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Is the Promotion of Foreign Direct Investment Delivering Spillover Benefits for the Domestic Manufacturing Sector in Tanzania?

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Abstract

Despite consistently receiving a significant share of the country's foreign direct investment (FDI), the manufacturing sector in Tanzania is characterized by low levels of technology and innovation, and the growth in the sector's value addition and exports have remained constant. This implies that FDI inflows are not delivering significant spillover benefits for domestic industries. Based on an analysis of local manufacturing and FDI firms operating in Tanzania, this study found limited spillover benefits to domestic enterprises, and recommends that, alongside its current policy framework to promote foreign and domestic investment, the Government needs to put equal weight upon fostering the transfer of technology, skills and innovation from investor to Tanzanian firms.

Introduction

Foreign direct investment is an important enabler of economic development. Given a favourable investment environment, FDI is crucial in building the technological capabilities of domestic companies in lower-middle-income countries such as Tanzania. Based on World Bank data, net FDI inflows into Tanzania amounted to USD 1.1 billion in 2022, making it one of the top 10 destinations for investment in Africa (World Bank 2024). By sector, with an average share of 21.4 percent of total FDI inflows over the period from 2005 to 2021, the manufacturing sector has consistently been the country's second largest recipient of FDI after the mining sector. However, despite receiving a significant share of foreign investment, manufacturing in Tanzania continues to be dominated by low technology exports and low levels of innovation compared with other African countries. This mismatch implies that FDI inflows have not led to significant benefits to local manufacturing firms. One of the important ways in which foreign direct investments impart technology, skills and innovation to domestic manufacturing is through creating linkages with local firms, such as:

- Backward linkages, where foreign investors source their goods or services from local firms and, in doing so, train or otherwise impart knowledge and technical assistance to domestic suppliers to raise the quality of those good and services.

- Forward linkages, where local firms use higher-quality or lower-priced intermediate products made by FDI firms in their own processes, which then benefits their consumers through better or cheaper final products

- Horizontal linkages though competition or demonstration. For example, the entry of an FDI firm into the country may encourage/compel local firms to improve their methods of production, distribution and marketing to compete with the foreign investor. The demonstration effect occurs when local companies see the superior technology of an FDI firm and, consequently, update their own operations or imitate new technologies used by the foreign investor. In addition, horizontal linkages include the movement of labour, for instance, where an employee of a FDI firm establishes a new enterprise in the same sector or a local firm employs a person from an FDI firm to benefit from their knowledge and skills.

Existing literature is not definitive as to the obstacles that limit spillovers to domestic manufacturing firms in Tanzania. Does the challenge arise from the reluctance of FDI firms to create linkages that transfer benefits to local manufacturing firms, or do Tanzanian firms lack the capacity to absorb, adopt or adapt new technology, innovation and skills? Equally, it is important to understand to what extent national policies for promoting FDI provide a conducive environment for spillover benefits to occur.

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Study objectives and methodology

Motivated by those questions, the current research: (i) examined the ways and extent in which FDI firms impart technology, skills and innovation (FDI spillover) benefits to local manufacturing firms in Tanzania; (ii) identified factors that drive spillover benefits to local manufacturing firms; and (iii) examined challenges and prospects for improving spillover benefits to local manufacturing firms.

To achieve its objectives, the study completed an empirical analysis of the extent and determinants of FDI spillovers based on secondary firm-level data for 1,354 domestically-owned firms from the most recent Annual Survey of Industrial Production (ASIP) in 2016, and primary firm-level data from key informant interviews conducted by the research team in 2024 with 150 firms in four regions of Tanzania: Arusha, Dar es Salaam, Coast and Kilimanjaro. Of these, 112 firms were local manufacturers, and 38 enterprises were FDI firms. The survey also consulted with four relevant government entities—the Ministry of Industry and Trade (MIT), Tanzania Industrial Research Development Organisation (TIRDO), Tanzania Investment Center (TIC) and the Tanzania Commission for Science and Technology (COSTECH)—as well as representatives from peak body institutions associated with manufacturing firms, including the Confederation of Tanzania Industries (CTI). In addition, a desk review was undertaken to examine Government policy initiatives to promote FDI and assess if these initiatives were favourable for FDI spillovers.

Findings

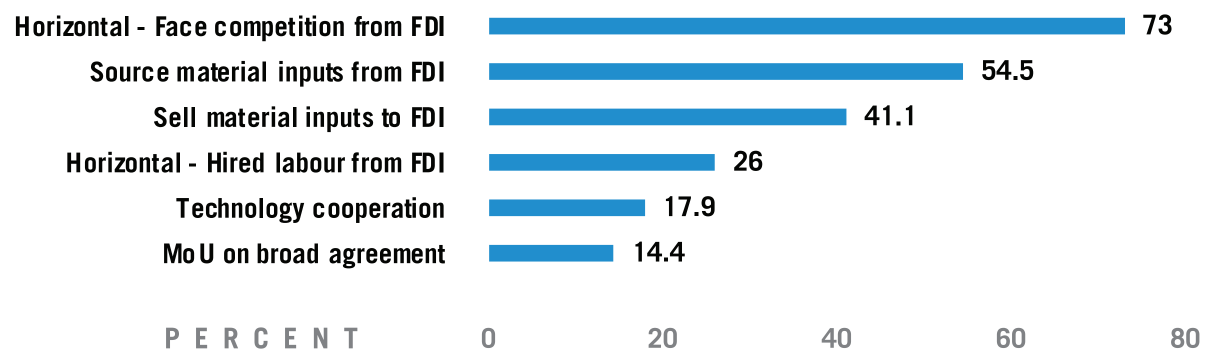
Extent and types of FDI spillovers to local manufacturers

Results of the empirical analysis of ASIP data indicate that FDI spillover benefits did accrue to local manufacturing firms but to a limited extent; only 471 respondent firms (34.8 percent of the local firms in the dataset) reported experiencing at least one spillover benefit. The analysis found that horizontal linkages were the most commonly reported mechanisms from which benefits were accrued by local firms, albeit through indirect routes rather than formal relationships such as customer/supplier linkages. For example, of the local firms that reported spillover benefits, 247 firms (52 percent) reported that they had "upgraded production technologies due to competition from FDI firms in the same industry" while 171 firms (36 percent) reported that they "directly adopted production techniques/processing by observing/copying from FDI firms in same industry."

Analysis of the ASIP data also provided insights on key drivers of spillover benefits. The findings show that the incidence of FDI spillovers was associated with higher levels of expenditure on research and development (R&D) by local firms, greater access to finance (to meet the cost of technology, innovation or skills), and existence of business linkages (sourcing/sales of goods) with FDI firms. In addition, some characteristics of domestic enterprises were identified as drivers of spillover effects of FDI. In particular, firm age (older firms), size (large-scaled enterprises), membership in industry associations, and operating in special economic zones (SEZs) were associated with higher probability of experiencing FDI spillovers.

Similarly, data from the 2024 firm survey found that horizontal linkages were the most common relationships between local manufacturing firms and FDI firms operating in Tanzania, while technological cooperation, i.e., relationships to share technology or to cooperate in product/software development, and broader Memorandums of Understanding (MoUs), i.e., relationships that cover multiple aspects at the one time (for example, exchange of goods, technology, skills, innovations, and/or developing new products) were the least common forms of relationship with FDI firms (Figure 1).

Figure 1: Existing relationships that local manufacturing firms have with FDI firms



Source: Authors' analysis of field data 2024

Of note, horizontal relationships (i.e., competition linkages) occur spontaneously when FDI firms enter the domestic economy, hence, they are easier to pursue compared to more transactional/direct linkages, such as forward, backward and technology linkages, which require effort to establish. Horizontal relationships whereby local firms hire employees who previously worked in FDI firms are also less common because most local firms do not have the capacity to pay the same or higher remuneration than FDI firms. More importantly, participating firms identified various spillover benefits from their relationships with FDI firms that have had a positive impact on their sales performance (ability to access new markets), competitiveness (reduced production costs) and improved productivity. For example, they reported that their interactions with FDI firms led to access to knowledge on more advanced machines that improved production processes and increased output or the quality of products, enabled access to new/export markets, and the adoption of modern managerial practices. In addition, some respondents noted that interactions led to improved environmental safeguards by reducing pollution and optimizing the use of energy. Other firms mentioned product innovations resulting from competition and/or copying production processes from FDI firms as well as access to skills needed to operate new machines or training, which enabled some employees to leave FDI firms and start their own enterprises using the knowledge and skills gained. Some firms also mentioned receiving support from FDI firms in terms

of a share of the investment needed to buy the machines and to pay for training on advanced skills.

Obstacles limiting FDI spillovers to local firms

Findings from the 2024 firm survey identified several obstacles that limit spillover benefits to local manufacturing firms. Domestic enterprises are predominantly informal and small in scale, hence, less able to compete with FDI firms, which are predominantly corporations and large in scale. Many local firms also do not have access to affordable credit or a skilled labour force, which constrains their ability to purchase and adopt new and advanced software, machines and technologies. In addition, the survey noted the existence of negative attitudes towards foreign investors entering and operating in Tanzania.

Respondents also cited challenges arising from an unfavourable business environment in the country, which limit the ability of local firms to grow and develop their capabilities, including high and unpredictable taxation, frequent electricity shortages, high transportation and production costs, and competition from cheap imports that limit market size for domestically manufactured products.

Current policy frameworks and initiatives for promoting foreign investment and increasing linkages between local and FDI firms

The desk review and consultations with relevant Government agencies and peak body associations found that the Government has put in place relevant laws, policies, strategies and regulations that aim to promote domestic and foreign investment, strengthen competitiveness and improve the business environment. Recently, the Government also passed the new Tanzania Investment Act (2022) with the goal of promoting the country as an attractive destination for foreign investors by streamlining investment processes, offering robust legal protections and providing fiscal incentives. As one the incentives to attract FDI, the country's employment policy guidelines allow investing firms to recruit up to ten foreign experts but, thereafter, employ ten locals for every additional foreign expert. This provides opportunities for Tanzanians to work in FDI firms and obtain skills and knowledge which they can then use in domestic enterprises.

In addition, with the support of development partners, such as the United Nations Conference on Trade and Development (UNCTAD), and with the involvement of local institutions, for example, TIC, TIRDO, the Small Industries Development Organization (SIDO) and the Tanzania Trade Development Authority (TANTRADE), the Government has implemented several initiatives to facilitate business linkages between investor and domestic firms. Such projects seek to identify new customers/suppliers, deepen partnerships and increase beneficial interactions to facilitate spillover benefits. Other initiatives include the ongoing Market Access Upgrade Programme Phase 2 (MARKUP II), a regional development initiative implemented by the International Trade Centre (ITC) under the auspices of the European Union (EU) that provides support to small and medium-sized enterprises (SMEs) in the East African Community (EAC) to enhance value addition, build capacity and expand access to the African Continental Free Trade Area (AfCFTA) market. Finally, business linkage initiatives have been successfully undertaken by the private sector, such as the partnership between Tanzania Breweries Ltd and Kioo Ltd, a glass bottle manufacturer, which led to significant product improvement and growth for both of these companies (Befeki, 2006).

Overall, the findings indicate that the current legal and policy framework is in favour of supporting technology transfer from FDI firms as one of the ways to promote the competitiveness of domestic manufacturers. However, there is limited evidence that the framework has actively or deliberately promoted FDI spillover benefits. Stakeholder agencies also reported challenges in implementation of business linkage initiatives, including limited budgetary allocations for research and development (R&D) institutions and other technology transfer activities, low levels of skills and training for the domestic labour force, and capital flight in the form of payments for the use of foreign technology.

Policy Recommendations

1. Based on the evidence, the study makes the following recommendations to Government to increase the spillover benefits from FDI firms to domestic manufacturing firms in Tanzania:

2. Continue to support initiatives that promote linkages between FDI firms and local manufacturers, including increases in domestic private investment and government budgets for R&D and other technology transfer activities, and greater support to institutions and platforms that facilitate FDI spillover benefits.

3. Promote firm-level capacity building, awareness and sensitization on the importance of nurturing relationships/linkages with FDI firms to tap the beneficial impact of the spillover effects, including improving access to information, modern technology, skills and market opportunities.

4. Increase investment in the technical and vocational education and training (TVET) sector to address the prevailing shortages of skills needed to support adoption of modern machines, new technology or innovation, and put in place a favourable environment for encouraging private sector investment in TVET skills development.

5. Strengthen the focus of investment policies to foster greater rapport and connection between FDI and local firms, enhance local absorptive capacities, and support activities to upgrade domestic innovation and technology.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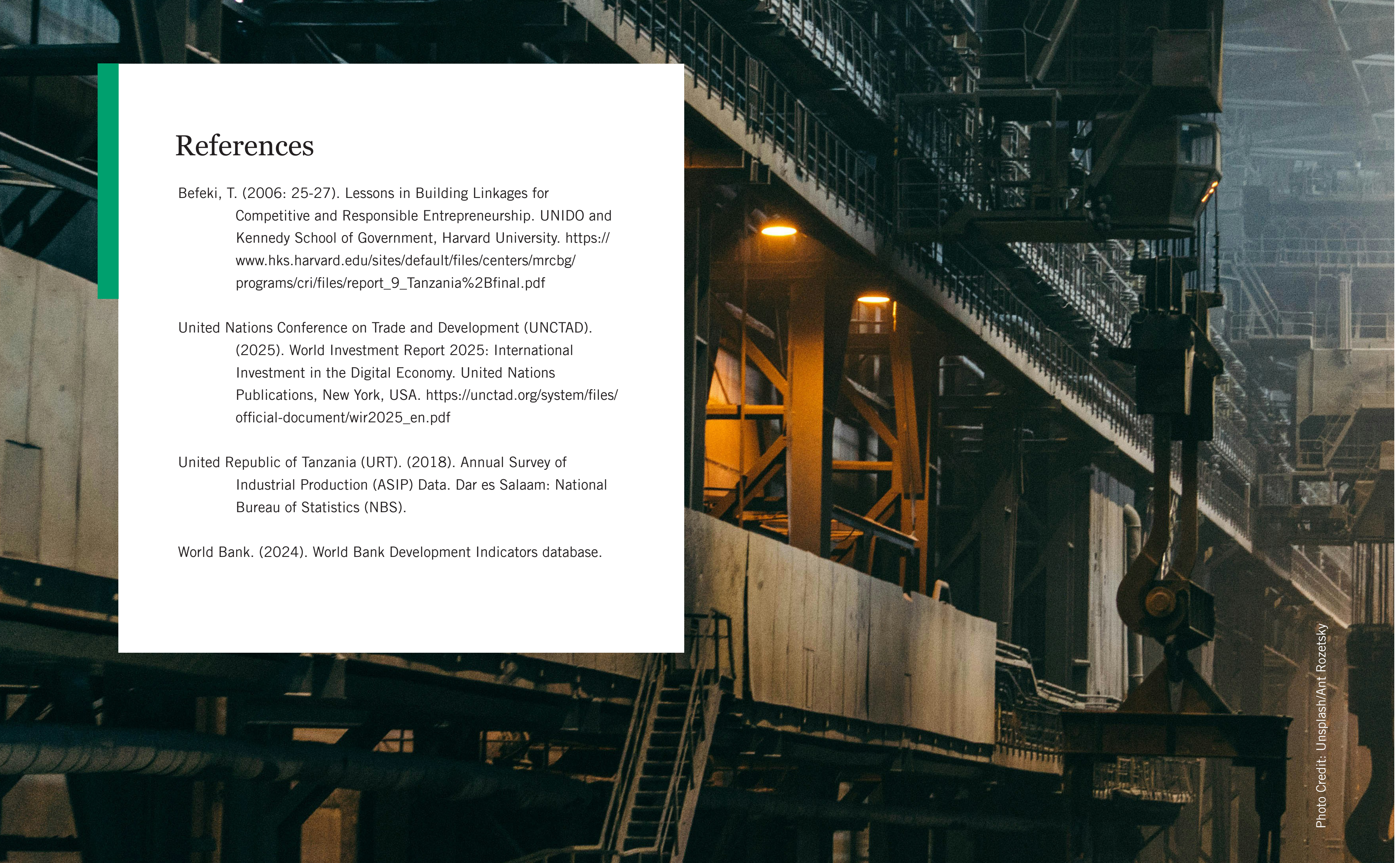

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