

EFFECT OF FOREIGN DIRECT INVESTMENT ON DOMESTIC ENTERPRISES IN THE GULF COUNTRIES

Yousuf Al Balushi, Supreme Council for Planning, Oman
Ashraf Mishrif, Qatar University, Qatar

ABSTRACT¹

This study examines the impact of foreign direct investment (FDI) on privately owned domestic firms in the Gulf oil producing countries. It provides its analysis through an examination of the role of FDI in sustainable economic development and the extent to which the interaction between FDI and private sector enterprises can enhance their productivity and competitiveness in domestic markets. In doing so, this study underlines the conditional factors and challenges of productivity enhancement in domestic enterprises in an economic structure and environment characterized by weak private sector. Empirical evidence collected from 96 survey questionnaires and 42 interviews with government officials and executives underscores the limited effect of FDI on domestic firms due to passive government role and improper management of FDI, weak absorptive capacity, and unattractiveness of private sector firms to local labor force.

KEYWORDS: Foreign direct investment, Domestic enterprises, Productivity spillover institutions; Gulf countries.

INTRODUCTION

The impact of foreign direct investment (FDI) on economic development has been widely examined in literature. As explained in the literature review, empirical studies sum-up three different perspectives on the effect of FDI on host country economy. The liberal perspective highlights the positive impact of FDI on development. Structuralists underscore the negative impact of FDI on development. While a more realistic perspective conditions the positive impact of FDI with certain internal conditions at the country and company levels. Lipsey (2002) and Borensztein, De Gregorio and Lee (1998) provide empirical evidence that supports the realist perspective and confirms that the positive effects of FDI depend on certain conditions. Such conditions whether in the form of policy framework or company characteristics are essential for effective transmission of productivity spillover effects from foreign to domestic enterprises.

Liberal economic theory argues that FDI affects positively the business sector in host country through competition and improvement in the legal and regulatory environment. It also argues that FDI can benefit the internal business sector through the transfer of technology, knowledge, capital, innovative managerial practices, marketing strategies and whole attributes of corporate culture to domestic enterprises. In a well-developed market, the business sector often receives substantial support from national government that is committed to develop infrastructure, create business linkages, provide access to finance, and provide public services essential for the efficient operation of companies. Companies can also increase their productivity by upgrading production techniques, accessing advanced technology, developing operational and marketing strategies, and allocating efficiently their capital and human resources. Mishrif and Al Balushi (2017) argue that this is a standard business practice in most developed countries, where foreign and domestic companies enjoy an array of supporting services from the government and operate in a healthy competitive market place.

¹ Publication : The Institute for Business and Finance Research

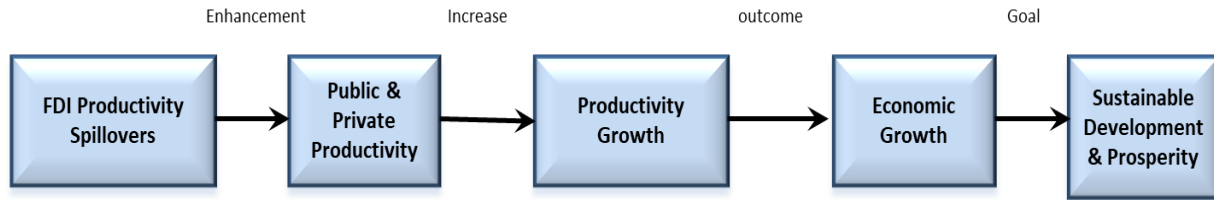
Yet, the distinctive characteristics of Gulf rentier economies that is marked by heavy dependency on hydrocarbons, central planning and dominance of the public sector have negatively affected the business sector and limited the share of the private sector in the development process. The rationale of examining the case of Arab Gulf states is manifold. First, Gulf economies do not depend on the productive sectors as oil represents between 39 and 70 per cent of GDP, 86 per cent and 90 per cent of government revenues, and 66 per cent and 98 per cent of exports. They are dominated by the public sector, while the private sector remains small and ineffective in the development process (Hvidt, 2013; Hertog, 2010). Second, most Gulf countries have embarked on large scale economic diversification programs; the success of these programs depends on the capacity of domestic enterprises to invest and expand in sectors such as finance, services and manufacturing. Third, the majority of state subsidies goes to public sector enterprises, while private sector enterprises lack financial and technical support. Fourth, most Gulf countries have established investment promotion agencies to attract FDI, which has steadily increased in Saudi Arabia, United Arab Emirates (UAE) and Oman since 2010. Literature review reveals that most studies conducted on FDI in the Gulf countries focus largely on the determinants of FDI, but there is hardly any research conducted on the effect of FDI on domestic enterprises in the Gulf context.

Methodologically, this study employs a multidisciplinary approach that allows for a comprehensive, in-depth analysis through a case study approach, together with a combination of qualitative and quantitative techniques. This approach enables us to collect sufficient primary and secondary data to analyse the extent to which domestic enterprises can benefit from the presence of their foreign counterparts. In doing so, this study conducts its analysis through two main aspects: the level and quality of transmission of productivity spillover effects from foreign to domestic enterprises; and the absorptive capacity of domestic enterprises to learn from their foreign counterparts to imitate and innovate in a way that enable them to create their own competitive advantages and become more productive and competitive. The study is divided into five main sections. The following section provides a literature review on the effect of FDI on economic development and the channels and mechanism through which productivity spillover effects are transmitted from foreign to domestic enterprises. Section three explains the methodology employed in this study and quantitative and qualitative techniques used to collect primary data. Section four presents data analysis and results. This section tests the two hypothetical assumptions that the effect of FDI on domestic firms depends on the level of productivity spillover effects from foreign to domestic firms and the strength or weakness of the domestic firm's absorptive capacity. Section five provides discussions of the key findings and concluding remarks.

LITERATURE REVIEW ON THE EFFECT OF FDI ON DOMESTIC ENTERPRISES

The effect of FDI on sustainable economic development has been widely examined in literature. For most developed countries, the way to achieve sustainable development is the diversification of the outcomes by producing new products and services and finding new markets. In this case, the host country should possess a high degree of innovation and higher absorptive capacity. For many developing countries, achieving sustainable development occurs by diversifying their income resources with both the government and the private sector playing essential roles. The government focuses on preparing the business environment in terms of role, regulations and creating a platform on which foreign and domestic enterprises can flourish. Figure 1 explains how the efforts by the government can improve the business environment, which, in turn, attract FDI and facilitate its interaction with the private sector, and subsequently improves the performance and competence of various industries and economic sectors. Foreign and local companies operating in host-developed countries tend to diversify outputs as means of economic diversification and growth, while those operating in host-developing countries concentrate on diversifying inputs or income resources to attain economic diversification and growth.

Figure 1: General Framework For Sustainable Development Using FDI



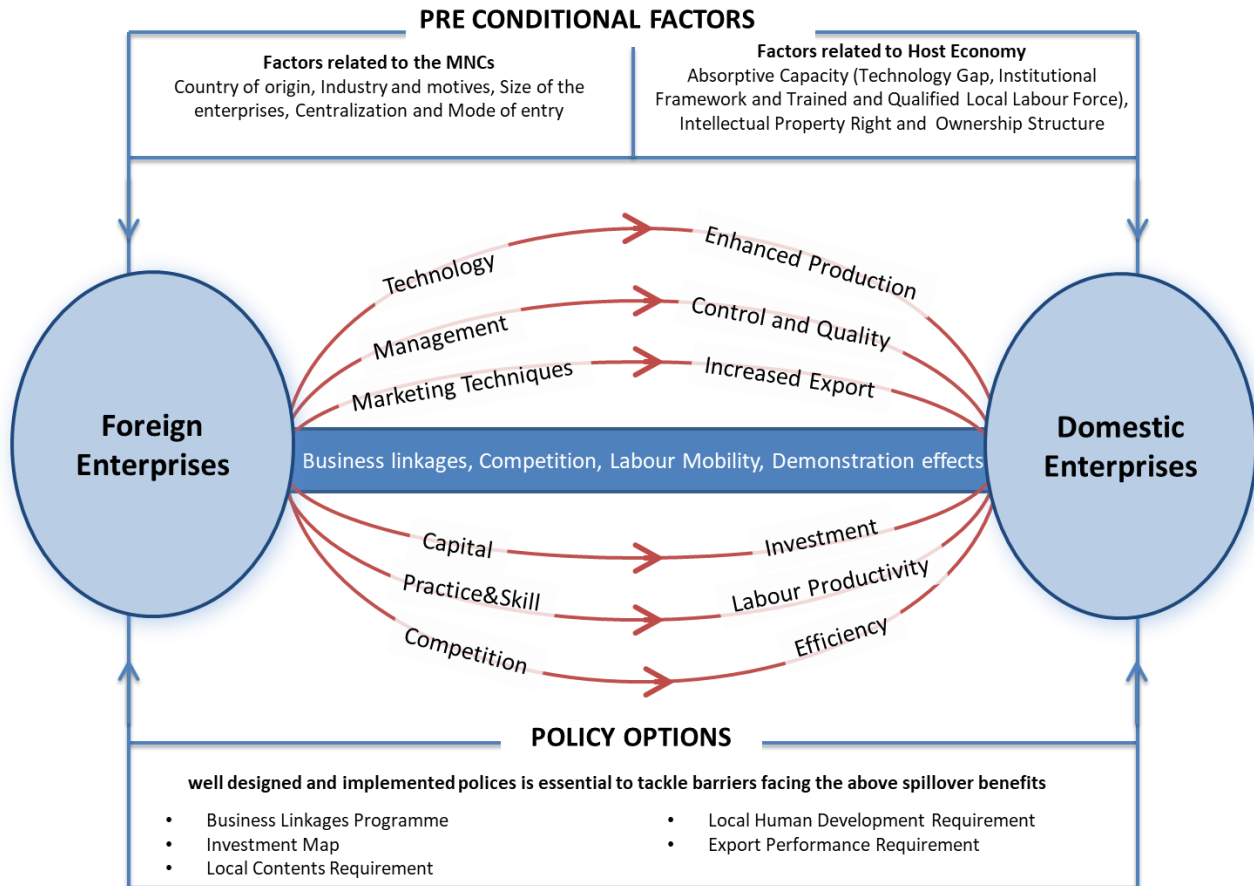
Source: Developed by the Authors

The contribution of FDI to sustainable economic development is positive when the relationship between foreign and domestic investment is complementary and when foreign investment is made in an underdeveloped sector of the economy (Mishrif and Al Balushi, 2017). Another study argues that the positive effect of FDI on domestic enterprises occurs when the former becomes more of a substitute to the latter, where the industry has plenty of domestic firms or domestic firms have access to technology that FDI brings to the host country (Blomstrom et al., 1999). This perspective follows the line of free market argument, where FDI operates with the least possible barriers and often results in raising the productivity of domestic enterprises. The findings of several studies conducted by Buckley et al (2007), Cave (1999), De Mello (1999), Fry (1992), Borensztein et al (1998), and Moran (1998) also find that FDI accelerates economic growth, increase income, and contribute to economic development beyond available domestic resources. Other studies argue that the positive effect of FDI can materialize only under certain local policy conditions. Mishrif and Balushi (2017) identify the absorptive capacities in host country economy, where the impact of FDI on economy depends largely on the nature of the industry and the degree of liberalization in domestic policies. Also, a study by Borensztein et al (1998) using data of 69 developing countries over a period of two decades, finds that FDI is an important vehicle for technology transfer, hence contributing relatively more to growth than to local investment. However, the study finds that the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Javorcik (2004) also argues that positive productivity spillover effects from foreign investment to local firms are associated with joint ventures sharing domestic resources and foreign ownership, but not with fully owned foreign firms. Mayer and Sinani (2008) used meta-analysis to underscore that FDI generates positive spillover under certain circumstances, often related to local firms' motivation and capability to react to foreign entry, such capabilities are grounded in their human capital and organizational structure. Thus, positive spillover effects depend on a number of factors, including host country's openness to trade (Bhagwati, 1978), the ability of industries to support learning, and the capacity of its domestic enterprises to internalize spillovers. For positive spillover to have an effect, the technological gap between foreign and domestic firms should not exceed a threshold (De Mello, 1999), and domestic firms should benefit from relatively developed internal financial markets and qualified human capital.

However, a number of studies find a negative effect of FDI on domestic enterprises due to intense competition and market dominance that often result in crowding out small and medium sized enterprises (SMEs). De Backer and Sleuwaegen (2003) identify three factors that could result in crowding out of local SMEs: when there is a large technological gap; labor force in host economy is not sufficiently qualified; and differences in the access to credit between foreign and domestic firms. Aitken and Harrison (1999) also argue that provision of offering high wages to employees in foreign firms in contrast to lower wages paid by local firms affect negatively the quality of the latter's workforce due to labor mobility from local to foreign firms and consequently their productivity. In fact, an increase of wages and the prices of locally supplied inputs often lead to reduced employment and displacement of domestic businesses. Fry

(1992) goes further to argue that the negative effect of FDI can result in the reduction of domestic enterprises, where foreign firms are technologically more advanced and capable of exploiting more rapidly and effectively business opportunities projected initially to domestic enterprises.

Figure 2: Framework of Productivity Spillover Effects from Foreign and Domestic Enterprise.



Source: Developed by the Authors

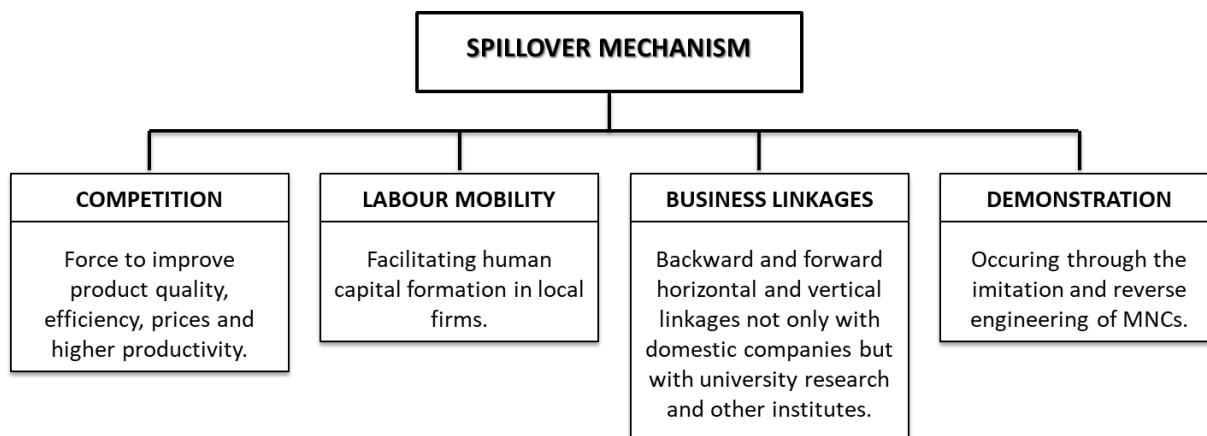
FDI affects domestic enterprises in many ways. Figure 2 highlights a number of channels and mechanisms through which spillover effects from FDI can enhance the performance of domestic enterprises. In the marketplace, foreign and domestic enterprises often cooperate and compete in the factor and product markets, and that such variation of interaction necessitates the need to determine the productivity spillover channels between foreign and local firms. Figure 2 maps the transmission of productivity spillover effects from foreign to domestic enterprises. While providing the overall framework of transmission process, including the pre-conditional factors that should exist and the policy options for enhancing the process, it identifies six channels through which foreign and local firms interact, namely technology transfer, management attributes, marketing techniques, capital flows, best practice and skills, and competition. Mishrif and Balushi (2017) argue that effective utilization of these channels is likely to improve the performance, raise the productivity and enhance the competitiveness of local firms. They also argue that in order to attain such objectives, “a number of pre-conditional factors relating to both foreign firm and host country economy should exist. At foreign firm level, productivity spillover effects are influenced by country of origin, type of industry, motives, size of the firm, centralization, and mode of entry”. At domestic firm level, spillover effects are affected by the absorptive capacity of the firm in terms of technology gap, size of the firm, organizational structure, ownership and

quality of its workforce. At policy level, effective utilization of productivity spillover channels requires well-designed and implemented policies to tackle the barriers that hinder the functionality of the channels.

In theory, technological spillover from foreign to domestic firms can enhance the production process, while management attributes improve control and quality of production. Proper implementation of foreign marketing strategies by domestic firms could increase their exports. FDI capital flows, mainly through joint ventures, enable domestic firms to expand their operations beyond their own financial capabilities. Spillover of business practices and skills from foreign to domestic firms can improve the quality of the workforce and increase its productivity. Competition plays a key role in enhancing the efficiency of domestic firms. Nonetheless, spillovers do not transmit automatically, or guaranteed, because foreign firms do not generally handover their competitive advantages to other firms (Cohen, 2006). To benefit from spillovers, domestic firms must prepare the ground through well-designed and implemented strategies to collaborate with their foreign counterparts to strengthen their absorptive capacity, narrow the technology gap, and enhance forward and backward linkages, while asserting government support to benefit access to funding and improved business environment (UNCTAD, 2003).

As for spillover mechanisms, Gorg and Greenaway (2004) identify four mechanisms for productivity spillovers, which are business linkages, labor mobility, competition and demonstration effects. Figure 3 shows that competition forces local firms to improve product quality, efficiency, price and, hence higher productivity. Labor mobility facilitates human capital formation in local firms. Business linkages influence productivity of local firm through backward, forward, horizontal or vertical linkages, not only with local firms but also with universities and other research institutions. Demonstration occurs through the imitation and reverse engineering of foreign firms in the host country economy.

Figure 3: Productivity Spillover Mechanisms



Source: Developed by the Authors from Gorg and Greenaway, 2004.

DATA AND METHODOLOGY

Building on previous studies by Lipsy (2002) and Borenztein, De Gregirio and Lee (1998), which argue that the positive effects of FDI depend on certain conditions, this study attempts to test this hypothesis through an empirical examination of the effect of FDI on domestic enterprises in the Gulf oil-producing countries. Such examinations requires collections of primary data and application on a case study approach to make the data meaningful and understood. In the context of the Gulf countries, we do have sufficient available data on FDI, which could be obtained from the databases of the World Bank and UNCTAD's World Investment Reports. However, there are no available reliable data on the size and number of domestic enterprises and the levels of their productivity. This lack of data on the second main

variable in this examination hinders the possibility of employing any form of statistical analytical programs or econometric models. For the sake of comparability, we limit our approach to the conventional methods of collecting and analysing primary data. We adopt a multidisciplinary approach that allows for a comprehensive, in-depth analysis through a case study approach of one representative country of the region, together with a combination of qualitative and quantitative techniques.

The similarities in the economic structure and outlook of Gulf economies allow for sparing the efforts to include all Gulf countries in the empirical part of this study. During the fieldwork, limited resources and lack of available data and access to data in all the Gulf countries have forced us to limit our analysis to a country-specific case study, where we examine the impact of FDI on domestic enterprises in the manufacturing sector in Oman. This approach enables us to have a good representative sample of the promising Omani manufacturing sector, which is almost identical in terms of size and structure to that of other Gulf countries. The selection of Oman is based on the country's efforts to launch an intensive economic reform program, aiming at liberalizing its trade and investment regime, improving its business environment, and diversifying its economy in light of its limited oil production and reserves. Mishrif and Balushi (2017) also argue that Oman has invested heavily in developing free zones and business parks to attract FDI to the industrial sector, where the scope of productivity spillover is significant compared to other sectors. These efforts bore their fruits in terms of substantial rise in FDI, which increased by 400 per cent, totaling US\$26.5 billion and amounting to 43 per cent of GDP in 2011, from its 2002 level (UNCAD, 2012). In the same year, manufacturing received almost 30 per cent (US\$2.3 billion) of total FDI, only second to oil and gas, which received 51 per cent (US\$7.1 billion). Most investments came from the UK, the USA and UAE, and concentrated in the manufacturing of basic chemicals or refined petroleum products. This type of investment has made substantial contribution to Omani economy, generating 45 per cent of economic value added and 88 per cent of exports (Oman Central Bank, 2013), while diversifying exports, particularly chemical products (32 per cent), basic metals (26 per cent) and food and beverages (15 per cent) (Omani Ministry of Commerce and Industry, 2011).

In this study, a combination of qualitative and quantitative techniques are employed to explore opinions and perceptions of all stakeholders concerned with FDI policies and whether these policies are appropriate for improving the performance and increasing productivity and competitiveness of domestic enterprises. A set of semi-structured interviews are conducted in Oman between January and June 2015 with foreign and local executives and with relevant government officials in Ministry of Commerce and Industry, Supreme Council for Planning, Investment Authority, Chambers of Commerce and Industry, and Free Zone Authorities in Duqam, Sohar and Salalah. Geographically, the samples collected from four major business and industrial cities: Muscat, Sohar, Duqam, and Salalah, where the vast majority of foreign operations are located. The authors conducted 42 interviews with policy makers and executives, of whom 13 interviewees are government officials, 9 interviewees from foreign firms, 10 interviewees from joint ventures, and 10 interviewees from domestic firms. Patton (2002) argues that this technique provides information that answers the research questions and allows for better understanding of the variables examined in relation to the role of local executives in maximizing the benefits of interactions with foreign firms, while guiding policy makers to develop policies aiming at facilitating the transmission of productivity spillover effects from foreign to local enterprises.

Meanwhile, the authors have designed and sent a survey to foreign and local company executives to allow for some generalization on their responses to specific questions regarding their firms and experience in working in Omani market. Each questionnaire sample is divided into five sections. The first section collects general data on the respondent's occupation, economic activity, ownership structure and business environment (questions 1-20). The second section focuses on how foreign operations affect the upgrading of domestic firms through spillover channels and mechanisms (questions 21-38). The third section collects data on preconditioned factors such as absorptive capacity, institutional framework, mode of entry and ownership (questions 39-53). The fourth section collects data on public policies, strategies and

incentives (questions 54-74). The fifth and final section draws a SWOT analysis for Omani business environment in relation to attracting FDI and formulating business linkages between foreign and domestic firms (question 75). From 114 returned questionnaires, only 96 completed (valid) questionnaires used in this study. The 76 per cent response rate shows that joint ventures (46 companies with response rate 92 per cent) were keener to participate in this study than local companies (34 firms with response rate 68 per cent) and foreign firms (34 companies with response rate 68 per cent).

DATA ANALYSIS AND RESULTS

Analysis of the descriptive and statistical data collected from the interviews and survey questionnaires unveils some important insights on the way FDI affects the performance of domestic enterprises in the Gulf context. It also provides us with new knowledge on how spillover effects of FDI affect the productivity of domestic firms. In doing so, this section provides its assessment and findings by analyzing the effectiveness of productivity spillover channels and mechanisms and the absorptive capacity of domestic firms to learn from their foreign counterparts. This section is divided into two main parts; each addresses one hypothetical element of the study. First, we use the primary data to explain how the low levels of transmission of productivity spillover effects minimize the effect of foreign direct investment on domestic companies. Second, we use data to explain the text to which the weak absorptive capacity of domestic companies hinders their ability to benefit from the presence of foreign direct investment in the host country.

Low Productivity Spillover Effects from Foreign to Domestic Enterprises

Analysis of primary data reveals low levels of productivity spillover effects from foreign to domestic enterprises in the Gulf countries. Analysis also reveals that the effectiveness of productivity spillover mechanisms is largely influenced by the institutional settings, business environment and demographic structure of the country, while also affected by key company characteristics such as ownership structure and geographical location. Determining the intensity and levels of interaction between foreign and domestic enterprises, we have considered the above factors when we conducted the survey in the case study Gulf State of Oman. In terms of ownership structure and geographical distribution, the survey shows that 70.8 per cent of manufacturing firms concentrate in Muscat, 11.5 per cent in Salalah, and 10.4 per cent in Sohar. Of the 96 firms surveyed, 40.6 per cent are joint ventures, 35.4 per cent are Omani, and 24 per cent are foreign-owned. As for foreign-local business arrangements, data shows that 28.1 per cent strongly agreed of existing arrangements and 67 per cent agreed of existing relationships in terms of purchasing materials, services, distribution, and maintenance, which result in upgrading the work practice of domestic enterprises. Survey responses confirm that, in the best case scenario, foreign firms pass on to their local counterparts the latest technology and quality standards, proven human resources plans, information technology systems, technical know-how, applying safety procedures, training manpower, and advanced management techniques. Nonetheless, evaluation of the effectiveness of productivity spillover mechanisms in facilitating interaction between foreign and domestic enterprises should include an examination of the key factors affecting performance of domestic enterprises.

Table 1 : Response Rate

	No. of Questionnaires sent	No. of Questionnaires returned	Response rate (%)
Fully domestic owned firms	50	34	68
Fully foreign owned firms	50	34	68
Joint venture	50	46	92
Total	150	114	76

Business linkage: quantitative and qualitative data shows that business linkages between foreign and domestic enterprises exist but remain weak in our case study. Analysis underscores an equitable level of business linkages, particularly backward linkages with suppliers, as foreign firms prefer to concentrate on their core activities and transfer their non-essential business to local enterprises. The executive of the joint venture Bahwan Exel brands this type of linkage as “complementary”. His views complement that of the executive of the local firm Oman Food Investment Holding Co., who argues that “the exposure by local firms and the linkage sought will improve the way local firms do their business”. But, when asked about their satisfaction with existing linkages, local firms expressed their dissatisfaction with the level of linkages because there are fewer linkages within a small scope with foreign companies (interview with the executive of the local manufacturing Poly Products LLC.). In the meantime, director of the foreign manufacturing firm Safety Industries argues that the extent of linkages is weak because local firms do not have sufficient capacity in terms of knowledge, skills and experience to engage with foreign firms.

Nevertheless, survey data reveals that business linkages are fundamentals for spillovers and are beneficial for Omani firms, even if there are no spillovers. Although backward and forward linkages exist on a small scale due to limited absorptive capacity of Omani firms, data identifies the importance of skills spillover (mean 4.40), technology linkage (mean 4.34), marketing techniques (mean 4.36), and managerial spillover (mean 4.11) as indispensable for effective linkages. Data also confirms the existence of indirect linkage with local firms covering demonstration effect and labor mobility that has a mean 3.98, with 11.5 per cent strongly agree and 77 per cent agree of the existence of this type of linkage. It also acknowledges the existence of direct forward linkage with local customers for supply of inputs, marketing and distribution at a mean 3.93, with 11 per cent strongly agree, and 74 per cent agree of the importance of this linkage. Such data underlines the potential for Omani firms to increase backward linkages by realizing that most foreign firms have incentives to provide technical assistance to and share knowledge with their local firms, particularly suppliers in order to improve the quality of their supply chain (Mishrif and Balushi, 2017).

Labor Mobility: labor market efficiency, in theory, is another key factor in facilitating the transmission of productivity spillover effects from foreign to local companies. It allows workers to change their employers and move from one firm to another. However, our case study shows that labor mobility is weakened by the unique economic structure in the Gulf countries that limits the transmission of spillover effects between companies. The dominance of the public sector over the small, weak and somewhat ineffective private sector, together with preference of local human capital to work in public sector jobs for job security and fiscal incentives, creates a tendency among nationals not to learn new knowledge and skills.

Moreover, local private firms are dominated by expatriates, who are typically employed on short-term contracts and do not stay in the country for long. Such peculiarity limits the effect of labor mobility in transmitting productivity spillovers from foreign to Omani firms. Analysis also shows that foreign firms contribute to this negative outcome due to their high wages, which incentivize citizens to move from local to foreign firms for better wages and social status (World Bank, 2009; Chatham House, 2014). In fact, survey data records mobility in the opposite direction, but with a higher mean of 3.98, with 19.8 per cent strongly agree and 64.4 per cent agree that workers move from local to foreign firms, than that recorded for workers moving from foreign to local firms, which stood only at a mean 3.23.

Competition: although competition is a healthy practice for local firms to upgrade their systems and working practices, Omani firms argue that competition gives foreign firms a competitive edge that makes them more productive than their local counterparts. Their argument complements the early findings of Aitken and Harrison (1999), who argue that the entry of foreign firms into a specific market is likely to result in crowding out of a significant number of local SMEs that cease to operate or lose their market share due to competition.

However, our data produces mixed results, as competition has both positive and negative effects on local firms. On the positive side, our data shows that foreign firms and joint ventures see the role of their companies complementary by having “different market targets, mainly for export, hence they work in partnership with local counterparts rather than competing with them”. As for local firms, only those with sound organizational, financial and human capabilities that enable them to remain in the market perceive competition as a healthy practice due to their need to innovate and develop more efficient production techniques.

On the negative side, survey data shows a mean 3.70, with 15.6 per cent strongly agree and 54.2 per cent agree that foreign firms compete with their local counterparts. Although the levels of competition vary, some local company executives argue that they face a high level of competition from foreign firms. The severity of competition has led one executive to argue that foreign firms come “to eat up our market share”.

Demonstration Effects: FDI transfers technology, knowledge, techniques, practices and skills and, hence, one expects greater potential of spillover effects to Omani companies through observation and imitation. Analysis shows that this factor is not as effective as one would expect because the majority of local firms are small and do not have the minimum requirement to learn effectively from their foreign counterparts. Supply chain manager of Occidental of Oman argues that “spillovers depend on the ability of domestic firms to learn ... the stronger and bigger the more they can learn ... [and] local companies need to improve their own absorptive capacity”.

The majority of interviewees condition the capacity of Omani firms to increase their productivity through this channel to (1) upgrading their technological and operating methods close to that of foreign firms; and (2) existence of some degree of similarity in the work practice and the goods produced in order for demonstration to take place and be effective.

Survey data, however, shows positive opinion on this channel, as 11.5 per cent of respondents strongly agree and 75 per cent agree that local firms learn through observation and imitation of their foreign counterparts by adopting their technology, marketing techniques, and changing their products to local condition and needs. In addition, 38.5 per cent strongly agree and 45.5 per cent agree that local firms make efforts in terms of demonstrating new technologies and training workers in order to master the new technology. Despite such efforts, this factor remains a challenge for most local firms.

Weak Absorptive Capacity of Domestic Enterprises

This study also finds a link between low productivity spillover in the Omani manufacturing sector and structural and organizational weaknesses that limit the absorptive capacities of Omani firms. It is apparent from the primary data that local firms have developed neither external nor internal strategies to create their own competitive advantages; nor were able to utilize the capabilities and practices brought in by foreign companies to their market. Our findings show a dissatisfaction with domestic enterprises’ ability to do this. Survey data reveals that 33 per cent of respondents have a low level of satisfaction and 4 per cent have a very low level of satisfaction about the quality and readiness of domestic enterprises to benefit from the presence of foreign companies. Analysis of interviews and secondary data produces similar results. For instance, Supply Chain Manager of Occidental Of Oman Inc. argues that Omani companies should try to get stronger and bigger in order to be able to learn from their foreign counterparts and must focus on improving their own absorptive capacity.

Descriptive analysis of the survey data presented in table 1 reveals a strong link between the absorptive capacity of the firm and availability of effective institutional arrangements to provide domestic enterprises with necessary technical and financial support that is essential for increasing their productivity

and competitiveness. Survey respondents consider institutional arrangements the most important factor, with the highest mean 4.41, for enhancing firms' absorptive capacity and transmission of spillover effects from foreign to domestic firms. Data shows that 50 per cent of respondents strongly agreed and 43.8 per cent agreed on the importance of this factor for the company. Despite such importance, available data and official reports confirm that there is a shortage of absorptive capacity in the country, particularly in terms of needed institutions to drive private sector-led growth, not in terms of quantity but quality, as there are numerous bodies, and programs in place, but working in a conflicting way. In addition, technical and managerial skills are needed to drive this transformation and private sector competitiveness. The quality of current institutions should be enhanced and new institutions created to build linkages and scale up success stories e.g. local content and in-country value programs. According to our findings, the level of coordination among institutions and with domestic and foreign companies is low. Qualitative data also reveals that although such institutions are vital to ensure that companies receive the appropriate support, there are no institutions dedicated to the enhancement of companies' absorptive capacity. For instance, the Director General of Research and E-Services in Public Authority for Investment Promotion and Export Development says "we have different government bodies, but we do not have a tool for that [coordinating their works to enhance absorptive capacity]. There are Ministry of Foreign Affairs, Ministry of Commerce and Industry, Oman Chamber of Commerce, and Public Establishment of Industrial State, but none of them focuses on building relations between foreign and domestic companies".

Another major weakness is the human capital resources of local firms. In an interview with Director General of Rusayl Industrial Estate, Public Establishment for Industrial Estates, he argues the most private sector companies lack skilled, high-qualified workforce because "Omanis prefer to wait for public jobs instead of working in the private sector". CEO of Freezone Sohar (SFZ) also stressed that "there is still a lot to be done about small and medium enterprise in Oman [because they are] very dominated by expatriates". He asserted "more engagement between the foreign direct investments and the private sector to educate, train and qualify local workforce". This is echoed by Director Poly Products L.L.C., a domestic manufacturing firm in Muscat, who argued that "We need to educate our people that human resource is the power of manufacture"; and by the Managing Director of Bahwan Exel, a joint venture manufacturing firm in Sohar, who says that "you can never stop investing in human capital". Survey data also stresses the importance of human capital with high mean of 3.92, where 18.8 per cent strongly agree and 62.5 per cent agree that this factor is vital to improve the absorptive capacity of Omani firms.

Table 1 : Factors Affect Absorptive Capacity of Domestic Enterprises

	No. of Samples		Mean*	Median	Mode	Range	Min.	Max.
	Valid	Missing						
Institutional Framework	96	3	4.41	4.5	5	4	1	5
Human Capital	96	3	3.92	4	4	4	1	5
Property Rights	96	3	3.86	4	4	3	2	5
R&D	96	3	3.64	4	4	4	1	5
Technology Gap	96	3	3.14	3	3	4	1	5

*Sorting mean – items at top of table have highest importance in influence and linkage formation.

Another measure of absorptive capacity is the technology gap between foreign and domestic firms. For domestic companies, closing the technology gap rated the least important priority, with mean 3.14. Table 1 shows that this mean is below the mean scored in property rights (mean 3.86) and R&D (mean 3.64). As for property rights, survey response reveals that 16.7 per cent answered strongly agreed and 46.9 per cent agreed of the importance of R&D for enhancing the absorptive capacity of firms. A senior economist

in the Central Bank of Oman explained this by arguing that “R&D is something that is not really focused on widely in the country. There are R&D centers but I think more and more is needed in future”. This view confirms that existence of intellectual property law promulgated by the royal decree No. 37 of 2000, but this law lacks enforcement and implementation. General Manager of Operations of the joint venture manufacturing firm Reem Batteries and Power Appliances Co. SAOC adds that “local companies have not got too much of facility because R&D requires both time and capital. This is why R&D is normally administrated by large companies”. If this to indicate anything, it mirrors the poor quality of research institutions and low R&D budget, which stood at only 0.1 per cent of GDP in 2010 (BTI Index, 2014). The majority of this modest R&D funding used by public sector enterprises because the private sector is scattered in small units and does not have the resources and ability to do R&D. Resident Managing Partner of Trowers & Hamlins, a joint venture Law firm in Muscat, reaffirms “the area that we have been lacking as a country [is] innovation and what you call technologies. We are very behind in R&D. There is no law at the moment that forces local companies or any company to spend money on R&D”. The attitude towards R&D varies from one company to another. In terms of domestic firms, the Director of Media & Communication in Public Establishment for Industrial Estates confirms that spending on R&D is “nothing, it is a big zero”. In foreign companies, the Senior Vice President of Shadeed Iron & Steel LLC., a foreign manufacturing firms in Sohar, says that “it is limited; more needs to be done”. The attitude is imprecise in joint manufacturing venture companies, as the Managing Director in Bahwan Exel in Sohar states “we do not have much of R&D”.

DISCUSSIONS

The analysis of qualitative and quantitative primary data presented above is consistent with the findings in literature. There are several possible explanations for the limited effect of FDI on domestic enterprises in the Gulf countries. As explained above, these countries depend heavily on the hydrocarbon sector and hence the majority of foreign and domestic investments go to oil and gas, a sector that has limited scope for productivity spillover effects due to lack of interactions between international oil companies and domestic companies. One could also attribute the limited effect of FDI on domestic firms to the passive role of the government in promoting and facilitating FDI into the most underdeveloped sectors of the economy. Mishrif and Al Balushi (2017) find strong correlations between the organizational structure and size of public institutions dealing with FDI and the levels of productivity spillovers effects from foreign to domestic companies. They conclude their study by “placing greater responsibility on the state in developing specialized institutions with clear mandates for effective transmission of productivity spillover effects from foreign firms to local ones”.

A third explanation is the weak absorptive capacity of domestic enterprises to learn from their foreign counterparts. Mishrif and Al Balushi (2017) argue that one cannot ignore the responsibility of the state in developing and implementing “effective investment policies that could strengthen absorptive capacity of local firms, hence increasing their productivity”. Their argument is consistent with the findings of this study, which reveal that the current level of investment in R&D at both country and company levels is insufficient to support domestic enterprises to benefit from the presence of FDI. Our findings also match similar results found by Halpern and Murakozy (2006), Abraham et al. (2006), and Girma et al. (2006). These studies argue that domestic firms with more advanced technology or R&D capability are likely to benefit most from the presence of foreign firms. Todo (2006) also argues that the size of R&D of domestic enterprises is directly associated with the magnitude of spillovers. Other empirical studies in the case of India (Kathuria, 2000) and the Czech Republic (Kinoshita, 2000) find that investment in R&D by domestic enterprises is a necessary condition for spillovers to occur. In terms of technology gap, Kokko et al. (1996) find a positive and highly significant effect of FDI on Uruguayan manufacturing firms with small technology gaps, while Takii (2005) stresses that large technology gaps reduce positive spillovers in the case of Indonesian firms. Similar results by Keller and Yeapl (2003), Damijan et al (2003), Kinoshita (2000) and Borensztein et al (1998) support the argument that FDI contributes to domestic productivity

growth only if the technology gap between domestic and foreign firms is not too large and when a sufficient absorptive capacity is available in domestic firms.

A weak absorptive capacity is caused also by the inability of the domestic company to attain qualified, high-skilled workforce. Although this a company problem, Al Qudsi (2005) argues that this is a nation-wide problem as Oman's labour market is characterized by three main disadvantages for productivity spillovers. First, citizens prefer to work in government jobs. Second expatriates who are hired on short-terms contracts represent the majority of workforce in domestic firms, hence companies are unable to build and keep knowledge and skills in-site. Third, there is a skill mismatch between national job seekers and the requirements of domestic firms. A number of empirical studies supports our human capital resource findings. For example, Borensztein et al (1998) suggest that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment; but the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Hoppe (2005) also finds that human capital is the most important for the absorption capacity. Moreover, Meyer (2004) stresses that productivity spillovers might happen through the human resources market, because local trained employees of the foreign firms might move to local suppliers and, hence, the transfer of proprietary knowledge can occur. Another possibility is that qualified employees might choose the entrepreneurship path and pursue their own businesses through foreign firms outsourcing arrangements. Generally, qualified national workforce prefers to work for the public sector than jointing domestic firms.

Our findings on productivity spillover mechanisms are consistent with established literature. Moran (2008) finds that business linkages are prerequisites for spillovers and are beneficial for domestic firms, even if there are no spillovers. This supports our finding that both backward and forward business linkages exist in Oman on a small scale. The small size of linkages results consequently in low level of transmission of productivity spillovers from foreign to domestic firms. Thus, there is a genuine need for domestic firms to upgrade their capabilities through effective linkage with their foreign counterparts. Crespo and Fontoura (2007), Smarzynska (2002), Bessonova, et al. (2002), Rodriguez-Clare (1996) and Lall (1980) find this possible because foreign firms may have incentives to provide technical assistance to, or share knowledge with, their local counterparts, particularly suppliers in order to improve and ensure the quality of the supply chain. Low productivity spillovers could also be attributed to the small size of domestic company because the size reflects the capability of firms to learn from their foreign counterparts (Yan Zhang, 2010; Ornaghi, 2004). This kind of shortage in firm's capability limits the impact of demonstration effect on domestic firms, as well as limiting its ability to compete with their foreign counterparts, if not ceasing their production or losing some market share. (Cohen, 2006; Griffith, et al., 2004; G6rg and Strobel, 2001; Aitken and Harrison, 1999).

CONCLUSION

This study examines the effect of FDI on domestic enterprises in Gulf oil producing countries. It used the empirical case study of Oman to test two key hypothetical assumptions that are vital to host country economy. The study focuses mainly on analysing the extent to which productivity spillover effects from FDI and absorptive capacity of domestic firms facilitate successfully the transmission of spillover effects from foreign to domestic firms. It reveals that productivity spillover channels and mechanisms have been ineffective in our case study and that in order to stimulate such mechanisms a more active government role should facilitate all channels of interactions between foreign and domestic firms. This finding validates the hypothesis that low productivity spillover effects have limited the impact of FDI on domestic firms. In the case of the second hypothesis, the study reveals that the vast majority of domestic firms are small in terms of size and operations and their inability to upgrade their financial, technological and human capabilities resulted in noticeable weakness in their absorptive capacity. Such finding

validates the second hypothesis that weak absorptive capacity of domestic firms often undermines their ability to benefit from the presence of their foreign counterparts.

The analysis of this examination fills a significant gap in literature as it provides new insights and knowledge on the conditions under which these factors affect domestic enterprises in such markets with distinctive characteristics as those of the Gulf oil producing countries. It offers new insights for policy makers to develop policies that could benefit private sector enterprises in a fast growing sector such as manufacturing, where the majority of firms are private-owned SMEs, with limited financial, human and technological capabilities. Gulf countries should also realize that the success of their economic diversification programs depends largely on their ability to develop the business environment, provide sufficient support to private sector companies to upgrading their capabilities and strengthen their absorptive capacity in a way that narrow the knowledge and technological gaps with their foreign competitors. However, we acknowledge the limitation of our study that focuses on a one-country-one sector approach and hope that it will open the way for a larger project to include sizable samples of countries and sectors across the entire Gulf region.

REFERENCES

- Aitken, B.J., Harrison, A.E (1999), Do Domestic Firms Benefit from Direct Foreign Investment? Evidence from Venezuela, *The American Economic Review*, Vol.89, No.3, pp.605-618.
- Al Qudsi, S (2005). Unemployment Evolution in the GCC Economies: its Nature and Relationship to Output Gaps, *Center of Labour Market and Information, UAE*.
- Arnold, J.& Javorcick, B. (2004). Gifted kids or pushy parents? Foreign acquisitions and plant performance in Indonesia. *World Bank policy research working paper 3597*. Washington, DC: The World Bank.
- Bertelsmann Transformation Index (2014), *Country report of Oman*, Berlin: Germany.
- Bessonove E et al (2002), Trade Liberalization, *Foreign Direct Investment and Productivity of Russian Firms*, CEFIR, Conference.
- Bhagwati J.N. (1978), Anatomy and Consequences of Exchange Control Regime, Vol 1, *Studies in International Economic Relations No.10*, New York.
- Blomström, M, and Kokko, A. (1997), The Impact of Foreign Direct Investment on Host Countries: A Review of the Empirical Evidence, *World Bank Policy Research Working Paper No. 1745*.
- Blomström, M, and Kokko, A. (1998), Multinational Corporations and Spillovers, *Journal of Economic Surveys*, Vol.12, No.2, pp.1-31.
- Blomström, M., Kokko, A., and Globerman, S. (1999): .The Determinants of Host Country Spillovers from Foreign Direct Investment: Review and Synthesis of the Literature, *EIJS Working Paper*, No. 76.
- Borensztein, E., Gregorio, J. and Lee, J. (1998). How Does Foreign Direct Investment Affect Economic Growth? *Journal of International Economics 45(1):115-135*.
- Caves, E. R. (1999). Spillovers from multinationals in developing countries: The mechanisms at work. In William Davidson Institute conference on 'the impact of foreign investment on emerging markets', School of Business Administration, University of Michigan, USA, 18–19 June.

- Cohen, S. (2006) *Multinational Corporations and Foreign Direct Investment*, Oxford University Press.
- Crespo, N., Fontoura, M.P. (2007), Determinant Factors of FDI Spillovers – *What Do We Really Know?*, *World Development*, Vol.35, No.3, pp.410-425.
- De Backer, K., and L. Sleuwaegen (2001) ‘Firm Productivity and Efficiency: Real or Apparent Differences between Domestic Firms and Foreign Multinational Firms?’, *DTEW Working Paper*, Katholieke Universiteit Leuven.
- De Mello, L.R., Jr. (1999) Foreign direct investment led growth : Evidence from time series and panel data. *Oxford Economic Papers*, 51(1), 133–151.
- Feinberg, S. E. and Majumdar, S. K. (2001): Technology spillovers from foreign direct investment in the Indian pharmaceutical industry. *Journal of International Business Studies*, Vol. 32, pp 421- 437.
- Fry, M. J. (1992) Foreign Direct Investment in a Macroeconomic Framework: Finance, Efficiency, Incentives and Distortions, *PRE Working Paper*, Washington, DC: The World Bank.
- Gorg, H. and Greenaway, D. (2004). Much ado about nothing? Do domestic firms really benefit from foreign direct investment? *World Bank research observer*, 19(2): 171-197.
- Görg, H. and Strobel, E. (2004): Spillovers from Foreign Firms through Worker Mobility: An Empirical Investigation, Discussion Paper, No. 463, *DIW Berlin, German Institute for Economic Research*.
- Gorg, H., & Greenaway, D. (2002). Do domestic firms really benefit from foreign direct investment? *CEPR Discussion Paper No. 3485*. London: Centre for Economic Policy Research.
- Greenaway, D., and Kneller, R. (2007), Firm Heterogeneity, Exporting and Foreign Direct Investment, *The Economic Journal*, No.117 (Feb., 2007), pp134-161.
- Hvidt, M 2013, Economic Diversification in the GCC Countries - Past Record and Future Trends: Research Paper No. 27: *Kuwait Programme on Development, Governance and Globalisation in the Gulf States*. The London School of Economics and Political Science, London. Research Paper. Kuwait Programme on Development, Governance and Globalisation in the Gulf States, vol. 27
- Hertog, Steffen (2010) Benchmarking SME policies in the GCC: a survey of challenges and opportunities. Eurochambres, Brussels, Belgium.
- Javorcik, S. B. (2004), Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages, *American Economic Review*, Vol. 94, pp 605-627.
- Javorcik, S. B. and Spatareanu, M. (2003): To Share or Not To Share: Does Local Participation Matter for Spillovers from Foreign Direct Investment?, *World Bank Policy Research, Working Paper 3118*: 47.
- Kim, L.(2001), The dynamics of technological learning in industrialization, *International Social Science* (168): 297-308.
- Kneller, R., Pisu, M. (2007), Industrial Linkages and Export Spillovers from FDI, *The World Economy*, Vol.30, Issue 1, pp.105-134.
- Kokko, A. (1992). Foreign direct investment, host country characteristics and spillovers. *Stockholm*: Stockholm School of Economics.

- Kokko, A. (1994). Technology, Market characteristics, and spillovers. *Journal of Development Economics*, 43, 279.
- Lall, S. (1980), Vertical inter-firm linkages in LDCs: An empirical study, *Oxford Bulletin of Economics and statistics*, Vol.42, No.3, pp.203-227.
- Lipsey, R. E. (2002): Home and Host Country Effects of FDI, *NBER Working Paper*, No. 9293, National Bureau of Economic Research, Cambridge, Mass. Page.40-47.
- Lipsey, R., Sjöholm, F. (2004), Foreign Direct Investment, Education and Wages in Indonesian Manufacturing, *Journal of Development Economics*, Vol.73, pp.415-422.
- Markusen, J.R., Venables, A.J. (1999), Foreign Direct Investment as a catalyst for industrial development, *European Economic Review*, Vol.43, pp.335-356.
- Meyer, K. (2004): Perspectives on Multinational Enterprises in Emerging Economies, *Journal of International Business Studies*, Vol. 34, pp 259-277.
- Meyer, K. and Sinani, E. (2005): .Spillovers from Foreign Direct Investment: A Meta-analysis., Working Paper, *Department of Economics*, University of Reading.
- Mishrif, A. (2010), Investing in the Middle East: the Political Economy of European Direct Investment in Egypt, *London and New York: I B Tauris*.
- Mishrif, A. and Al Balushi, Y. (2017) Relationship between inward investment and productivity in Oman, *Journal of Business and Financial Affairs*, Vol. 6, Issue 2, pp.1-8.
- Mishrif A, Al-Naamani S (2017) Regional Integration, the Private Sector and Diversification in the GCC Countries. In: Ashraf Mishrif, Yousuf Al-Balushi editors. *Economic Diversification in the Gulf Region: The Private Sector as an Engine of Growth*, Palgrave Macmillan, New York and Singapore.
- Moran, T.H.(1998) Foreign Direct Investment and Development: The New policy Agenda for Developing Countries and Economies in Transition, *Institute for International Economics*, Washington, DC.
- Navaretti, Giorgio Barbra & Venables, Anthony J. (2004), *Multinational Firms in the World Economy*, Princeton University Press.
- Ornaghi, C. (2004). 'From Innovation to Productivity', *Ph. D. Dissertation, Universidad Carlos III de Madrid, Departamento de Economía, Madrid*.
- Patton, M. (2002), *Qualitative research and evaluation methods. 3th ed. London: Sage publication*.
- Peter J. Buckley, Chengqi Wangb, Jeremy Clegg(2007). *The impact of foreign ownership, local ownership and industry characteristics on spillover benefits from foreign direct investment in China*, *Centre for International Business, International Business Review* 16 142–158.
- Saggi, K. (2000): .Trade, Foreign Direct Investment, and International Technology Transfer: A Survey., *World Bank, Working Paper, No. 2349*.
- Samarzyska B (2002), Spillovers from Foreign Direct Investment through Backward Linkages: Does Technology Gap Matter?, *Mimeo, World Bank*.

Takii, S. (2005), Productivity Spillovers and Characteristics of Foreign Multinational Plants in Indonesian, 75, pp. 521-542.

UNCTAD (2003) World Investment Report, FDI Policies for Development: *National and International Perspectives*, New York and Geneva.

Wei, Y., Liu, X., and Wang, C. (2008). Mutual productivity spillovers between foreign and local firms in China. *Cambridge Journal of Economics*, 32(4): 609.

Yan Zhang, Haiyang Li, Yu Li, Li-An Zhou, (2010), FDI spillovers in an emerging market: the role of foreign firms' country origin diversity and domestic firms' absorptive capacity, *Journal: Strategic Management Journal*.