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Research Report

Reducing the reliance on global value chains by strengthening backward linkages

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Columbia FDI Perspectives

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Reducing the reliance on global value chains by strengthening backward linkages

by

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MNE affiliates in host countries have two major options to acquire production inputs: rely on global value chains (GVCs) and hence import inputs from foreign suppliers, or purchase inputs from local suppliers. The second option, backward linkages, is the focus of this *Perspective*.

Backward linkages should be a policy concern for national governments seeking to attract FDI as [they represent the most likely channel through which positive spillovers from foreign affiliates can occur](#): local firms play a complementary role as suppliers of production inputs or intermediate products. They do not compete with MNEs, but rather work with them; MNEs are therefore more likely to support positive spillovers to local firms.

Despite the importance of GVCs in the world economy, the need to strengthen backward linkages has become imperative with unforeseen events like the Covid pandemic, the blockage of the Suez Canal and geopolitical tensions causing GVC disruptions and delays in the delivery of intermediate products.

Backward linkages provide several benefits to local firms and MNEs.

Local firms, as suppliers of inputs, benefit from:

- [Increased sales](#) revenues from selling to MNEs.
- [Economies of scale](#) from higher production volumes, leading to reduced input production cost, higher profitability and competitiveness.

- [Improved production quality from MNE-knowledge transfers](#) that provide learning opportunities for new production and management practices.
- Comprehensive industry knowledge to anticipate clients' needs.

MNEs sourcing production inputs locally benefit from:

- [Cost efficiencies from the reduction of transportation costs](#) and savings on import tariffs. They may also benefit from lower input costs due to competitive pricing from local suppliers.
- [Better quality control of inputs](#) due to close proximity to local suppliers, as they can monitor and oversee production processes.
- [Risk diversification](#) from disruptions in GVCs, improving chances of continued operations under challenging circumstances.

Considering the potential benefits for both local firms and MNEs, governments can do a number of things to strengthen backward linkages and reduce GVC reliance:

- *Support the supply capabilities of local firms:* Governments can support the supply capabilities of local firms to increase their attractiveness for MNEs to form local linkages by setting up supplier development programs¹ in partnership with MNEs as advisers. Governments can improve access to finance for local firms and help them upgrade technologies and obtain certification certificates, to enable them to meet supply requirements. They should also promote technical education and training, increasing the absorptive capacity of local firms to utilize the knowledge and technological spillovers from MNEs. This motivates MNEs to rely less on foreign inputs and expertise.
- *Provide incentives:* Governments can offer financial and fiscal incentives to MNEs, such as tax breaks, subsidies, low-interest loans, and grants. The implementation of policies and government incentives that promote the use of local suppliers can also incentivize MNEs to deepen their commitment to source inputs locally.
- *Develop local supplier networks:* Governments should facilitate the development of supplier networks by improving coordination and information exchange between purchasing and supplying companies in value chains and encouraging local firms to collaborate and pool resources to fulfil MNE supplier contracts that may be bigger than one firm's capacity. This can help create a cluster of interconnected businesses that can

fulfil larger supplier requirements and increase the quality and availability of locally produced inputs.

- *Improve infrastructure:* Governments should invest in infrastructure that facilitates backward linkages, such as transportation networks, logistics hubs and communication systems, to reduce the cost and time associated with domestic production and the distribution of inputs.
- *Reduce the information asymmetry gap through investment promotion:* It is not enough to design and implement policies that promote linkages.. Investment promotion agencies (IPAs) must communicate the availability and benefits of linkages to investors, beginning with the first phase of the investment cycle. As the availability of strong supplier networks constitutes an attractive factor for MNEs, IPAs should include these facts in their investment promotion efforts.
- *Create supplier databases with a detailed description of their capabilities:*² This will help MNEs find potential local suppliers. Business-to-business matchmaking events can be organized to facilitate backward linkage possibilities.
- *Monitor and evaluate of linkage processes:* Governments should develop tools and mechanisms to regularly monitor and evaluate the backward linkages formed. These should include an assessment of the impact of linkages and the provision of feedback channels to improve policies and ways to ensure that vulnerabilities within linkage systems are identified and strengthened.
- *Focus on talent development:* Train specialize personnel for different types of suppliers.

The benefits of backward linkages for local firms and MNEs, including a reduction of reliance on GVCs, make it important for governments to implement appropriate policies and adopt a comprehensive approach that involves all relevant stakeholders.

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¹ The new [WTO Investment Facilitation for Development Agreement](#) (IFDA) explicitly encourages such programs.

² The [IFDA](#) explicitly encourages such data bases.

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