

# Relationship between Inward Investment and Productivity in Oman

Mishrif A<sup>1\*</sup> and Balushi YA<sup>2</sup>

<sup>1</sup>Department of International Affairs, Qatar University, Doha, Qatar

<sup>2</sup>Supreme Council for Planning, Oman

## Abstract

This study explores how the peculiarity of economic structure and institutions affect the relationship between inward investment and productivity of domestic firms in Oman. It provides its analysis through an examination of the policy framework that shapes the business environment; affects the quality of institutions and proper implementation of policies targeting inward investment; and influences productivity channels and mechanisms that facilitate the transmission of spillover effects from foreign to domestic enterprises. While international business literature attributes low productivity to low absorptive capacity of local firms, this study stresses the correlation between the quality of institutions and levels of productivity. Empirical evidence collected from 96 survey questionnaires and 42 interviews with government officials and executives confirms the essential role of the state through the creation of specialized institutions and proper implementation of investment policies in facilitating the transmission of productivity spillover effects from foreign to domestic enterprises.

**Keywords:** Inward investment; Domestic firms; Productivity; State; Institutions; Gulf countries

## Introduction

The relationship between inward investment and economic development in host countries is widely examined in literature. As explained in literature review, there are differing views on the possible effects of this type of investment on economic development. Empirical studies identified three general perspectives on the likely impact of inward investment on development: one highlights the positive impact of inward investment on development; the second underscores the negative impact of inward investment on development; and the third perspective conditions the positive impact of inward investment with certain internal policy conditions. In light of the views presented in the third perspective, one could argue that the spillover effects of inward investment do not happen automatically, but require a policy framework and channels through which spillovers can affect domestic economy or local companies.

The critical issue here is how can host country governments create and develop an appropriate policy framework and regulatory environment through which domestic economy can benefit from inward investment? Conventional views highlight the importance of government commitment and support to the business sector by developing infrastructure, creating business linkages, providing access to finance, and providing public services essential for the efficient operation of companies. Companies can also increase their productivity by upgrading production techniques, accessing advanced technology, developing operational and marketing strategies, and allocating efficiently their capital and human resources. This is a standard business practice in most developed countries, where public and private sector companies enjoy an array of supporting services from the government and operate in a healthy competitive marketplace.

However, in many developing countries such as the Arab Gulf countries, the economic structure, central planning and dominance of the public sector often limit the share of the private sector in the development process and attractiveness of these economies to inward investment. The Arab Gulf states present a special case study for a number of reasons. The first is the nature of the economic structure, where oil represents between 39 and 70 per cent of GDP, 86 per cent and 90 per cent of government revenues, and 66 per cent and 98 per

cent of exports. The Gulf rentier economies are largely dominated by the public sector, while the private sector remains small and ineffective in the development process [1-3]. The second factor is that most studies conducted on inward investment in the Gulf focused on the determinants and attractiveness of the Gulf countries to foreign investors, but there is hardly any research conducted on the impact of inward investment on the productivity spillover effects on local firms in the Gulf context. The third factor is the growing trend towards economic diversification away from oil to non-oil sectors, hence more investments are needed in sectors such as finance, services, and manufacturing. Therefore, this study adopts a multidisciplinary approach that allows for a comprehensive, indepth analysis through a case study approach, together with a combination of qualitative and quantitative techniques.

This study seeks to explore how the peculiarity of Gulf economic structure and institutions affect the relationship between inward investment and the productivity of domestic firms. It examines this relationship through three main aspects: the policy framework that shapes the business environment; the institutions and policies targeting inward investment; and productivity channels and mechanisms that facilitate spillover effects. In doing so, section two provides a theoretical perspective on inward investment and productivity spillover. Section three provides a literature review on productivity spillover channels and mechanisms. Section four examines inward investment policies and growth rates. Section five explains the methodology employed in this study and quantitative and qualitative techniques used to collect primary data. Section six provides discussions and analysis of the extent to which the three factors examined have affected the relationship between inward investment and productivity of domestic firms.

**\*Corresponding author:** Ashraf Mishrif, Department of International Affairs, CAS, Qatar University, Doha, Qatar, Tel: +974 66203605; E-mail: [amishrif@qu.edu.qa](mailto:amishrif@qu.edu.qa)

**Received** May 08, 2017; **Accepted** May 10, 2017; **Published** May 20, 2017

**Citation:** Mishrif A, Balushi YA (2017) Relationship between Inward Investment and Productivity in Oman. J Bus Fin Aff 6: 266. doi: [10.4172/2167-0234.1000266](https://doi.org/10.4172/2167-0234.1000266)

**Copyright:** © 2017 Mishrif A, et al. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.

## Theoretical perspectives on inward investment and productivity spillover

The impact of inward investment on host country economy has been widely debated in literature. The common perception is that the relationship between inward investment and domestic investment is likely to be complementary when inward investment is made in an underdeveloped sector of the economy. Blomstrom et al. [4] argue that this type of relationship becomes more of a substitute by inward investment to domestic investment, where the sector has plenty of local firms or when local firms have already had access to technology that foreign firms bring into the country. In either cases, there is a strong linkage between the effects of inward investment on local firms and between the type of inward investment made and host country economic conditions.

However, surveying the literature shows contrasting views on the effect of inward investment on host country's domestic economy. One can distinguish three different perspectives on the effectiveness of inward investment on productivity spillovers. The first and most widely debated argument is the free market perspective, which underscores the positive impact of inward investment on host country economy, in particular raising the productivity of local firms. The findings of several studies conducted by Cave, Fry, Borensztein et al. Moran, De Mello and Buckley et al. find that inward investment is expected to accelerate economic growth, to increase income, and to contribute to economic development beyond available domestic resources [5-10].

The second is the radical perspective, which argues that inward investment has negative impact on the productivity of local firms in host country due to intense competition and market dominance that often result in crowding out small and medium sized enterprises (SMEs). De Backer and Sleuwaegen [11] identify three factors that could result in crowding out of local SMEs: when there is a large technological gap; labour force in host economy is not sufficiently qualified; and differences in the access to credit between foreign and local firms. They also argue that inward investment increases the income gap in a society through provision of offering high wages to its employees in contrast to lower wages paid by local firms. This assessment features in a number of studies conducted by Aitken and Harrison [12] and De Backer and Sleuwaegen [11]. The negative effects of inward investment can also be realized in the reduction of local investment, where foreign firms are technologically more advanced and capable of exploiting more rapidly and effectively business opportunities projected initially to local enterprises [6]. Foreign firms can influence negatively employment and local market, particularly when these firms increase wages and the prices of locally supplied inputs, subsequently leading to reduced employment and displacement of local firms. Kokko [13] also argues that raising imports and worsening the terms of trade can result in a loss of the potential local productivity comparative advantage and increased prices of capital goods.

The third is the pragmatic perspective, which argues that the positive impact of inward investment can materialize only under certain local policy conditions. Chief amongst these conditions is the absorptive capacities in host country economy, where the impact of inward investment on economy depends largely on the nature of the industry and the degree of liberalization in domestic policies. This perspective underscores the importance of empirical evidence rather than ideological strands in its analysis. For instance, a study by Borensztein et al. [7] using data of 69 developing countries over a period of two decades finds that inward investment is an important

vehicle for technology transfer, hence contributing relatively more to growth than to local investment. However, the study finds that the higher productivity of inward investment holds only when the host country has a minimum threshold stock of human capital. Javorcik [14] also argues that positive productivity spillover effects from inward investment to local firms are associated with joint ventures sharing domestic resources and foreign ownership, but not with fully owned foreign firms. Mayer and Sinani [15] used meta-analysis to underscore that inward investment generates positive spillover under certain circumstances, often related to local firms' motivation and capability to react to foreign entry, such capabilities are grounded in their human capital and organizational structure. In sum, positive spillover effects depend on a number of factors, including host country's openness to trade [16], the capacity of its local firms to internalize spillovers, and the ability of sectors to support learning. Another factor is the technological gap between foreign and local firms that should not exceed a threshold [9], as well as the existence of relatively developed local financial markets and qualified human capital.

## Literature review on productivity spillovers from inward investment

To understand productivity spillover effects, inward investment needs to be analyzed in a much broader sense, not just its role as provider to capital and technology but also as an avenue to benefit host country economy and human development in general. In fact, maximizing the economic impact of inward investment can best be realized when appropriate linkage channels are created between foreign and local firms. At the firm level, Javorcik [14] defines spillover as knowledge created by a foreign firm that is used by a local firm for which the latter firm does not compensate the former. At host country level, Javorcik [14] argues that the process of capturing productivity spillover effects is complicated because it is hard to determine precisely the factors that can influence the degree of spillovers in each economy. Their conclusion confirms the findings of other studies, which argue that the effect of inward investment on host economy is mixed in terms of level, direction and even existence of spillovers from investment [17-20]. Meyer and Sinani [15] argue that spillover effects connected with inward investment and generated by non-market transactions involving foreign resources often spread to local firms without a contractual relationship. This reflects either an improved productivity or other benefits such as imitation, acquisition of skills, increased competition and exports, all of them are channels through which host country can achieve productivity gains via intra-industry spillovers [16]. However, further investigation is needed to determine when precisely spillovers may be large, small or absence.

**Productivity spillover channels:** Foreign and local firms interact in many ways. In the marketplace, they cooperate and sometimes compete in factor and product markets. They trade with each other by supplying input factors or exchanging technology. There is also non-market interaction between firms' externalities. This variation of interaction necessitates the need to determine the productivity spillover channels between foreign and local firms. We have identified six key channels through which foreign and local firms interact, namely technology transfer, management attributes, marketing techniques, capital flows, best practice and skills, and competition. Effective utilization of these channels is likely to raise productivity and competitiveness of local firms and improve efficiency of the host country domestic market. In doing so, a number of pre-conditional factors relating to both foreign firm and host country economy should exist. At foreign firm level, productivity spillover effects are influenced by country of origin, type

of industry, motives, size of the firm, centralization, and mode of entry. At host economy level, spillover effects are affected by the absorptive capacity of the economy in terms of technology gap, institutional framework, and quality of the local workforce; by intellectual property rights; and by ownership structure. At policy level, effective utilization of productivity spillover channels requires well-designed and implemented policies to tackle the barriers that hinder the functionality of the channels. The most important policies concerning inward investment are business linkages programs, investment map, and local contents requirement. Meanwhile, key policies concerning host economy are local human development requirement and export performance requirement.

**Productivity spillover methods and mechanisms:** Navaretti and Venables [21] identify four methods through which productivity spillover effects are transmitted from foreign firms to their local counterparts. The first method is market transactions, which occur during a handover of propriety assets from foreign to local firms. Asset transfer takes place directly in the market in the form of licensing agreements or association with the supply of inputs, assembly and marketing. The second method is technological externalities, where transfers take place through externalities that do not necessarily benefit foreign operations and methods of transfer are difficult to estimate. This occurs when some workers move from foreign to local firms, providing their knowledge to local competitors. Transmission also happens through informal contacts or when foreign and local firms interact explicitly with unanticipated information leakage takes place in favor of the local firm. The third method is pecuniary externalities, which appear when a foreign firm - often characterized by economies of scale - affects host economy by network and aggregation effects. Regardless of whether foreign operation is government-driven to develop infrastructure or privately driven to create new goods or service for the public, local firms can substantially benefit from foreign investment in their markets. However, negative pecuniary externalities could result from foreign operations leading to an increase in the demand for factors of production that result in higher prices; consequently harming local firms and making them uncompetitive. The fourth method is pro-competitive effects, which stem from the increased competition caused by the entry of inward investment in host economy. In a perfectly competitive market, local firms often reduce their prices and profit margins and operate efficiently in order to become more competitive. However, when the market is imperfectly competitive or a fixed cost structure exist, the least efficient local firms cannot resist the pressure and forced to shut down activities, leaving the more competitive foreign firms enjoying monopoly power and higher prices.

Moreover, the entry of inward investment could affect local firms through four mechanisms that have direct impact on productivity spillover effects. The first mechanism is competition, which forces local firms to improve product quality, efficiency, price and hence higher productivity. The second is labor mobility, which facilitates human capital formation in local firms. The third is business linkages, which could influence productivity of local firm through backward, forward, horizontal or vertical linkages, not only with local firms but also with universities and other research institutions. The fourth is demonstration, which occurs through the imitation and reverse engineering of foreign firms in the host country economy.

### **Investment policy and growth in Oman and Arab Gulf countries**

Literature review shows a limited number of studies examining the

impact of inward investment on Gulf economies. A study by Sadik and Bolbol [22] argues that inward investment in the Gulf countries has not had any positive spillovers on technology and productivity above those of other types of capital formation. It concludes that the effect of inward investment on total factor productivity is lower than that of domestic investment in some of the countries; this indicates a possible dominating negative crowding out effect. Another study by Hussein [23], who used recent growth theories and statistical techniques, finds a weak relationship between inward investment and GDP in the Gulf countries and that this investment contributed only very modestly to gross fixed capital formation, as the overall build-up of capital formation is mainly financed by domestic capital and private funds. It concludes that Gulf countries should be selective in attracting inward investment because they have abundant financial resources to finance their development. This necessitates further investigation on the impact of inward investment on Gulf economies through higher efficiency in physical and human capital and increase in productivity of domestic firms that drive the development process.

Moreover, a study by Mishrif and Al-Naamani [24] argues that regional economic arrangements of the 2003 customs union and 2008 common market have diminished barriers to trade and investment among the member states of the Gulf Cooperation Council (GCC) and facilitated the flow of capital and other factors of production in the region. Liberalization of the trade and investment regime has improved the investment environment, hence amplified the importance and increased size of the GCC market. This, in turn, encouraged and facilitated the internationalization of Gulf SMEs in the regional markets, enabling them to gain competitive advantages at the regional level. At the national level, GCC countries have also embarked on building economic zones and cities, aiming at providing advanced information and communications technology, infrastructure and services to attract foreign investors. According to Hivdt [2], GCC countries established more than 55 cities or zones targeting knowledge-intensive industries. For example, UAE has launched several new free trade and industrial zones intended to establish the country as a global Centre for trade in gold bullion, research and development of technology, and financial services.

To promote economic development and diversification, Gulf countries have actively sought to attract inward investment through new policies aimed at boosting the attractiveness of their investment environment. These policies include investment incentives, streamlining procedures of registering companies, simplifying legal and regulatory frameworks, introducing favorable tax regimes, expediting the issuing of visas, creating one-stop shops to reduce time needed to approve and register investments, marketing available investment opportunities, and eliminating or reducing minimum capital requirements [25]. For example, Bahrain increased the share of foreign ownership from 49 to 100 per cent of businesses in all, but a few strategic sectors such as oil and aluminum. Kuwait established a Foreign Investment Capital Office to process foreign investment applications, passed a law allowing 100 per cent foreign ownership, and reduced corporate taxes from 55 per cent to 25 per cent. Qatar streamlined investment approval procedures, reduced maximum corporate tax from 35 per cent to 30 per cent, and allowed 100 per cent foreign ownership in agriculture, industry, health, education, and tourism. Saudi Arabia established an investment authority to facilitate foreign investment applications processing, and cut corporate income tax on foreign investment from 45 per cent to 30 per cent. It permitted non-Saudis to own real estate for their business or residence, except in the two holy cities. Oman has allowed 100 per cent foreign ownership of companies in most sectors and allowed



foreign firms to own buildings and lease land, while opening up the service sector to full foreign ownership in line with the provisions of World Trade Organization.

These policies have contributed to significant improvement in the business environment in most Gulf countries. According to World Bank's Doing Business Report 2017 [26], all Gulf countries recorded very high in terms of ease of doing business compared to other countries in the Arab region, and well above the regional average. The UAE ranked first regionally and 26 globally on the ease of doing business. Bahrain and Oman ranked second and third regionally and 63 and 66 globally, respectively. Qatar ranked sixth regionally and 83 globally, followed by Saudi Arabia in the seventh place regionally and 94 globally. Kuwait came in the eighth place regionally and 102 globally, making the country the least attractive business environment in the GCC. Among the 22 Arab countries, only Morocco and Tunisia recorded fourth and fifth regionally and 68 and 77 globally, respectively, ahead of Qatar, Saudi Arabia and Kuwait in 2016. This underlines a significant improvement in the quality and efficiency of Gulf regulatory systems, as well as streamlining administrative procedures and time taking in starting a business, registering property, dealing with construction permits, getting electricity, getting credits, paying tax, trading across borders, enforcing contracts and resolving insolvency. In 2016, UAE was ranked first regionally and globally in paying tax; first regionally and fourth globally in getting construction permits and getting electricity; and first regionally and 25 globally in enforcing contracts. In the same year, Oman ranked first regionally and 32 globally in starting business; while Saudi Arabia ranked first regionally and 82 globally in getting credit [26].

The impact of policy reforms and gradual improvement in the business environment has resulted in substantial rise in inward investment in to the Gulf countries. According to the World Investment Report 2013, inward investment increased from a relatively modest US\$1 billion on average during 1990–2000 to US\$28 billion during 2001–2011, with an intermediate growth of US\$61.7 billion targeting mainly services in 2008. However, political and economic instability caused by the 2008 global financial crisis and the 2011 Arab uprisings affected negatively the flow of inward investment in to the Gulf region. Data show that capital inflows into the Gulf countries decreased gradually from US\$51.4 billion in 2009 to US\$42.6 billion in 2010, US\$29.5 billion in 2011, US\$28.5 billion in 2012, US\$23.5 billion in 2013, US\$23 billion in 2014, and US\$19.8 billion in 2015 (UNCTAD, 2016). In terms of FDI stock, data show that GCC FDI stocks increased from US\$32.2 billion in 2002 to US\$81.5 billion in 2005, US\$321.3 billion in 2010 and US\$430.6 billion in 2015. In terms of sectoral distribution, available data for 2011 show that the services sector accounted for 59 per cent of inward investment, manufacturing for 27 per cent, and the primary sector (mainly the oil and gas upstream industry where restrictions on FDI participation) for 14 per cent. Services were also dominant in greenfield investment projects, attracting 51 per cent of estimated investments during 2003–2011; 44 per cent targeted manufacturing, and 5 per cent went to the primary sector. Among member countries, Saudi Arabia was the preferred destination for inward investment, followed by the UAE, while Kuwait was way down the list with a very small share.

## Methodology

The methodological approach and research techniques employed in this study are largely determined by the nature of its investigation. As explained above, there are sufficient available and reliable data on

inward investment in all Gulf countries, but we do not have access to any reliable data on productivity, which is the second main variable in this examination. Lack of data on productivity hinders the possibility of employing any form of statistical analytical programs or econometric models. For the sake of comparability, we limit our approach to the conventional methods of collecting and analysing primary data. In order to examine the relationship between inward investment and productivity in the Gulf countries, this study adopts a multidisciplinary approach that allows for a comprehensive, in-depth analysis through a case study approach, together with a combination of qualitative and quantitative techniques.

The distinctive features and similarities in the economic structure and outlook of Gulf economies allow for sparing the efforts to include all Gulf countries in the empirical part of this study. Also, limited resources and lack of available data and access to data in all these countries have forced us to limit our analysis to a country-specific case study, where we examine the impact of inward investment on productivity spillover of local manufacturing firms in Oman. This one-country-one-sector approach enables us to have a representative sample of the promising Omani manufacturing sector, which is almost identical in terms of size and structure to that of other Gulf countries. Since the mid-1990s, Oman has embarked on an intensive economic reform program, aiming at liberalizing its trade and investment regime, improving its business environment, and diversifying its economy in light of its limited oil production and reserves. It invested heavily in developing free zones and business parks to attract foreign investment to the industrial sector, where the scope of productivity spillover is significant compared to other sectors. These efforts bore their fruits in terms of substantial rise in inward investment stock, which increased by 400 per cent, totaling US\$15 billion and amounting to 43 per cent of GDP in 2011, from its 2002 level [27]. In the same year, manufacturing received almost 30 per cent (US\$2.3 billion) of total inward investment, only second to oil and gas, which received 51 per cent (US\$7.1 billion). Most investments came from the UK, the USA and UAE, and concentrated in the manufacturing of basic chemicals or refined petroleum products. This type of investment has made substantial contribution to Omani economy, generating 45 per cent of economic value added and 88 per cent of exports (Oman Central Bank, 2013), while diversifying exports, particularly chemical products (32 per cent), basic metals (26 per cent) and food and beverages (15 per cent) [28].

Moreover, a combination of qualitative and quantitative techniques are employed to explore opinions and perceptions of all stakeholders concerned with investment policies and whether these policies are appropriate for enhancing or increasing productivity in local firms. A set of semi-structured interviews are conducted in Oman between January and June 2015 with foreign and local executives and with relevant government officials in Ministry of Commerce and Industry, Supreme Council for Planning, Investment Authority, Chambers of Commerce and Industry, and Free Zone Authorities in Duqam, Sohar and Salalah. Geographically, the samples are collected from four major business cities: Muscat, Sohar, Duqam, and Salalah, where the vast majority of foreign operations are located. Interviews are conducted with 42 policy makers and executives, of whom 13 interviewees are government officials, 9 interviewees from foreign firms, 10 interviewees from joint ventures, and 10 interviewees from local firms. This technique allows for better understanding of the variables examined in relation to the role of government policies in facilitating the transmission of productivity spillover effects from foreign to local firms.

A survey is also designed and sent to foreign and local company

executives to allow for some generalization on their responses to specific questions regarding their firms and experience in working in Omani market. Each questionnaire sample is divided into five sections. The first section collects general data on the respondent's occupation, economic activity, ownership structure and business environment (questions 1-20). The second section focuses on how foreign operation influence the upgrading of local firms through spillover channels and mechanisms (questions 21-38). The third section collects data on preconditioned factors such as absorptive capacity, institutional framework, mode of entry and ownership (questions 39-53). The fourth section collects data on public policies, strategies and incentives (questions 54-74). The fifth and final section draws a SWOT analysis for Omani business environment in relation to attracting inward investment and formulating business linkages between foreign and domestic firms (question 75). From 114 returned questionnaires, only 96 completed (valid) questionnaires used in this study. The 76 per cent response rate shows that joint ventures (46 companies with response rate 92 per cent) are keener to participate in this study than local companies (34 firms with response rate 68 per cent) and foreign firms (34 companies with response rate 68 per cent).

## Data Analysis and Discussion

Descriptive and statistical data collected from the interviews and survey reveal some important insights on the factors affecting the transmission of productivity spillover from foreign to local enterprises. More importantly, this type of data has initially provided us with new insights on how the policies designed to attract inward investment affect the levels and quality of productivity in host country economy. In analyzing such data and insights, this section is divided into three parts; each addresses one hypothetical element of the study. First, we use the primary data to explain how the policies designed by host country government to improve the investment environment affect the levels of interactions between foreign and local companies. Second, we use data to explain the effectiveness of public institutions and policies targeting inward investment in improving the relationship between foreign and domestic enterprises. Third, we use data to determine policy channels and mechanisms that affect productivity and facilitate the transmission of spillover effects from inward investment operations to local enterprises.

### Relationship between investment policies, environment, and inward investment growth

Qualitative and quantitative data reveal a strong correlation between the appropriateness and proper implementation of government policies aimed at attracting inward investment and the quality of the investment environment, which is a key determinant for the attraction and facilitation of investment. This assumption is supported theoretically and empirically in previous studies covering the topic in different political, economic and geographical context [28]. Survey data underscores the importance of host country's geographical location, the quality of infrastructure, the size of the market, abundance of raw materials, the quality of human capital, and tax incentives in attracting foreign investment. To identify and measure the factors most important for inward investment in Oman, we use a five-point Likert Scale, where 1 is strongly disagree and 5 strongly agree. Data show that utilizing quality infrastructure is the most important factor, with the highest mean 4.22. This reflects the size of investments made by the government in building new industrial cities and free zones connected with modern highways and ports; supported by the creation of power stations, housing, schools and hospitals; and provided with

utilities such as water, electricity and gas. Survey respondents express their high satisfaction with the utilization of geographical location in enhancing the quality of the business environment. Utilization of location through large seaports, which scores the second highest mean of 4.21, underlines the importance of linking Oman to European, African, Arabian and southeast Asian markets. Both foreign and local companies appreciate the role of the state in increasing the size of the domestic market, which scores a mean of 4.20. This is highly appreciated by companies producing to meet the needs of the domestic market. Tax policies and tax incentives come in the fourth place, scoring a mean of 4.05. Foreign investors appreciate positive effects of fiscal policies such as reduction in corporate and income tax on foreign corporations. However, participants have shown some concerns about their abilities to secure raw materials (mean 3.84), collecting market information (mean 3.79), follow major clients (mean 3.70), acquiring technology (mean 3.67), investing with others in same industry (mean 3.55), and accessing cheap labor (mean 3.36).

The survey also provides some interesting insights on the perception of foreign companies operating in Oman. When considering the most important factor for investing in this country, only 23 per cent of total survey respondents strongly agreed that Oman is a good investment market for foreign companies, while 74 per cent agreed, and 3 per cent disagreed. This positive views on the country's attractiveness to inward investment contrast with the modest inward investment flows, which stood at US\$850 million, US\$876 million, US\$739 million and US\$822 million in 2012, 2013, 2014 and 2015, respectively [29]. The contrast between the perceptions and primary data presented in the survey regarding country's investment environment and its locational advantage show the Oman is not fulfilling its full potential of attracting inward investment.

Qualitative data collected from interviews supports the above conclusion. Indeed, the vast majority of interviewees argue that Oman has a welcoming friendly business environment, which, if utilized efficiently, could maximize the potential of the country as an attractive destination for inward investment. On the corporate side, the director general of Nizwa Industrial Estate argues that Oman has "good infrastructure ... attractive regulations ... [and] natural resources that could make it an attractive place to invest". Another executive highlights the positive effect of political stability and Oman's peaceful relations with neighboring countries and proximity to emerging markets. The executive of Public Establishment for Industrial Estate stresses the "importance of location" and the "existence of manpower" for his company. Paul Spyropoulos of Bahwan Exel LLC appreciates the "ease of doing business and availability of various capabilities in the country" for his company in the past eight years. On the policy making side, the modest levels of satisfaction and low inward investment flows are largely a result of weak investment promotion strategies and poor implementation of key investment policies introduced by the government. For example, a senior economist at the Central Bank of Oman attributes the unsatisfactory outcome of government policies to "inadequate priority given by policy makers"; hence indicating that inward investment promotion is not a top priority for the government. One can hardly pinpoint a single factor for such passive role by the government towards inward investment. However, there are a few possible explanations for this. One explanation is that Oman in a state of political transition for some years due to the ill health of Sultan Qabos bin Said. This ongoing transition, which causes slow pace of policy formation and implementation, is a natural outcome of this domestic political situation, particularly when there is no clear line to the throne. Another explanation is the concentration of inward investment in the

hydrocarbon sector, mainly oil and gas. Some participants argue that the inattention paid by policy makers to develop appropriate policies to guide inward investment to the most needed economic sectors is to blame for the lack of foreign investment outside the energy sector and slow pace of economic development and diversification.

### **Relationship between effectiveness of public institutions and productivity spillover**

Primary data underscore a negative effect of inefficient institutional frameworks on productivity spillovers from foreign to local companies. Analysis of the role of the Public Authority for Investment Promotion and Export Development in attracting inward investment highlights the incompetence of this newly established authority (created in 2011) to develop appropriate investment policies to effect productivity spillover. It is evident from our data that this authority realizes its own limitations on structural, organizational and functional levels. While this authority ought to be dealing solely with the promotion and facilitation of inward investment and act as a one-stop-shop, the current organizational and administrative structures of the government still allow many public institutions to get involved with inward investment. Many interviewees explicitly voice the overlap in responsibility among ministries and government organizations. For example, the director general of Research and eServices of Public Authority for Investment promotion and Export Development argues that there are many ministries and public institutions concerning inward investment and that “none of them focuses on building relations between foreign companies and local companies”. On the one hand, overlap in duties and responsibilities among government institutions reflects weak linkage and lack of coordination among government departments dealing with inward investment. This makes no one accountable for the lack of implementation of policies or follow-up on investment projects. On the other hand, data show that it is not only efficiency of public institutions that matters, but also the effectiveness of the strategic and institutional framework that guides public institutions to function properly. For example, the absence of strategic direction for investment has led the chief executive of Rusayle Industrial Estate to argue that public institutions “need to have a strategy and requirements that are enforceable and measurable and done by trained and qualified technocrats”. Another executive argues that “no one works under a very clear prescribed mandate”.

The above argument raises serious concerns about the relationship between the state and the private sector and between the government and public institutions that are responsible for the implementation of investment policies. Such concerns originate in the weak institutional structure at the state level, as Oman and most Gulf countries have only recently embarked on nation-state building. They also originate in the rentier nature of the Gulf economies and their unique economic structure that is largely dependent on the hydrocarbon sector for government income and export revenues. The creation of large public sector and civic administration in rentier economies serves the state as effective channels for income distribution and employment. While such structure could serve as social contract between the state and society, it affects negatively the relationship between the state and the private sector. In addition, the nature of the relationship between the state, the business and the society has significant impact on the functionality of institutions and overall economic performance in most Gulf countries, where the private sector receives little attention in terms of consultation in policymaking and distribution of public funds and investments.

Moreover, analysis of primary data underlines the correlation

between the success and failure of investment policies in attaining their objectives and the quality of public institutions on the one hand, and between the capacity of these institutions to function properly and increase or decrease in productivity on the other hand. The majority of survey respondents and interviewees stress that inefficient public institutions weaken the expected outcome of productivity spillovers and, hence call for creation of a single organization to take the lead in the initiation, management, monitoring and measuring the levels of productivity spillover effects from foreign to local firms. For example, a foreign firm executive stresses the link between the efficiency of public institutions and increase in productivity because “spillover do not occur without proper policies and enforcement mechanisms”. Analysis also underlines shortfalls in the government role to address productivity spillover shortages due to lack of a well-developed investment map and absence of specialist body responsible for designing policies aimed at facilitating business linkages between foreign and local firms and achieving sustained growth rates in productivity. Nonetheless, we do not assume that these shortfalls are not realized at the heart of government, as the director of investment promotion at the Public Authority for Investment Promotion and Export Development admitted that “Oman needs an investment strategy that identifies [the targeted] sectors for FDI and which sector to start with”. He also stresses that “FDI can benefit from preparing an investment map”, which is lacked at the time being.

### **Relationship between productivity spillover mechanisms and foreign-local firms' interactions**

Although productivity spillover mechanisms are often dealt with from the business perspective, it is imperative to underline here that their effectiveness are largely influenced by the institutional settings, political and economic context, and demographic structure of the country. One should also stress the importance of associating productivity spillover mechanisms with key company characteristics such as ownership structure and geographical location in order to be able to assess the intensity and levels of interaction between foreign and local companies. We consider these factors when conducting the survey, which reveals that 70.8 per cent of manufacturing firms concentrate in Muscat, 11.5 per cent in Salalah, and 10.4 per cent in Sohar. Of the 96 firms surveyed, 40.6 per cent are joint ventures, 35.4 per cent are Omani, and 24 per cent are foreign-owned. As for foreign-local business arrangements, data show that 28.1 per cent strongly agreed of existing arrangements and 67 per cent agreed of existing relationships in terms of purchasing materials, services, distribution, and maintenance, which result in upgrading the work practice of local firms. Survey responses confirm that, in the best case scenario, foreign firms pass on to their local counterparts the latest technology and quality standards, proven human resources plans, information technology systems, technical know-how, applying safety procedures, training manpower, and advanced management techniques. Nevertheless, the need to assess the effectiveness of productivity spillover mechanisms in facilitating foreign-local firms' interactions requires examination of the four significant factors that directly affect the relationship between foreign and local firms.

**Competition policy:** Competition is a product and a reflection of the quality of the regulatory system. When designing investment policies, policymakers consider competition a healthy practice in order for local firms to upgrade their systems and working practices, as well as being a necessary mechanism to create a good business environment. Our data shows that this is not the case for Omani firms, which argue that competition gives foreign firms a competitive edge



that makes them more productive than their local counterparts. Their argument complements the early findings of Aitken and Harrison [12], who argue that the entry of foreign firms into a specific market is likely to result in crowding out of a significant number of local SMEs that cease to operate or lose their market share due to competition. Nevertheless, our data indicate mixed results, as competition has both positive and negative effects on local firms. On the positive side, our data shows that foreign firms and joint ventures see the role of their companies complementary by having “different market targets, mainly for export, hence they work in partnership with local counterparts rather than competing with them. As for local firms, only those with sound organizational, financial and human capabilities that enable them to remain in the market perceive competition as a healthy practice due to their need to innovate and develop more efficient production techniques. On the negative side, survey data shows a mean 3.70, with 15.6 per cent strongly agree and 54.2 per cent agree that foreign firms compete with their local counterparts. Although the levels of competition vary, some local enterprises executives argue that they face a high level of competition from foreign firms. The severity of competition has led one executive to argue that foreign firms come “to eat up our market share”.

**Labor mobility:** Labor market efficiency is, in theory, another key factor in facilitating the transmission of productivity spillover effects from foreign to local companies. It allows workers to change their employers and move from one firm to another. In our case study, labor mobility is negatively affected by the unique economic structure that limits the transmission of spillover effects between companies. Analysis shows that the dominance of the public sector over the small, weak and somewhat ineffective private sector, together with preference of local human capital to work in public sector jobs for job security and fiscal incentives, creates a tendency among nationals not to learn new knowledge and skills. Moreover, local private firms are dominated by expatriates, who are typically employed on short-term contracts and so do not stay in the country for long. Such peculiarity limits the effect of labor mobility in transmitting productivity spillovers from foreign to Omani firms. Analysis also shows that foreign firms contribute to this negative outcome due to their high wages, which incentivize citizens to move from local to foreign firms for better wages and social status [30,31]. In fact, survey data records mobility in the opposite direction, but with a higher mean of 3.98, with 19.8 per cent strongly agree and 64.4 per cent agree that workers move from local to foreign firms, than that recorded for workers moving from foreign to local firms, which stood only at a mean 3.23.

**Business linkage:** Data analysis shows that the majority of policy makers and business leaders agree that business linkages exist but are not strong in our case study. Survey data and interviews underscore a reasonable level of business linkages, particularly backward linkages with suppliers, as foreign firms prefer to concentrate on their core activities and transfer their non-essential business to local firms. The executive of the joint venture Bahwan Exel labels this type of linkage as “complementary”; this is complemented by the executive of the local firm Oman Food Investment Holding Co., who argues that “the exposure by local firms and the linkage sought will improve the way local enterprises do their business”. Surprisingly, when asked about their satisfaction with existing business linkages, local firms expressed their dissatisfaction with the level of linkages because there are fewer linkages within a small scope with foreign companies (interview with the executive of the local manufacturing Poly Products LLC.). Meanwhile, foreign executives argue that the extent of linkages is not strong because local firms do not have sufficient capacity in terms

of knowledge, skills and experience to engage with large foreign operations (interview with the director of the foreign manufacturing firm Safety Industries) [32,33].

Nonetheless, survey data stresses that business linkages are prerequisites for spillovers and are beneficial for Omani firms, even if there are no spillovers. Although backward and forward linkages exist on a small scale due to limited absorptive capacity of Omani firms, data identify the importance of skills spillover (mean 4.40), technology linkage (mean 4.34), marketing techniques (mean 4.36), and managerial spillover (mean 4.11) as essential for effective linkages. Data also confirm the existence of indirect linkage with local firms covering demonstration effect and labor mobility that has a mean 3.98, with 11.5 per cent strongly agree and 77 per cent agree of the existence of this type of linkage. It also acknowledges the existence of direct forward linkage with local customers for supply of inputs, marketing and distribution at a mean 3.93, with 11 per cent strongly agree, and 74 per cent agree of the importance of this linkage. Such data underline the potential for Omani firms to increase backward linkages by realizing that most foreign firms have incentives to provide technical assistance to and share knowledge with their local firms, particularly suppliers in order to improve the quality of their supply chain.

**Demonstration effects:** As the transfer of technology, knowledge, techniques, practices and skills, characterizes inward investment, one would expect greater potential of spillover effects to Omani companies through observation and imitation. Analysis shows that this factor is not as effective as one would expect because the majority of local firms are small and do not have the minimum requirement to learn effectively from their foreign counterparts. Supply chain manager of Occidental of Oman argues that “spillovers depend on the ability of domestic firms to learn ... the stronger and bigger the more they can learn ... [and] local companies need to improve their own absorptive capacity”. The majority of interviewees condition the capacity of Omani firms to increase their productivity through this channel to (1) upgrading their technological and operating methods close to that of foreign firms; and (2) existence of some degree of similarity in the work practice and the goods produced in order for demonstration to take place and be effective. Survey data, however, show positive opinion on this channel, as 11.5 per cent of respondents strongly agree and 75 per cent agree that local firms learn through observation and imitation of their foreign counterparts by adopting their technology, marketing techniques, and changing their products to local condition and needs. In addition, 38.5 per cent strongly agree and 45.5 per cent agree that local firms make efforts in terms of demonstrating new technologies and training workers in order to master the new technology. Despite such efforts, this factor remains a challenge for most local firms [34-36].

## Conclusion

This study examines the relationship between inward investment and productivity spillovers in the context of Arab Gulf countries. The analysis fills a significant gap in literature as it provides new insights and knowledge on the relationship between the two variables in countries with unique economic structure, where the government controls most economic activities, the private sector is very small, and local human resources are not effectively engaged in domestic firms. It validates the hypothesis that the peculiarity of economic structure and the quality of public institutions of host country are responsible for facilitating or hindering the transmission of spillover effects from inward investment to local companies. The case study of Oman underlines a negative relationship between the economic structure that is dependent on oil

and gas and distribution of inward investment outside this sector; and between the imbalance in the size and capacity of the public and private sectors and the low absorptive capacity of private sector companies that receive little support from the government.

The study also underscores the role of the state in increasing the levels of productivity of local firms through the creation of appropriate public institutions and specialized bodies, with the aim of maximizing spillover effects from inward investment to their local firms. The findings suggest that the impact of inward investment on the productivity of domestic firms is limited due to passive government role in developing and implementing effective investment policies that could strengthen absorptive capacity of local firms, hence increasing their productivity. Although most discussions on inward investment and productivity has been examined from the international business perspective, this study finds strong correlations between the organizational structure and size of public institutions dealing with foreign investment and the levels of productivity spillovers from inward investments. Our case study confirms this, while placing greater responsibility on the state in developing specialized institutions with clear mandates for effective transmission of productivity spillover effects from foreign firms to local ones.

## References

- Hertog S (2010) Benchmarking SME Policies in the GCC: A survey of challenges and opportunities. A research report for the EU-GCC Chamber Forum project.
- Hertog S, Luciani G, Valeri M (2013) The Politics of Business in the Middle East After the Arab Spring, Hurst.
- Hvidt M (2013) Economic Diversification in GCC Countries: Past Record and Future Trends, Research Paper, Kuwait Programme on Development, Governance and Globalisation in the Gulf States. SDU 27: 51.
- Blomström M, Kokko A, Globerman S (1999) The Determinants of Host Country Spillovers from Foreign Direct Investment: Review and Synthesis of the Literature. *Inward Investment Technological Change and Growth*, pp: 34-65.
- Caves ER (1999) Spillovers from multinationals in developing countries: the mechanisms at work. University of Michigan, USA.
- Fry MJ (1992) Foreign Direct Investment in a Macroeconomic Framework: Finance, Efficiency, Incentives and Distortions. PRE Working Paper, Washington DC: the World Bank.
- Borensztein E, Gregorio J, Lee J (1998) How Does Foreign Direct Investment Affect Economic Growth? *Journal of International Economics* 45: 115-135.
- Moran TH (1998) Foreign Direct Investment and Development: The New policy Agenda for Developing Countries and Economies in Transition. Institute for International Economics, Washington, DC.
- De Mello L (1999) Foreign direct investment led growth: Evidence from time series and panel data. *Oxford Economic Papers* 51: 133-151.
- Buckley P, Wangb C, Clegg J (2007) The impact of foreign ownership, local ownership and industry characteristics on spillover benefits from foreign direct investment in China. Centre for International Business, *International Business Review* 16: 142-158.
- De Backer K, Sleuwaegen L (2003) Firm Productivity and Efficiency: Real or Apparent Differences between Domestic Firms and Foreign Multinational Firms? DTEW Working Paper, Katholieke Universiteit Leuven.
- Aitken BJ, Harrison AE (1999) Do Domestic Firms Benefit from Direct Foreign Investment? Evidence from Venezuela. *The American Economic Review* 89: 605-618.
- Kokko A (1994) Technology, Market characteristics, and spillovers. *Journal of Development Economics* 43: 279-293.
- Javorcik SB (2004) Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages, *American Economic Review* 94: 605-627.
- Meyer K, Sinani E (2008) Spillovers from Foreign Direct Investment: A Meta-analysis. Department of Economics, University of Reading, England.
- Gorg H, Greenaway D (2004) Much ado about nothing? Do domestic firms really benefit from foreign direct investment? *World Bank Research Observer* 19: 171-198.
- Bhagwati JN (1978) Anatomy and Consequences of Exchange Control Regime. *Studies in International Economic Relations*, pp: 219-221.
- Saggi K (2000) Trade, Foreign Direct Investment, and International Technology Transfer: A Survey. World Bank Group.
- Lipsey RE (2002) Home and Host Country Effects of FDI. National Bureau of Economic Research, Cambridge, Mass, pp: 40-47.
- Blomström M, Kokko A (1998) Multinational Corporations and Spillovers. *Journal of Economic Survey* 12: 1-31.
- Navaretti GB, Venables AJ (2004) Multinational Firms in the World Economy. Princeton University Press.
- Sadik A, Bolbol A (2001) Capital Flows, FDI, and Technology Spillovers: Evidence from Arab Countries. *World Development* 29: 2111-2125.
- Hussein MA (2009) Impact of foreign direct investment on economic growth in the Gulf Cooperation Council countries. *International Review of Business Research Papers* 3: 362-376.
- Mishrif A, Al-Naamani S (2017) Regional Integration, the Private Sector and Diversification in the GCC Countries. In: Ashraf Mishrif, Yousuf Al-Balushi editors. *Economic Diversification in the Gulf Region: The Private Sector as an Engine of Growth*, Palgrave Macmillan, New York and Singapore.
- Abdul Basher S, Fachin S (2011) The Long-Run Relationship Between Savings and Investment in Oil-Exporting Developing Countries: A Case Study of the Gulf Arab States. Qatar Central Bank.
- World Bank (2017) Doing Business Regional Profile 2017: Arab World. Washington D.C.
- UNCTAD (2012) World Investment Report 2012: Towards a New Generation of Investment Policies. New York and Geneva: UN.
- Ministry of Commerce and Industry (2012) Annual Industry Report 2011, Muscat, Oman.
- Mishrif A (2010) Investing in the Middle East: The Political Economy of European Direct Investment in Egypt. Tauris Academic Studies, London and New York.
- UNCTAD (2015) World Investment Report 2015: Reforming International Investment Governance. UN, New York and Geneva.
- World Bank (2009) From Privilege to Competition Unlocking Private-Led Growth in the Middle East and North Africa. Mena Development Report, Washington D.C.
- Chatham House (2014) Elusive Employment: Development Planning and Labour Market Trends in Oman. Royal Institute of International Affairs, London.
- Cohen S (2006) Multinational Corporations and Foreign Direct Investment, Oxford University Press.
- Crespo N, Fontoura MP (2007) Determinant Factors of FDI Spillovers – What Do We Really Know? *World Development* 35: 410-425.
- Görg H, Strobel E (2004) Spillovers from Foreign Firms through Worker Mobility: An Empirical Investigation. *Scandinavian Journal of Economics* 107: 693-709.
- UNCTAD (2011) World Investment Report 2011: Non-Equity Modes of International Production and Development. UN, New York and Geneva.