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FDI and Development – A Local Impact Dimension of Globalization

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Item Type	Preprint
Authors	Kimakowitz, Ernst von
Publisher	Humanistic Management Center
Rights	With permission of the license/copyright holder
Download date	2026-07-08 08:29:49
Link to Item	http://hdl.handle.net/20.500.12424/199177

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FDI and Development – A Local Impact Dimension of Globalization

Backward Linkages Between
Transnational Corporations and
Domestic Small and Medium
Enterprises in Developing Countries

Ernst von Kimakowitz

1

What is good development?

2

What are Backward Linkages?

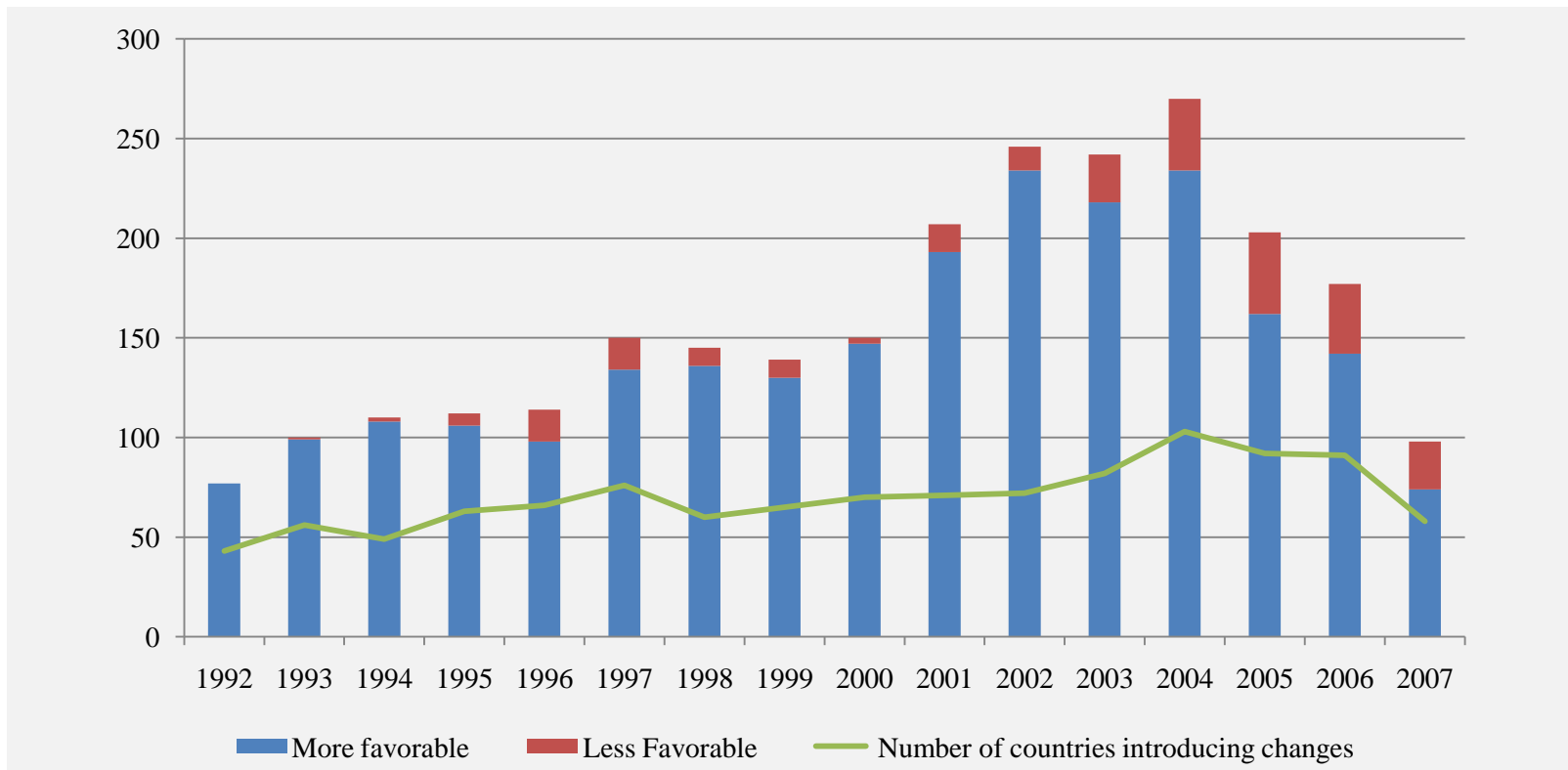
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How can backward linkages contribute to or hinder development efforts?

Contextualization

- With the end of the bipolar world the whole planet has joined in one global market place
 - The global governance regime has led to a situation in which sovereign policy options regarding investment flows have been reduced heavily and international investors find similar, market enabling conditions on a global scale
 - FDI in developing countries has increased dramatically over the last 30 years
- In this context the question of how TNCs impact development efforts is of great relevance and their interactions with domestic SMEs provides a strong lever for development conducive corporate conduct

Global Regulatory Changes Regarding FDI



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What is good development?

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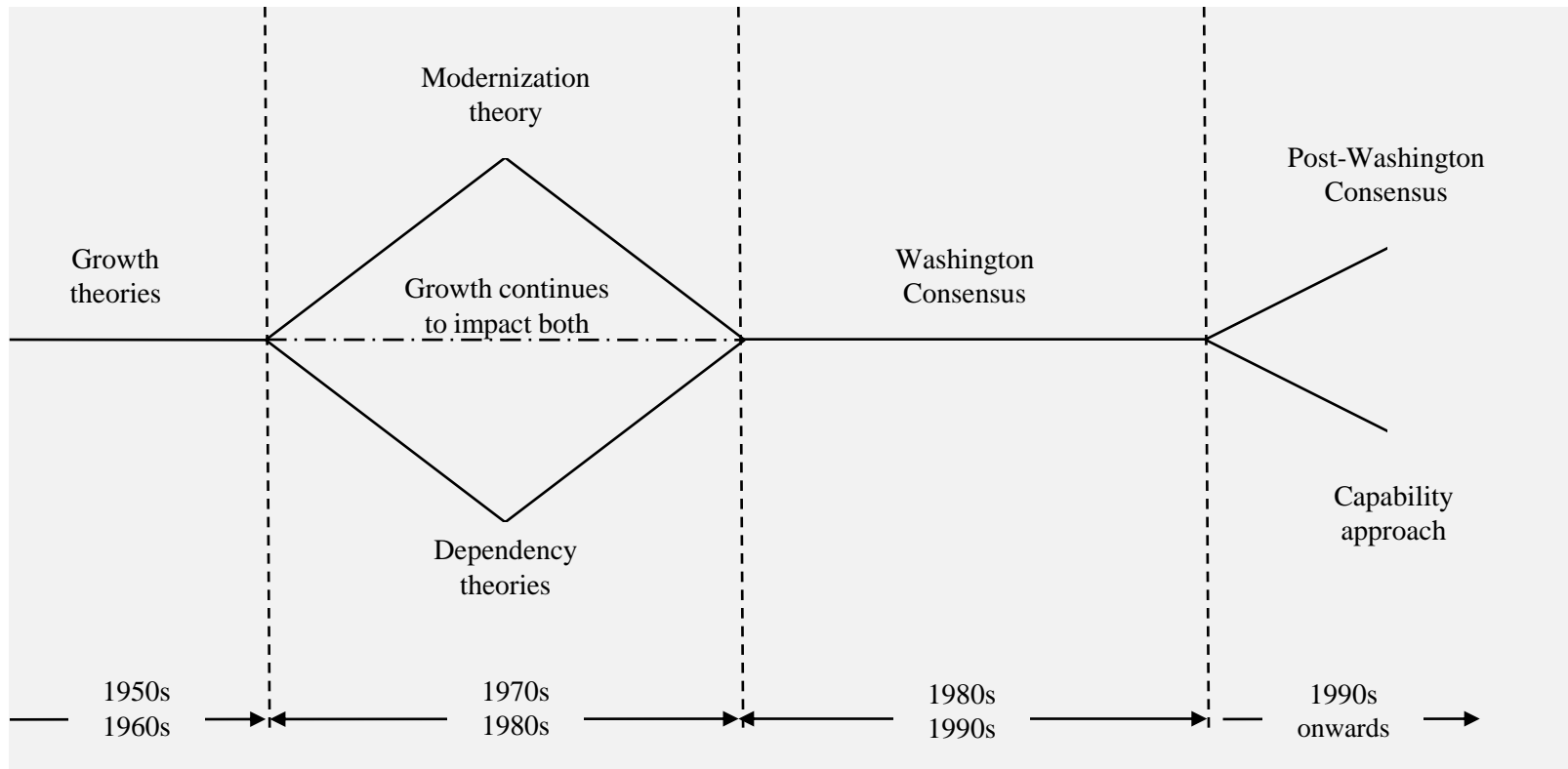
What are Backward Linkages?

3

How can backward linkages contribute to or hinder development efforts?

What is Good Development?

The evolution of development thinking



What is Good Development?

Neoliberal reforms

The market does things better than governments, so governments should not intervene, as the outcome will be inferior to the outcome market forces will produce.

1. Neoliberalism suggests governments rely on monetary policy, aiming at price stability rather than using fiscal measures to address employment and growth targets.
2. The main reason for unemployment is a lack of flexibility in the labor market and, therefore, policies should increase the labor market flexibility through legislative reform and not attempt to create employment through demand management and industrial policy.
3. The deregulation and liberalization of, especially, financial markets – including the free movement of capital between countries – are suggested so that investors can seek opportunities free of regulatory hindrance.

(Arestis & Malcom, 2004)

What is Good Development?

Neoliberalism and the Washington Consensus

- Neoliberal orthodoxy was initially conceived for OECD countries to get out of the recession of the early 1980s
- Once the big donor countries made their weight count in the Bretton Woods organizations, neoliberal policy prescriptions became a requirement for developing countries to secure support of the World Bank and IMF

“A widespread assumption existed that development ought to be nothing more than the extension of neoclassical orthodoxy to low- and middle-income countries.”

(Barrett, 2008)

What is Good Development?

The Washington Consensus

1. Fiscal policy discipline;
2. Redirection of public spending from subsidies ("especially indiscriminate subsidies") toward a broad-based provision of key pro-growth, pro-poor services;
3. Tax reform;
4. Interest rates that are market determined and positive (but moderate) in real terms;
5. Competitive exchange rates;
6. Trade liberalization;
7. Liberalization of inward foreign direct investment;
8. Privatization of state enterprises;
9. Deregulation; and
10. Legal security for property rights.

(Williamson, 1990)

What is Good Development?

The Washington Consensus

As Grzegorz W. Kolodko, the Polish finance minister between 1994 and 1997, said *the Washington Consensus* was widely interpreted as:

“Liberalize as much as you can, privatize as fast as you can, and be tough in fiscal and monetary matters!”

(Kolodko, 1999)

What is Good Development?

The outcome of the Washington Consensus



- + Inflation got under control
- Argentinean default (2001)
- Steeply rising income disparities
- Rising unemployment
- Hasty sell-off of national assets to international investors

What is Good Development?

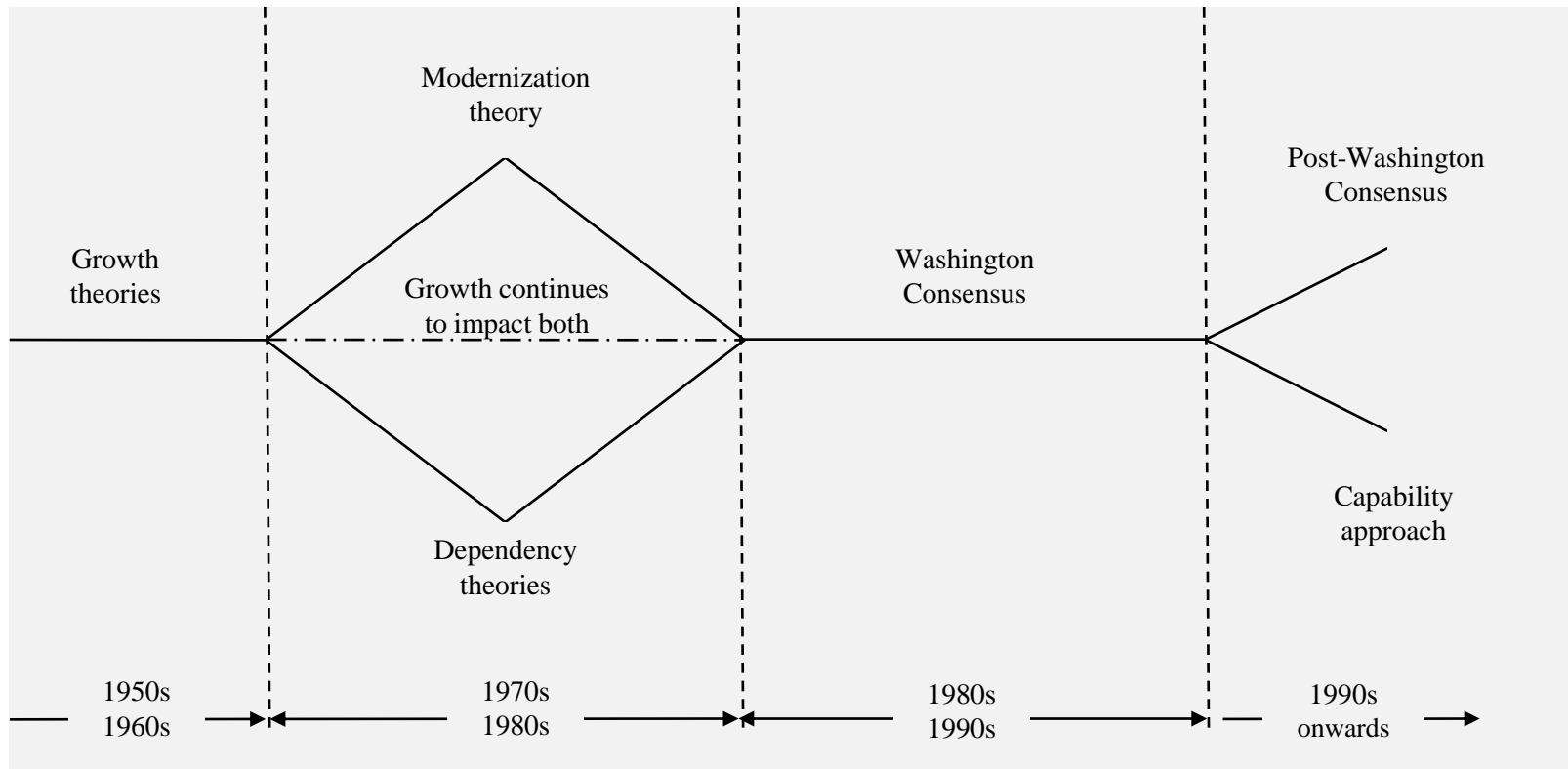
The outcome of the Washington Consensus

“The countries that have managed globalization on their own, such as those in East Asia, have, by and large, ensured that they reaped huge benefits and that those benefits were equitably shared; they were able substantially to control the terms on which they engaged with the global economy. By contrast, the countries that have, by and large, had globalization managed for them by the International Monetary Fund (IMF) and other international economic institutions have not done so well”

(Stiglitz, 2004)

What is Good Development?

The evolution of development thinking



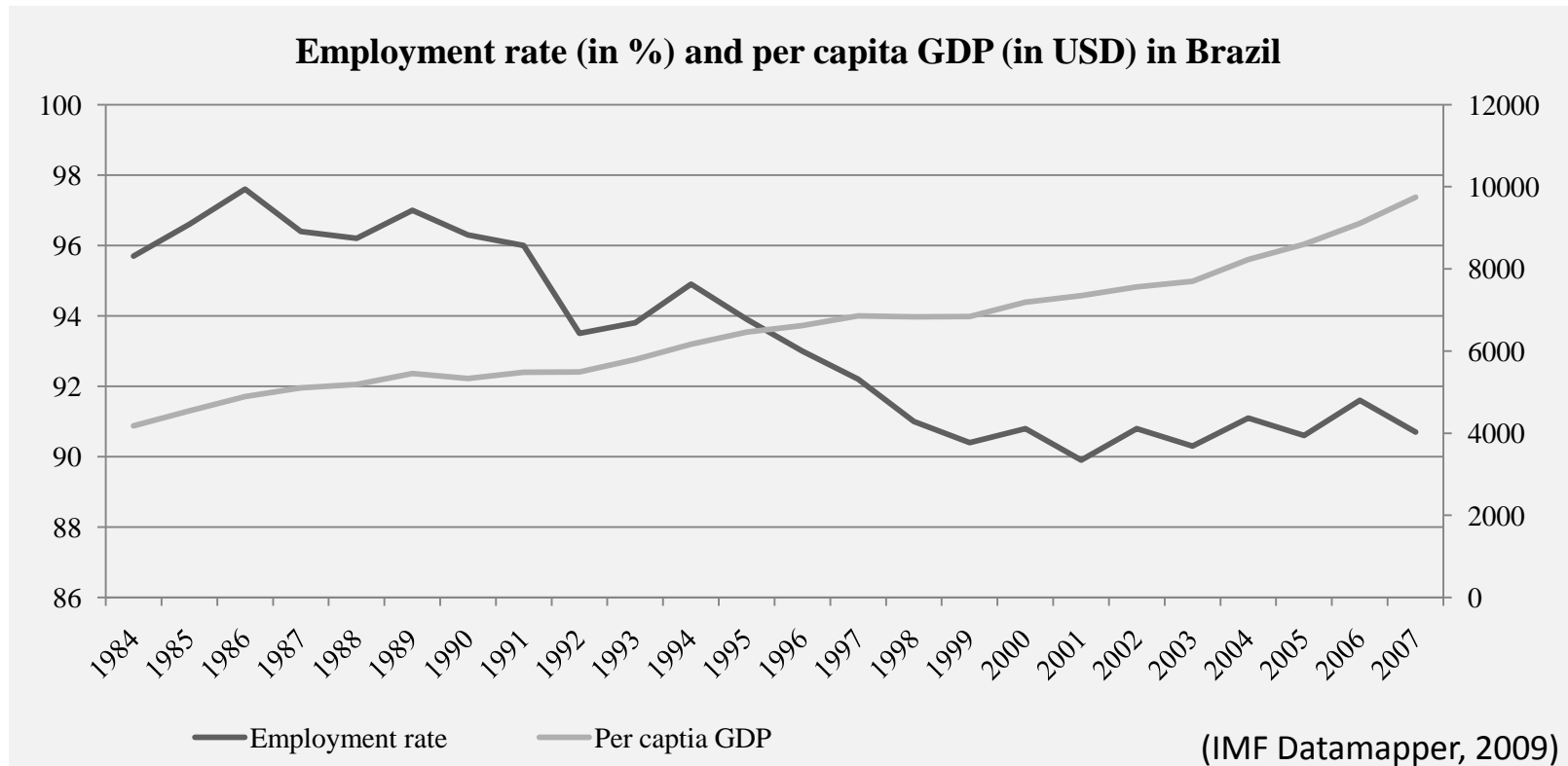
What is Good Development?

The post-Washington Consensus

Poverty reduction replaces GDP growth as the prime development target of the Washington consensus – but only in rhetoric.

- The Washington Consensus can be summarized as: privatization, liberalization, and macroeconomic stability equals growth equals development.
- The post-Washington Consensus can be summarized as: a capable state promoting privatization, liberalization, and macroeconomic stability equals growth equals development.
- Not the primacy of markets itself has been challenged by the post-Washington consensus. What has changed is the path envisaged towards establishing of the primacy of markets.

What is Good Development?



What is Good Development?

The capabilities approach

Country	GNP per head 1982 (USD)	Life expectancy 1982 (Years)	Infant mortality 1982	Child death rate 1982	Adult literacy rate 1980	Higher education ratio 1981 (%)
Sri Lanka	320	69	32	3	85	3
China	310	67	67	7	69	1
Mexico	2,270	65	53	4	83	15
Brazil	2,240	64	73	8	76	12
India	260	55	94	11	36	8

(Sen, 1985)

What is Good Development?

Critique of the mono concentration on utility

- **Distributional indifference:** In line with one of the main criticisms of the Washington Consensus (and neoclassical economics and neoliberal practice in general) in the development context, utilitarian calculus tends to be blind to distributional questions. Since the sum total is all that matters, this leads to conclusions in development assessments based on aggregated data (which are then 'individualized' by dividing them into per capita figures) without assessing the way in which the observed factor is shared within that society.
- **The neglecting of rights, freedoms, and other non-utility concerns:** Utilitarian calculus leaves no room for the intrinsic value of legitimate claims of rights and freedoms, as long as they do not impact the utility.
- **Adaptation and mental conditioning:** Human nature allows us to adapt to highly adverse circumstances without falling into despair. Measuring individual well-being in a utilitarian approach falls short of accounting for circumstances, as attitudes adapt and mental states are conditioned by what seems feasible. (Sen, 1999)

What is Good Development?

The capabilities approach

The capability approach is built on three main constructs: functionings, capability, and agency.

- **Functionings** express the valued ‘beings and doings’ of a person.
 - **Capability** can be interpreted as an index of a person’s functionings, which represent a ‘functionings bundle’ that is a subset of the functionings that could have been achieved.
 - **Agency** describes personal commitment towards a cause that leads to active engagement based on the perceived merit of the cause in the light of one’s own values.
- In combination, these three constructs enable one to assess the freedom someone has to live the kind of life one has reason to value.

What is Good Development?

The capabilities approach

“The capability approach is a broad normative framework for the evaluation and assessment of individual well-being and social arrangements, the design of policies, and proposals about social change in society.”

(Robeyns, 2005)

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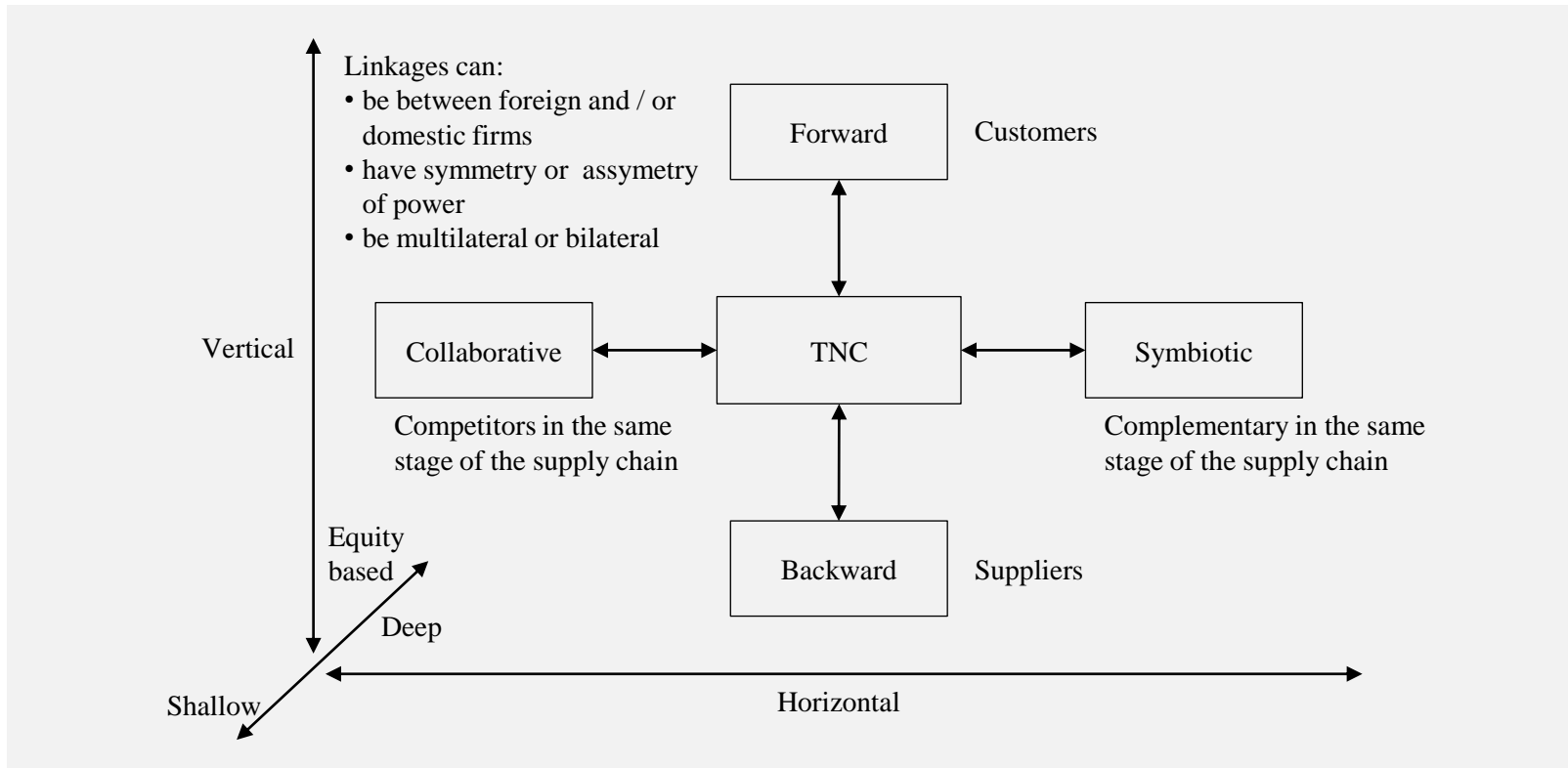
What are Backward Linkages?

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How can backward linkages contribute to or hinder development efforts?

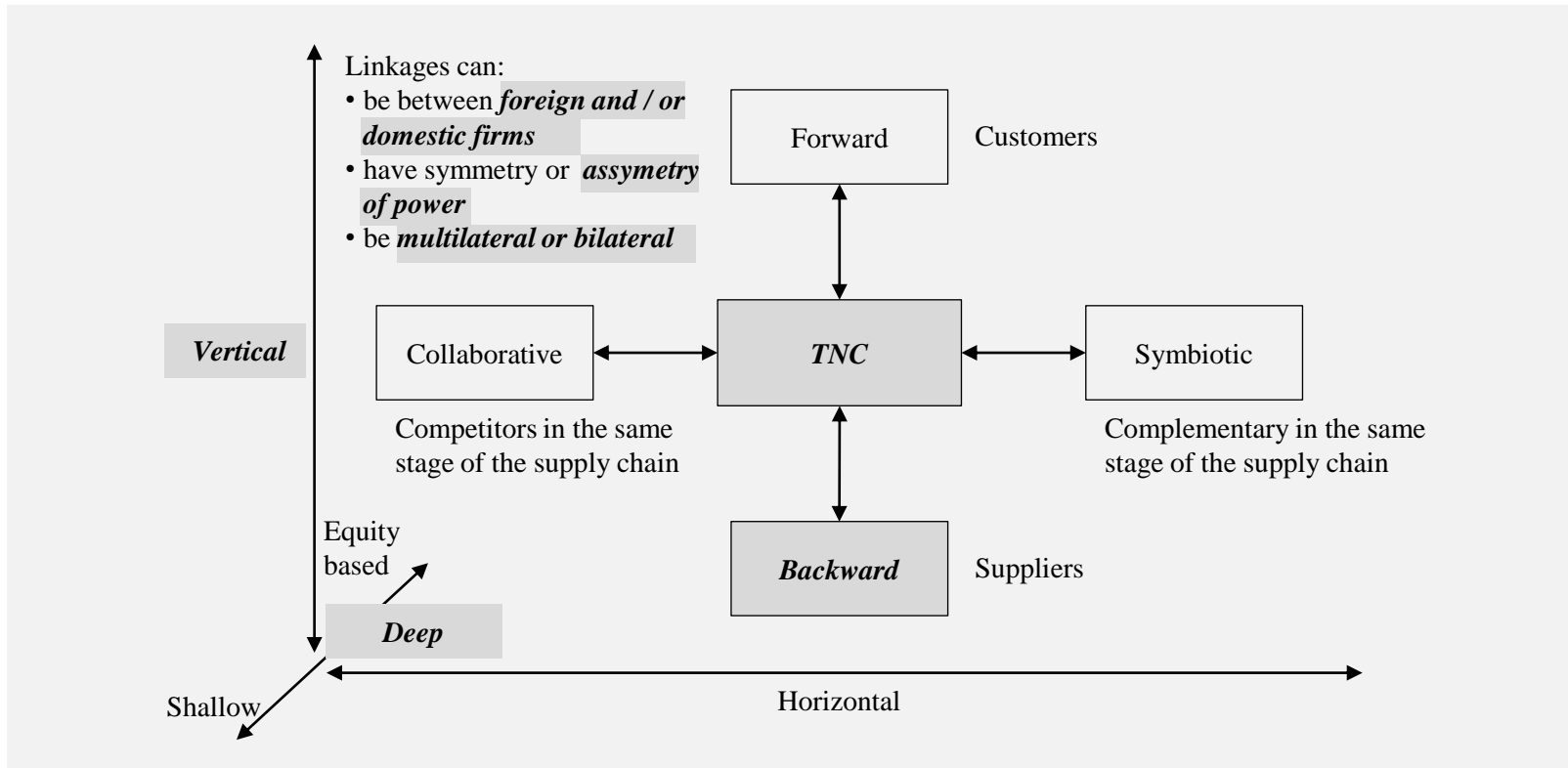
What are Backward Linkages?

A typology of business linkages



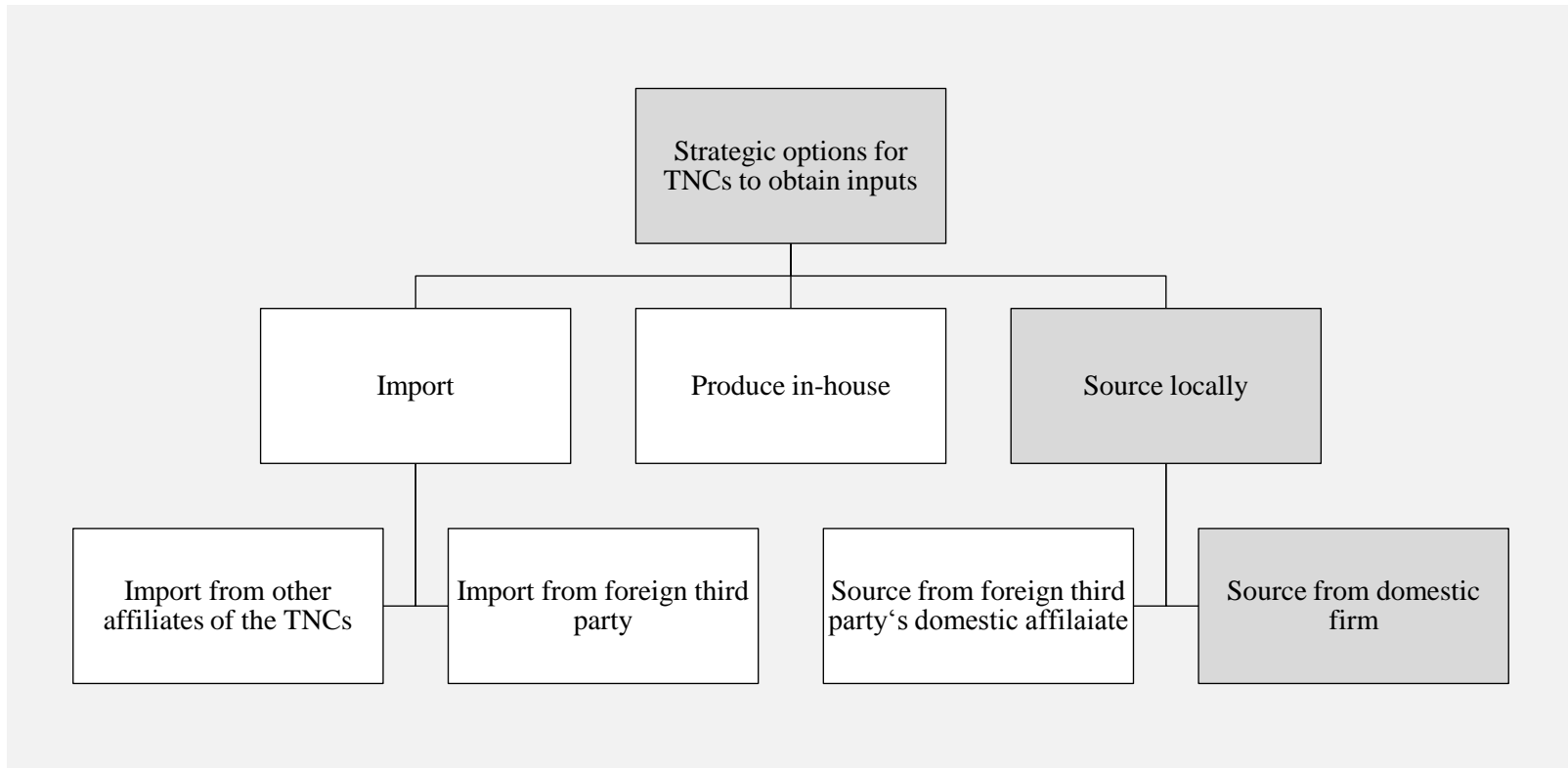
What are Backward Linkages?

Business linkages in the development context



What are Backward Linkages?

Strategic sourcing options in the development context



What are Backward Linkages?

Business linkages in the development context

The effects of backward linkages on domestic suppliers are threefold:

1. They impact the production volume of domestic enterprises.
2. The character and degree of interference and contractual arrangements vary.
3. Their demands may make the upgrading of domestic suppliers necessary regarding technological, process-related, and managerial and organizational capacities.

(Dunning, 1993)

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Backward Linkages and Development

The development impact of TNCs

Pre 1970s

Transnational corporations are there because they are there

1970s – 1990s

Transnational corporations support capital formation

1990s to date

Transnational corporations generate spillover effects

Backward Linkages and Development

The development impact of TNCs

Pro

- Provision of capital inflows to poorer parts of the world.
- Most effective way of transferring knowledge, best practices and high standards
- TNCs buy goods and services from domestic companies in large quantities, providing local firms with additional income.

Con

- Initial capital inflows are outweighed by subsequent outflows
- Attractiveness of developing countries is based on the abundant provision of cheap labor and low standards
 - TNCs crowd out domestic competitors leading to subsequent income and job losses

Backward Linkages and Development

Ambiguity prevails

TNCs can be both, corporate predators and development agents

- Broad based consensus exists though over the *potential* of backward linkages to be development conducive
- This is based on the spillover effects they can generate by causing positive externalities in the local economy
- Empirical evidence however suggests that these spillover effects occur less and slower than hoped for

What are spillover effects

- High-quality FDI does a lot more than support capital formation in developing countries and possibly strengthening the balance of payments.
- The right investors contribute an entire bundle of development-conducive factors “best described as an aggregate, not as individual items; in other words, the whole may be greater than the sum of its parts” (Cohen S. D., 2007).
- This bundle contains technologies, managerial savvy, high-standard safety, health, and environmental practices and access to international markets, thus delivering a template of best practices across the whole range of corporate activities.

What are spillover effects

- Often domestic suppliers are receiving investments from TNCs to enable them to deliver supplies in line with required standards
- Positive spillover effects from TNC – domestic SME supplier relationships then occur if domestic firms manage to use those investments to copy some practices and enhance their productivity or efficiency without the TNC being able to internalize the full value of those gains (Blomström & Kokko, 1998).
- In other words, for positive spillover effects to occur, SMEs need to benefit from their supplier role to a TNC in business activities which are not related to that relationship.

Backward Linkages and Development

Why the promise of spillover effects fails to materialize

- TNCs follow a business case logic when investing in domestic suppliers and thus any such investments are coupled with the aim to subsequently absorb the full value generated through those investments.
- This often leads to contractual constructs between TNCs and domestic SMEs that Gereffi, Humphrey and Sturgeon (2005) describe as a captive relationship.
- Captive relationships emerge when small suppliers are transactionally dependent on large buyers. Switching customers is very costly due to customer-specific investments creating a high degree of dependency of the supplier on one single buyer. Captive relationships are often characterized by a high level of control, monitoring, and interference by the large buyer company.

Backward Linkages and Development

Why the promise of spillover effects fails to materialize

- Any reflection on spillover effects stemming from backward linkages must therefore include the insight that, left to their own devices, market forces will only produce a very limited amount of positive spillover effects.
- Responsible corporate conduct of TNCs in developing countries acknowledges this incapacity of markets to deliver positive externalities autonomously and structure backward linkages in ways that entail the deliberate will to have positive developmental impact on the host economy by nourishing spillovers rather than by preventing them.

So what can be done?

Two examples

A multi stakeholder approach

- UNCTAD Program to reap development impact from backward linkages
- Following frustration in establishing bilateral relationships the focus has shifted to a multi stakeholder approach
- This includes TNCs, SMEs, development banks, vocational training institutions and local and national governmental institutions

The mission

Contribute to social and economic development by enhancing local productive capacity and the efficiency of the domestic enterprise sector.

- Achieving this takes more than just being a matchmaker.
- Business linkages need to be built, including the desire to make a positive development impact.

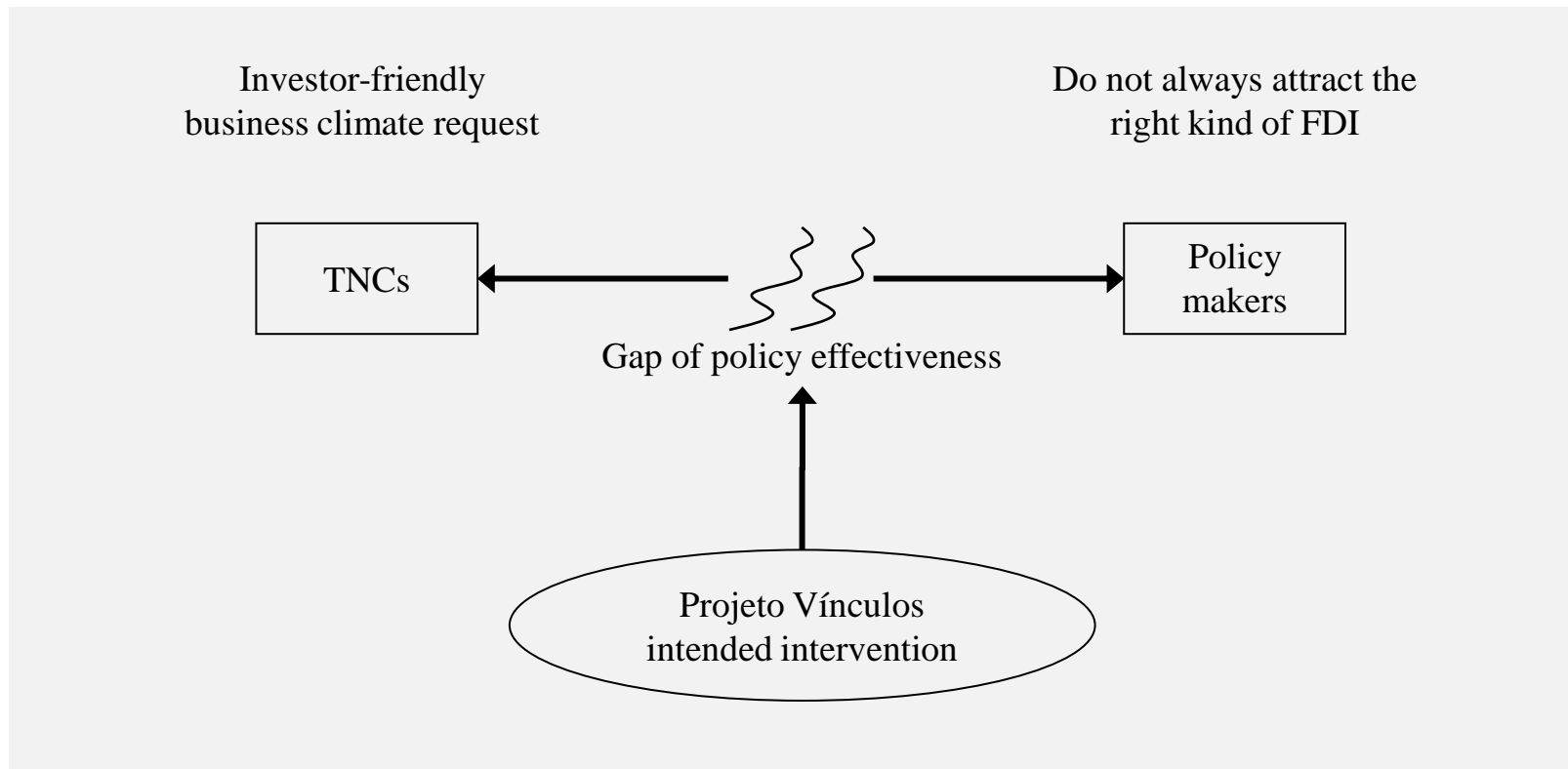
Projeto Vinculos

Geographic presence and participating TNCs

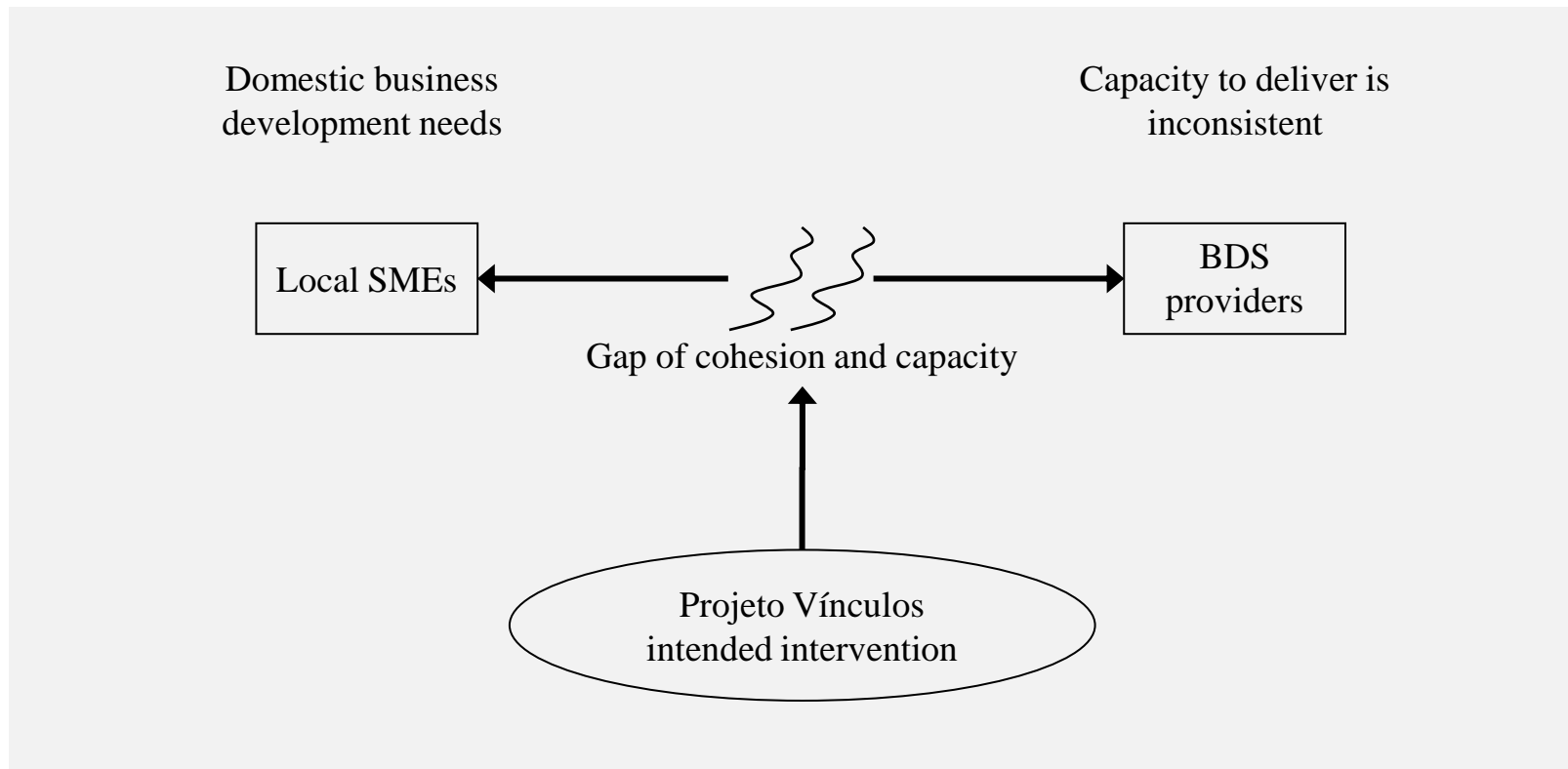


Source: UNCTAD

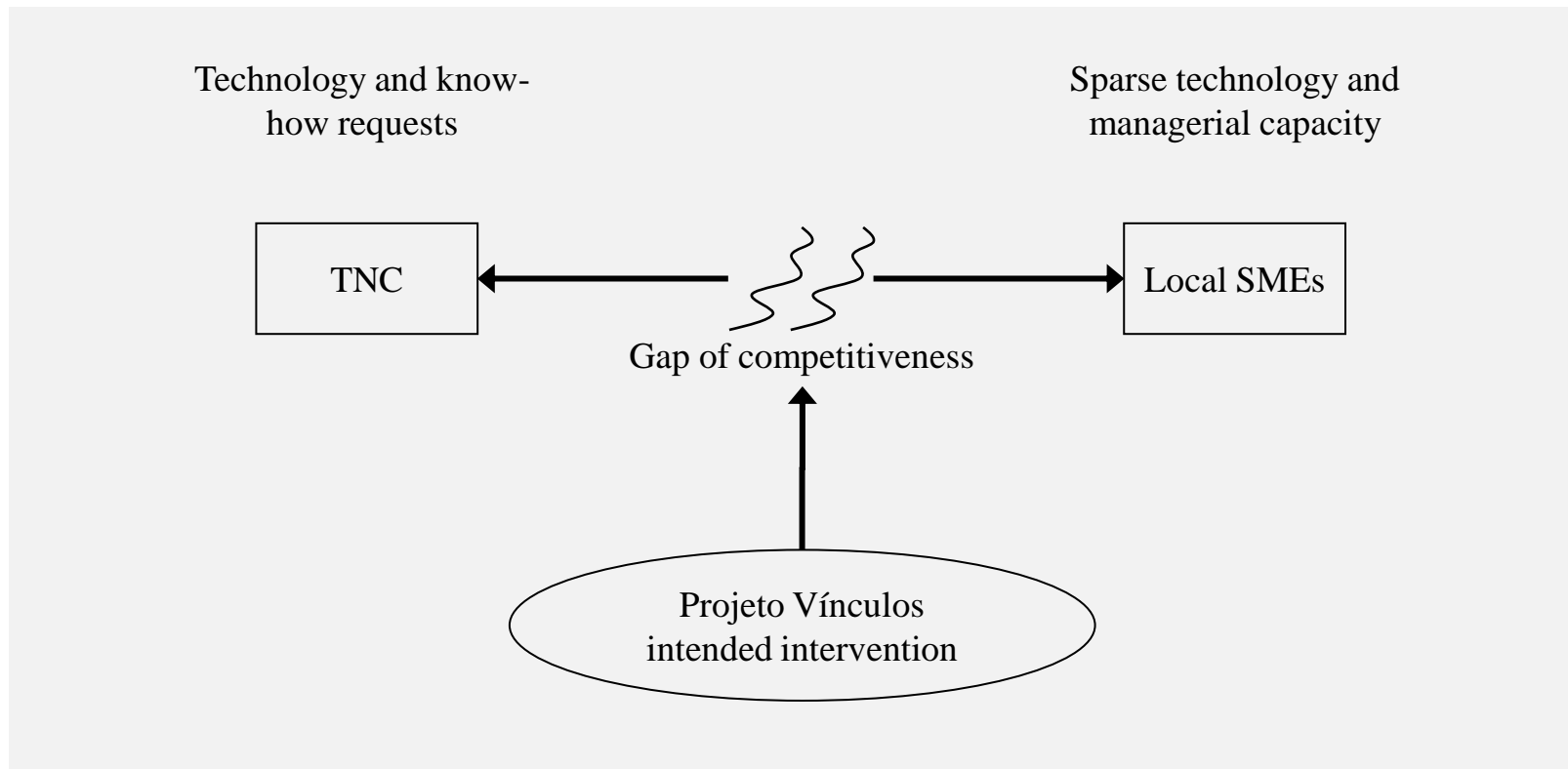
Intervention in TNCs and Policy Makers relationships



Intervention in TNCs and Policy Makers relationships



Intervention in TNCs and Policy Makers relationships



Bosch's Fit for Global Approach

Development conducive backward linkages

Supplier development program based in the automotive industry

- Stringent participants' selection
- Long term commitment
- The main claim heading the program consists of four dimensions which are (1) Business Purpose, (2) Impact on Society, (3) Impact on Customers and (4) Corporate Solidarity

Bosch's Fit for Global Approach

Characteristics	Group 1	Group 2	Group 3
Support areas	Well defined, and technically capable	Few areas with different functions	No clear definition of responsibilities
Strategy	Medium and long term shared within the organization	Medium and long term not shared within the organization	Short term, focus on 'extinguishing fires'
Leadership Style	Democratic	Autocratic (owners' 'strong hands')	Autocratic with family conflicts
Human Resources	Well structured, focus on developing managers abilities	Structured, focus on technical formation	Pure back office

Source: Bosch

Bosch's Fit for Global Approach

The training comprises of 384 hours spread over 18 - 24 months

- Bringing suppliers up to Bosch's global standards
- Encouraging the sharing and dissemination of knowledge and experiences within the participating SMEs
- Motivating suppliers to establish human resource policy targeting workers' development and managerial competence
- Increasing occupational safety and environmental protection and raising awareness of civil responsibilities of business.
- Applying problem solving and problem prevention tools to enhance the product quality
- Ergonomics and work standardization
- Identify and further develop suppliers that demonstrate the potential to become global suppliers

Bosch's Fit for Global Approach

Results of the Bosch supplier development program 2003 - 2007

- 7 suppliers have become worldwide Bosch preferred suppliers
- 19 suppliers have reached the Bosch preferred supplier status for Latin America
- 2 suppliers have become direct exporters, exporting goods and services worth US\$ 1.5 million per year
- The FFGA program concept is now also being rolled out by Bosch in China
- Improved SME supplier productivity has raised competitiveness and reduced production costs
- Improved occupational safety and environmental protection

Bosch's Fit for Global Approach

Two factors making a difference

- Bosch avoids having captive suppliers by aiming for a 30% threshold on purchasing volume of a supplier total production (with a definitive cap at 50%)
- The Fit for Global Approach shares the cost savings of the supplies in the relationship between Bosch and its suppliers but not in any third party contracts

Spillover effects are powerful development levers but they do not do not occur automatically

- In an environment where coercive policy measures are unavailable corporations need to be encouraged to act responsible
- Good development is more than GDP growth
- Examples exist where business benefits and developmental aims go hand in hand but they need to be moderated and deliberately aimed for
- This can either be done through enlightened managerial decision making and / or with the support of meta level organizations.

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