How FDI can diversify GCC economies

OIL DEPENDENCE

FDI COULD HELP GULF CO-OPERATION COUNCIL MEMBERS DIVERSIFY THEIR OIL-RELIANT ECONOMIES, BUT IT WOULD REQUIRE A CO-ORDINATED APPROACH BY GOVERNMENTS, LOCAL BUSINESSES AND FOREIGN INVESTORS, WRITES **YOUSUF HAMAD** OF OMAN'S SUPREME COUNCIL FOR PLANNING

Illustration by John Holcroft

The economic structure of Gulf oil-producing countries has considerable limitations, not least the so-called 'Dutch disease', whereby the long-term impact of high dependency on oil and the subsequent wealth generated from this resource-based sector negatively impacts upon other non-oil industries. In the member states of the Gulf Co-operation Council (GCC), this is apparent in the concentration of public and foreign investment in the state-run hydrocarbon sector, which has come at the expense of a small, underdeveloped private sector.

In my recent PhD research I examined how FDI can enhance the productivity of local manufacturing firms in the GCC. Using a case study approach and a combination of quantitative and qualitative methods, my analysis was based on primary data collected from 42 qualitative interviews and nearly 100 surveys of foreign, joint-venture and local companies in Oman. The thesis examined the impact of the business environment on interactions between foreign and local firms, government policies and productivity spillovers. It also looked at the effectiveness of mechanisms facilitating spillover effects from foreign to local firms, in order to realise an appropriate framework for productivity spillover from foreign firms in oil-producing economies.

The study examined the extent to which Gulf oil-producing countries are utilising inward investment to improve the productivity of domestic manufacturing firms, with specific reference to Oman. It looks at the region through the prism of rentier state theory (RST), one of several theories advanced to explain the predominance of authoritarian regimes in the Gulf region, including Oman. RST theory describes the specific political and economic features of countries that derive all, or a substantial portion, of national revenues from the rent of indigenous resources to external clients.

Laying the groundwork

My thesis identified several ways of developing and enhancing the efficiency of the private sector, including the use of FDI by multinational companies (MNCs), and the associated spillover effect this can have. There are several possible channels of productivity spillover benefits that might boost economic performance in a host economy. These include business linkages, labour mobility, and competition and demonstration effects.

However, these benefits do not accrue automatically and should not be taken for granted. In order to benefit from spillover effects, the host economy must prepare the ground through well-designed and well-implemented policies. This is an area of great focus for Oman, and one that is being rigorously pursued.

To ensure a win-win situation, all stakeholders, particularly the government, private sector and MNCs, must participate and collaborate to recognise and tackle typical barriers or constraints to spillover effects. This may require the strengthening of absorptive capacity, a narrowing of the technology gap, the enhancing of forward and backward links, establishing an institutional framework, enhancing links between FDI and domestic firms, and ensuring a well-trained and qualified local labour force is available. In Oman, the 'Omanisation' and the 'In-Country Value' development programme initiatives are mechanisms designed to support the implementation of the aforementioned pre-requisites.

The findings of my research suggest that the impact of inward investment on the productivity of domestic firms in Oman has been limited. The RST theory provides an important explanation for this, particularly the political economic contextual factors that have considerable relevance in explaining decisions to invest, and the sustainability of investment and spillover effects. Other factors include the government's passive role in developing and implementing effective investment strategies and policies to enhance the productivity of local firms; the weak absorptive capacity of most local firms; and the preference among nationals of working in the public rather than the private sector.

Change at the top

The findings of my study have filled a significant gap in research and literature, as the impact of interactions between foreign and local firms on the productivity of the latter has not previously been examined in the Gulf context, which has a unique economic structure in which the government is dominant in all economic activity and local human resources are not largely engaged in domestic firms.

My research found that the majority of inward investment is concentrated in the oil and gas sectors, with little investment in key sectors, such as manufacturing, which could facilitate economic diversification strategies. The study also found a correlation between the small size of the private sector in Gulf economies and the low absorptive capacity of local firms to interact, learn and compete with their foreign counterparts.

Hence, in order for productivity spillovers between FDI and domestic firms to be realised, the study recommends a new holistic approach that focuses on building a partnership between government (public sector), domestic business (private sector) and FDI (external sector). This international joint-venture business model must be driven by the government, because of its dominant role and control of resources, and must ensure a win-win arrangement for all partners.

To be an effective leader in this context, it is essential that the government creates a single institution responsible for the development and implementation of policies concerned with the enhancement of productivity spillovers. Such an institution could be much more effective than several scattered and fragmented institutions over a large number of ministries and governmental bodies, which are partly responsible for the low levels of productivity spillovers that currently prevail. The responsibilities of this government institution should include playing an active role in high-level co-ordination among all stakeholders in foreign investment; setting standards for implementation practices and monitoring processes regarding the transmission of productivity spillovers; and allocating inward investment in industries that are essential for its economic development and prosperity.

In the case of Oman and the Gulf oil-producing countries, foreign investment has not contributed to economic diversification and the development of national human capital resources because of its concentration in the capital-intensive hydrocarbon sector. This trend could change to allow for the transfer of skills, knowledge, technology, management and marketing attributes to local firms operating in the non-hydrocarbon sectors.

Plan of action

Policymakers must realise that productivity spillovers evolve over a long period, hence it is necessary to initiate legislation to encourage existing foreign firms to establish business support centres to facilitate interaction and co-operation with local firms. In light of the limited absorptive capacity of local firms in Oman and the wider Gulf region, my study suggests that policymakers diversify sources of inward investment in order to expose local firms to various technological advancements, production techniques and management practices. Domestic firms should bear the responsibility for enhancing their absorptive capacities by merging into bigger entities capable of being credible partners, and becoming more creative and dynamic in dealing with their foreign counterparts.

Responsibility for maximising spillover effects for the local economy not only rests with the government. Foreign firms operating in GCC economies ought to consider knowledge as public goods, and the transfer of knowledge and technology to local firms should be deemed an integral part of the process exemplifying the exchange of public goods.

It is common knowledge within the GCC region that Oman endeavours to be progressive in the pursuit of many of the aforementioned objectives. The country has maintained an acceptable level of growth based on a prudent approach to economic management. It continues to encourage foreign capital investment for the mutual benefit of both the country's overall development, as well as offering a respectable return to investors.

Included among the advantages Oman offers prospective investors are: competitive pricing of gas feedstock; continuous improvement of port services; renewable corporate tax holidays in specific zones; low rentals in industrial estates; equal tax treatment and investment privileges for foreign and local investors; availability of foreign ownership of up to 70% in most sectors and 100% in certain sectors; unified law, which is applicable to investment by both local and foreign entities; free-trade zone areas; government equity participation and soft loans; and many similar investment-friendly measures.

According to independently published reports, foreign investors in Oman have achieved returns of circa 30% in some sectors. Furthermore, Oman is a signatory to a number of multilateral agreements, as well as international and regional organisations, and has a number of bilateral agreements that have resulted in the country being considered favourably by the reputable rating agencies as a destination that is open for business, and that offers a safe and caring environment for establishing, developing and growing business enterprises both in the country itself as well as a gateway to the surrounding regional markets. ■

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