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Multinationals in Sub-Saharan Africa: Domestic linkages and institutional distance

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A B S T R A C T

This paper analyzes the role of institutional distance in the establishment of domestic linkages by multinational enterprises in a cross-section of 19 Sub-Saharan countries. Investors' familiarity with formal and informal procedures in the host country lowers uncertainty and facilitates networking with local firms. Hence, a similar degree of institutional development boosts linkages between domestic firms and multinationals. Using a novel dataset from the 2010 Africa Investor Survey by UNIDO, we find that institutional distance in terms of contract enforcement deters the domestic linkage if institutions are worse in host countries than in the origin country. Additionally, institutional distance matters more for multinationals from industrialized countries. The paper contributes to the literature on domestic linkages by including the understudied institutional dimension, to the still scarce literature on South–South foreign direct investment in least developed countries and contributes to the definition of clearer targets for foreign investment policies.

1. Introduction

The establishment of domestic linkages by multinational enterprises (MNEs) and its relevance in promoting industrial development has been the focus of numerous academic studies and a frequent

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target of investment policies. A common consensus has been reached that linkages from foreign affiliates to domestic firms can enhance the benefits from foreign direct investment (FDI) (UNCTAD, 2001). In this regard, local sourcing is seen as a win–win situation where local firms benefit from higher demand and employment as well as potential technology and knowledge transfer, while MNEs' benefit from lower costs, specialization gains and better adaptation to local markets. Literature on FDI spillovers has also identified the vertical backward linkage as the main driver for positive externalities to the local economy.[1] A proper understanding of the factors that drive multinationals to source locally is therefore crucial for the design of adequate investment policies. While literature on the subject has traditionally focused on the analysis of foreign investor characteristics that boost establishment of local linkages, to the best of our knowledge, there are no studies that have specifically looked at the impact of host country institutions on the domestic linkages. We aim to fill this gap and additionally, expand on this issue, by arguing that not all investors care about host country institutions to the same extent since the *home country* institutional background also plays a crucial role. Building on the literature on South–South[2] FDI at the macro level, the literature on domestic linkages determinants and transaction costs economics we argue that larger institutional distance might deter the domestic linkage since unfamiliarity of foreign investors with formal and informal procedures and the way of doing business may impede efficient interaction with local suppliers. Perceived transaction costs are then higher, networking with local firms is relatively more difficult and concerns about reliability of local suppliers may arise. Indeed when governance is poor, knowledge of informal procedures becomes crucial and this effect becomes especially relevant for least developed host countries. So is the case of Sub-Saharan Africa, where institutional backgrounds are relatively poor, where foreign investors face a significant degree of uncertainty and where weak institutions deter FDI flows.[3]

In order to examine the above arguments we analyze the impact on the share of domestically purchased inputs of several institutional indicators that we categorize into two groups. First, we focus on institutional quality regarding security of private sector transactions, where we look mainly at contract enforcement. Second, we turn to institutions related to well-functioning and ethical behavior of the public sector where we look mainly at control of corruption. Methodologically, we start our analysis by looking at the impact of host country institutional quality *levels* and then we move on to the effect of institutional *distances*. In a first stage, we analyze the effect of institutional distance on the linkages in absolute terms. However as pointed out by Aleksynska and Havrylchyk (2013) the effect of facing better or worse institutions might drive MNE behavior towards local sourcing in opposite ways, since a better institutional background relative to home should not deter the interaction with local suppliers. Therefore in a further step we disaggregate our main dependent variable into positive and negative institutional distance and address their impact on the domestic linkage separately.

In brief, using firm-level data from the 2010 Africa Investor Survey by UNIDO we explore in this paper the relationship between institutional distance and domestic linkages by multinationals in a cross-section of 19 Sub-Saharan countries. Our main findings are as follows: (i) contract enforcement being worse than at home, i.e. negative institutional distance, has a negative impact on domestic linkages, (ii) this effect is larger for northern firms that seem to care more about institutional distance relative to southern firms, (iii) factors like being engaged in a joint venture or sharing a common colonial past seem more relevant factors for the linkage generation of southern multinationals, (iv) we do not find this effect for control of corruption levels whose effect on the linkage is negative, suggesting a “guidance role” for local suppliers when northern MNEs are in relatively more corrupt countries. The study helps the definition of clearer targets for foreign investment policies and mainly two features highlight its relevance. Firstly, by analyzing the effects of institutional distance as a significant domestic linkage determinant it contributes to and brings together insights from both, literature on determinants of domestic linkages and literature on host country effects of South–South

[1] See Görg and Strobl (2001) for a review on this literature branch or the seminal paper by Javorcik (2004).

[2] “North” refers to industrialized countries and “South” refers to developing economies as defined in The International Yearbook of Industrial Statistics (UNIDO, 2010).

[3] See, for instance, Asiedu (2006).