SUPPORTING ECONOMIC TRANSFORMATION

BRIEFING PAPER

LOCAL CONTENT POLICIES AND BACKWARD INTEGRATION IN NIGERIA

Neil McCulloch, Neil Balchin, Max Mendez-Parra and Kingsley Onyeka

October 2017

Key messages

- Local content policies for developing backward linkages can help build industrial capabilities and the move towards higher value-added manufacturing activities. However, Nigerian and international experiences have yielded mixed results to date.
- Policies should not only create jobs and boost investment, but benefit consumers too.
- Mandated regulatory policies on local content tend to have little impact on productivity and developing value chains. Instead, the government of Nigeria should bring key stakeholders together, discuss local content commitments and hold stakeholders to account to deliver results.

Introduction

This paper summarises the main findings and policy recommendations in the report of the same name prepared by the Nigerian Economic Summit Group (NESG) and ODI's Supporting Economic Transformation (SET) programme. The report analyses and discusses the economics behind the use of local content policies to increase backward integration; the local content policies applied in Nigeria and the results; international experience with similar policies; and views from firms and policy-makers. Although these policies might be effective in increasing domestic backward linkages, their design and implementation should be based on a cost-benefit analysis and should consider the costs for consumers and downstream industries.

The Nigerian experience

Prior to the recent recession, Nigeria experienced rapid growth for a decade accompanied by limited structural change and little economic transformation. The country's high levels of informality and heavy reliance on oil and gas exports has meant little attention has been paid to developing the manufacturing sector or diversifying into more complex products. Many of Nigeria's manufacturing firms are inward-looking, inefficient and uncompetitive.

Boosting backward linkages could facilitate higher value-added processing and manufacturing activities in Nigeria. If done well, this could stimulate economic development; promote the development of local industries; create economic linkages; build local capacity, capability and technology; develop workforce skills; boost employment; and minimise capital flight.

Getting backward linkage policies right relies on a good understanding of the economics of local content. This requires facilitating dialogue by actors in each value chain and agreeing on, and enforcing, mutual commitments. Similarly, positive 'externalities' can be exploited, for example by incentivising training by the private sector or the building of infrastructure with both public and private uses; and dynamic learning, leading to quality improvements and cost reductions, can be encouraged through targeted and strictly time-bound support.

Nigeria has long experience of local content policy in the oil and gas sector. The evidence suggests these policies have helped deepen backward linkages in the sector, for example in fabrication and construction, well construction and completion, control systems and information and communication technology.

Nigeria has also applied local content policy in other sectors. In the cement sector, Nigeria has achieved a significant level of backward integration, with more than 95% of the materials used for cement production in Nigeria sourced locally. Similarly, there have been several policies to promote backward integration in food processing. Nonetheless, imports are still the dominant source of inputs into food, beverages and tobacco in Nigeria.

International experience

The experience of other countries holds useful lessons for Nigeria. Norway successfully managed its transition to a competitive producer of a variety of oil field services and equipment. This was not achieved by specifying local content requirements, but by giving priority to procuring from firms based in Norway that were *competitive* in terms of price, quality and delivery time. By contrast, Brazil adopted a nationalistic approach to the development of its indigenous oil and gas sector, by closing out competition from foreign enterprises, resulting in higher costs and lower quality and productivity in the domestic industry.

Outside the oil and gas sector, Indonesia has had a renewed focus on localisation in recent years, including using local content policies prohibited under WTO law, such as a duty exemption for imports of machines, goods and materials if 30% of the total value of machines used are sourced domestically.

Evidence suggests local content requirements in Indonesian manufacturing have been ineffective in reducing firms' dependence on imported inputs. By contrast, local content policies played a positive role in driving the expansion of the garment industry in Bangladesh, in part because policies were backed by efforts to build local capacity within the sector through the establishment of specialised institutions to boost garment-industry skills, encourage technology transfer and the development of local technologies.

Nigerian firms backwardly integrated into world value chains. They present higher use of foreign inputs than Indonesia (roughly of similar size) and slightly less than in Kenya. A total of 30% of the inputs used by large firms in Nigeria are imported.

Stakeholder views

Nigerian firms face major challenges in strengthening backward linkages. These include difficulties in obtaining adequate and reliable power supply; costly and politically-sensitive processes of gaining access to land; poor-quality transportation infrastructure; the high cost of capital; long lead times before efforts yield rewards; inconsistency of policy implementation; inadequacy of knowledge and skills in the workforce; and lack of foreign exchange.

Firms have strong but sometimes opposing views on key local content policies. Most firms felt that specifying a mandatory local content share would be unhelpful. On tariffs, firms that produced processed products for the domestic market using imported inputs were in favour of low tariffs on their raw material inputs and high tariffs on their final product. However, several firms pointed to the negative side effects of tariffs, for example the knock-on impact on downstream sectors, the increase in corruption and the concern that tariffs primarily benefit vested interests, particularly where quotas or bans have been used to create rents in specific sectors. At the same time, there was widespread support for efforts to boost skills and upgrade technology, as well as for special tax and financial incentives to deepen backward linkages.

Senior officials have different visions of what local content policies mean. Some see backward linkages as a way of promoting self-sufficiency under the motto, 'We should grow what we eat and eat what we grow.' Others see local content policy as a way of saving foreign exchange and reducing pressure on the exchange rate. Another group promotes local content to boost productivity and drive export competitiveness. While these arguments have merit, they are not necessarily mutually compatible, since they suggest a focus on different sectors and policy instruments.

Policy recommendations

- *Don't try and make one size fit all.* Policies should be nuanced by the circumstances of the sector.
- *Do the maths.* Evaluation of backward integration should consider whether it creates jobs and boosts investment and value added in the sector, but also the impact on consumers. Policies that provide benefits for a sector or firms while imposing higher costs on consumers should be avoided.
- *Engage, facilitate and enforce commitments.* The government should bring together key players to discuss the opportunities and challenges of backward integration, agree investments and the benefits they will accrue. Once agreed, the players should be held to account for delivery.
- *Focus on fundamental improvements to the business climate.* Many of the challenges to backward integration are challenges to doing business in general. Improving the business enabling environment is essential not only to the success of backward integration but also to the growth of Nigeria's economy overall.

References

McCulloch, N., Balchin, N., Mendez-Parra, M., Onyeka, K. (2017) *Local content policies and backward integration in Nigeria.* SET Report. London: ODI.

ODI UKaid from the British people