal of Business and Social Sciences, Vol. 4, No 11 (2016), p. 28.
[12] van der Ven (2016), *supra* note 7, p. 37.
[13] C. Soludo, O. Ogbu, H.J. Chang, *supra* note 10, p. 213.
[14] Ibid.
[15] T. Farole, *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience*, 2011, the World Bank, pp. 67-68.

invested ones".[16] Indeed, the need to intervene in the market to include SMEs within a country's industrialization strategy did not comport with the laissez-faire ideology of the structural adjustment era.

Similar to ISI, the structural adjustment policies had disappointing results.[17] While poverty had been reduced in some SSA countries, the structural economic changes that were anticipated did not materialize. Moreover, it became increasingly clear that laissez-faire policies would not resolve major challenges such as food security, the environment, finance, and economic inequality. Thus, around the turn of the century, SSA countries began moving away from the extremes of the ideological spectrum, towards a combination of protectionist and liberal policies.[18]

Indeed, SSA industrial policy plans adopted and developed since 2000 typically contain the dual objective of increasing domestic value added, including through protectionist measures, while attracting investment and increase export through market liberalization policies.[19] For instance, Rwanda's Vision 2020 considers it "necessary … to implement[] policies to encourage foreign direct investment" while its Small and Medium Enterprises (SMEs) aims to adopt policies that maximize SME-growth.[20] Tanzania's Sustainable Industrial Development (1996-2020) and Kenya's 2010 National Industrial Policy Framework place emphasize on the promotion of SMEs, while promoting FDI.[21]

In sum, SSA commitment to attracting FDI and encouraging the integration of SMEs into value chains has fluctuated during the last decades. Moreover, the dual objective of attracting FDI and while stimulating the growth of domestic businesses is a more recent phenomenon. It is against this backdrop that this paper examines the interplay between SME and FDI promotion policies.

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[16] OECD, "Promoting Entrepreneurship and Innovative SMEs in a Global Economy: towards a more responsible and inclusive globalisation" (3-5 June 2004), p. 11.

[17] Yaw Ansu, "Industrial Policy and Economic Transformation in Africa: strategies for Development and a Research Agenda," in Joseph E. Stiglitz, Justin Yifu Lin and Ebrahim Patel (eds.), the Industrial Policy Revolution II: Africa in the 21st Century (Palgrave Macmillan, 2013), p. 494.

[18] Ibid ; van der Ven, *supra* note 7, p. 38.

[19] Van der Ven (2016), *supra* note 7, p. 38.

[20] Republic of Rwanda, Ministry of Finance and Economic Planning, Rwanda Vision 2020), 2000, p. 21; Republic of Rwanda, Ministry of Trade and Industry, Small and Medium Enterprises (SMEs) Development Policy, 2010.

[21] United Republic of Tanzania, Ministry of Industries and Trade, Sustainable Industries Development Policy SIDP (1996-2020); 1996; available at: https://tanzania.go.tz/egov_uploads/documents/Sustainable-Industries-Development-Policy_sw.pdf; Republic of Kenya, Kenya's National Industrialization Policy Framework, 2010, p.6, available at: http://www.trademarksa.org/sites/default/files/publications/EAC%20Kenya%20National%20Industrialization%20Policy%20Framework%20-%20Combined%2018-11-2010%20Revised.pdf.

II. Impact of FDI promotion policies on SMEs

A. Unequal playing field between MNEs and SMEs

1. Incentive packages contingent on minimum capital requirement

Almost all SSA countries have adopted policies to attract foreign and domestic investment. Specifically, tax incentive policies are the most common among SSA investment promotion policies.[22] This includes tax concessions, accelerated depreciation allowances, capital gains exemptions, location tax allowances, exemptions on import duties, and tax credits.[23] Most SSA countries do not *de jure* discriminate against domestic investors, i.e., domestic investors that meet the investment criteria are also eligible to receive benefits. However, eligibility is often contingent on investing a minimum amount of capital. These minimum capital requirements can be extremely high, especially in light of the GDP per capita in many SSA countries. For instance, in 13 SSA countries, investment incentives are contingent on minimum capital requirements exceeding 200% of income per capita.[24] Given that many domestic SMEs are unable to meet the minimum capital requirements, a number of SSA governments have removed and/or reduced capital requirements for domestic investors. For example, in Ghana[25] and Zambia, to be eligible to benefits, foreign investors must invest a minimum USD 500,000.[26] To receive benefits in Rwanda, foreign investors must invest a minimum of US$250,000 while the threshold for national investors is US$100,000.[27] Kenya has imposed a threshold of USD 100,000 on foreign investors, and one million shillings - approximately USD 10,000 – for domestic investors.[28]

Despite the fact that numerous SSA countries have lowered or removed the minimum capital requirement, they can still be sufficiently high to prevent SMEs from accessing similar fiscal benefits as larger investors that have the requisite paid-in capital. For instance, Rwanda's

[22] D.T. Ayentimi, J. Burgess, K. Brown, "Developing effective local content regulations in sub-Saharan Africa: The need for more effective policy alignment", Multinational Business Review, Vol. 24 Issue:4 (2016), pp. 354-374, p. 361.
[23] Ibid.
[24] V. Saltane, P.G Serna, "Why are minimum capital requirements a concern for entrepreneurs?, available at: http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB14-Chapters/DB14-Why-are-minimum-capital-requirements.pdf.
[25] In Ghana, the minimum capital for foreign investors engaged in a joint venture with Ghanaian enterprises is USD 200,000.
[26] UNCTAD, "Economic Development in Africa: Catalysing Investment for Transformative Growth in Africa", Report 2014, p. 64. available at: http://unctad.org/en/PublicationsLibrary/aldcafrica2014_en.pdf; Zambia Development Agency, Investor Guide, 2016.
[27] UNCTAD, Investment Policy Review Rwanda, 2006. Available at: http://unctad.org/en/docs/iteipc200611ch2_en.pdf.
[28] Kenya's Investment Promotion Act.

minimum capital requirement of USD 100,000 for domestic investors is 142 times Rwanda's GDP per capita. Moreover, the average capital employed by Rwandan SMEs is USD 26.080, and 60% employs less than US$80,000.[29] This means that even though Rwanda has lowered the minimum capital requirement for domestic investors to USD 100,000, this is higher than at least 60% of what Rwandan SMEs are able to afford. Thus, Rwandan SMEs operating in the same sector as the larger businesses benefiting from tax breaks and other benefits stipulated above will be at a significant disadvantage when competing against these larger investors.

Similarly, the minimum capital requirements have discriminatory effects vis-à-vis foreign SMEs, which could bring similar benefits to domestic economies as large companies. The rationale behind imposing minimum capital requirements is, inter alia, that they inspire investors to consider investments more cautiously, thus protecting investors and consumers from new investments that may not be financially viable.[30] Moreover, large amounts of paid-in capital are considered to correlate with generating maximum economic activity. However, paid-in minimum capital is not an accurate proxy for economic activity, firm size, or risks. For instance, a small company in the service industry will have a low start-up capital, but will not automatically contribute less to an economy, or have a higher risk to fail.[31] Indeed, especially in SSA countries with high unemployment, attracting medium-size formal businesses could provide an important source of employment.[32]

In sum, while most investment promotion laws in SSA do not *de jure* discriminate against SMEs, minimum capital requirements often exclude domestic SMEs from receiving various benefits larger investors are eligible, resulting in a disadvantage for SMEs.

2. Incentive packages contingent on export requirements

In addition to investment promotion policies, 30 SSA countries have also adopted a separate set of incentives for investors to set up Special Economic Zones (SEZ)[33] – i.e., "spatially delimited areas within an economy that function with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy".[34] The aim of SEZs is to overcome barriers that hinder investment, such as restrictive policies,

[29] African Development Bank, "Leveraging Capital Markets for Small and Medium Enterprise Financing in Rwanda" (2013), available at: https://www.afdb.org/fileadmin/uploads/afdb/Documents/Project-and-Operations/Rwanda_-_Leveraging_Capital_Markets_for_Small_and_Medium_Enterprise_Financing.pdf, p.7.
[30] Saltane, *supra* note 24, p. 42.
[31] Ibid., p. 43.
[32] Ibid.
[33] T.Farole (2011), *supra* note 15, p. 67.
[34] Ibid., p. 17.

inadequate infrastructure, poor governance etc.[35] Typically, countries aim to attract investment in the SEZ in order to generate exports (foreign exchange), and create local employment.[36]

In many SSA countries, investors in a SEZs are entitled to receive generous fiscal and non-fiscal benefits. These benefits fall into three categories: (i) fiscal incentives, including exemptions from income tax, import duties, VAT, withholding tax, stamp duty; (ii) procedural incentives in order to reduce bureaucracy, including exemptions from compliance with various national laws; and (iii) infrastructural incentives, such as ready-made factory unites, serviced land or office space, designed to reduce start-up time and costs.[37] However, especially in Export Processing Zones (EPZs), receiving these benefits is often contingent on meeting minimum export targets. For instance, investors in Namibia's EPZ, are entitled to receive tax exemptions on corporate tax, import tax, sales tax, and transfer duties on good and services for ten years, provided they export 100% of products in the first year, but with subsequent reduction to 70% and 30%.[38] In Ghana, investors with SEZ status benefit from 100 percent exemptions from all direct and indirect duties, a full exemption from income tax on profits for 10 years, and a full exemption from payment of withholding taxes from dividends arising out of the free zone.[39] SEZ-status is, however, contingent on exporting 70% of products. In Kenya, EPZ investors that export 80% of their products are eligible to receive a 10 year tax holiday; exemptions from withholding of taxes and dividends, import duties on raw materials and intermediate inputs, VAT, stamp duty, and restrictions on management or technical requirements.[40]

While most SEZs or EPZs do not *de jure* discriminate against domestic investors, they often do so *de facto*. Since few SSA SMEs[41] are direct exporters, most of them will be unable to meet the requirement of exporting 70 or 80 percent of the products. This problem is aggravated in countries like Kenya or Rwanda that are part of the East African Community ("EAC"), as sales to other EAC countries are also considered "local sales". Thus, requiring that an enterprise exports 80% as a precondition to receive SEZ status in Rwanda, Kenya, Burndi and Tanzania

[35] Ibid.
[36] Ibid., p. 64.
[37] E. Kathure Mwiti-Mbwiria, "Firm-Resources as Entrepreneurial Determinant and Performance of Manufacturing Small and medium (SMEs) foreign firms investing in Kenya", International Journal of Advanced Research in Management and Social Sciences, Vol. 4, No. 6, 2015. pp. 5-6.
[38] Namibia's Investment Centre 1996:1.
[39] WTO, Ghana's Trade Policy Review; Ghana's Free Zone Act 1995, Article 28.
[40] Kenya's Export Promotion Council, available at: <http://epckenya.org/index.php?option=content&task=view&id=47&Itemid=66>.
[41] WTO, "World Trade Report 2016: Levelling the Trading Field for SMEs", p. 38.

not only precludes non-exporting SMEs from taking advantage of SEZ benefits, but also SMEs that are regional exporters but mainly supply to other EAC countries.[42]

Critically, this means that most SMEs cannot access the generous fiscal and non-fiscal benefits to which investors with SEZ or EPZ-status are entitled, thus creating an unequal playing field.[43] This is acknowledged in some SME programs. For instance, the Tanzania SME policy review notes that while some progress has been made to alleviate the fiscal burden on SMEs, "tax incentives/exemptions as per the Tanzania Investment Act (1997) mainly apply to large and medium size companies".[44] While typically SMEs and MNEs serve different markets – with domestic firms focusing on the domestic market and foreign firms on the international market – this unequal playing field creates an barrier to SMEs aiming to move up on the value chain and enter the international market. For instance, numerous initiatives aim to increase the participation of SSA SMEs as direct exporters through, *inter alia*, taking advantages of trade preference programs like AGOA. The unequal playing field created by *de facto* excluding domestic SMEs from receiving generous benefits means that, in addition to all other hurdles SMEs must overcome, such as access to finance, efficiency, quality and scale, they are now also competing with MNEs benefiting from corporate tax breaks, import tax breaks, and often subsidized facilities – while they must often pay full taxes.

In some situations, SME-specific programs may provide SMEs with a number of benefits, thereby narrowing the gap with large SEZ-based investors. However, the benefits offered under these programs are often less than the benefits provided to large investors. For instance, in Swaziland, local SMEs rely on the Basotho Enterprises Development Corporation to receive technical and financial support.[45] Under this program, SMEs receive workspace which average 29 rand per square meter in prime locations.[46] Large firms, in comparison, can access factory shells at rates that appear to be around 7.5 rand per square meters, and free of charge for the first two years.[47]

[42] Government of Rwanda, "Special Economic Zone Policy, 2010. Available at: http://www.minicom.gov.rw/fileadmin/minicom_publications/policies/SEZ_Policy_Cleaned_.pdf, p. 17.
[43] T. Farole, *supra* note 15, pp. 6, 225.
[44] UNIDO, "Tanzania SME Development Policy Review: Ten years after" (2012), p. 23.
[45] C. Staritz and S. Frederick, "Sector Case Study: Apparel", in T. Farole and D. Winkler, *Making Foreign Direct Investment Work for Sub-Saharan Africa: Local spillovers and competitiveness in global value chains* (The World Bank, 2014), p. 234
[46] *Ibid*.
[47] *Ibid*.

In addition, most of the SME financing schemes have strict eligibility criteria, which means that even in situations where SMEs would be in theory eligible to receive certain benefits, these often remain untapped.[48]

In sum, most investment promotion projects focus on attracting large MNEs, which reduces SMEs competitiveness vis-à-vis MNEs, thus creating a significant SME disadvantage.

B. Unequal playing field between local and foreign SME suppliers

In addition to generating a competitive disadvantage of SMEs aiming to become direct exporters, the spatial and legal structures that govern SEZs and EPZs also create a competitive disadvantage for domestic SMEs to serve as input suppliers to firms located in the SEZ/EPZ.[49] For instance, while enterprises in SEZ can purchase inputs from international suppliers on a duty and VAT-free basis, VAT and/or other taxes are still incurred when SEZ MNEs purchase products from domestic enterprises located outside the SEZ.[50] For instance, in Lesotho, domestic manufacturing firms supplying firms in the EPZ are subject to the standard 25% tax regime, in contrast to foreign suppliers which can provide inputs to SEZ firms on a duty and tax-free basis.[51] Similarly, Tanzanian local suppliers selling to enterprises in a SEZ relying on imported goods are not eligible to tax exemptions, in contrast to foreign suppliers. Moreover, as direct exporters, foreign SME suppliers qualify for duty exemptions on imported inputs. However, local supplier SMEs selling to enterprises in the SEZ or EPZ are not direct exporters and thus may not in all countries be eligible to receive duty drawbacks. Thus, the tax and duty exemptions for enterprises in the SEZ impose a *de facto* penalty on local supplier firms.[52]

A number of SSA countries have attempted to reduce this competitive disadvantage by providing input suppliers who supply to enterprises into the SEZs with indirect exporters status, making them eligible to receive the same benefits as direct exporters, including duty exemptions.[53] For instance, Ghana considers the sale of goods and services by a domestic

[48] See, e.g., J. Abor, N. Biekpe, "Small business financing initiatives in Ghana", Problems Perspective Management, 4(3) (2006), pp. 69-77 (concluding that most SME schemes in Ghana remain unutilized).
[49] T.Farole, C. Startiz, D.Winkler "Conceptual Framework" in T.Farole and D.Winkler, *Making Foreign Direct Investment Work for Sub-Saharan Africa: Local spillovers and competitiveness in global value chains* (The World Bank, 2014), p. 46; T. Farole (2011), *supra* note 15, p. 225.
[50] T. Farole and D. Winkler (2014), *supra* note 45, p. 249.
[51] T. Farole (2011), *supra* note 15, p. 175.
[52] M. Hansen, "From Enclave to Linkage Economies? A review of the literature on linkages between extractive multinational corporations and local industry in Africa", DIIS Working Paper (2014:02), p. 25; Mjimba, V. "The Nature and Determinants of Linkages in Emerging Minerals Commodity Sectors: A Case Study of Gold Mining in Tanzania". MMCP Discussion Paper, the Open University and University of Cape Town, 2011, p. 48.
[53] P. Harrold, M. Jayawickrama, D. Bhattasali, Practical Lessons for Africa from East Asia in Industrial and Trade Policies, world Bank Discussion Paper, (1996), p. 69.

enterprise from the non-EPZ area into the EPZ area as exports, and does not require a domestic enterprise selling to an EPZ-based enterprise to obtain an export license.[54] Likewise, East Africa's Manufacturing under Bond program entitles exporters, including indirect exporters, of manufactured goods to import plant, machinery and raw materials tax free.[55]

While such programs may r*educe* the unequal playing field between foreign and domestic SMEs, it does not *level* the playing field in SSA. For instance, the administrative hurdles and delays involved in requesting a duty drawback often means that SMEs rarely claim their duty drawbacks.[56] A particular obstacle for SMEs that are indirect exporters is inability to attach the original bill of export with their claims, as this bill is in the possession of the final exporter.[57] As the costs of reclaiming duty outweighs the benefits, less than 10 percent of eligible duty drawback is estimated to be claimed through these systems.[58]

SEZ/EPZs are likewise unconducive to generating forward linkages with SMEs. With the exception of Nigeria, Lesotho, Senegal and Kenya, all the zones in SSA restrict the sale of goods from the SEZ to local markets.[59] Moreover, any goods sold in domestic markets requires customers to pay VAT and import duties as if the products were coming from outside the country.[60] While these regulations attempt to protect the domestic market from competition from firms in the zones, they also serve as a barrier to generating linkages between local and foreign businesses. These barriers are even more pronounced in Customs Unions, as mentioned above, given that investors are unable to sell to any of the countries that comprise the Customs Union as all such sales are considered to be local. For investors looking mainly to serve the regional bloc, SEZ local market sale restrictions are less attractive.[61]

A number of other factors not directly related to EPZ policy also contribute to the often uncompetitive position of domestic SME suppliers compared with foreign suppliers. For instance, it is common for MNEs to reduce costs by bundling inputs. For instance, with textile being the most valuable input of a garment – around 75 percent of the total value of a t-shirt, for instance - MNE enterprises sourcing their textile from a foreign enterprise will be included

[54] Farole (2011), *supra* note 15, p. 227.
[55] East African Community, Customs, Manufacture Under Bond (MUB), available at: https://customs.eac.int/index.php?option=com_content&view=article&id=48&Itemid=95.
[56] Ibid., p. 228; http://includeplatform.net/wp-content/uploads/2015/03/GTF-Export-Promotion-in-Ghana-SR-formatted.compressed.pdf, p. 13.
[57] Farole (2011), *supra* note 15, p. 236, fn. 9.
[58] Ibid.
[59] Ibid., p. 226.
[60] C. Staritz et al. "Harnessing Foreign Direct Investment for Local Development? Spillovers in Apparel Global Value Chains in Sub-Saharan Africa", 2016, p. 15.
[61] Farole (2011), *supra* note 15, p. 146.

to also source other inputs from that same supplier. Another important element that makes it often more difficult for SMEs in SSA countries to compete at an equal playing field with foreign suppliers is access to financing. Indeed, due to the higher (perceived) risk of investment, the higher administrative costs, and the lack of skills, the costs and collateral requirements for SMEs taking out a loan are significantly higher in SSA countries compared to their counterparts.[62] A World Bank study found that SMEs in SSSA are more financially constrained than in any other developing region.[63] Another study found that SMEs in China pay an average interest rate of 4.7 percent, compared to 10 percent in Ethiopia, 14 percent in Ethiopia, 146 percent in Zambia, and 124 percent in Tanzania.[64] Likewise, the requirements for collateral are also much higher in most SSA countries, with banks charging up to 150% of the loan amount as collateral.[65] as well as restrictions on the type of collateral that is accepted.

In sum, widespread policies adopted by many SSA countries to attract FDI create an unequal playing field for domestic SMEs – vis-à-vis international investors and international suppliers.

C. WTO consistency of investment promotion policies

As set out in the previous section, investment-promotion policies typically encompass the provision of a number of benefits contingent on exporting a minimum percentage. Often, these benefits are provided in the context of an EPZ or SEZ. While the WTO disciplines do not specifically refer to the legality of EPZ or SEZ *per se*, subsidies are regulated under the SCM Agreement.

Under the SCM Agreement, a measure is considered a subsidy if it constitutes "a financial contribution by a government or any public body within the territory of a Member". This includes the provision of benefits at below-market rate, including through a direct transfer of funds (grants, loans, equity infusions, etc.), potential direct transfer of funds or liability (e.g. loan guarantees) and government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives).[66]

[62] NEPAD/OECD Investment Initiative, "Investment for African Development: Making it Happen", 25-27 May 2005. Available at: https://www.oecd.org/investment/investmentfordevelopment/34783838.pdf.
[63] P.Calice, V. Chando and S.Sekioua, "Bank Financing to Small and Medium Enterprises in East Africa: Findings of a Survey in Kenya, Tanzania, Uganda and Zambia", World Bank Working paper Series (2012).
[64] World Bank, "Light Manufacturing in Africa: Targeted Policies to Enhance Private Investment and Create Jobs", 2012. Available at: http://siteresources.worldbank.org/DEC/Resources/LightManufacturingInAfrica-FullReport.pdf, pp. 80-81; see also Dalberg, Report on Support to SMEs in Developing Countries through Financial Intermediaries, 2011.
[65] Dalberg, Report on Support to SMEs in Developing Countries through Financial Intermediaries, 2011, p. 18.
[66] C. van der Ven, *supra* note 7, p. 43. *SCM Agreement*, Article 1.1.

Under the SCM Agreement, certain types of subsidies are prohibited *per se*, whereas other subsidies, called actionable subsides, are impermissible only if another country can demonstrate proof of injury. Two types of subsidies are per se prohibited: export subsidies, i.e., "subsidies contingent, in law or in fact ,whether solely or as one of several conditions, upon export performance …" and local content subsidies, i.e., subsidies contingent on using domestic inputs over foreign inputs.

Accordingly, in the context of EPZ/SEZs, the following incentives could amount to prohibited export subsidies under the SCM Agreement: exemptions, remissions or deferral of direct taxes or social welfare charges if contingent on exports; allowance of special direct tax deductions (e.g., income tax and corporate tax) for exports above those granted on goods sold for domestic consumption; and provision of domestic products and services for exports at terms more favorable than those for domestic goods.[67]

However, not all subsidies contingent on export are prohibited under the SCM Agreement. Notably, Article 1.1(a)(1)(ii) of the SCM Agreement provide that duty exemptions on the remission of indirect taxes on the import of inputs consumed in the production of the goods to be exported, do not fall within the scope of the SCM Agreement. This includes, *inter alia*, exemptions of exported products from import duties; exemptions from indirect taxes, and exemptions of goods consumed in the production process from import duties and indirect taxes when end products are exported.[68]

Moreover, not all countries are subject to the provisions of Article 3(1)(a) of the SCM Agreement, which prohibits export subsidies. Indeed, two categories of countries are exempt from this provision: (i) least-developed countries designated as such by the United Nations, and (ii) a list of specific countries (including, from SSA, Cameroon, Cote d'Ivoire, Congo Ghana, Kenya, Nigeria, Senegal) until GDP per capita in these members has reached $1,000. Kenya is the only country that reached over US$1,000 and its exemption expired in 2015.[69]

Thus, for the time being, most SSA countries are not prohibited to subsidize exports under the WTO, and thus, act in accordance with the WTO in providing various types of benefits to investors that are contingent on export. However, some countries may be reaching the US1,000 in the near future, which means they want to think about implementing changes to

[67] S. Creskoff and P. Walkenhorst, "Achieving WTO Compliance for Special Economic Zones in Developing Countries", (2009), p. 3.
[68] Ibid.
[69] Farole (2011), *supra* note 15, p. 177.

their EPZ/SEZ regime. One way to ensure the EPZ?SEZ regime will be consistent with the SCM Agreement is by removing the local sale restriction on enterprises located in the EPZ/SEZ. This is discussed in more detail in the policy options section below.

III. Impact of FDI-SME linkages and SME value-added promotion policies on FDI

Having examined the potential of FDI policies on SMEs and their WTO-consistency, this section does the reverse: it examines the impact of local content requirements on FDI.

Typically, local content requirements are adopted to advance certain industrial policy objectives, including socio-economic objectives such as supporting SMEs through increase FDI-SME linkages.[70] Specifically, local content requirements require investors to meet certain specific goals with respect to their operations in the host country. This can include, for instance, recruiting and developing the capabilities of the local workforce; developing domestic firms' capabilities; supporting local firms through local resource souring, etc.[71] The rationale for these policies is that the more foreign investors are obliged to buy locally, the more linkages they will form with local firms, and thus, the more value will be added to the domestic economy.[72]

SSA governments utilize local content requirements in different ways: as entry requirement, a requirement for obtaining a concession, an operating license, or to access investment incentives. In SSA, they are most commonly embedded in government procurement. Local content requirements vary between stringent requirements, i.e., stipulating the percentage of goods that must be supplied from a local firm, or more flexible arrangements inviting investors to propose how they will deliver value to the local economy. This section engages in a general assessment of the dissuasive impact, if any, of these different types of local content requirements.

A. The impact of local content requirements on FDI

A number of SSA countries have imposed stringent local content requirements, most frequently embedded in government procurement programs. For instance, in South Africa, a tenderer is required to subcontract a minimum of 30% of the value of the contract to SMEs and

[70] G. C. Hufbauer and J. Schott, *Local Content Requirements: A global Problem*, Peterson Institute (2013), p. 10.
[71] D. Ayentimi et al., (2015), *supra* note 22, p. 359.
[72] OECD, "Encouraging Linkages Between Small and Medium-Sized Companies and Multinational Enterprises" (2005), p. 19.

other individuals covered by the Act.[73] With the local procurement policy (LPP) the Government of Botswana aims to reserve up to 30 per cent of government supplies procurement to manufacturing firms based in Botswana.[74] In Sierra Leone, at least 20% of managerial and 50% of intermediate positions shall be held by Sierra Leonean citizens (although the ratio will be increased).[75] More specifically, SSA countries tend to employ local content requirements in the extractive industry. For example, Nigeria's 2010 Content Act requires that all entities active in the oil and gas industry to incorporate Nigerian content as a key element in project development and management. Similarly, Ghana provides that operators shall "as far as practicable" prefer local inputs to imported goods. It has instituted a 10% preference threshold, to be increased with 10% each year.[76]

However, local content requirements do not need to be explicit. Less direct local content requirements involve systems that evaluate the local content of an investment on the basis of several criteria, one of which is local content.[77] For instance, foreign investors interested in Namibia are eligible to receive favorable tax rates upon showing a feasibility study demonstrating that the investment will not unfairly disadvantage Namibian businesses, and that the enterprise will contribute positively to Namibia's growth.[78] Moreover, Ghana's Minerals and Mining Act (2006) requires mining companies to submit a five-year local procurement plan containing targets and strategies to increase local procurement, including through developing capacity of suppliers.[79]

The advantages and disadvantages of local content requirements have been debated extensively.[80] Proponents argue that local content requirements are needed to build up local domestic industry and are crucial to establish linkages between domestic and foreign businesses. In the right types of settings, performance requirements can promote the development of SMEs. For instance, the use of targeted local content policies by the Thai Government in the automobile industry led to a 77% decrease in the value of imported parts

[73] World Bank, PPPIRC, "Laws and Regulations Generally Promoting SMEs/Local Content", available at: http://ppp.worldbank.org/public-private-partnership/laws-and-regulations-generally-promoting-smes-local-content.
[74] NEPAD/OECD 2005, *supra* note 62, p. 27.
[75] World Bank, PPPIRC, "Laws and Regulations Generally Promoting SMEs/Local Content", available at: http://ppp.worldbank.org/public-private-partnership/laws-and-regulations-generally-promoting-smes-local-content.
[76] UNCTAD (2014), *supra* note 8, p. 10.
[77] Ibid., p. 4.
[78] C. van der Ven (2016), *supra* note 7, pp. 48-50.
[79] Farole and Winkler (2014), *supra* note 45, p. 137.
[80] GIZ, "Space for Local Content Policies and Strategies: a crucial time to revisit an old debate", p. 7.

and components in each domestically assembled vehicle.[81] Likewise, local content measures imposed by the South African government in its vehicles sector from 1965 to 1985 decreased import penetration ratios by nearly one-quarter.[82] Moreover, in countries such as South Korea, Chinese Taipei, Brazil, Mexico and Thailand, local content requirements have been arguably successful.[83]

Opponents, on the other hand, argue that local content requirements induce production inefficiencies, are an ineffective way to foster MNE-SME linkages, and are difficult to implement.[84] A key determinant of the success of local content requirements is local absorptive capacity in the workforce and domestic enterprises, and the extent to which it has been coordinated with industrial and trade policies. Indeed, one study found that where local content requirements were not accompanied by efforts to boost the competitiveness of the domestic SME suppliers, removal of these requirements may force many local suppliers out of business."[85] Thus, the effectiveness of local content requirements as policy tool to foster SME-FDI linkages is context-specific.

While empirical and conceptual literature is yet to be fully advanced on the impact of local content policy on FDI attraction, researchers and industry actors have argued that advancing local content policy as a stand-alone strategy could undermine efforts to attract FDI, especially in Sub-Saharan Africa.[86] For instance, enforcing local content policy requirements in an environment that is constrained by the lack of infrastructure, capital, technical know-how, innovation and domestic suppliers' competitiveness could generate an unfavorable investment climate for FDI, and thus restrict global competitiveness.[87] Moreover, from an economic point of view, local content requirements impose a burden on MNEs that is, at a minimum, equivalent to additional taxation.[88] As a result, inflexible local content requirements could deter investment[89], or result in investors allocating only relatively unimportant aspects of the value chain to a given location.[90] As noted by Ayentimi et al., "the absence of flexibility in local content policy requirements has the potential to undermine the efforts and resources by

[81] UNCTAD (2014), *supra* note 8, p. 4.
[82] Ibid.
[83] NEPAD/OECD 2005, *supra* note 62, p. 19.
[84] GIZ, supra note 80, p. 7.
[85] P. Sauve, "Life Beyond Local Content: Exploring Alternative Measures of Industry Support in the Context of WTO Accession", Journal of International Trade, 2016, Volume 1, p. 14.
[86] D.T. Ayentimi 2016, *supra* note 22, p. 363. Citing Kragelund 2016, Bakare 2011) [cite more studies].
[87] Ibid, citing Hansen et al, 2016, Fessehai, 2012.
[88] OECD 2005, supra note 62, p. XX.
[89] D.T. Ayentimi (2016) *supra* note 22, p. 265.
[90]OECD 2005, *supra* note 62, p. 17.

governments in Sub-Sahara Africa as incentives to attract FDI".[91] Likewise, an OECD paper noted that "[a]s with other performance requirements, local content obligations also have a potential dissuasive impact on inflows of investment, particularly for export-oriented affiliates".[92] Similarly, according to an UNCTAD report "the additional local content requirements could serve as a barrier to FDI, with some firms choosing instead to export rather than incur the costs and risks of domiciling their activities in the host country".[93]

The extent to which, local content requirements deter foreign investor is case, country, investor, and value-chain specific. For instance, the dissuasive impact of local content requirements on FDI tends to be more significant in small host countries. Indeed, large markets like China tend to appeal to MNEs even if investment is contingent on meeting strict local content requirements. It is thus unsurprising that the greatest number of performance requirements are typically in larger markets.[94] Relatedly, the objective of the investor, and the value chain in which the investor operates, also impacts the deterrent effect of local content requirements. For instance, an efficiency-seeking investor in a footloose industry such as the apparel sector, seeking cheap labor and/or market access under AGOA, will have the choice to invest in a number of different countries (e.g., Kenya, Rwanda, Lesotho, Ethiopia, Mauritius etc.). As noted by Ndemo and Smallbone:

> [o]ne of the key factors that policy makers need to consider, in seeking to attract and exploit the potential benefits of FDI, is the large number of locations in the world with similar characteristics, which clearly affect the bargaining position of individual governments with potential investors. In the absence of other location advantages, competition between places typically focuses on offering lower costs, which can contribute to the so-called 'race to the bottom'.[95]

Similarly, in situations where there exists a large number of locations with similar characteristics,, imposing local content requirements as market entry condition – while the other similarly situated countries do not – will have a dissuasive effect on foreign investors. However, in situations where only few countries possess the sought-after industry or raw materials - as is the case, for instance, in certain extractive industries – foreign investors will typically have a higher tolerance to comply with local content requirements.

[91] D.T. Ayentimi (2016) *supra* note 22, p. 265.
[92] OECD 2005, *supra* note 62, p. XX.
[93] UNCTAD (2014), *supra* note 8, p. 13.
[94] Ibid., p. 19.
[95] E.Ndemo, D.Smallbone, "Linkage Dynamics between Small and Large Firms in Kenya", DBA Africa Management Review, March 2015, Vol 5 No. 1, p. 57.

Moreover, the absorptive capacity of a country's SMEs, i.e., the ability to identify, assimilate and exploit knowledge from the environment,[96] is a key element in determining the effect on foreign investors. Where local content requirements – or other types of programs providing preferential rights – are unreflective of the capacities of local SMEs, it will render businesses inefficient, thus hindering their competitiveness. This happened for instance, in Malaysia which established the Vendor Development Program (VDP) that provided incentives to promote the creation and expansion of indigenous conglomerates and local firms, at first exclusively targeting firms owned or managed by the ethnic Malays called Bumiputera.[97] Under the VDP, Bumiputera firms were given preferential rights to supply Proton with locally-produced goods. Bumiputera firms were unable to meet the quality standard required, however, and as a result, Proton cars acquired a lower quality image which undermined the car project's viability, in addition to SME prospects.[98] Indeed, as Farole (WB) noted, "introduction of local content requirements before local industry can respond adequately is likely to weaken the competitiveness of investors, undermining the overall objectives".[99] Since Malaysia ultimately removed the ethnic ownership restrictions, Proton was able to seek out other local suppliers in Malaysia with a better capacity to produce higher quality products at a reasonable price.[100]

Flexibility in local content requirements likewise impact the dissuasive effect they may have on foreign investors. Governments that tie local content requirements to incentives such as tax and duty exemptions, expatriate permits, or majority ownership, or that provide investors leeway in how to add value to the local economy are typically less burdensome to foreign investors. For instance, in 2003, the Malaysian government frequently utilized such programs, extending full tax exemption incentives from ten to fifteen years to firms that had acquired "Pioneer Status" i.e., companies promoting products or activities in industries or parts of Malaysia which the government considered to be of high priority.[101] In providing options to foreign investors, it reduces the deterrent effect compared to rigid and mandatory local content requirements.

[96] P. Lugemwa, "Foreign Direct Investment and SME growth: Highlighting the need for absorptive capacity to support linkages between transnational corporations and SMEs in developing countries", International Journal of Economics, Finance and Management Sciences, 2014:2(4):245-256, p. 250; OECD and World Bank, "Inclusive Global Value Chains: Policy options in trade and complementary areas for GVCs Integration by small and medium enterprises and low-income developing countries", 2015.
[97] UNCTAD, "Best practices in Investment for Development", Investment Advisory Series (2011), pp. 23, 24.
[98] Ibid.
[99] Farole and Winkler (2014), *supra* note 45, p. 270.
[100] UNCTAD 2011, *supra* note 97, p. 24.
[101] U.S. Department of State, "2011 Investment Climate Statement – Malaysia", available at: https://www.state.gov/e/eb/rls/othr/ics/2011/157318.htm.

In sum, local content requirements can act as deterrent factors on foreign investors. The extent to which local content requirements dissuade investors is dependent on a number of different factors: the objective of the investor, the size of the domestic market, and the capability of domestic suppliers, and the coercive nature of the local content requirements.

B. WTO consistency of local content requirements

Local content requirements are regulated by a number of different WTO Agreements, including: the Trade Related Investment Measures Agreement (TRIMs), the GATT 1994, and the SCM Agreement.

Specifically, under the TRIMS Agreement, local content requirements refer to a government requiring enterprises operation in its territory to source all or part of the components of their manufacturing processes from domestic suppliers. The TRIMS Agreement prohibits such practice – even if the requirements is equally applied to domestic and foreign enterprises.[102] Specifically, TRIMS Article III:4 provides that "[t]he prohibition of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use". It lists a number of prohibited performance requirements in its illustrated list, including: measures which are "are mandatory or enforceable under domestic law … or compliance with which is necessary to obtain an advantage, and which require: the purchase or use by an enterprise of products of domestic origin or from any domestic source…".[103]

The TRIMS Agreement is based on the principle of national treatment set out in Article III of the GATT 1994. Specifically, Article III:5 provides that Members shall not "establish or maintain any internal quantitative regulation…that any specified amount or proportion of any product … must be supplied from domestic sources".

Thus, in accordance to these provisions, requiring, for instance, 30% of textile must be bought from local suppliers would likely contravene a Member's obligations under GATT Article III:5.

However, there exists a key exception to the prohibition on local content requirements. GATT Article III:8 establishes that Members are exempted from complying with the

[102] Bridges Volume 12, Nr.3 "TRIMS and Local Content" (2008). Available at: https://www.ictsd.org/bridges-news/bridges/news/trims-local-content.
[103] TRIMS Agreement, Annex, Illustrative list, (1)(a).

obligations under Article III in the context of government procurement. However, as has been clarified by the Appellate Body in *India – Solar Cells*, the scope of this exemption is narrow. In that case, the Appellate Body confirmed that a government can only include local content requirements if the product that is being procured is in a competitive relationship with the product that is being discriminated against. In other words, a government could request that 30% of uniforms are locally procured, but it cannot, in a WTO-consistent manner, require that 30% of textile inputs in uniforms it is procuring are sourced locally.

In addition, it is *per se* prohibited under Article 3(1)(b) of the SCM Agreement to adopt subsidies contingent on the use of domestic over imported goods. In other words, providing benefits contingent on local sourcing is, to the extent the benefits are "subsidies" under the SCM Agreement, impermissible. Similar to export subsidies, a local content subsidy is *per se* prohibited under the WTO, per se i.e., Members do not have to prove adverse effects for the subsidy to be WTO-inconsistent. However, as has been explained above in the context of export subsidies, indirect tax exemptions do not fall within the definition of subsidies under the SCM Agreement, and are thus not subject to the local content restrictions under the SCM Agreement.

In contrast to the disciplines on export subsidies, least-developed countries and countries with GDP per capita of less than US$1,000 are not exempted from this provision. This means that SSA countries that are WTO Members are subject to the local content disciplines in the SCM Agreement.

Thus, SSA countries that provide additional corporate or income tax reductions or contingent on sourcing local inputs would be in contravention with their obligations under Article 3(1)(b) of the SCM Agreement. Accordingly, requiring enterprises to source locally through linking local content requirements to additional benefits may, depending on the benefit, be impermissible under the WTO.

In practice, however, it is unlikely that a SSA will be challenged as a result of linking additional benefits to local sourcing requirements. Indeed, few WTO disputes have been brought on the basis of subsidies that alter market conditions solely within the domestic market. Only when subsidized domestic firms begin exporting to foreign markets may a WTO Member become interested in challenging such a practice at the WTO.[104]

IV. Policy options to create equal footing between FDIs, local SMEs, and SMEs

[104] P. Sauve (2016), *supra* note 85, p. 16.

Having analyzed tensions between investor promotion programs on SMEs, and local content requirements vis-à-vis foreign investor, and their WTO consistency, this section suggests a number of policy options for SSA governments to consider to minimize any negative impact on competing policy goals. The first section focuses on policies that SSA governments can adopt to foster the growth of SMEs, and the second offers some thoughts about FDI-SME linkage programs.

A. Attracting FDI while creating an equal playing field for SMEs

To ensure that SSA countries' FDI policy does not inadvertently hamper the growth of local SMEs, governments must ensure that their FDI promotion policies do not discriminate against local SMEs. This is recognized by an UNCTAD study, which states that: "in order to have an FDI policy that is in line with the objective of promoting domestic entrepreneurship, there is a need for incentives to be provided in a manner that does not discriminate against local investors".[105] Similarly, Farole noted in a World Bank study that "[m]ost important… is to ensure that foreign-owned companies do not have privileged access to such instruments over domestic producers."[106] Thus, at a minimum, SSA governments must ensure their policies do not make it more costly for SMEs to operate and grow compared to large(r) firms. There are various options for SSA countries to consider:

First, SSA governments should aim to make available investment incentives to domestic SMEs. One way to do this is through lowering or removing the minimum capital requirement for domestic investors. While numerous governments in SSA have adopted a lower minimum capital requirement for domestic businesses compared to foreign investors, these requirements are often still unrealizable for SMEs compared to the average capital these businesses have. Lowering minimum capital requirements vis-à-vis foreign investors is also an option to consider. Indeed, and as mentioned above, minimum capital requirements is often an inaccurate indicator of the developmental benefits an investor may bring to a domestic economy. In this context, rather than a minimum capital requirements, SSA could also consider adopting a different set of indicators, such as requiring an investor to conduct a feasibility study.

Second, SSA countries should make comprehensive and proactive efforts to reduce some of the obstacles for domestic SMEs from taking advantage SEZs or EPZs. Indeed, as noted by the

[105] UNCTAD (2011), *supra* note 97, p. 64.
[106] Farole and Winkler (2014), *supra* note 45, p. 269.

World Bank, "[o]pening up such [SEZ/EPZs] to domestic investors not only helps promote their productivity and level playing field, but can facilitate greater FDI integration through physical proximity and networks".[107] One key way to help domestic firms integrate is by opening up the zone to both foreign and domestic investors. This would mean not only legally making it possible for domestic investors to move into the zone, but also removing *de facto* barriers.

Removing the export contingency with respect to businesses locating in an SEZ is an option that may lower obstacles of domestic participation in these zones. This would facilitate SMEs – which are often unable to meet the export requirement – to register in SEZs and receive the fiscal and other benefits associated with SEZ/EPZ membership. Moreover, removing the export requirement would increase local sales, and thus increase the opportunity to construct forward linkages between FDI and local businesses. This could have a positive effect on investors, especially those that are targeting regional markets like the EAC. Moreover, removing the export contingency element of a zone would ensure the zone would not amount to a prohibited export subsidy under the SCM Agreement. Indeed, it is increasingly common for successful zone programs in SSA to remove the export requirement.[108] To date, this approach has been adopted by a handful of SSA countries, including Nigeria, Lesotho, Senegal, and Kenya (in its newly established SEZ, which removed the restriction on selling to the local market[109]).[110]

However, in considering whether to remove the export requirement on EPZ/SEZ investments, SSA countries must also analyze the impact of such a policy change on the domestic industry. In this context, an important factor for SSA countries to consider would be whether opening the domestic market to products created in the EPZ will result in out crowding of local SMEs, which are often unable to sell products at the same competitive costs and may not be able to reach the same quality standards. If such a study indicates that the costs to the domestic industry will be significant, it be premature for a SSA country to remove the domestic sale restriction.

[107] Farole and Winkler (2014), *supra* note 45, p. 267.
[108] Farole (2011), *supra* note, 15, p. 178.
[109] Oxford Business Group, "Kenya's new plan for special economic zones", available at: https://www.oxfordbusinessgroup.com/analysis/zone-new-plan-sezs-should-help-shake-country%E2%80%99s-offering-investors.
[110] Farole (2011), *supra* note 15, p. 226;

In addition, given that SEZs are designed to attract larger businesses, even when eliminating the export requirement, attracting numerous local SMEs into SEZs on a large scale may not be realistic. [111] Thus, SSA governments must be creative to find ways to maximize the spillover effects of FDI on SMEs. One such innovative approach has been pioneered in Ghana's Tema Free Zone, which has established a hybrid EPZ, i.e., part of the zone is a free-zone, and the other part is a non-free zone targeting smaller, non-exporting domestic companies. While these companies are not eligible to receive the fiscal and customs benefits, this arrangement aims to facilitate competitiveness of the smaller business and through enabling them to take advantage of a common infrastructure and cluster-based support services, such as common packaging and labeling facilities, warehousing etc. The Kenya Athi River Incubator program is another example of a program that aims to better integrate SMEs into EPZs/SEZs. As part of this program, Kenya has rented out small units to SMEs for service and light manufacturing - available from 26 to 550 square meters, at subsidized rates.[112] Moreover, SMEs participating in this incubator program are eligible to receive the same benefits as large investors in the zone, and are subject to more lenient export requirements: during the first year, they must export only 20 percent of their output, but 60 percent by the fourth year.[113] Importantly, however, they are eligible to receive the same benefits as large EPZ firms.

Another way to integrate domestic SMEs into SEZs/EPZs would be through setting up plug-and-play industrial parks, i.e., lost-cost, ready-made factory shells. This approach has been successfully adopted in China, with zones providing Chinese SMEs with basic infrastructure, such as roads, energy, water and sewage, security, affordable industrial land, technical training, standardized factory shells, and free housing accommodation next to the plant.[114] In China, this model significantly reduced start-up costs and risks for SMEs with sufficient scale, capital and growth prospects to take advantage of larger facilities, [115] playing "a very critical role in helping Chinese small enterprises to grow into mid-size and large enterprises".[116] That said, SMEs were not eligible to the same type of subsidies that were provided to larger businesses in these zones.[117] Rwanda appears to be in the process of adopting a similar model plug-and-play

[111] Ibid., p. 6.
[112] Kenya Export Processing Zone Authority, available at: http://www.epzakenya.com/index.php/about-us/available-space.html.
[113] Farole (2011), *supra* note 45, p. 229, and fn. 10.
[114] World Bank (2012), *supra* note 64.
[115] Ibid., p. 72.
[116] Ibid.
[117] Ibid.

model[118], and more SSA countries may consider implementing variations of the plug-and-play system.

Third, SSA governments may want to reconsider the effectiveness of providing indiscriminate and generous incentive packages to investors with respect to the goal of attracting "the right type" of investment, i.e., investment that generates maximum spillover to a domestic economy. Indeed, while incentive packages could lead in attracting investment in the short term, the correlation between incentive packages in SEZs and positive, long-term development outcomes is weak.[119] Especially for small and low income-countries seeking investment in the manufacturing sector, studies have found that governments have limited power to either attract the right type of investment, or to ensure that the investors become deeply integrated into a domestic economy, thus establishing the desired SME-FDI linkages and spillover.[120] Thus, governments may need to reconsider whether all the tax revenue foregone on generous tax reduction programs for foreign investors is the most effective way to spend resources on promoting FDI-SME linkages. One way to adopt a more targeted approach would be to focus on attracting market-seeking investment in sectors a domestic economy has a comparative advantage in. That said, it may not be realistic for many small countries in SSA to be extremely selective about the type of investment coming into the country. Indeed, the possibility to attract FDI is often limited in these countries.[121] Nevertheless, awareness of the different propensity of different types of investors and investment with respect to benefits to SMEs could be reflected in a country's investment policy – in line with a country's industrial outlook.[122]

However, the most significant level of intervention for governments to create a more equal SME-FDI paying field is at the local SME level. In the context of SEZ/EPZ, governments must be mindful of the barriers created as a result of the nature of EPZ/SEZ towards sourcing from local SMEs. At a minimum, this will include ensuring a more efficient administration of duty-drawback schemes, and, for SSA countries who have not adopted such a regulation, ensure that SME suppliers to businesses in the EPZ/SEZ receive status as indirect exporters. For example, in Korea, providing inputs at world prices to indirect exporters was a key factor in its successful duty exemption and drawback schemes.[123] In doing so, Korea "assured

[118] Interviews conducted by Author with SMEs in Kigali, Rwanda (June 2016).
[119] Farole (2011), *supra* note 15, p. 261.
[120] Farole and Winkler (2014), *supra* note 45, p. 264.
[121] Ibid., p. 266.
[122] See, e.g., C. van der Ven (2016), *supra* note 7.
[123] P. Harrold et al. (1994), *supra* note 54, p. 69.

unrestricted choice between imported and domestically produced inputs, while treating indirect exporters equally with direct exporters in assuring access to duty-free imports and other export incentives".[124]

In addition, as a key barrier to generating linkages is the lack of SMEs capable of delivering goods of requisite quality[125], governments should target supply-side absorptive capacity issues.[126] This would include horizontal interventions, such as improving access to finance for SMEs, access to information, and access to skills, but some aspects of this should be sector-specific.[127] Indeed, on the basis of an understanding of the growth potential of different sectors, governments, with the help of the private sector and/or universities, should target and prioritize the development of SMEs in specific sectors to ensure that these sectors develop the requisite technical skills and can meet the quality standards required of foreign investors.[128]

B. Promoting FDI-SME linkages without deterring FDI

In addition to undertaking concerted efforts to reduce disadvantages for SMEs, SSA governments also play an active role in encouraging FDI-SME linkages. However, on the basis of the discussion above, governments are encouraged to do so by looking at options beyond mandatory performance requirements as these will have less of a deterrence effect and will also more be more effective. As noted by Ndemo and Smallbone, "the current policy challenge is to exploit the development potential of local supplier networks through voluntary means, although some attempt to building the capacity of local SMEs to supply is almost certainly required, facilitated by intermediaries, as well as by active promotion".[129]

One way to do so is through *sui generis* analyses of an investors' potential for local value addition, and drawing up special terms and conditions with respect to that investor. Some SSA governments are already doing this. For instance, in Kenya, foreign investors only receive an investment certificate if the investment is considered beneficial to the economic development of Kenya. In making this assessment, the Kenya Investment Authority considers a number of factors, including the investment's impact on the creating of employment, acquisition of new

[124] Ibid., p. 70.
[125] D. Smallbone, "Foreign Direct Investment and SME Development: Some Policy Issues for Transition and Developing Countries" available at: http://yearbook.unwe.bg/uploads/Yearbook/Yearbook_2007_No2_D%20Smallbone.pdf.
[126] Farole (2014), *supra* note 45, p. 265.
[127] Ibid .
[128] Farole and Winkler, *supra* note 45, p. 265.
[129] E. Bitange Ndemo and D. Smallbone, "Linkage Dynamics between Small and Large firms in Kenya", DBA Africa Management Review, 2015, Vol 5 No. 1, pp. 38-59.

skills or technology for Kenyans, contribution of tax revenues, foreign exchange, utilization of domestic raw materials, supplies or services, among others.[130] Similarly, Rwanda's foreign investment regime requires foreign investors, *inter alia*, to submit with their application for investment (i) detailed information of any raw materials sourced within the country; (ii) detailed information about the projected knowledge and technology transfer; (iii) the projected environmental impact; and (iv) and the projected number of employees, including those in managerial positions.[131] On the basis of the sustainability study, the Rwandan authorities provides the groundwork for an investor-specific contract, which may or may not contain specific performance requirements. For instance, C&H, a recent Chinese garment investment in Rwanda's SEZ, was approved contingent on establishing a training program for Rwandans, and subsequently employing these Rwandans.[132] C&H currently employs 300 workers for export production, while training another 550.[133]

This flexible approach encourages linkages that are efficient and sustainable and they are the product of a firm's own capabilities.[134] As noted in a World Bank study:

> "[a] more effective approach to facilitating FDI-local economy linkages is for government to encourage (or oblige) investors to come up with their own proposals on who they will deliver spillovers to the local economy, allowing for flexibility so that different sectors and firms contribute substantially to improving linkages in ways that are efficient and sustainable".[135]

Moreover, such an non-coercive approach will not be considered a prohibited local content requirement or a violation of different provisions of the WTO.

SSA could also facilitate FDI-SME linkages through creating databases that enable foreign investors to locate local suppliers. Such an approach has been extensively used in Malaysia and Singapore's programs to facilitate SME-FDI linkages. Some SSA countries are taken note. For instance, Rwanda is planning to establish a supplier database, on the basis of Malaysia's vendor development programme, and India and Mozambique's databases. Specifically, Rwanda's supplier database will identify large Rwandan and foreign companies committed to support development of local businesses by providing product specification,

[130] Kenya Investment Promotion Act 2004, available at: http://www.kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/InvestmentPromotionActCap485B.pdf.
[131] Republic of Rwanda, Rwanda Development Board, "The Law on Investment Promotion and Facilitation", Available at: http://www.rdb.rw/uploads/tx_sbdownloader/Investiment_promotion_law_04.04.16.pdf.
[132] Interviews conducted by Author with SMEs in Kigali, Rwanda (June 2016).
[133] International Growth Centre, "Raising Exports and Attracting FDI in Rwanda", Policy Brief 2016, p. 29.
[134] Farole and Winkler (2014), *supra* note 45, p. 270.
[135] Ibid.

specifying purchase criteria and transferring know-how to suppliers.[136] These companies are required to sign an memorandum of understanding with potential suppliers, stating that they are committing to purchase the products, if certain criteria are met.[137] The Rwanda Development Bank identifies relevant institutes to help provide training sessions and provide financing from participating banks, who are willing to fund the SME.[138]

Another key way for SSA governments to proactively engage in FDI-SME linkages is by incentivizing SMEs to become "FDI-supplier ready". In other words, rather than only focusing on ways to encourage and incentivize *foreign investors* to link with SMEs, governments must consider focusing on incentivizing *SMEs* to develop the requisite capacity to meet the demands of foreign suppliers in specific sectors. This has been a common industrial strategy in a number of Asian countries. For instance, in 1996, Malaysia created the Industrial Linkage Programme (ILP), which aimed to encourage TNC-SME linkages by offering tax incentives to SMEs producing eligible products for foreign suppliers, and by reimbursing foreign businesses who incur costs by helping to improve SME capabilities. Specifically, eligible SMEs receive tax exemptions of 100 percent on statutory income for five years and investment Tax allowance of 60 percent on qualifying capital expenditure incurred within a period of 5 years. These incentives are contingent on manufacturing promoted products and activities, and on supplying to TNCs or large companies. While establishing such a program is costly, SSA governments may be able to make some funds available that were previously used to attract, indiscriminately, any foreign business that is able to meet the minimum capital requirement.

In sum, there are a number of options for SSA to consider to encourage SME-FDI linkages beyond imposing local content requirements: requiring or encouraging foreign investors to prepare a feasibility study about the benefits they will bring to the local economy; establish FDI-SME linkage programs; and focus on providing SMEs with the right incentives to meet quality and quantity requirements and become effective suppliers to FDI.

V. Conclusion

This paper has exposed tensions between policies adopted to promote FDI and policies adopted to stimulate the growth of SMEs. Indeed, this paper has demonstrated that generous incentives offered to investors creates an unequal playing field vis-à-vis SMEs – which are often

[136] Rwanda Ministry of Trade and Industry, "Rwanda Private Sector Development Strategy 2013-2018", p. 69.
[137] Ibid.
[138] Ibid.

precluded from receiving similar benefits. Moreover, EPZ/SEZ promotion policies often disadvantage SMEs from supplying enterprises in the zone compared to foreign suppliers. This paper has also demonstrated that local content requirements adopted to maximize FDI-SME linkages may, in certain situation, have the effect of dissuading foreign investors from making investments. Finally, this paper has demonstrated that a number of the FDI and SME-promotion policies adopted by SSA countries risk being WTO-consistent.

The tensions between FDI and SME-promotion policies – and the WTO – are indicative of the fragmented nature of policy making in many SSA countries. Indeed, in most SSA countries, SME policy is the responsibility of a different ministry/government sector than investment promotion. As noted by Farole: "… the problem of many of the African zone programs has been the failure to maintain consistent policy links between the programs and wider strategies of trade and industrialization".[139] Indeed, in SSA, policies are often drafted with the sole focus of advancing the policy objective that is being addressed: i.e., getting more FDI, or encouraging the growth of SMEs. There is often little communication between the different departments responsible for these different set of private players, resulting in a lack of policy coherence.

This siloed way of policy making is also reflected in the international community: most development studies or objectives focus on either separately on FDI policy or SMEs; or, alternatively, on all possible policy goals a country should seek to achieve. The SDGs are an example of the latter, containing a wish-list of numerous objectives countries should reach, ranging from issues such as clean water and education to inclusive growth. While the SDGs are a notably achievement, the challenge that comes with enumerating an all-encompassing lists of policy goals lies in the trade-offs and tensions that exist between some of these objectives, both in terms of policy effect and often also in terms of resource allocation. Indeed, as this paper has illustrated, policies that may advance SDG Goal 8 to "promote sustained, inclusive and sustainable economic growth…" and Goal 9 to "promote inclusive industrialization and foster innovation" may not be in line with Goal 17.10 of "promoting a universal, rules-based, open, and non-discriminatory and equitable multilateral trading system under the World Trade Organization…", Goal 17.11, which aims to "significantly increase the exports of developing countries" or Goal 17.15, aiming to "respect each country's policy space and leadership to establish and implement policies for poverty eradication and sustainable development". Indeed, as demonstrated in this paper, increasing exports requires in many SSA

[139] Farole (2011), *supra* note 18, p. 155.

countries increasing FDI; increasing FDI requires FDI-promotion policies; FDI promotion policies that provide fiscal and other benefits to FDI but not to SMEs can create an unequal playing field, thereby undermining the growth and development of SMEs, and thus, inclusive growth; FDI policies that provide direct fiscal exemptions likely violate various provisions in the WTO; yet adopting such policies is part of a country's policy space to achieve sustainable development.

This is an oversimplification, yet it illustrates how difficult it can be for SSA governments to meet all the objectives of the SDG. Indeed, focusing on certain overarching objectives without a clear understanding of how these different objectives interact and work together, may not be the most effective way to achieve sustainable development.

Moreover, while trade-offs are inherent to every policy decision, this does not mean that trade-offs cannot be minimized. In this context, this paper has described a number of best practices that certain countries have adopted to ensure that policies attracting FDI and encouraging the growth of SMEs mutually reinforcing. Indeed, SME and FDI promotion policies can be WTO-consistent and do not have to be mutually exclusive. However, governments will only understand the importance of minimizing the negative effects of certain policies and look to creative solutions once they aware of the potential tensions between various policies.

This paper aims to be a small contribution to exposing some of these policy tensions, and an invitation towards finding creative solutions to ensure SSA increase FDI-SME linkages.