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Increasing 'local content' in infrastructure procurement. Part I

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The funding invested in infrastructure construction in low-income countries (particularly the countries of sub-Saharan Africa) does not benefit contractors, suppliers and workers from those countries as much as it might. Increasing the input of local labour, goods and services could make a major contribution to economic growth and the achievement of the millennium development goals. This paper aims to show policymakers that expanding the local content of infrastructure construction is an achievable objective and to provide practical guidance on how to do it. Based on an extensive literature search, this paper (Part I of a double paper) shows that the procurement process can serve as a powerful tool to promote local content in infrastructure construction. However, a number of challenges are identified, notably the preference of clients, donors, engineers and the business community for expensive, high-tech and large-scale projects that are not within the capability of the local industry, as well as the failure of international agencies to balance objectives. In Part 2 of this work, some suggestions are put forward for overcoming the challenges and promoting specific policy objectives through minor changes to the procurement process.

1. INTRODUCTION

It is now widely accepted that sustained economic growth is necessary for alleviation of poverty and achievement of the United Nations (UN) millennium development goals (MDGs). However, the extent of poverty reduction will depend upon the degree to which the poor participate in the growth process and share in its proceeds. Increasing the input of local labour, goods and services (local content) in infrastructure construction could make a major contribution to economic growth. At the same time it would open up opportunities for the poor to participate in the growth process through the creation of jobs in the construction and supply industries.

Building capacity and promoting local content in the delivery of infrastructure projects should therefore be a high priority for many low-income countries, particularly those of sub-Saharan Africa. However, few countries have a clear policy for the promotion of local content in infrastructure construction; those that do often have difficulty implementing it. The paper is directed primarily at least developed countries, most of which are in sub-Saharan Africa. It has two objectives

- (a) to show policymakers that expanding the local content of infrastructure projects is an achievable objective with real long-term benefits
- (b) to provide practical guidance to assist governments to achieve this through actions at various stages of the procurement cycle.

Part 1 of this double paper focuses on promoting local content as a policy objective and addresses the following questions.

- (a) What is meant by local content?
- (b) Why is it important to promote local content in African construction?
- (c) Why is it necessary to use procurement to achieve this?
- (d) What are the key challenges?

Part 2 (Wells and Hawkins, 2010) will provide options to address the challenges and achieve specific policy objectives of

- (a) increasing employment throughout the construction supply chain
- (b) increasing work for local contractors
- (c) creating market openings for locally produced materials and components.

While any of the proposed actions may be adopted on any individual projects, together they constitute the elements of a national policy for promoting local content in public construction procurement.

2. POLICY ISSUES

2.1. What is meant by local content?

Local content is a recognised term in the oil and gas industry. It can be defined in terms of the ownership and/or location of enterprises involved in production and/or the value added in the production process. Local content in infrastructure construction is taken here to include the involvement of local enterprises and labour in planning, design and construction services, as well as the local added value in transactions occurring throughout a contractor's supply chain. Local in this context is understood to mean national, but it could be defined to mean any geographic or administrative area. Infrastructure is defined to mean the physical assets needed for the delivery of a service, rather than the provision of the service. Procurement is broadly defined to encompass all stages from the identification of need to the delivery and subsequent maintenance of the asset (Figure 1).

It should be noted that promoting local content is not the same as capacity building, although there is a relationship between

Figure 1. Stages of the procurement cycle

them and this is often reciprocal. For example, buying from local enterprises is one of the most effective means of building their capacity, while building the capacity of local enterprises (e.g. by training) can enhance their ability to bid and win contracts.

2.2. Why is it important to promote local content in infrastructure construction?

Currently, much of the funding invested in infrastructure in low-income countries does not benefit contractors and suppliers from these countries. An analysis of World Bank funded projects in 1998 and 1999 showed that foreign construction firms dominate in developing country markets (UNCTAD, 2000a). This is particularly so in sub-Saharan Africa. The African Development Bank (ADB, 2006) reported less than 40% by value of new works contracts were awarded to companies from the subcontinent in 2006; this figure includes contracts awarded to international firms (notably from China) that have set up offices in African countries.

Foreign companies winning contracts in low-income countries often bring managers, supervisors and skilled labour with them or may source these categories of workers internationally. Materials and components are also sourced from the home country of the contractor or on the global market. There is little information available on the supply chains of contracting companies, but recent studies of Chinese contractors working in Africa reveal that they generally source materials, components and equipment from China (CCS, 2006; Chen and Orr, 2009). Clearly, sourcing materials from overseas limits opportunities for local firms to win contracts and also restricts the opportunities for local labour to gain employment in the construction materials industries.

Procuring services and goods from local contractors and suppliers will bring immediate benefits to low-income economies. These include increased employment opportunities for local people on the construction site and throughout the

contractor's supply chain. Employment offers an important route out of poverty. The process of constructing, operating and maintaining infrastructure facilities can generate very significant opportunities for the generation of employment and there is a broad consensus for maximising these opportunities. In October 2007, Ministers of Labour and Public Works from 11 southern African countries issued a statement in which they committed to support the creation of appropriate policies, institutions and tools to ensure that the employment intensity of infrastructure investment is increased to its full potential (ILO, 2007).

Procuring locally would also create opportunities for local businesses as consultants, contractors, subcontractors, producers or suppliers of material and equipment for the local construction industry. The development of local industry, embodying enhanced knowledge and skills, is essential for the maintenance of infrastructure assets. Maintenance is a long-neglected issue. Estache (2006) estimated that the investment needed to maintain existing assets in sub-Saharan Africa (at 4% of gross domestic product (GDP)) is almost as high as the investment needed for new infrastructure projects to meet the MDGs. Reliance on foreign enterprises to design and construct facilities often means they are not sustainable as the expertise may no longer be available once the construction is complete. As noted by Taylor *et al.* (1999: p. 173), 'in the developing world, any procurement process which fosters or reinforces dependencies must be regarded as inconsistent with the principle of sustainability'.

In summary, the possible longer-term development outcomes from a concerted attempt to increase the local content of infrastructure projects include poverty reduction, inclusive economic growth and more sustainable infrastructure. The immediate and long-term benefits are illustrated in Figure 2.

2.3. Why is it necessary to use procurement to achieve this?

While there may be widespread agreement with a policy of supporting the participation of local producers in the supply of infrastructure assets, questions are raised about the role of procurement in the process. The view is often expressed that assistance to local industries should be on the supply side, and that procurement policies should be 'neutral' in terms of promoting development. However, current demand-side policies are not neutral and, as a consequence, the playing field is not level.

2.3.1. Creating a level playing field. To create a level playing field where the local construction industry can compete on equal terms with foreign competitors, the following policy issues have to be resolved.

- (a) The continued tying of bilateral assistance to developing countries to the purchase of goods and services from the donor country. A survey by the Organisation for Economic Co-operation and Development (OECD, 2006) found that 25% of aid to 34 participating countries was tied. One of the worst offenders was the USA with only 7% of their aid untied. This is despite the recommendation of the OECD's development assistance committee (OECD/DAC) in 2001 to untie aid and the efforts of some donors to promote this as a key objective

under the Paris declaration. The entry of China (whose aid is generally tied) into African infrastructure funding in recent years has further increased the problem (Chen and Orr, 2009). Even when aid is not tied, donor country firms involved in the provision of design services often specify their own national suppliers and products (Hillebrandt, 2006). It has been suggested that using procurement to promote local content and technology transfer to developing countries could be one way of offsetting the adverse effects of tied aid (UNCTAD, 2000a).

- (b) The difficulties encountered by local enterprises, many of which are small, in accessing the public procurement market; these include the high fixed costs of access (regulation and prequalification costs), the high costs of tender information and the policy of 'bundling' contracts, which favours large firms and financial constraints (ITC, 2000). The most critical constraint to local construction firms winning contracts is lack of access to capital, particularly working capital. One of the key advantages of Chinese contractors in construction markets in Africa in recent years is their ready access to cheap finance from state-owned banks (CCS, 2006).
- (c) Fiscal policies that disadvantage local suppliers. For example, foreign companies often benefit from tax concessions on imported materials and equipment – concessions that are denied to domestic contractors, particularly in construction. In a recent study in Ghana, contractors complained of having to pay import duties and VAT on metal formwork imported from Spain, while foreign contractors were able to import such items duty free (McDonald, 2008).

The above factors combine to ensure that providers of construction services from the least developed countries are often unable to compete for projects in their own home markets (UNCTAD, 2000b). In addition, there are significant barriers to trade in construction services that prevent firms from developing countries gaining access to more developed country markets (UNCTAD, 2007). While supply-side assistance is also needed, the fact remains that lack of access to markets is the most critical factor inhibiting the development and growth of many small producers.

2.3.2. Tilting the playing field to favour the weaker side. Until the above issues are satisfactorily addressed, enterprises from developing countries are at a disadvantage compared with international competitors. It has been argued that when one side is seriously weaker than the other, the playing field needs to be tilted to favour the weaker (Chang, 2008). In implicit recognition of this fact, many international agencies support the idea of using procurement as a tool to develop local industries through the offer of special incentives to local enterprises – in effect tilting the playing field.

For example, UN agencies have advocated increased sourcing of goods and services from developing countries in order to reduce poverty and secure maximum development impact. They have also introduced a number of capacity building initiatives to bring this about. There is general agreement with the idea of increased sourcing from the very countries the aid agencies are there to assist. As noted by van de Grondon *et al.* (2007: p. 170)

By sourcing locally or regionally the procurement function itself is able to become a mechanism of development assistance, in that it provides institutional investment in local or regional businesses by contracting with them.

In support of this policy, the Model Law of the UN commission on international trade law (UNCITRAL, 1994) (upon which many developing countries are basing their procurement laws) allows the use of procurement as an industrial policy instrument and states that preferences at the evaluation stage for industrial development purposes are within the rules (Arrowsmith *et al.*, 2000). Guidance on the Model Law (UNCITRAL, 1994) states

The Model Law recognises that enacting states may wish in some cases to restrict foreign participation with a view in particular to protecting certain vital economic sectors of their national industrial capacity against deleterious effects of foreign competition.

The multilateral development banks (MDBs) also appear to support this approach (World Bank, 2006a). Four basic principles guide their procurement requirements

- (a) *economy and efficiency* in the procurement of goods, works and services
- (b) *fairness* (giving eligible bidders a fair opportunity to compete)
- (c) *development* (encouraging the development of suppliers in borrowing countries)
- (d) *transparency* in the procurement process.

For the purposes of this paper, the most significant of these is the third principle. To encourage the development of domestic industries, MDBs permit borrowers to give preference to bids offering goods manufactured within the borrowing country and countries below a specified threshold of per capita GDP are allowed to give preference to bids for works contracts from eligible domestic contractors.

The World Trade Organization government procurement agreement (GPA) (WTO, 1996), a pluri-lateral agreement with the objective of achieving greater liberalisation and expansion of world trade, also recognises the need for developing countries to promote the establishment or development of domestic industries, including the development of small-scale and cottage industries, as well as economic development of other sectors of the economy (Fenster, 2007). Special terms allow developing countries to enter the GPA while retaining this right. However, no country in Africa is party to the GPA and no African country is negotiating accession. It is, in fact, hard to see what they would gain from reciprocal negotiated agreements in public procurement markets, as their markets are essentially already open to foreign companies.

2.3.3. Historical evidence of tilting the playing field. The use of public purchasing to support strategic industries (including construction) has been consistently pursued by most developed countries and a good number of developing countries. The best-known example is the US 'Buy America' policy. Under the 'Buy America' Act (1933) and subsequent legislation, the basic legal requirement on federal purchasers is that materials, supplies, articles or (since 1990) services that are acquired for public use should be substantially American (McCrudden, 2007). In 2005, 94% of payments made by the Federal Government went to companies located in the USA (UNCTAD, 2007: p. 80).

Among developing countries, India stands out as having promoted local, small and public sector enterprises in its procurement policies over many years (ITC, 2000). These policies have resulted in a high local content in the procurement of infrastructure. It is estimated that 100% of inputs to water and rural road projects and 75% of inputs to power projects are local. In China, procurement regulations require that government shall buy nationally unless the required goods, construction or services are not available or cannot be acquired on reasonable commercial terms and conditions (Wang, 2004).

The successful use of public purchasing to support the development of a national construction industry is demonstrated in the case of Singapore. Thirty years ago, the local construction industry in Singapore was seriously underdeveloped. Now, local firms are represented in all classes and are fully competitive in their own home market, as well as winning a substantial number of projects overseas. A recent investigation of the factors responsible for the development of Singaporean contractors found that public sector clients played a key role (Ofori and Lean, 2001). For many years, the housing and development board has offered bidding preferences to firms with good performance records, as well as a pre-financing loans scheme. Contractors were asked to rank ten factors in order of importance in furthering their development. Top in the overall ranking was 'government's attempt to improve the industry's operating environment' and this was followed by 'public sector client's help' and 'government's financial incentives'. In fifth place was ranked 'private client's help'. This shows very clearly the importance of demand-side issues for developing construction industries.

2.4. What are the key challenges?

2.4.1. Tension between conflicting interests. In low-income countries a high proportion of infrastructure investment is donor funded. A major challenge to the promotion of local content in procurement is the need to resolve conflicts of interest that may occur within and/or between donor and beneficiary governments. Governments play many roles as clients, regulators, policymakers, etc. While the agreed long-term policy goal may be to increase local sourcing, the preference of clients for expensive imported products and the desire of donor governments to promote their own exports, as well as a tendency to rely on standard engineering solutions, can lead to over-designed systems that local industries are unable to build or maintain (World Bank, 2006b). In this example the short-term interests of clients and donors come into conflict with the longer-term development objective.

2.4.2. Failure to balance objectives. The MDBs play a key role in the funding of infrastructure projects in low-income countries. Despite recognising the need to balance local development with other procurement objectives, the MDB procedures for the appointment of contractors generally insist on international competitive bidding (ICB) and acceptance of the lowest evaluated price bid. These are very different from the criteria for the appointment of consultants, which are based primarily on quality. In the appointment of contractors, the World Bank specifically does not allow any evaluation criteria other than price and the capability and resources of the bidders to undertake the contract (World Bank, 2006a). With the tender process led by price, the technical component of the bid is often weak and objectives such as developing the local economy are

overlooked. The World Bank also prohibits any mandatory requirement that foreign firms enter into joint ventures with local firms and any restrictions on the sources of labour and materials except for unskilled labour in the contracting country. (The World Bank's criteria for assessing country procurement systems are available via the internet (World Bank, 2010).)

Many low-income countries are currently reforming their procurement regulations and procedures under the direction of the World Bank. The requirements of MDBs for open tender in the appointment of contractors and acceptance of the lowest evaluated price bid have been passed on, together with many other restrictions, as a central plank of these procurement reforms. While recognising the desire to enforce strict rules where few previously existed, the insistence that developing countries fully open their markets may restrict their ability to take advantage of opportunities to use procurement as an industrial policy instrument. It also clearly weakens their bargaining position in multilateral trade talks (Bull *et al.*, 2006). It is for this reason that there is little interest in joining the GPA from African countries.

2.4.3. Knowledge issues. A further challenge lies in the fact that the procurement of works is generally regulated and implemented alongside the procurement of goods. However, the processes involved are very different. The procurement of works involves very long pre- and post-bid stages crossing several technical areas. These include project preparation (pre-bid) and contract management (post-bid), both of which are within the body of knowledge of built environment professionals. A strong case may be made for dealing with the two areas of procurement separately. At the very least it is important to recognise that different skill sets are needed for procuring construction services to those needed for procuring goods and that expertise is needed in both.

Procurement officials may also not be aware of social or economic development needs. Procurement is often still seen as an administrative function in which compliance with regulations is the most valued performance criterion (Harland *et al.*, 2004). For this reason, it may be appropriate for governments to develop and disseminate guidelines on how to incorporate local content policies into procurement decisions. Some suggestions are presented in Part 2 of this paper.

3. CONCLUSIONS

It has been argued that more could be done to ensure that the funds invested in infrastructure in low-income countries benefit contractors, suppliers and workers from those countries. Increasing local content in the construction and maintenance of infrastructure would generate income and employment locally, and contribute to economic growth and poverty reduction. The use of procurement to achieve this objective is supported by international agencies and has been practised by a number of countries over many years. However, the ability of some of the poorest countries to use procurement to support development is currently constrained by conflicting interests among donor and beneficiary governments, the failure of international agencies to balance objectives and lack of knowledge among procurement officials.

The current focus of donors is on strengthening country procurement systems. At the same time, donors should recognise that building local capacity is a valid objective and

should support countries that are seriously trying to do this. Donors and/or their developing country partners may wish to explore opportunities to deliver more positive development outcomes, while still observing fairness, transparency, economy and efficiency in procurement.

While recognising that there are very real capacity constraints, Part 2 of this paper shows that there are a number of ways to promote the objectives of generating local employment, promoting local enterprises and developing the capacity of the local supply chain without necessarily sacrificing on cost or quality. This can be done without any major changes to procurement policies or contravening international procurement rules. The suggestions include actions at earlier stages of the procurement cycle.

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