Models of National & Regional Economic Development; the Role of Foreign Direct Investment (FDI)

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Introduction

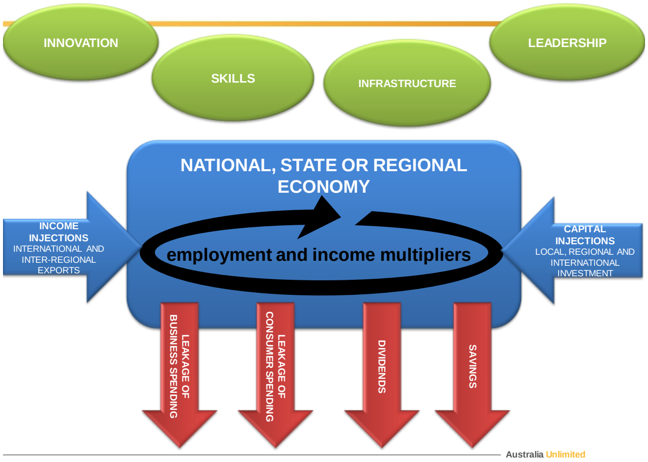
Successful investment attraction into Australia in today's complex and connected trading environment is likely to require a nuanced approach from FDI practitioners. This needs to reflect a deep understanding of the competitive strengths and weaknesses of the host economy. Gone are the days of a scatter gun approach where any investment project gain was regarded as a 'win'. Not all FDI is equal. Some merely passes through the host economy whereas other projects leave a permanent legacy of enhanced skills and innovation capacity.

This paper reviews the workings of regional economies, using both traditional models of analysis and more recent conceptual frameworks which focus on clusters, urban agglomeration and the creation of shared value. The purpose in making this review is to assist FDI practitioners to better understand what they are trying to sell, and to help them make a pitch to investors which resonates with the modern business imperative to optimise commercial performance in the context of the environmental and social expectations of the enterprise.

Traditional Frameworks for Contemplating Regional Economic Growth

The conventional model for considering the drivers of economic growth at the national or regional level is summarised in the following chart. Output and income growth is driven by inter-regional exports and inward investment, which spark successive rounds of business expansion amongst the direct and indirect suppliers to exporters, as well as household income growth which, in turn, further stimulates local economic activity. These multiplier effects are diluted by a range of income leakages, including imported inputs to the supply chains of exporters, flows of household spending to external retail providers, investment of locally generated savings in other regions and the payment of dividends to external investors.

Figure 1 Traditional 'Multiplier Model' of Regional Development



Source SGS Economics & Planning Pty Ltd

In a sense, the objective of regional development strategies is straightforward. It is to keep income injections (inter-regional exports and inward investment) ahead of the leakages, thereby maximising local multiplier effects.

The capacity of any regional economy to achieve this outcome depends on several contextual factors. These include the quality of hard and soft infrastructure supporting economic activity, the propensity for innovation in the economy, the quality of its skills stocks and the effectiveness of regional leadership in marshalling the strengths, and mitigating the weaknesses, of the host economy.

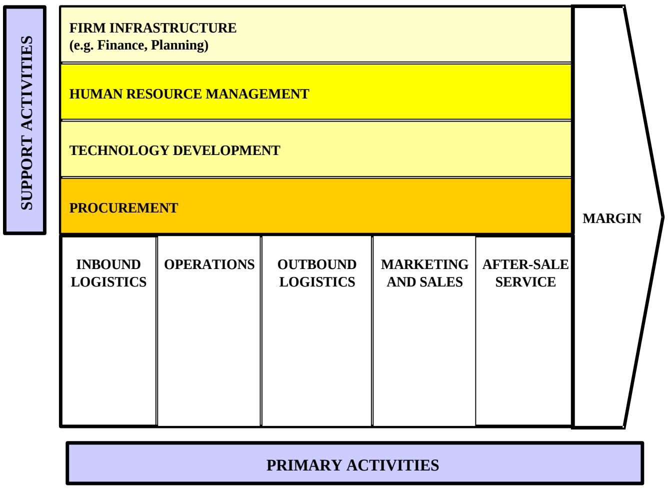
FDI attraction efforts could be directed at building the ranks of exporter firms in the regional economy. But as this simple model highlights, such a strategy would be of limited value if most of the inputs required by the exporter are themselves imported into the region, or if there is nothing in the region, by way of skills, infrastructure and innovative capacity, to 'hold' the new exporter firm(s) in the region in the long term. A more effective FDI strategy might focus on strengthening one of these contextual factors, for example, attracting a strategic R&D capability into the region, or finding an investor to plug a key infrastructure gap, using an innovative public private partnership.

A more sophisticated approach to FDI promotion along these lines requires a broader understanding of modern business competitiveness, ranging beyond the confines of the simple 'multiplier model'. A starting point for this is Michael Porter's (1985) concept of the 'value chain'.

The Unbundling Value Chain

Porter's value chain is reproduced at Figure 2. It postulates that any enterprise will be engaged in five basic value adding steps, ranging from sourcing inputs to after-sales service. The margin which they can generate from this activity will depend on the quality of their procurement strategy, their technological competiveness, the development and astute deployment of their human resources and the robustness of their overall financial and business strategy.

Figure 2 Porter's Value Chain



With increasing outsourcing, the enterprise value chain has rapidly 'unbundled'. This is being fuelled by the general forces behind the continuing globalisation of regional economies, namely, trade liberalisation, cheaper travel, legal innovations in cross-border trade and cultural convergence. There is now an increasing separation between the 'thinking', 'making' and 'distribution' aspects of the value chain.

Analysis of FDI inflows into Australia show that much of this capital is going into enterprises focussed on sales support, IT, financial brokerage, business services and R&D, that is, the 'thinking' parts of the value chain (Table 1 and Table 2). This is so notwithstanding the dominance of the resources boom in popular perceptions of foreign investor activity in Australia. Whilst, this part of the value chain is dominating investment flows, there is a danger that FDI practitioners will be drawn towards enterprises and projects primarily engaged in the 'making' and 'distribution' aspects of value, because these activities have a higher profile and enjoy broad public perception as 'substantive' investment into Australia.

Table 1 Sectoral Composition of FDI Projects in Australia – 2003 - 2011

Sector	Projects	%
Software & IT services	349	23.2%
Business Services	184	12.3%
Financial Services	155	10.3%
Communications	91	6.1%
Coal, Oil and Natural Gas	90	6.0%
Metals	80	5.3%
Industrial Machinery, Equipment & Tools	71	4.7%
Transportation	59	3.9%
Aerospace	42	2.8%
Food & Tobacco	41	2.7%
Other Sectors	340	22.6%
Overall Total	1,502	

Source: FDI Intelligence from Financial Times Ltd

Table 2 Activity Composition of FDI Projects in Australia – 2003 – 2011

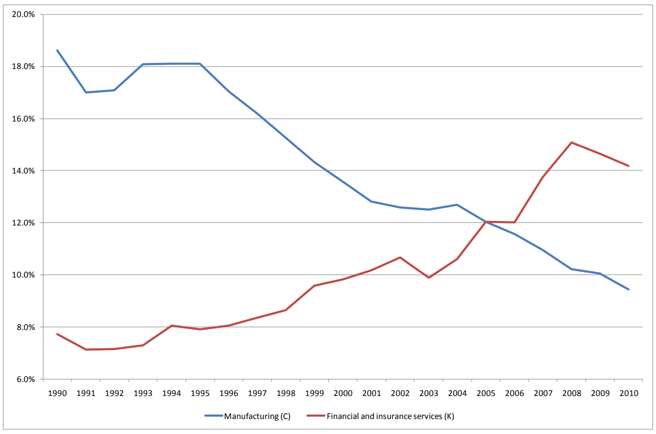
Business Activities	Total	
Sales, Marketing & Support	468	31.2%
Business Services	307	20.4%
Manufacturing	185	12.3%
Headquarters	95	6.3%
Logistics, Distribution & Transportation	92	6.1%
Extraction	88	5.9%
Design, Development & Testing	61	4.1%
ICT & Internet Infrastructure	45	3.0%
Research & Development	28	1.9%
Customer Contact Centre	26	1.7%
Other Business_Activitiess	107	7.1%
Overall Total	1,502	

Source: FDI Intelligence from Financial Times Ltd

The profound influence of 'value chain unbundling' is evident in the changing role of manufacturing in the Australian economy. The Melbourne regional economy provides a striking case study. As shown in Figure 3, a key infrastructural activity in Porter's terms – finance and insurance services – overtook manufacturing as a contributor to Melbourne's gross income in the mid 2000s. While Melbourne continues to be known as a manufacturing and logistical hub, the truth is that, these days, the metropolis earns its way mainly by selling ideas, know-how and experiences rather than things. Indeed, it is likely that Melbourne is a major player in Australia's mining boom, through its export of design, engineering, finance, legal, HR and strategic management services.

From an FDI practitioner perspective, Melbourne's prowess in making things continues to loom large – witness Victoria's major 'win' in attracting foreign investment into the Toyota Hybrid Car manufacturing facility at Altona. However, a more effective FDI marketing strategy for Melbourne, in the context of the value chain unbundling phenomenon, might be to focus on its 'thinking infrastructure', including further investment in R&D and the attraction of leading business services firms.

Figure 3 Share of Value Added ('GDP') – Melbourne Metro Area



Source ABS and SGS calculations

Business Responses in a World of Unbundled Value Chains

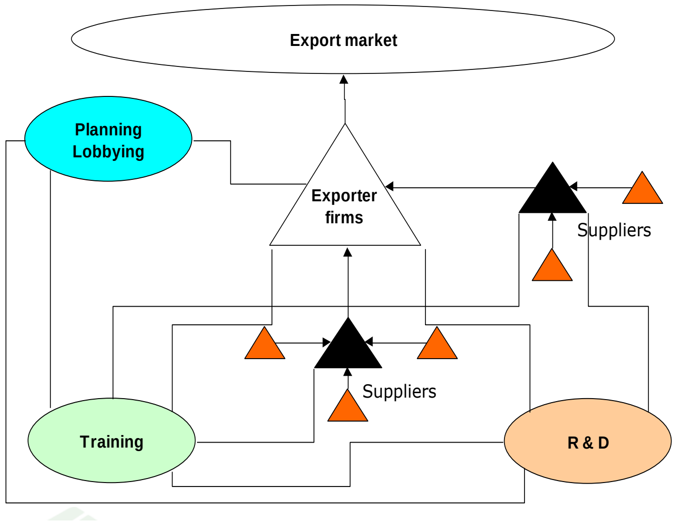
Further pointers to help FDI practitioners target their promotional and investment recruitment efforts may be found in the ways that businesses are looking to maintain competitiveness in the context of rapidly unbundling value chains. Essentially, this is occurring through three broad strategies:

- re-bundling through business clusters;
- creating Shared Value (CSV); and
- Harnessing the productivity benefits of urbanisation.

Outsourcing clearly provides economies of scale and enables enterprises to externalise a range of risks. The downside is that there is a loss of economies of scope; the connections between the thinking and making parts of the value chain can become mechanistic and there is no cross-flow of vital information to improve innovation in both areas. Given the right regional conditions, enterprises can mitigate this downside by effectively re-connecting to outsourced parts of the value chain, albeit through informal and sometimes opportunistic collaborative arrangements. Legal outsourcing continues to prevail, but firms across the value chain share information and develop trading relationships which enable them to better manage supply risks and gain insights to customer needs and more efficient production methods.

This is the so-called 'industry cluster' process. It is characterised by groups of exporters, supplier firms and supporting institutions (in policy development, training and R&D) working together to create a competitive advantage that will span across the participating sectors. Clusters are typically geographically defined – e.g. the McLaren Vale Wine Cluster in South Australia.

Figure 4 Business Cluster Schematic



Source SGS

The upshot for FDI practitioners is that there may be great reward in identifying current or emergent clusters and looking for opportunities to strengthen these teams of enterprises, whether this be by finding another key exporter, or an investor who is interested in contributing to, and profiting from, the formation of new circuits of knowledge flow in the cluster (for example, via a multi-party research project).

Michael Porter, also the architect of the early literature on business clusters, has more recently suggested that as well as reconnecting to other local enterprises to build competitive advantage, the successful modern company needs to reconnect to local communities and to societal objectives generally if it is to optimise its innovation capacity and maximise profits. This notion of 'Creating Shared Value (CSV)' calls on senior management in the private sector to identify social and environmental problems (many of which are linked to the impoverishment of local business ecologies through excessive unbundling) and turn these into business opportunities. This is not be confused with Corporate Social Responsibility (CSR), which is palliative, reactive and redistributive in nature. Business opportunities under CSV may be found in wide variety of areas, including for example, turning waste energy into supplementary power sources for local communities, working with marginalised groups in the labour market to improve skills flow and, ultimately, business competitiveness and providing security of work orders for local feeder enterprises thereby mitigating supply risk for exporting firms.

Again, the upshot for FDI practitioners is that there are likely to be many strategic opportunities across Australia to link overseas investors with CSV projects involving local firms. There are a number of major enterprises across the globe, GE for example, which hold a declared and aggressive agenda to pursue CSV strategies as a means of business development. This form of FDI is likely to leave a long standing legacy of regional competitiveness and economic robustness.

The third area in which enterprises are seeking to create new advantage in a world of unbundled value chains – albeit in less conscious or deliberative way - is by building on the productivity benefits offered by larger, denser cities.

Cities provide a clear productivity advantage as is shown in Table 3; in general, the larger the city the greater is the average total value added per hour worked. This stems from the economies of scale and scope provided by large cities which, in turn, are linked to their (generally) superior offer of skills and their capacity to 'broker' partnerships between complementary businesses in the joint production of goods and services.

If these advantages of scale and complementarity can be provided in an urban environment which is conducive to connectivity, the productivity boost can be accentuated. Thus, city structure as well as size is important. This is also evident in Table 3, in the relatively rapid productivity growth in Melbourne versus all other cities, related in no small part to key projects such as City Link, the Western Ring Road, Docklands, East Link and investment in central city tourism and cultural assets.

Table 3 $ of Gross Value Added per Hour Worked – Major Metropolitan Areas - Australia

	Sydney	Melbourne	Brisbane	Adelaide	Perth
1999	64.0	55.9	53.5	52.8	58.1
2004	68.6	62.0	57.9	57.2	64.3
2009	**71.0**	**66.7**	**60.3**	**61.0**	**60.6**
Change 99 - 09	10.9%	19.3%	12.7%	15.5%	4.3%

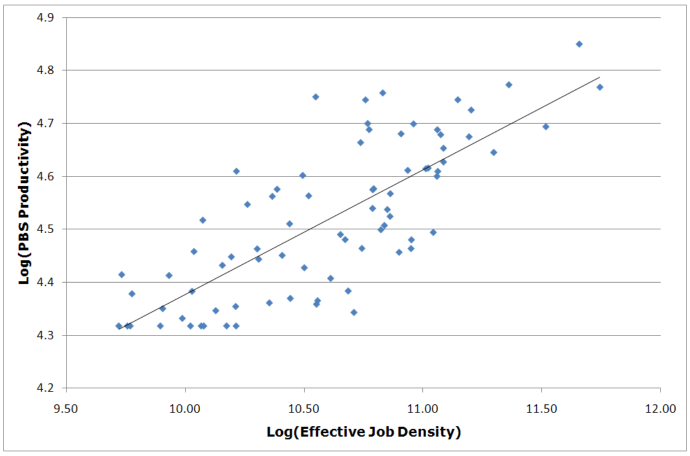
Source ABS and SGS calculations

Not all businesses gain equally from the economies of scale and scope generated by big cities. The elasticity of productivity versus urban density is quite strong for property and business services, that is, enterprises engaged in the thinking part of the value chain (Figure 5). Meanwhile manufacturing and logistics generally eschew central, and often congested, areas as they prefer to avoid the traffic and other production process delays generated by such locations (Table 4).

The fact that Advanced Business Services, including elite enterprises in the financial brokerage, legal advisory, strategic planning , design and human resource management fields, thrive in large, well structured cities is of particular note. These "Knowledge Intensive Business Services" (KIBS), to give them their alternative common name, have been shown to play a vital part in promoting organic innovation within the economy, this being the primary way in which mature economies reinvent themselves over time.

Across most leading economies, these businesses show a clear tendency to concentrate in one or two key cities to take advantage of the productivity boosting effect outlined above. This is equally true of Australia (see Table 5)

Figure 5 Property and Business Services – Labour Productivity versus Effective Job Density Melbourne 2010



Source ABS and SGS calculations

Table 4Urban Agglomeration Productivity Elasticities by Sector – Melbourne

Industry	Urban Agglomeration Elasticities	R^2
Manufacturing	-0.11	0.55
Construction	0.13	0.80
Wholesale Trade	0.02	0.05
Retail Trade	0.06	0.42
Accom, Cafes & Rest.	0.28	0.57
Transport & Storage	-0.05	0.07
Finance & Insurance	0.11	0.40
Property & Business Services	0.17	0.60
Govt Admin & Def	0.20	0.18
Education	0.07	0.45
Health & Community Serv's	0.09	0.63
Cultural & Recreational Serv's	0.23	0.42
Personal & Other Serv's	0.25	0.37
Total	0.08	

Source ABS and SGS calculations

Table 5 Distribution of Advanced Business Services - Australia

Metropolitan Area	Export oriented Advanced Business Service jobs	Share of Advanced Business Services export jobs	Share of all jobs nationally
Sydney	63,061	49.78%	20.91%
Melbourne	43,091	34.02%	18.52%
Brisbane	8,742	6.90%	9.64%
Canberra	6,505	5.14%	1.93%
Perth	5,277	4.17%	7.73%
Adelaide	net importer	0%	5.59%
Hobart	net importer	0%	0.98%
Darwin	net importer	0%	0.60%

Source Spiller (2009)

There are a number of implications for FDI practitioners from these links between urbanisation and productivity. Firstly, it is important to keep in mind that Australia's primary wealth drivers are likely to be connected to the vitality of the major cities, with Sydney, in particular, playing a crucial role. FDI which strengthens the cities is likely to be at least as important strategically to Australia as the attraction of more investment into the nation's rich resource sector.

Secondly, FDI practitioners need to understand the KIBS sector more fully and find ways of tapping into the insights which these agents can provide in terms of the competitive strengths and weaknesses of regional economies.

Conclusion

FDI practitioners need to set aside a scatter gun approach to investment attraction, in favour of a more nuanced approach which reflects a sophisticated understanding of the receiving regional economy. The concepts of business clusters, creating shared value and productivity gain through urbanisation provide useful pathways to the discovery of strategic FDI opportunities which, if realised, would permanently strengthen the host economy.