

Lack of Effectiveness of Local Content Requirements in Increasing Local Procurements by Foreign Affiliates: Implications for Extending the Length of Operation through Political Stability

Dec, 2005

Shujiro Urata

Professor, Waseda University and

Senior Economist, Japan Center for Economic Research

Dual Roles of “Local Backward Linkages”

What does a host country expect from foreign corporations entering their market? Direct and immediate effects including growth in employment and exports certainly bear importance but of greater significance are the incubation and development of domestic industries and sustained economic growth as its consequence, which the transfer of technological and management expertise will make possible.

From the viewpoint of incoming foreign companies, there will continue to be currency and logistic risks as long as they source inputs from their home or neighboring countries. Additionally, customs clearance is often complicated and based on opaque decisions in many developing countries. Therefore, the ideal solution will be to procure raw materials, parts and components from local suppliers.

“Local procurement ratio” can therefore be used to evaluate the success of expansion into developing countries from the standpoint of foreign companies, as well as that of host countries. In a recently conducted study, we statistically examined determinants of the local procurement ratio of Japanese foreign affiliates. While the overseas expansion of Japanese companies was stagnant after the onset of the Asian crisis, it has recently been regaining momentum. This analysis should provide a perspective and guidance on future directions of foreign direct investment by multinationals and political and economic management of host countries.

Length of Operation and Industrial Agglomeration Identified As Significant Factors

In investigating the determinants of the local procurement ratio, we classify control variables into three categories.

The first category includes factors relating to local affiliates, namely, the length of operation, the share of equity of the affiliates held by the Japanese parent company and

the share of local sales in total sales. The second concerns parent firms in Japan and is represented by the ratio of research and development expenditure to total sales. The third category pertains to countries that play host to Japanese affiliates and include the degree of industrialization, represented by the ratio of manufacturing GDP to overall GDP, industrial agglomeration, for which the number of local Japanese affiliates is used as a proxy, and local content requirements set forth by the local government.

Our analysis shows that variables that are significant in increasing the local procurement ratio are the length of operation, local sales orientation, the degree of industrialization and industrial agglomeration, while neither levels of parent ownership in affiliates or parent-level R&D intensity has significant explanatory power. Despite the expectations, local content requirements that are imposed on incoming foreign companies for the purpose of lifting the local procurement ratio of foreign affiliates prove to be ineffective in achieving the desired goal.

Determinants of Local Procurement Ratio

	Effect on local procurement ratio	
	Significant positive	Not significant
Variables related to Japanese foreign affiliates	<div style="border: 1px solid black; padding: 2px; text-align: center;">Years of operation</div> <div style="border: 1px solid black; padding: 2px; text-align: center;">Share of local sales in total sales</div>	<div style="border: 1px solid black; padding: 2px; text-align: center;">Share of affiliate equity owned by Japanese parent</div>
Variables related to Japanese parent companies		<div style="border: 1px solid black; padding: 2px; text-align: center;">Ratio of R&D expenditure to total sales</div>
Variables related to host countries	<div style="border: 1px solid black; padding: 2px; text-align: center;">Degree of industrialization</div> <div style="border: 1px solid black; padding: 2px; text-align: center;">Industrial agglomeration</div>	<div style="border: 1px solid black; padding: 2px; text-align: center;">Local content requirement</div>

Source: Based on the estimation results of a quantitative study by the author and colleagues. Statistically tested at a significance level of 1%

In Asia, where many Japanese companies have expanded their operations, the local procurement ratio by their manufacturing affiliates has been on an increasing trend. According to statistics compiled by the Ministry of Economy, Trade and Industry, the local content ratio of Japanese affiliates in the region increased to 46.4% in 2002, compared with 32.2% in 1993. In 2002, specifically by region, the number was 44.4%, 51.3% and 43.7% for the newly industrializing economies (NIEs including Korea, Taiwan and Hong Kong), ASEAN countries and China, respectively.

Importance of Development in Hard and Soft Infrastructure

One of the findings from this analysis is that, in order to strengthen backward vertical linkages of foreign affiliates with local suppliers and build a network among them, it is critical for host countries not only to successfully attract foreign companies but to

develop such political and economic environment that foreign affiliates that make a foray will keep their operation for an extended period of time.

Specifically, host countries need to put in place hard and soft infrastructure that ensures uninterrupted economic activity, ranging from a stable macroeconomic environment with inflation and the currency well under control to secure and reliable transportation, communication and electricity services to a highly transparent, fair and equitable legal system, and develop supporting industries that supply foreign affiliates with raw materials and other necessary goods and services. While self-help efforts of host countries form the basis for meeting these requirements, financial and technical assistance from Japan and other developed countries and various international organizations should be effectively utilized. The effective use of comprehensive economic partnership agreement (EPA) and other types of bilateral and multilateral agreements is also an important consideration.

Note: This article is based on a paper co-authored by the author, “Reconsidering the Backward Vertical Linkages of Foreign Affiliates: Evidence from Japanese Multinationals,” RIETI Discussion Paper, March 2005.