

**Inclusive Industrialization:**

**The interplay between Investment Incentives and SME promotion policies in Sub-Saharan Africa**

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\* Sidley Austin, LLP (Geneva office). The author expresses thanks to Chloe Morice, and especially to Nicholas Jordan for helpful research assistance. The author also thanks the participants of the 2017 Law and Development Conference for helpful feedback on an earlier draft of this paper.

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# 1 INTRODUCTION

The 2030 Agenda for Sustainable Development (2030 Agenda), adopted by the United Nations General Assembly in 2015, seeks to promote “three dimensions of sustainable development: the economic, social, and environmental”.<sup>1</sup> The emphasis on *sustainable* development is reflected in the 17 Goals that comprise the 2030 Agenda.

Specifically, Goal 9 of the 2030 Agenda addresses economic sustainability through promoting “*inclusive and sustainable industrialization...*”.<sup>2</sup> In the context of industrialization, “sustainable” refers to long-term—as opposed to ephemeral—economic growth; growth that is embedded within a host country—as opposed to being entirely dependent on external actors and variables; growth that creates benefits and opportunities for different social groups; and growth that does not take place at the expense of environmental and social objectives. The reference to “inclusive” industrialization, in turn, indicates that industrial development must be all encompassing, *i.e.*, it must include all countries, all businesses, and all people, and offer an equitable distribution of benefits to all stakeholders.<sup>3</sup>

The growth and development of Small and Medium Enterprises (SMEs)—businesses with less than 250 employees—as well as their integration into international value chains, is a key element of inclusive and sustainable industrialization. Indeed, with SMEs constituting over 95% of most Sub-Saharan African (SSA)<sup>4</sup> economies, failure to include them in a country’s industrialization process would lead to social and economic exclusion, missed economic opportunities, and a widening of the existing gap between winners and losers of globalization—the antithesis of inclusive and sustainable industrialization.

The importance of SMEs participation in industrialization is expressly recognized in Goal 9 of the 2030 Agenda, which aims to “increase ... small-scale industrial and other enterprises... into value chains and markets”.<sup>5</sup> Likewise, Goal 8 highlights the importance of promoting “policies that...encourage the...growth of micro, small and medium-sized enterprises”.<sup>6</sup>

While SMEs are crucial for securing *inclusive and sustainable* economic growth in SSA, economic policies that solely focus on SME growth and value chain integration will not result in structural economic transformation. Indeed, SMEs are often too small to generate large-scale structural transformation as they lack the capital, scale, quality and know-how to of large (multinational) firms. Therefore, any effective industrialization strategy in SSA must also involve attracting Foreign Direct Investment (FDI), which is associated with potential benefits including technology transfer, employment gains, skills upgrading and growth. In this context, the Addis Ababa Action Agenda—an integral part of the 2030 Agenda—“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”.<sup>7</sup>

Much has been written about policy options SSA countries can consider to attract FDI, and to encourage the growth of SMEs. Likewise, there exists a large body of literature that analyzes how FDI can encourage the growth of SMEs as a result of spillover effects, FDI-SME

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<sup>1</sup> 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.

<sup>2</sup> *Ibid.*, Goal 9. (emphasis added).

<sup>3</sup> Li Yong, *Inclusive and Sustainable Industrial Development*, available at: <<https://isid.unido.org/about-isid.html>>, accessed 6 August 2017.

<sup>4</sup> This paper uses the acronym “SSA” to refer to both the terms “Sub-Saharan African” and the noun Sub-Saharan Africa”.

<sup>5</sup> United Nations General Assembly, (2015), *supra* note 1, Goal 9.3.

<sup>6</sup> *Ibid.*, Goal 8.3.

<sup>7</sup> 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.

linkages, and value chain integration. However, the possible negative interplay between the policy objective of stimulating industrialization through attracting FDI, and the parallel objective of promoting the growth of domestic SMEs, remains largely unexplored.

This paper examines whether, and in what circumstances, FDI incentives could undermine SME competitiveness and, conversely, whether, and in what circumstances, policies aiming to promote SMEs through encouraging FDI-SME linkages could, inadvertently, impede FDI.

While governments adopt a myriad of different policies that effect FDI and SME growth, the scope of this paper is limited to two sets of commonly used policies: incentive packages to attract investors, including into Special Economic Zones (SEZs) and Export Processing Zones (EPZ); and local content requirements adopted to maximize benefits to the host-country. On the basis of an examination of these policy instruments, this paper demonstrates various ways in which investment incentives can exacerbate the competitive disadvantage between SMEs and large firms, and between *domestic* and *foreign* SME suppliers. Conversely, it demonstrates that in certain situations, local content policies can directly undermine FDI policy, and deter FDI.

This paper is structured as follows: section 2 provides a brief historical overview of the ideological trends in SME and FDI promotion policies in SSA since independence. section 3 analyses the interplay between investment incentives and SME policies—with Section 3.1 focusing on situations in which investment incentives could widen the competitive disadvantage of SMEs vis-à-vis other firms, and section 3.2 on the deterrent effect of local content requirements. Section 4 explores various policy options that SSA countries could consider to minimize the possible negative interplay between FDI investment incentives and SME promotion policies. Finally, section 5 provides a brief conclusion.

Where relevant, this paper draws upon the experience of several SSA countries, including Tanzania, Rwanda, Kenya, Zambia, Ethiopia, Ghana, Botswana, and Nigeria, and Asian countries, including China, Thailand, Korea and Malaysia. These references are used merely to illustrate certain concepts; they do not, however, comprehensively depict the industrialization processes and policies in these countries.

## 2 TRENDS IN SME AND FDI POLICIES IN SSA

Since independence, roughly in the 1960s, SSA countries' positions towards SME and FDI promotion policies have varied. By and large, the approach to FDI and SME promotion reflected the dominant ideologies associated with different industrialization phases.

Generally, between 1960-1970, SSA countries adopted policies to protect their domestic industry against foreign competition and reduce dependency on imported products through import substitution (ISI). To this end, many SSA countries adopted import tariffs, import quotas, exchange-rate controls, production subsidies, and overvalued their currency. During this phase, FDI was heavily restricted, and local content requirements were adopted to channel investment away from import-heavy, low value-added, foreign-controlled industrialization.<sup>8</sup>

To strengthen the economic participation of domestic firms, this period saw an increase in SME-focused policies, such as grants, subsidized credits, and fiscal benefits. For instance, during this period, Tanzania established an SME agency; Cote d'Ivoire adopted a ministry dedicated to the promotion of SMEs<sup>9</sup>; and Ghana erected a number of institutions to assist SMEs,

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<sup>8</sup> UNCTAD, "Local Content Requirements and the Green Economy, (2014), available at: <[http://unctad.org/en/PublicationsLibrary/ditcted2013d7\\_en.pdf](http://unctad.org/en/PublicationsLibrary/ditcted2013d7_en.pdf)>, p. 5.

<sup>9</sup> C. Soludo, O. Ogbu and H.J. Chang, *The Politics of Trade and Industrial Policy in Africa*, (2004) pp. 310-320.

including through financial and technical support.<sup>10</sup> However, despite the existence of these institutions, SME promotion activities never fully took off during this period.<sup>11</sup>

A radical policy reversal took place in the mid-1980s, when it became increasingly clear that the ambitious targets set by ISI remained unrealized.<sup>12</sup> Pressured by the World Bank and the International Monetary Fund, SSA countries began to adopt export-oriented industrialization (EOI) policies, also known as structural adjustment policies. This typically included the adoption of exchange-rate devaluations, tariff reductions, the removal and/or reduction of quantity restrictions, the elimination of production subsidies, and the adoption of export and investment promotion policies through export compensation schemes, and duty and VAT remissions.<sup>13</sup>

During this phase, most SSA countries adopted investment promotion policies and put in place SEZs or EPZs.<sup>14</sup> For instance, Kenya established its first EPZ in 1996; Ghana adopted its Investment Promotion Act in 1994 and established its first EPZ in 1995; and Tanzania adopted an Investment Promotion Act in 1997. During this period, few SME policies were put in place; rather, the strategies to develop the private sector were “skewed towards the needs of large-scale businesses, including foreign invested ones”.<sup>15</sup> Indeed, proactively including SMEs in a country’s industrialization strategy did not comport with the laissez-faire ideology of the structural adjustment era.

Similar to ISI, structural adjustment policies had disappointing results.<sup>16</sup> While they had contributed to reduced levels of poverty in some countries, the anticipated structural transformation did not materialize. Moreover, it became increasingly clear that laissez-faire policies would not resolve major challenges such as food security, environmental sustainability, and financial and economic inequality. As a result, this period was marked by a “softening of convictions on both sides”,<sup>17</sup> *i.e.*, SSA countries began moving away from a predominantly ideological approach to industrialization, keen on adopting a more pragmatic attitude.<sup>18</sup>

Indeed, many industrial policy plans adopted by SSA countries since 2000 contain policy objectives that reflect protectionist elements from the ISI period, and the liberalization policies associated with the EOI phase.<sup>19</sup> For instance, Rwanda’s Vision 2020 considers it “necessary ... to implement[] policies to encourage foreign direct investment” while its Small and Medium Enterprises Policy aims to adopt policies that maximize SME-growth.<sup>20</sup> Tanzania’s Sustainable Industrial Development Policy (1996-2020) and Kenya’s 2010 National Industrial Policy Framework emphasize the promotion of SMEs, while promoting FDI.<sup>21</sup>

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<sup>10</sup> J.A. Peparah, A.O. Mensah and N.B. Akosah, *Small and Medium Sized Enterprises (SMEs) accessibility to public procurement: SMEs entity perspective in Ghana*, 4 *European Journal of Business and Social Sciences*, no 11 (2016), p. 28.

<sup>11</sup> *Ibid.*, pp. 25-40.

<sup>12</sup> 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 and Development Review* (2017), p. 37.

<sup>13</sup> *Ibid.*

<sup>14</sup> T. Farole, *Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience* (Washington, D.C.: World Bank, 2011), pp. 67-68.

<sup>15</sup> OECD, “Promoting Entrepreneurship and Innovative SMEs in a Global Economy: towards a more responsible and inclusive globalisation” (3-5 June 2004), p. 11.

<sup>16</sup> Yaw Ansu, “Industrial Policy and Economic Transformation in Africa: strategies for Development and a Research Agenda,” in J.E. Stiglitz, J. Yifu Lin and E. Patel (eds.), *The Industrial Policy Revolution II: Africa in the 21st Century* (Palgrave Macmillan, 2013), p. 494.

<sup>17</sup> D. Rodrik, *Industrial Policy for the Twenty-First Century*, Faculty Research Working Paper Series, (2004).

<sup>18</sup> *Ibid.*

<sup>19</sup> Van der Ven (2017), *supra* note 12, p. 38.

<sup>20</sup> Rwanda, *Rwanda Vision 2020*, (2000), p. 21; Rwanda, Ministry of Trade and Industry, *Small and Medium Enterprises (SMEs) Development Policy* (2010).

<sup>21</sup> Tanzania, Ministry of Industries and Trade, *Sustainable Industries Development Policy SIDP (1996-2020)* (1996). Kenya, *Kenya’s National Industrialization Policy Framework*, 2010, p.6.

In sum, SSA countries' commitment to attracting FDI and encouraging the integration of SMEs into value chains has fluctuated during the last decades. While the ISI phase discouraged FDI, the OEI phase did not target SME competitiveness. Only during the last—and current—industrial phase, which started roughly at the turn of the century, did SSA governments begin to adopt investment incentives and SME promotion policies in parallel. The co-existence of these two objectives is thus relatively new and introduces new challenges and opportunities. It is against this backdrop that this paper examines the interplay between investment incentives adopted to attract FDI, and SME promotion policies.

### **3 THE INTERPLAY BETWEEN INVESTMENT INCENTIVES AND SME POLICIES**

Investment incentives could limit SME competitiveness vis-à-vis two types of firms: (i) large (often foreign) firms; and (ii) foreign (SME) suppliers to SEZ firms. Section 3.1 addresses investment incentives that could aggravate the competitiveness gap between large firms and SMEs, while section 3.2 addresses investment incentives that could impact domestic SMEs competitiveness compared to foreign (SME) suppliers.

#### **3.1 Impact of investment incentives on SMEs**

##### **3.1.1 Investment incentives can increase the competitiveness gap between *large firms* and *SMEs***

This section assesses the impact of investment incentives adopted to attract FDI, on SMEs. Specifically, it focuses on two sets of investment incentives that are typically provided in SSA countries: (i) incentive packages, comprised of fiscal and non-fiscal benefits, contingent on minimum capital requirements; and (ii) investment incentives typically provided to investors with SEZ or EPZ status.

###### **3.1.1.1 Incentive packages contingent on minimum capital requirements**

Almost all SSA countries have adopted policies to attract foreign and domestic investment. Specifically, duty and tax incentives are the most common among SSA investment incentives.<sup>22</sup> This includes tax concessions, accelerated depreciation allowances, capital gains exemptions, location tax allowances, exemptions on import duties, and tax credits.<sup>23</sup>

In most SSA countries, SMEs are not *de jure* precluded from accessing these tax benefits, *i.e.*, the regulation setting out the tax benefits does not stipulate that domestic investors are ineligible. However, it is often challenging for capital-starved SMEs to meet the eligibility requirements attached to the tax incentives, and thus, to actually receive the benefits. This problem has not gone unnoticed. For instance, the International Growth Center has highlighted this problem, noting that “[i]ncentives tend to discriminate against smaller firms, against local firms on a *de facto*, if not a *de jure* basis”.<sup>24</sup> Likewise, the Tanzania SME Policy Review notes that “tax incentives/exemptions as per the Tanzania Investment Act (1997) mainly apply to large and medium size companies”.<sup>25</sup> SMEs inability to take advantage of tax exemptions is largely

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<sup>22</sup> D.T. Ayentimi, J. Burgess and K. Brown, *Developing Effective Local Content Regulations in Sub-Saharan Africa: The Need for More Effective Policy Alignment*, 24 *Multinational Business Review*, no.4 (2016), p. 361.

<sup>23</sup> *Ibid.*

<sup>24</sup> K. Tuomi, *Review of Investment Incentives: Best Practices in Attracting Investment*, (International Growth Centre, June 2012), available at: <<https://www.theigc.org/wp-content/uploads/2014/09/Tuomi-2012-Working-Paper.pdf>>, p.8.

<sup>25</sup> UNIDO, *Tanzania SME Development Policy Review: Ten Years After* (2012), p. 23.

caused by high minimum capital requirements SMEs are unable to meet: in 13 SSA countries, minimum capital requirements exceed 200% of the income per capita.<sup>26</sup>

Typically, SSA countries impose minimum capital requirements in order to inspire investors to consider investments more cautiously, thus protecting investors and consumers from new investments that may not be financially viable.<sup>27</sup> Moreover, it is considered that large amounts of paid-in capital correlates with generating maximum economic activity. However, paid-in minimum capital is often 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.<sup>28</sup> Indeed, especially in SSA countries with high unemployment, attracting medium-size businesses—foreign and domestic—could provide an important source of employment.<sup>29</sup>

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, Ghana<sup>30</sup> and Zambia require a US\$ 500,000 capital requirement for foreign investors only.<sup>31</sup> Rwanda has lowered its minimum capital requirement of US\$ 250,000 to US\$ 100,000 for domestic investors.<sup>32</sup> Similarly, Kenya has imposed a threshold of US\$ 100,000 for foreign investors, and one million shillings—approximately US\$ 10,000—for domestic investors.<sup>33</sup>

Notwithstanding these efforts, however, inability to meet the reduced minimum capital requirements remains an obstacle to smaller domestic enterprises. For instance, in Rwanda, the domestic firm minimum capital requirement of US\$100,000 remains an obstacle for many SMEs.<sup>34</sup> This is unsurprising, given that US\$ 100,000 is 142 times Rwanda's GDP per capita and the average capital used by Rwandan SMEs is US\$ 26,080, with 60% employing less than US\$ 80,000.<sup>35</sup> In other words, Rwanda's reduced minimum capital requirement for domestic investors is roughly four times the average capital employed by Rwandan SMEs!

When SMEs are unable to meet the minimum capital requirement, they will not be eligible to receive tax exemptions large firms with the requisite capital are entitled to. This increases the operational expenses of SMEs, and thus, widens the competitiveness gap between SMEs and large firms. Thus, even where minimum capital requirements are significantly reduced for domestic SMEs, they can be a factor that increases the unequal playing field between SMEs and large firms.

### 3.1.1.2 Investment incentive packages contingent on export requirements

In addition to the investment incentive packages discussed above, as many as 30 SSA countries provide incentives to invest in a SEZ<sup>36</sup>, *i.e.*, a “spatially delimited area[] within an economy that

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<sup>26</sup> 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>>.

<sup>27</sup> *Ibid.*, p. 42.

<sup>28</sup> *Ibid.*, p. 43.

<sup>29</sup> *Ibid.*

<sup>30</sup> In Ghana, the minimum capital for foreign investors engaged in a joint venture with a Ghanaian enterprise is US\$ 200,000.

<sup>31</sup> 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](http://unctad.org/en/PublicationsLibrary/aldcafrica2014_en.pdf)>; Zambia Development Agency, *Investor Guide* (2016).

<sup>32</sup> UNCTAD, *Investment Policy Review Rwanda* (2006), available at: <[http://unctad.org/en/docs/iteipc200611ch2\\_en.pdf](http://unctad.org/en/docs/iteipc200611ch2_en.pdf)>.

<sup>33</sup> Kenya, *Investment Promotion Act* (2009).

<sup>34</sup> Tuomi (2012), *supra* note 24, p. 13.

<sup>35</sup> African Development Bank, *Leveraging Capital Markets for Small and Medium Enterprise Financing in Rwanda* (2013), p. 7.

<sup>36</sup> T. Farole (2011), *supra* note 14, p. 67.

function[s] with administrative, regulatory, and often fiscal regimes that are different (typically more liberal) than those of the domestic economy”.<sup>37</sup> SEZs aim to attract investment by reducing barriers such as restrictive policies, inadequate infrastructure, poor governance etc.<sup>38</sup> Typically, these benefits fall into three categories: (i) fiscal incentives, including exemptions from income tax, transfer duties, corporate tax, import duties, VAT, withholding tax, and stamp duty; (ii) procedural expediency and legal exemptions that reduce bureaucratic hurdles; and (iii) infrastructural incentives, such as ready-made factory units, serviced land or office space, designed to reduce start-up time and costs.<sup>39</sup>

However, eligibility for these benefits is often contingent on meeting minimum export targets. That is, firms must export a minimum percentage of their production in order to receive these benefits. For instance, investors in Namibia’s EPZ are entitled to generous benefits packages, provided that they export 100% of products in the first year, and 70% in subsequent years.<sup>40</sup> In Ghana, investors with SEZ status are fully exempt from all direct and indirect duties, in addition to corporate and other tax deductions, provided they export 70% of all products.<sup>41</sup> 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, value added tax (VAT), stamp duty, and restrictions on management or technical requirements.<sup>42</sup>

While most SEZs do not *de jure* discriminate against SMEs, they often do so *de facto*. Few SSA SMEs are direct exporters<sup>43</sup>; instead, SMEs mainly produce for the domestic market. This means that for many SMEs, it is impossible to meet the minimum export requirements of 70-100%. This problem is aggravated for SSA countries that form part of a customs union. For instance, Kenya and Rwanda are both Members of the East African Community (EAC). Accordingly, sales from Kenya to Rwanda are considered “local sales”—and not exports. Thus, requiring that a firm exports 80% as a precondition to receive SEZ status and benefits means that a firm must export 80% to countries *other than* the members of the EAC, *i.e.*, countries other than Rwanda, Kenya, Burundi and Tanzania. Given that most export in African countries is intra-regional, this creates an additional obstacle for SMEs that are regional exporters, mainly supplying to other EAC countries. 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.<sup>44</sup>

While SMEs and large multinational firms often serve different markets—with domestic firms focusing on the domestic market and foreign firms on the international market—this unequal playing field creates a barrier to SMEs aiming to move up in the value chain. This 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 large firms benefiting fiscal benefits, procedural expediency and subsidized facilities—while they must often pay full taxes and duties, are subject to full procedural processes, and are not eligible to receive similar infrastructural subsidies.

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<sup>37</sup> *Ibid.*, p. 17.

<sup>38</sup> *Ibid.*

<sup>39</sup> E. Kathure Mwiti-Mbwiria, *Firm-Resources as Entrepreneurial Determinant and Performance of Manufacturing Small and Medium (SMEs) Foreign Firms Investing in Kenya*, 4 International Journal of Advanced Research in Management and Social Sciences, no. 6 (2015), pp. 5-6.

<sup>40</sup> Namibia’s Investment Centre (1996).

<sup>41</sup> WTO, Ghana’s Trade Policy Review (2014); Ghana, *Free Zone Act* (1995), Article 28.

<sup>42</sup> Kenya’s Export Promotion Council, available at:

<http://epckkenya.org/index.php?option=content&task=view&id=47&Itemid=66>.

<sup>43</sup> WTO, *World Trade Report 2016: Levelling the Trading Field for SMEs*, (Geneva: WTO Publications, 2016), p. 38.

<sup>44</sup> T. Farole (2011), *supra* note 14, pp. 6, 225.

### 3.1.1.3 Benefits provided under SME promotion programs

To understand the extent to which fiscal and non-fiscal investment incentives contribute to the competitiveness gap between SMEs and large firms, it is imperative to also look at benefits provided to SMEs under SME promotion programs.

Under various SME programs, SMEs are eligible to receive a number benefits, thereby somewhat narrowing the competitiveness gap with large SEZ-based investors. However, the benefits offered under SME promotion programs are often incomparable to the benefits provided to large investors.

This contrast is well illustrated in Swaziland, where local SMEs rely on the Basotho Enterprises Development Corporation to receive technical and financial support.<sup>45</sup> Under this program, SMEs receive subsidized workspace in prime locations, which averages 29 Rand per square meter.<sup>46</sup> 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.<sup>47</sup> In other words, large enterprises can access factory shells at less than 1/3 of the price that SMEs pay under the Basotho Enterprise Development Corporation.

Moreover, benefits provided under SME-targeted programs only rarely include any type of tax exemption. Rather, SME promotion in SSA typically comes in the form of capacity building, financing schemes, providing exhibition facilities, export market assistance, etc. For instance, in Ghana, policy interventions to enhance SME performance focuses on “improving their operational efficiency and competitiveness, enhancing their access to finance, and improving their technical and entrepreneurial skills”.<sup>48</sup> Ethiopia supports SMEs through facilitating access to finance, subsidized production facilities, and capacity building programs to strengthen SME-engagement.<sup>49</sup> Rwanda focuses on capacity building, the simplification of tax procedures, access to finance, trade facilitating, and vocational programs.<sup>50</sup>

While such programs may spur SME-growth, the benefits they provide to SMEs are not of the same magnitude as the generous tax and non-tax investment incentives provided to large firms that meet the eligibility requirements. Thus, SME promotion programs may somewhat reduce, but do not *remove*, the competitiveness gap that is created through the generous tax and other benefits provided to large SEZ-registered enterprises.

### 3.1.2 Investment incentives can increase the competitiveness gap between *domestic and foreign SME suppliers*

In addition to generating a competitive disadvantage for SMEs, the spatial and legal structures that govern SEZs and EPZs create a barrier for domestic SMEs to serve as input suppliers to firms located in the SEZ/EPZ.<sup>51</sup> For instance, while SEZ-registered firms can purchase inputs from international suppliers on a duty and VAT-free basis, domestic suppliers located outside the free zone are still subject to VAT and/or other taxes.<sup>52</sup> By way of illustration, in Lesotho, domestic manufacturing firms supplying to firms in the EPZ are subject to the standard 25% tax regime, whereas foreign suppliers are able to provide inputs to EPZ-registered firms on a duty and tax-free basis.<sup>53</sup> Thus, everything else being equal, it would be cheaper for EPZ-registered firms to purchase inputs from foreign suppliers than from domestic suppliers. As a result,

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<sup>45</sup> T. Farole and D. Winkler (eds.), *Making Foreign Direct Investment Work for Sub-Saharan Africa: Local Spillovers And Competitiveness in Global Value Chains* (Washington, D.C.: World Bank, 2014), p. 234

<sup>46</sup> *Ibid.*

<sup>47</sup> *Ibid.*

<sup>48</sup> Ghana, *Ghana Shared Growth and Development Agenda GSGDA II*, (2014-2017).

<sup>49</sup> Ethiopia, *Growth and Transformation Plan 2010/11 – 2014/5*, Vol.1, (2010).

<sup>50</sup> Rwanda, *Small and Medium Enterprise Policy*, 2010.

<sup>51</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 46; T. Farole (2011), *supra* note 14, p. 225.

<sup>52</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 249.

<sup>53</sup> T. Farole (2011), *supra* note 14, p. 175.

investment incentives discourage linkages between SEZ-based firms and domestic SME suppliers.<sup>54</sup>

Moreover, foreign-based suppliers selling internationally, including to SEZ-registered firms, qualify for duty drawbacks with respect to imported inputs. However, domestic supplier SMEs relying on imported inputs—and selling to firms in a free zone in their country—are not direct exporters and may, therefore, not automatically qualify to receive duty drawbacks.

Recognizing this problem, some SSA countries have attempted to remove these obstacles. For instance, in Ghana, the sale of goods and services by a domestic firm to firms in the EPZ area qualify as *exports*.<sup>55</sup> Thus, domestic firms are eligible to benefit from the export incentives available to a national exporter, such as duty drawbacks. Likewise, the EAC's Manufacturing under Bond program entitles exporters of manufactured goods, including indirect exporters, to import plant, machinery and raw materials on a tax free-basis.<sup>56</sup>

However, due to administrative hurdles and delays, SMEs rarely claim duty drawbacks—even if they are entitled to them.<sup>57</sup> A particular obstacle for SMEs is the inability to attach the original bill of export with their claims, as this bill is in the possession of the final exporter.<sup>58</sup> As the costs of reclaiming duty outweighs the benefits, less than 10% of eligible duty drawback is estimated to be claimed through these systems.<sup>59</sup> Thus, domestic SMEs remain at a competitive disadvantage vis-à-vis foreign SMEs.

The spatial and legal structure of SEZs is likewise unlikely to generate forward linkages between large SEZ-based firms and domestic SMEs. With the exception of Nigeria, Lesotho, Senegal and Kenya, SEZs in SSA restrict the sale of goods to local markets.<sup>60</sup> Any goods sold in domestic markets require customers to pay VAT and import duties, as if the products were coming from outside the country.<sup>61</sup> While these regulations attempt to protect the domestic market from competition from firms in the SEZ/EPZ, they simultaneously constitute a barrier to generating linkages between domestic SMEs and SEZ-registered businesses. These barriers are even more pronounced in customs unions, given that, as mentioned above, investors are restricted from selling to customs union countries as such sales are considered “local”. This creates a significant disincentive for regional investors to seek SEZ status.<sup>62</sup>

There are a number of factors directly related to SEZ policy that contribute to the competitive disadvantage of domestic SME suppliers compared to foreign suppliers. For instance, it is common for large multinational firms to reduce costs by bundling inputs around the most valuable input. In the context of the textile and garment value chain, textile is the most valuable input of a garment—around 75% of the total value of a t-shirt. This means that large multinational firms sourcing their textile from one (often foreign) firm tend to source other inputs from that same supplier.

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<sup>54</sup> See, e.g., the situation in Tanzania, described in M. Hansen, *From Enclave to Linkage Economies? A review of the literature on linkages between extractive multinational corporations and local industry in Africa*, (Copenhagen: Danish Institute of International Studies, 2014), p. 25; and Mjimba, V., *The Nature and Determinants of Linkages in Emerging Minerals Commodity Sectors: A Case Study of Gold Mining in Tanzania*, MMCP Discussion Paper no. 7 (March 2011).

<sup>55</sup> T. Farole (2011), *supra* note 14, p. 227.

<sup>56</sup> 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](https://customs.eac.int/index.php?option=com_content&view=article&id=48&Itemid=95).

<sup>57</sup> *Ibid.*, p. 228; <http://includeplatform.net/wp-content/uploads/2015/03/GTF-Export-Promotion-in-Ghana-SR-formatted.compressed.pdf>, p. 13.

<sup>58</sup> T. Farole (2011), *supra* note 14, p. 236, fn. 9.

<sup>59</sup> *Ibid.*

<sup>60</sup> *Ibid.*, p. 226.

<sup>61</sup> C. Staritz and S. Frederick, *Harnessing Foreign Direct Investment for Local Development? Spillovers in Apparel Global Value Chains in Sub-Saharan Africa*, (Vienna: Austrian Foundation for Development Research (ÖFSE), 2016), p. 15.

<sup>62</sup> T. Farole (2011), *supra* note 14, p. 146.

Access to finance is another important element that makes it more difficult for SMEs in SSA countries to compete on an equal playing field with foreign SME suppliers. Indeed, due to the higher risk of investment, the higher administrative costs, and the lack of skills, it is significantly more costly for SSA SMEs to take out a loan compared to their non-African counterparts.<sup>63</sup> One study found that SMEs in SSA are more financially constrained than in any other developing region.<sup>64</sup> Another study found that SMEs in China pay an average annual interest rate of 4.7%, compared to 10% in Ethiopia, 14% in Vietnam and Tanzania, and 21% in Zambia.<sup>65</sup> Moreover, the requirements for collateral are also much higher in most SSA countries compared to other developing countries, with banks charging up to 150% of the loan amount.<sup>66</sup>

In sum, the spatial and legal structures that govern SEZs discriminate against domestic SME suppliers in two key ways: (i) domestic SME transactions with SEZ-based firms are subject to VAT and/or other taxes, unlike foreign-based firms that are entitled to import on a duty and tax-free basis; and (ii) domestic SME suppliers to SEZ-based firms may not be in a position to receive duty drawback for imported inputs—in contrast to their foreign-based counterparts. This means that—all other factors being equal—it is cheaper for SEZ-based firms to supply from foreign SMEs. Moreover, factors not directly related to SEZ policy, such as the practice of input bundling and lack of access to finance, further contribute to the competitiveness gap that exists between foreign and domestic input suppliers.

## 3.2 Impact of local content requirements on FDI

### 3.2.1 Introduction

Having highlighted potential tensions between investment incentives adopted to promote FDI, and the promotion of SMEs, this section does the reverse: it examines potential tensions between local content requirement, the quintessential FDI-SME linkages promotion policy, and the objective to attract FDI.

Typically, local content requirements are adopted to advance certain industrial policy objectives, including supporting SMEs through increased FDI-SME linkages.<sup>67</sup> Specifically, local content requirements impose on investors specific goals for their operations in the host country. This can include recruiting and developing the capabilities of the local workforce, developing domestic firms' capabilities, and supporting local firms through local sourcing.<sup>68</sup> The rationale behind these policies is that the more foreign investors buy or source locally, the more linkages they will form with local SME firms, which, in turn, will maximize spillover effects.<sup>69</sup> In other words, in SSA, local content requirements are typically adopted to promote the growth of domestic firms, most of which are SMEs.

SSA governments use local content requirements in different ways: as an entry requirement, a concession requirement, a requirement to obtain an operating license, or as a

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<sup>63</sup> OECD and NEPAD, *Regulatory Environment for Foreign Direct Investment*, background paper given at Investment for African Development: Making it Happen (Entebbe, 25-27 May 2005), available at: <<https://www.oecd.org/investment/investmentfordevelopment/34783838.pdf>>.

<sup>64</sup> 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*, Working Paper Series no. 146 (Tunis: African Development Bank, 2012).

<sup>65</sup> H.Dinh, V. Palmade, V. Chandra, and F. Cossar, *Light Manufacturing in Africa: Targeted Policies to Enhance Private Investment and Create Jobs*, (Washington, D.C.: World Bank, 2012), p.80.

<sup>66</sup> Dalberg, *Report on Support to SMEs in Developing Countries through Financial Intermediaries* (2011), available at: <[http://www.eib.org/attachments/dalberg\\_sme-briefing-paper.pdf](http://www.eib.org/attachments/dalberg_sme-briefing-paper.pdf)>, p. 18.

<sup>67</sup> G. Hufbauer and J. Schott, *Local Content Requirements: A global Problem*, (Washington, D.C.: Peterson Institute for International Economics, 2013), p. 10.

<sup>68</sup> D. Ayentimi *et al.*, (2015), *supra* note 22, p. 359.

<sup>69</sup> OECD, *Encouraging Linkages Between Small and Medium-Sized Companies and Multinational Enterprises* (2005), available at: <<http://www.oecd.org/daf/inv/investmentfordevelopment/35795105.pdf>>, p. 19.

condition to quality for tax exemptions and other benefits. In SSA, local content requirements are most commonly embedded in government procurement programs. Local content requirements are not all the same; rather, they vary between stringent requirements, *e.g.*, requiring firms to buy a fixed percentage of goods from local firm, to more flexible requirements, *e.g.*, requiring proposals from investors on how the local economy will benefit from their investment.

This section provides a general assessment of the dissuasive impact on FDI, if any, these different types of local content requirements can have.

### 3.2.2 Local content requirements that could deter FDI

Many SSA countries have adopted policies that include stringent local content requirements, most frequently embedded in government procurement programs. For instance, in South Africa, a tenderer must subcontract a minimum of 30% of the value of the contract to SMEs and other individuals covered by the Act.<sup>70</sup> Similarly, Botswana's local procurement policy reserves up to 30% to manufacturing firms based in Botswana.<sup>71</sup> In Sierra Leone, at least 20% of managerial and 50% of intermediate positions are reserved for Sierra Leonean citizens.<sup>72</sup>

Local content requirements are particularly common in the extractive industry. For example, Nigeria's 2010 Content Act requires all entities active in the oil and gas industry to incorporate Nigerian content as a key element of project development and management. Similarly, Ghana provides that operators shall "as far as practicable" prefer local inputs to imported goods;<sup>73</sup> accordingly it has instituted a 10% preference threshold that will increase by 10% annually.<sup>74</sup>

However, local content requirements do not need to be explicit. Indirect 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. For instance, foreign investors in Namibia are eligible to receive favorable tax rates upon creating a feasibility study that demonstrates the investment will not unfairly disadvantage Namibian businesses, and that the firm will contribute positively to Namibia's growth.<sup>75</sup> 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.<sup>76</sup>

The advantages and disadvantages of local content requirements have been debated extensively.<sup>77</sup> Proponents argue that local content requirements are needed to build up domestic industry and are crucial to establish linkages between domestic and foreign businesses. Indeed, in the right setting, performance requirements can, at least temporarily, promote domestic development. 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 and components in each domestically assembled vehicle.<sup>78</sup> Likewise, local content measures imposed by the South African government in its vehicles sector from 1965 to 1985 decreased import penetration

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<sup>70</sup> World Bank, *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>>.

<sup>71</sup> OECD and NEPAD (2005), *supra* note 63, p. 27.

<sup>72</sup> World Bank (2012), *supra* note 65.

<sup>73</sup> Ghana, *Local Content and Local Participation in Petroleum Activities – Policy Framework*, (Accra, February 2010).

<sup>74</sup> *Ibid.*

<sup>75</sup> van der Ven (2017), *supra* note 12, pp. 48-50.

<sup>76</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 137.

<sup>77</sup> See, *e.g.*, Johnson, L., Space for Local Content Policies and Strategies: A Crucial Time to Revisit and Old Debate (Bonn: Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ), 2016), p. 7; W. Pollen, "Local Content Requirements, Help or Hindrance?", *African Business Magazine*, 24 August 2016.

<sup>78</sup> UNCTAD (2014), *supra* note 8, p. 4.

ratios by nearly one-quarter.<sup>79</sup> Moreover, in countries such as South Korea, Chinese Taipei, Brazil, Mexico and Thailand, local content requirements have been, arguably, successful.<sup>80</sup>

On the other hand, opponents argue that local content requirements induce production inefficiencies, do not foster FDI-SME linkages, and are difficult to implement.<sup>81</sup> Moreover, they highlight that the effectiveness of local content requirements is determinant by a number of factors, including the absorptive capacity of the workforce and domestic firms, and the extent to which local content policies are part of a coordinated package of industrial and trade policies. Indeed, one study found that where local content requirements were adopted without putting in place parallel efforts to boost the competitiveness of domestic SMEs targeted by the local content requirements, removal of these requirements might force many domestic suppliers out of business.<sup>82</sup> Thus, the effectiveness of local content requirements as a policy tool to foster SME-FDI linkages is context-specific.

While empirical and conceptual literature has found mixed results regarding the impact of local content policy on FDI, advancing local content policy as a stand-alone strategy could undermine efforts to attract FDI, especially in SSA.<sup>83</sup> Indeed, enforcing local content requirements in an environment that is constrained by, for instance, a 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.<sup>84</sup> From an economic point of view, local content requirements impose a burden on FDI that is, at a minimum, equivalent to additional taxation.<sup>85</sup> As a result, inflexible local content requirements could deter investment<sup>86</sup>, or result in investors allocating only relatively unimportant aspects of the value chain to a given location.<sup>87</sup> 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 governments in Sub-Saharan Africa as incentives to attract FDI”.<sup>88</sup> 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”.<sup>89</sup> Similarly, according to an United Nations Conference on Trade and Development (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”.<sup>90</sup> Moreover, it must be noted that, imposing a burden on FDI equivalent to additional taxation would directly undermine the generous duty and tax exemptions adopted to attract FDI, as discussed in section 3.1 above.

The extent to which local content requirements deter foreign investors is case, country, investor, and industry specific. To begin, the dissuasive impact of local content requirements depends, in part, on the *size of the host country*. They tend to be more significant in small host countries, and less significant in large markets like China. Unsurprising, the greatest number of performance requirements are typically in larger markets.<sup>91</sup>

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<sup>79</sup> *Ibid.*

<sup>80</sup> OECD and NEPAD (2005), *supra* note 63, p. 19.

<sup>81</sup> L. Johnson, *supra* note 77, p. 7.

<sup>82</sup> P. Sauvé, *Life Beyond Local Content: Exploring Alternative Measures of Industry Support in the Context of WTO Accession*, 1 *Journal of International Trade* (2016), p. 14.

<sup>83</sup> See, e.g., T. Ayentimi (2016), *supra* note 22, p. 363.

<sup>84</sup> *Ibid.*

<sup>85</sup> OECD (2005), *supra* note 69, p. 17.

<sup>86</sup> D.T. Ayentimi (2016), *supra* note 22, p. 265.

<sup>87</sup> OECD (2005), *supra* note 69, p. 17.

<sup>88</sup> D.T. Ayentimi (2016), *supra* note 22, p. 265.

<sup>89</sup> OECD (2005), *supra* note 69, p. 19.

<sup>90</sup> UNCTAD (2014), *supra* note 8, p. 13.

<sup>91</sup> *Ibid.*, p. 19.

The *objective of the investor*, and the industry in which the investor operates, also influences the deterrent effect of local content requirements. For instance, an efficiency-seeking investor in a footloose industry, such as the apparel sector, looking for cheap labor and/or market access under the African Growth and Opportunity Act (AGOA), could choose to invest in several different countries (e.g., Kenya, Rwanda, Lesotho, Ethiopia, Mauritius etc.). In this context, local content requirements could deter FDI. 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’.<sup>92</sup>

Similarly, in situations where a large number of locations with similar characteristics exist, imposing local content requirements as a market entry condition—while similarly situated countries do not—would likely discourage foreign investment. However, in situations where only a few countries possess a sought-after industry or raw materials, as is the case in certain extractive industries, foreign investors will typically have a higher tolerance to comply with local content requirements.

Another key element that determines the effect on foreign investors is the *absorptive capacity of a country’s SMEs*, i.e., the ability to identify, assimilate and exploit knowledge from the environment.<sup>93</sup> Where local content requirements do not reflect the capabilities of domestic SMEs, mandatory FDI-SME linkages could render a business uncompetitive. For instance, this happened under Malaysia’s Vendor Development Program (VDP), which promoted the creation and expansion of indigenous conglomerates and domestic firms.<sup>94</sup> Under the VDP, Bumiputera firms were given preferential rights to supply Proton with locally-produced goods. Bumiputera firms were unable to meet the required quality standard, however, and as a result, Proton cars acquired a lower quality image that undermined both the project’s viability and SME prospects.<sup>95</sup> Indeed, as a study by the World Bank noted, “introduction of local content requirements before local industry can respond adequately is likely to weaken the competitiveness of investors, undermining the overall objectives”.<sup>96</sup> After Malaysia eliminated its ethnic ownership restrictions, Proton was able to seek out other domestic suppliers with a better capacity to produce higher quality products at a reasonable price.<sup>97</sup>

The *level of flexibility* likewise impacts any dissuasive effect local content requirements might have on foreign investors. Local content requirements that are linked 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 domestic economy, are typically less burdensome than strict, mandatory requirements imposed as a condition of entry. The Malaysian government frequently made use of these 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

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<sup>92</sup> E. Ndemo and D. Smallbone, *Linkage Dynamics between Small and Large Firms in Kenya*, 5 DBA Africa Management Review, no. 1 (2015), p. 57.

<sup>93</sup> 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), 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).

<sup>94</sup> UNCTAD, *Best Practices in Investment for Development*, Investment Advisory Series (2011), pp. 23, 24.

<sup>95</sup> *Ibid.*

<sup>96</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 270.

<sup>97</sup> UNCTAD (2011), *supra* note 94, p. 24.

industries or parts of Malaysia the government considered to be of high priority.<sup>98</sup> Giving foreign investors options reduces the deterrent effect on FDI—compared to rigid, mandatory local content requirements.

In sum, local content requirements, which are often adopted to promote FDI-SMEs linkages, have the potential to deter foreign investors. The magnitude of the dissuasive effect depends on a number of different factors, including: the market size of the host-country, the objective of the investor, the absorptive capacity of domestic suppliers, and the level of flexibility embedded in the local content requirements.

### 3.3. Conclusion

This section has provided, on the one hand, an overview of various ways in which investment incentives adopted to attract FDI can exacerbate the competitive disadvantage between, on the one hand, SMEs and large firms, and, on the other hand, domestic SME and foreign SME suppliers. Conversely, this section has demonstrated how local content requirements adopted to stimulate the growth of local SMEs can deter FDI. This directly undermines the tax exemptions and other benefits so generously provided in many SSA countries to attract FDI.

## 4 POLICY OPTIONS

In the context of the discussion above, this section suggests a number of policy options SSA governments can consider in order to minimize the negative externalities of investment incentives on SMEs, and of SME policies on a country's ability to attract FDI. The first section focuses on policies that attract FDI while minimizing any negative spillover on SMEs, while the second section provides examples of policies that could stimulate SME-FDI linkages while minimizing the deterrent effect on FDI.

These policy options, are, however, of general nature and not tailored to the specific situations in SSA countries. Indeed, the first step to take for any SSA government interested in increasing harmony between SME and FDI policies would be to conduct further research and collect actual data with respect to (i) the effectiveness of the FDI and SME programs in place; and (ii) the degree to which these policies negatively impact FDI and SMEs promotion. Ultimately, adopting the right set of policies requires SSA governments to conduct a cost-benefit analysis, situated in the context of a country's policy priorities.

### 4.1 Investment incentives that minimize SMEs competitive disadvantage

SSA countries that, on the one hand, aim to attract FDI and, on the other hand, aim to promote SMEs must be mindful not to impede the growth of domestic SMEs. As noted by an UNCTAD study: “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”.<sup>99</sup> A World Bank study likewise cautioned that “[m]ost importantly...the issue is to ensure that foreign-owned companies do not have privileged access to such instruments over domestic producers”.<sup>100</sup> To minimize the negative impact of investment incentives on SMEs, SSA governments could consider some of the options set out below.

#### 4.1.1 Lowering/reducing minimum capital requirements

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<sup>98</sup> United States Department of State, “2011 Investment Climate Statement – Malaysia”, available at: <<https://www.state.gov/e/eb/rls/othr/ics/2011/157318.htm>>.

<sup>99</sup> UNCTAD (2011), *supra* note 94, p. 64.

<sup>100</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 269.

SSA governments could ensure that SMEs are entitled to the same benefits, including tax exemptions, provided to large firms. One way to do this is by lowering, or removing, the minimum capital requirement for domestic investors. While numerous governments in SSA have adopted lower minimum capital requirements for domestic firms compared to foreign firms, these requirements are often still unrealizable for SMEs. Rather than making certain benefits contingent on meeting a minimum capital requirement, SSA countries could consider adopting a different set of indicators to measure the risk and economic benefits of an investment.

#### 4.1.2 Increase SME participation in SEZs

SSA countries could consider reducing some of the spatial and structural obstacles that prevent domestic SMEs from entering into, and benefiting from, SEZs. This would not only increase SME productivity, but would also facilitate greater FDI integration.<sup>101</sup>

Opening up SEZs to domestic SMEs would require reducing the export contingency requirement for domestic SMEs, as these are often unrealizable for SMEs. In addition to increasing SME investment in the free zone, this would also increase the opportunity to construct forward linkages between SMEs and SEZ-based firms. In fact, it is increasingly common for zone programs in SSA to remove the export requirement.<sup>102</sup> To date, this approach has been adopted by Nigeria, Lesotho, Senegal, and Kenya.<sup>103</sup> For SSA governments interested in reducing the export contingency requirement for SMEs, it may be worth studying these examples.

However, reducing the export contingency requirement for SME is no panacea. Indeed, in assessing whether to remove the export contingency requirement, SSA countries must study the anticipated benefits this may bring, but also look at any additional “costs” or harmful effects. In this context, an important factor to consider is whether opening the domestic market to products created in an SEZ would result in crowding out local SMEs, which are often unable to sell products at the same competitive costs and quality as those produced by large firms in the SEZ. Moreover, enabling a larger number of SMEs to take advantage of the tax benefits provided to large firms will further reduce the tax revenue of a country—another important consideration to keep in mind when analyzing what policy to adopt.

In light of some of these challenges, some SSA countries have adopted innovative approaches to maximizing the spillover effects of FDI on SMEs. One such innovative approach is Ghana’s Tema Free Zone, which is 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. The non-exporting domestic firms are not eligible to receive the tax and fiscal benefits that firms in the free zone receive. However, this arrangement facilitates competitiveness of domestic SMEs through enabling them to take advantage of the EPZ infrastructure and by providing cluster-based support services, such as common packaging, labeling facilities, and warehousing facilities.

Another example of an innovative approach to better integrating SMEs into free zones is the Kenya Athi River Incubator program. Under 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.<sup>104</sup> Moreover, SMEs participating in this incubator program are eligible to receive the same fiscal and other benefits as large investors in the zone and are subject to more lenient export requirements: during the first year, they must export only 20% of their production,

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<sup>101</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 267.

<sup>102</sup> T. Farole (2011), *supra* note, 14, p. 178.

<sup>103</sup> T. Farole (2011), *supra* note 14, p. 226; 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>>.

<sup>104</sup> Kenya Export Processing Zone Authority, available at: <<http://www.epzkenya.com/index.php/about-us/available-space.html>>.

and by the fourth year, the export requirement increases to 60%.<sup>105</sup> Thus, this incubation program attempts to remove the competitiveness gap between FDI and SME by (i) reducing the export contingency—the *de facto* investment obstacle—and (ii) by providing SMEs with the same fiscal and non-fiscal benefits as are provided to large firms.

Another way to integrate domestic SMEs into SEZs would be through setting up plug-and-play industrial parks comprised of low-cost, ready-made factory shells. China successfully adopted this approach, establishing zones providing Chinese SMEs with basic infrastructure such as roads, energy, water, sewage, security, affordable industrial land, technical training, standardized factory shells, and free housing accommodation next to the plant.<sup>106</sup> 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.<sup>107</sup> This program has been attributed to having played “a very critical role in helping small Chinese small firms to grow into mid-size and large firms.”<sup>108</sup> That said, in contrast to the Kenya Athi River Incubation Program, SMEs did not receive the same subsidies that were provided to the large firms in these zones.<sup>109</sup>

#### 4.1.3 Reconsider the provision of FDI incentive packages

To reduce the competitiveness gap between FDI and SMEs, SSA governments should reconsider providing indiscriminate and generous fiscal and other benefits eligible investors in the free zone. While such incentive packages could attract investment in the short term, the correlation between providing incentive packages to investors in SEZs, and positive, long-term development outcomes is weak.<sup>110</sup> Indeed, studies have found that SSA governments have limited power to either attract the right type of investment, or establish the desired SME-FDI linkages.<sup>111</sup> Given the lack of long-term effectiveness of these incentive packages, governments may want to reconsider whether it is the most effective way to spend its resources.

One way to adopt a more targeted approach to attracting FDI would be to focus on attracting market-seeking investment, with a focus on sectors in which the host country has a comparative advantage. While it might not be realistic for many small SSA countries to be *extremely* selective about the type of investment coming into the country,<sup>112</sup> a country’s investment policy could, at a minimum, reflect awareness of different types of investors and the anticipated benefits on the local economy, including SMEs.<sup>113</sup>

#### 4.1.4 Interventions at SME level

However, to maximize SME-FDI linkages, SSA governments’ most significant interventions would be at the local SME level. In the context of SEZs, governments must be mindful of the *de facto* and/or *de jure* barriers to local sourcing. At a minimum, this would include providing “indirect exporters” status to domestic suppliers to firms in the SEZ, and create a more efficient administration of duty-drawback schemes. For example, a key factor in Korea’s successful duty exemption and drawback schemes was provision of inputs at world prices to both direct and indirect exporters.<sup>114</sup> In doing so, Korea “assured unrestricted choice between imported and

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<sup>105</sup> T. Farole (2011), *supra* note 45, p. 229, and fn. 10.

<sup>106</sup> World Bank (2012), *supra* note 65.

<sup>107</sup> *Ibid.*, p. 72.

<sup>108</sup> *Ibid.*

<sup>109</sup> *Ibid.*

<sup>110</sup> T. Farole (2011), *supra* note 14, p. 261.

<sup>111</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 264.

<sup>112</sup> *Ibid.*, p. 266.

<sup>113</sup> *See, e.g.*, van der Ven (2017), *supra* note 12.

<sup>114</sup> P. Harrold, M. Jayawickrama, and D. Bhattasali, *Practical Lessons for Africa from East Asia in Industrial and Trade Policies*, World Bank Discussion Paper, (1996), p. 69.

domestically produced inputs, while treating indirect exporters equally with direct exporters in assuring access to duty-free imports and other export incentives.”<sup>115</sup>

Furthermore, as discussed in more detail in section 4.2.2 below, governments should target supply-side absorptive capacity issues.<sup>116</sup> This would include horizontal interventions, such as improving access to finance for SMEs, access to information, and access to skills, but also vertical interventions that target specific industries.<sup>117</sup> Indeed, with the help of the private sector and/or universities, SSA governments should target and prioritize the development of SMEs in specific sectors to ensure that these sectors develop the requisite technical skills to meet the quality standards required of foreign investors.<sup>118</sup>

## 4.2 Promoting FDI-SME linkages while minimizing FDI-deterrence

### 4.2.1. Encourage FDI-SME linkages through flexible, voluntary FDI policies

In addition to undertaking concerted efforts to reduce competitive disadvantages for SMEs, SSA governments must also play an active role in encouraging FDI-SME linkages. SSA governments could do so by looking beyond mandatory performance requirements because these will be less FDI-deterrent, and 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* ... .”<sup>119</sup>

One way to do so would be through conducting a *sui generis* analysis of the investor’s potential for local value addition, and, on that basis, establish special contractual conditions with respect to that investor. 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 how 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.<sup>120</sup>

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: the impact on employment creation, new skills or technology acquisition for Kenyans, tax revenue contributions, foreign exchange, and domestic raw materials, supplies, or services utilization, among others.<sup>121</sup>

Similarly, Rwanda’s foreign investment regime requires foreign investors to, *inter alia*, submit with their application for investment (i) detailed information about raw materials that are anticipated to be sourced within the country; (ii) detailed information about the projected knowledge and technology transfer; (iii) the projected environmental impact; and (iv) the projected number of Rwandan employees, including those in managerial positions.<sup>122</sup> On the basis of such a sustainability study, the Rwandan authorities provide the groundwork for an investor-specific contract, which may or may not contain investor-specific performance

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<sup>115</sup> *Ibid.*, p. 70.

<sup>116</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 265.

<sup>117</sup> *Ibid.*

<sup>118</sup> *Ibid.*

<sup>119</sup> E. Ndemo and D. Smallbone (2015), *supra* note 92, (emphasis added).

<sup>120</sup> *Ibid.*

<sup>121</sup> Kenya Investment Promotion Act 2004, available at:

<<http://www.kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/InvestmentPromotionActCap485B.pdf>>.

<sup>122</sup> Rwanda Development Board, “The Law on Investment Promotion and Facilitation”, available at:

<[http://www.rdb.rw/uploads/tx\\_sbdownloader/Investment\\_promotion\\_law\\_04.04.16.pdf](http://www.rdb.rw/uploads/tx_sbdownloader/Investment_promotion_law_04.04.16.pdf)>.

requirements. For instance, C&H, a recent Chinese garment investor in Rwanda's SEZ, received the SEZ license contingent on establishing a training program for Rwandans, and subsequently employing these Rwandans.<sup>123</sup> C&H currently employs 300 Rwandan workers, while training another 550.<sup>124</sup>

In theory, Kenya's and Rwanda's case-by case approach would encourage linkages that are efficient and sustainable, and reflect a firm's capabilities.<sup>125</sup> That said, further research should be done on how effective such approach to FDI is in practice. How precisely are these different factors taken into account when contracts are awarded to foreign businesses? Who makes these decisions? Have investors been rejected for failure to provide information regarding the sustainability and local value added of their proposed investments? To ensure investment facilitation, governments adopting a case-by-case approach to evaluating the sustainability of an investment must be transparent about its criteria, and evaluation processes.<sup>126</sup>

#### **4.2.3 Create SME databases**

SSA governments could also facilitate FDI-SME linkages through creating databases that enable foreign investors to locate local suppliers. Malaysia and Singapore are among the Asian countries that have successfully used this approach to facilitate SME-FDI linkages. It is starting to be adopted in some SSA countries as well. For instance, Rwanda is planning to establish a supplier database, mirroring Malaysia's Vendor Development Programme, as well as India and Mozambique's FDI-SME databases. Specifically, Rwanda's supplier database will identify large Rwandan and foreign companies committed to help SMEs upgrade their products to meet the product specifications and purchase criteria.<sup>127</sup> These large companies must sign a memorandum of understanding with potential suppliers, which binds them to purchase SME's products, provided that the relevant quality criteria are met.<sup>128</sup> The Rwanda Development Bank identifies relevant institutes to help provide training and financing.<sup>129</sup>

#### **4.2.2. Increase local SME's absorptive capacity**

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 solely focusing on the "demand" side of the equation, *i.e.*, encouraging foreign investors to create linkages with SMEs, SSA governments could also consider focusing on the "supply" side of FDI-SME linkages. This would require adopting incentives to help SMEs meet the demands of foreign suppliers. Indeed, this has been a common industrial strategy in various Asian countries. For example, in 1996, Malaysia created the Industrial Linkage Programme, which aimed to encourage FDI-SME linkages by offering tax incentives to SMEs producing products that meet the requirements of large multinational firms, and by reimbursing foreign firms for the costs they incurred by training SME. Specifically, eligible SMEs received tax exemptions of 100% on statutory income for five years and investment tax allowance of 60% on qualifying capital expenditure incurred within a period of 5 years. These tax exemptions were contingent on manufacturing a select number of products and activities promoted by the government. While operating such a program is costly, governments could make funds available by reallocating funds currently used to provide FDI investment incentives.

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<sup>123</sup> Interviews conducted by the Author with SMEs in Kigali, Rwanda (June 2016).

<sup>124</sup> P. English, P. McSharry, and K. Ggombe, *Raising Exports and Attracting FDI in Rwanda*, International Growth Center Policy Brief no. 38402 (2016), available at: < <https://www.theigc.org/wp-content/uploads/2017/01/English-et-al-2016-policy-brief.pdf>>, p. 29.

<sup>125</sup> T. Farole and D. Winkler (2014), *supra* note 45, p. 270.

<sup>126</sup> See also Article 10 of "Structured Discussions on Investment Facilitation", JOB/GC/169, 1 February 2018.

<sup>127</sup> Rwanda Ministry of Trade and Industry, "Rwanda Private Sector Development Strategy 2013-2018", p. 69.

<sup>128</sup> *Ibid.*

<sup>129</sup> *Ibid.*

## 5 CONCLUSION

This paper has exposed tensions between policies adopted to promote FDI and policies adopted to stimulate the growth of SMEs. Specifically, this paper has demonstrated that generous incentives offered to foreign investors, to which SMEs are ineligible, increase the competitiveness gap between large firms and SMEs. Moreover, the spatial and legal characteristics of SEZ policies discourages SEZ-based firms from domestic sourcing. Conversely, this paper has demonstrated that the effect of local content requirements adopted, *inter alia*, to encourage FDI-SME linkages can be equivalent to a tax on investment, thus directly undermining the effectiveness of investment incentives, and possibly deterring FDI.

The tensions between FDI investment incentives and SME policies is reflective of a wider institutional problem: the failure to harmonize policies. As noted by a World Bank Report, “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.”<sup>130</sup> This is, in part, the result of SSA’s fragmented nature of policy making. Typically, SME policies and investment incentives fall under the responsibility of a different ministry and/or department. There is often little communication between these ministries/ departments, resulting in a lack of policy coherence. Accordingly, policies are often adopted on the basis of a sole objective. This can be to attract more FDI or to encourage the growth of SMEs—but they seldom target both objectives simultaneously.

This silo approach to thinking about development policy is also reflected in the international community: with respect to FDI and SME policies, most development studies or focus separately on either FDI or SMEs policies or, alternatively, generate a litany of policy goals incorporating every objective a country should seek to achieve. The SDGs are an example of the latter, running the gamut from clean water and education, to macro-economic reform and inclusive growth. While the SDGs constitute a notable achievement, it must be acknowledged that trade-offs and tensions exist between some of these objectives—both in terms of policy effect, and in terms of resource allocation. 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. This paper has attempted to expose some of these policy challenges in the dual objectives of attracting FDI and encouraging SME growth.

While trade-offs are inherent to every policy decision, this does not mean that trade-offs cannot be minimized. This paper has described a number of best practices that certain countries have adopted to ensure that policies for attracting FDI and encouraging the growth of SMEs are mutually reinforcing. Indeed, investment incentives to attract FDI and SME policies do not have to be mutually exclusive; rather, they can—and must—go hand-in-hand to generate inclusive and sustainable industrialization. However, governments will only understand the importance of minimizing the negative effects of certain policies and look to creative solutions to overcome them once they are aware of the potential tensions between various policies. This paper aims to make a small contribution by exposing some of these policy tensions, and acts as an invitation to finding creative solutions for sustainable and inclusive industrialization in SSA.

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