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Research Report

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Foreign direct investment (FDI) in the apparel sector in several Sub-Saharan African (SSA) countries has experienced significant growth in the context of preferential market access. But expectations of FDI leading to spillovers to the local economy and the development of locally-embedded apparel export industries have not materialized. A shift from FDI attraction through fiscal incentives to more strategic industrial policies that target FDI spillovers, local value added and linkages is urgently needed for broader local development effects.

At the beginning of the 2000s, there was a boom in FDI in the apparel sector in several SSA countries. Factors making this possible were the introduction of the U.S. African Growth and Opportunity Act (AGOA) combined with continued expansion of global production networks (GPNs) and Multi-Fibre Arrangement (MFA) quotas. This contributed to a major growth in production, exports and employment for low-skilled workers, particularly in Kenya, Lesotho, Swaziland, Madagascar, and Mauritius. Beyond this, the possibility of exploiting the spillover potential of this FDI raised significant hopes of developing locally-embedded SSA apparel export industries.

Yet more than a decade later, there has been very little progress made in reaching this objective – outside of Mauritius. Despite significant investments to attract FDI through building export processing zones (EPZs) and offering fiscal incentives, virtually no locally-owned apparel firms are exporting or even subcontracting to exporters, local value added remains low, local participation in management is limited, and domestic suppliers are almost absent in core and even most non-core inputs. This policy note explores why this is the case with a focus on Kenya, Lesotho and Swaziland and provides policy recommendations on what can be done to take better advantage of the FDI spillover potential in order to develop embedded SSA apparel industries.

Apparel sector development in SSA

Over the past 15 years, several SSA countries have developed export-orientated apparel sectors, in particular Kenya, Lesotho, Madagascar, Swaziland, and Mauritius (where the process started already in the 1970s) that accounted for more than 90% of SSA's apparel exports in the 2000s. This took place, first, within a policy framework of "export-led growth" as governments hoped that the sector would play a central role in (starting) the industrialization process as it did in other countries – historically, in the UK, the US, Germany, Japan, Hong Kong, Taiwan and South Korea and more recently in China, Sri Lanka, Vietnam and Bangladesh. Second, in light of MFA quota restrictions on large Asian producing countries while SSA countries secured preferential market access to developed countries, in particular through AGOA's preferential market access to the United States (Staritz 2011).

Despite exceptional growth of these countries' apparel sectors in the beginning of the 2000s, since around 2004 the industry has declined quite drastically in all of the main SSA apparel exporter countries. Direct reasons for this decline are significant changes in the environment for global apparel trade, in particular the phase-out of the MFA at the end of 2004, as well as changing sourcing strategies of global buyers, including the increasing importance of time factors and flexibility, non-manufacturing capabilities and supply chain consolidation (Staritz 2011, 2012). The global economic crisis has accelerated these developments through a downturn in global demand. Besides these "external" reasons, "internal" factors are also important in explaining the decline. One has to mention in particular the specific integration of SSA countries into apparel GPNs based on MFA quota hopping and preferential market access dominated by FDI and a disintegrated apparel industry with limited local or regional linkages. With the exception of South Africa and Mauritius, production in the main SSA apparel exporter countries is largely focused on assembly of imported textile inputs with limited local value added and linkages. Despite these challenges, apparel still constitutes the most significant manufactured export from SSA. If South Africa is excluded, just over one half of all SSA manufactured exports comprise apparel (Kaplinsky/Morris 2008).

FDI spillovers to local industries

It is important to understand the channels by which FDI can impact local firms and the factors that determine whether or not spillovers actually take place. Put briefly, the knowledge and technologies that foreign investors bring can seep into the local economy through three channels: through workers (picking up skills at FDI firms and moving on to local firms), through competition and technology diffusion (strengthening local firms in the sector over time), and perhaps most importantly through supply linkages, which not only is a conduit for technology transfer but builds a base for a local apparel sector (Staritz/Frederick 2012).

However, in our research of the apparel sectors in Kenya, Lesotho, and Swaziland, it is clear that a number of factors have severely limited the potential of FDI spillovers across these three channels. These limiting factors can be categorized as: (i) the characteristics and strategies of FDI; and (ii) the capabilities of local firms and workers and the policy dynamics in the host country.

Turning first to the issue of FDI, it is critical to recognize that the role that locations have within apparel GPNs and the strategies of foreign investors (and global buyers, i.e. retailers and brand owners) have a very significant impact on the potential for FDI spillovers in the first place. In locally-owned firms, which functions are performed in a location and which production methods are used is primarily a question of local conditions. In foreign-owned firms, it is often a more complex decision making process. Foreign-owned firms are able to leverage the functions, skills and expertise of their head offices and other foreign production plants, so the choices on what and how to produce in a given location are based on how that location fits into their GPN. Thus, spillover possibilities are determined by local capabilities, skills and operating environments, as well as by the role the locations have in the production networks of foreign investors (Morris et al. 2011; Staritz/Morris 2012, 2013).

Broadly, three types of FDI firms can be differentiated in Kenya, Lesotho, and Swaziland, each with different spillover potential:

Type 1: Asian-based transnational producers: Largely from Taiwan, Hong Kong and China, the spillover potential from these firms is limited for several reasons. First, activities based in SSA tend to be limited to manufacturing, while higher value functions (including input sourcing, product development and design, merchandising, buyer relationships) take place in the head offices abroad. Thus, local management has little control over sourcing decisions and most inputs are sourced on a global scale from their own textile mills or global networks to get better prices and secure conformity for their global manufacturing plants. Second, these firms sell mainly basic products in high volumes to the U.S. market, which also limits subcontracting and local supply potential due to manufacturing strategies and conformity requirements. Third, because the SSA-based facilities are simply assembly plants there is limited potential for local skills development outside of manufacturing processes; moreover, management positions are largely filled by expats, and language and cultural barriers also hinder knowledge transfer.

Type 2: More locally embedded Asian investors: These are typically owner-managed single operation firms with investors largely from India (in Kenya) and China or Taiwan (in Lesotho and Swaziland). They have higher spillover potential as they are not part of tightly organized GPNs, and so control more decision-making locally. However, these firms tend to lack close relationships with buyers (instead they normally work through buying offices in Asia and the United States) which makes them more vulnerable in their GPNs, and therefore less likely to advocate to their buyers to make use of local suppliers. They also generally work with sourcing offices abroad to get inputs. Thus, local supply potential remains limited. Where spillover potential is stronger is in skills development, as all functions related to the business are controlled locally.

Type 3: Regional South African investors: In Lesotho and Swaziland at least, South African investors who have relocated production to take advantage of labor costs and flexibility as well as preferential market access, are becoming increasingly important (Morris et al. 2011; Staritz/Morris 2012). While these firms focus on the regional market South Africa with close relationships to South African retailers, they resemble type 1 investors in that their local units conduct manufacturing, with higher value activities taking place in the South African head offices. On the other hand, local proximity to the South African head offices also allows for greater interaction, which: (i) opens up more scope for shifting higher value functions to local units and testing the use of local suppliers (where available); and (ii) allows for greater skills transfer to local workers. In addition, because these firms produce with shorter runs and higher fashion content where technical skills are more important, there is greater interest in local skill development.

Finally, as the apparel operations in Kenya, Lesotho and Swaziland largely fulfill manufacturing processes using standard production technology, the technology spillover potential is limited from the onset. When foreign investors came initially they brought crucial knowledge and capabilities with regard to production set up and processes. However, few firms have undertaken major process innovations after their initial investment. Differences exist however between Asian- and South African-owned firms in the case of Lesotho and Swaziland with South African firms having invested more in process upgrading given their different production model.

The second factor limiting FDI spillovers is on the host country side, leading to limited spillovers even where FDI firms are interested in transferring more functions and sourcing to host countries. A particular obstacle for spillovers is the absence of local firms that can absorb potential spillovers, as input suppliers or subcontractors for FDI firms. This has been absent in all three countries, although to a lesser extent in Kenya. These host country conditions also limit capacity of absorption through skilled labor. While the research found that FDI firms invested very little beyond basic training for manufacturing, limited skills are also related to the lack of industry-specific training institutions dedicated to the apparel industry and the mismatch between skills provided by these institutions and the needs of investors.

Policy recommendations

Given the context described above, governments need to consider policies at three different levels – first, to ensure the sustainability of the existing sector; second, to increase the potential for FDI spillovers; and, third, to improve the local absorption capacity.

While the focus of this note is on FDI spillovers, a critical point is that the SSA apparel sector, including Lesotho, Swaziland and Kenya, is in crisis and without the sustainability of the sector there is no point in talking about spillovers. If FDI firms are struggling to survive, they are not likely to spend much time or effort worrying about spillovers. So, improving competitiveness and initiating upgrading more generally is critical for the sustainability of apparel exports in all three countries. This secures that these countries remain and extend their role as global apparel exporters which is a prerequisite for FDI and spillovers in the sector. Policies need to focus in particular on industrial policies with a focus on improving firm-level competitiveness and expanding the base of the skilled labor and management pool as well as improving the physical, bureaucratic and industry-specific training infrastructure (Morris et al. 2011; Staritz/Morris 2012, 2013). Further, the sustainability of the wider regional textile and apparel sectors will be an important foundation for national efforts. This will require taking a regional perspective on value chains and increasing regional investments in particular in textiles, the key missing link in SSA's cotton to apparel value chain. It will also include focusing on regional end markets, in addition and as alternatives to international markets.

Policies to increase FDI spillovers will need to improve domestic conditions taking into account GPN dynamics and foreign investors' strategic interests. On the former, in particular policies are required to support the establishment and development of locally owned firms across the value chain and to incentivize linkages where local firms exist as well as local management positions where local skills are available. Increasing local involvement at the management and entrepreneur level is crucial to extend the impact of the apparel industry beyond its direct employment creation effect. Policies have however often not focused on supporting the establishment and development of local managers, firms, suppliers and linkages. With the focus on employment and foreign revenue generation, existing policies have catered to foreign investors that are involved in larger and export-oriented investments. There are no straightforward policy recommendations for developing local entrepreneurship. However, certain internal conditions and policies are at least preconditions for local entrepreneurial activities: (i) access to low-cost and long-term finance for productive investment; (ii) access to industry-specific skill training in areas such as management and higher value and technical functions; (iii) support in establishing relationships with foreign investors, buyers and input suppliers; (iv) access to at least the same and preferably higher incentives as foreign investors; and (v) use of public procurement to further the development of local firms and suppliers. Further, coordination among agencies responsible for the different parts of the apparel, textile and cotton value chain as well as in charge of foreign (often larger scale) and local (often smaller) establishments would need to be improved.

To increase the FDI spillover potential, a shift from broad-based investment promotion and FDI attraction strategies focused on fiscal incentives to more strategic approaches that take into consideration GPN dynamics and FDI strategic interests, and target FDI with spillover and upgrading potential is crucial. The tax-free incentives that are currently available to foreign firms in all three countries would need to move away from simple tax breaks but link them to increased local sourcing, investments in training and increased use of locals in higher skill positions, and other performance criteria, including the compliance with high labour/social and environmental standards. In line with the development of local suppliers, dynamic local content policies could be envisaged. Further, criteria for the use of expatriates could be developed. Expatriates potentially have an important role in skill transfer and learning. However, the often limited management experience of expatriates and cultural and language barriers greatly limit this potential. Hence, cultural and language classes for expatriates at all levels should be required. In conjunction with the development of industry-specific training facilities, limits for expatriates in positions where local skills exist could be established and enforced. FDI should be targeted for investments in areas that are currently not available but required by apparel firms such as textiles and complex trims, and joint ventures (JVs) between foreign and local investors should be encouraged.

These policies would require a joint, public and private sector coordinated strategy for the development of the industry and recognition that the apparel and textile sectors have a crucial role to play in the industrial development process of these economies. Further, they require local policy space for proactive policies which might be limited in certain areas such as local content policies in light of trade and investment agreements. Unless this is done the benefits of the apparel industry will be limited to its direct employment creation, rather than its ability to generate skills and spillovers, greater levels of upgrading and local and regional linkages that support the industrial development of these economies on a broader front.

Conclusions

FDI in the apparel sector has provided for many low-income countries (LICs) an entry point into apparel exporting and created employment opportunities for low-skilled workers. Several developing countries have also been successful in achieving substantial spillovers and developing a locally-owned apparel sector based on FDI. Apparel sector FDI has benefited Kenya, Lesotho and Swaziland in terms of employment and export generation. It has also created and/or revitalized operating skills and industrial capabilities and led to the improvement of trade-related infrastructure. However, the three countries have been less successful in initiating spillovers to the local economy despite significant emphasis on attracting FDI through the use of financial incentives and instruments like EPZs. FDI has been largely related to low local value added, limited local linkages and participation in management, inadequate skill development and productivity improvements, and missing local entrepreneurial response.

The limited spillovers relate to the nature of FDI and the strategic interest of foreign investors not to create such spillovers, in particular with regard to traditional transnational producers. Taiwanese firms with links to triangular manufacturing networks have a competitive advantage as head offices have close relationships with buyers and input suppliers, attract orders, and manage and provide higher-value added functions. At the same time this type of network limits spillover potential in branch plants in the three countries. Beyond FDI`s strategic interest, FDI spillovers are also related to local conditions and limited local skills and capabilities. Local linkages and technology and knowledge spillovers have also not developed because there has been practically no entrepreneurial response to the presence of foreign firms. Reliance on expatriates also reflects weak local technical and management skills and non-existing or inadequate training institutes. These local conditions seem to be in particular constraining for more locally embedded foreign investors (type 3) and investors with a less well-developed and more fluid international division of labor (type 2).

Governments have increasingly worried about these challenges related to FDI in the apparel sector and how to increase the local spillovers of these investments. Governments need to consider both FDI and supply side policies to facilitate spillovers. On the former, this will mean a shift to strategic approaches targeting spillover and upgrading potential. On the latter it will require a focus on improving firm-level competitiveness and skills as well as improving the physical, bureaucratic and training infrastructure. Critical to increase the local absorptive capacity will be policies to support the establishment and development of locally owned firms across the value chain. Finally, broader strategies to ensure the sustainability of the national and wider regional textile and apparel sectors will be an important foundation for FDI-specific efforts.

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Endnotes

1 This policy note is based on a background paper on the apparel sector for a World Bank study "FDI and Global Value Chains in Sub-Saharan Africa: Understanding the Factors that Contribute to Integration and Spillovers" written jointly with Stacey Frederick of the Center on Globalization, Governance and Competitiveness (CGGC) at Duke University (see Staritz/Frederick 2012). For the paper, field work was conducted in Kenya, Lesotho and Swaziland in March 2012. The research builds on joint work and regular discussions with Mike Morris of Policy Research on International Services and Manufacturing (PRISM) at the University of Cape Town.

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