

## **The political economy of local content in African extractives: lessons from three African countries**

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**Abstract:** *Extractive foreign direct investment (FDI) is heralded as the new development opportunity in Africa. But extractive FDI has a record of producing enclaves in host countries with few linkages to the local economy. Only if it creates local content will extractive FDI become a catalyst of development. This paper analyses the trajectories of local content policies and practices in three African countries – Tanzania, Uganda and Mozambique. We argue that we cannot understand the dynamics and outcomes of local content policies in African extractives without understanding how local content has become ingrained in ruling coalitions’ rent-seeking and maintenance activities in the three countries. We discuss the consequences of evolving local content practices for political patronage.*

## **Introduction**

Extractives are considered the new development opportunity for Africa (UNECA, 2013; AEO, 2013; UNCTAD, 2013).<sup>1</sup> To exploit these resources, Africa needs foreign direct investment by extractive multinational companies (MNCs) as Africa lacks the technology, expertise and market access that is needed to capitalize on natural resource endowments. Africa has seen a massive surge in extractives FDI over the past decade, during which 60% of all FDI being invested in Africa has been in natural resource extraction (AEO 2013).<sup>2</sup> This FDI offers potentially huge development opportunities: extractive FDI may generate government revenue and export income and more broadly create jobs and income. Indirectly, extractive FDI may facilitate economic growth through trickle-down effects and may spur employment and income generation in agriculture, industry and services through linkages and spillovers (Jourdan 2008; Morris et al. 2011a).

Several reports from international organizations and researchers have recently focused on how extractive MNCs can be induced to link up to African host economies (UNCTAD, 2010; UNECA, 2013; Kaplinsky and Farooki, 2011; Morrissey, 2012; Buur et al 2013; Altenburg, 2013; Hansen,

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<sup>1</sup> In this paper our focus is big investments in energy (oil, gas and coal) and minerals. This is a subset of extractive industries involved in natural resource sectors, which also include production related to land (i.e. forestry, agriculture) and to fisheries. See Morris et al. (2011a: 8) for a recent classification.

<sup>2</sup> For resource-rich countries investments were even higher. Alone during the 2000s three quarters of all FDI in Africa went to the resource-rich countries (African Development Bank, 2013: 47), up from two thirds in the 1990s (Arbache et al. 2008: 73).

2014). It is argued that a key condition for more inclusive FDI is that foreign extractive investors foster broad and deep linkages with the host economy through local sourcing of functions and activities, the training and guidance of local firms, Corporate Social Responsibility (CSR) programmes, and engagement in local capacity building (see UNCTAD 2005, 2010; AEO 2013). By fostering such linkages, extractive MNCs may not only spur job creation and upgrades both upstream and downstream in the extractive industries; they may also create broader spillovers in other industries, for example in the form of demonstration and competition effects (Morrissey 2012) and may thereby promote industrial diversification. Ultimately, linkages in extractives may assist industrial development and economic transformation by developing skills and capabilities in local manufacturing and service sectors (UNECA 2013).

Of all the aspects of linkages, local content - understood as the extent to which MNCs purchase inputs and services locally – has become a disputed aspect, both in the literature on FDI and empirically. While taxation and royalties are still the focus of much debate, local content has now also become a battleground of extractive-based development. Across Africa, governments are introducing local content measures in legislation and concessions, and MNCs and local economic entrepreneurs are struggling to meet growing demands for local content. In this article, we focus on the dynamics of local content development: what has been attempted so far, and what shapes these practices? In our analysis we highlight key lessons from case studies of local content practices in three East African countries: Tanzania, Uganda and Mozambique.

Our argument has three intertwined parts. First, we argue that the literature with an economic perspective on local content correctly suggests that low absorption capacity by domestic economic entrepreneurs hinders linkage formation. But that problem is more than a technical issue, which could have easily been rectified. The real problem is that ruling elites have little incentive to support linkage development for domestic economic entrepreneurs if they are without much political importance for the survival of the ruling elites. Instead, ruling elites protect and engage with domestic economic entrepreneurs who have already captured the local content markets, because this is where rents can be extracted from entrepreneurs in support of elite political survival strategies. Secondly, we argue that while low institutional capacity and governance (including corruption), are indeed important problems, they are not really the real

issue. Few societies have a 'pure' or perfectly functioning institutional governance setup across all sectors. Such problems would be solved if implementation of industrial policies for linkage development actually mattered for the ruling elites. Then they would ensure that 'pockets of institutional and governance efficiency' would be created and supported. Finally, we argue that an appreciation of how deeply local content has become ingrained in ruling coalitions' rent-seeking and maintenance activities in the three countries is the key to understanding the dynamics and outcomes of local content policies in African extractives.

We start out by explaining what local content is. We then move on to contrast economic and political economy perspectives on local content. In the empirical part we present three case analyses of local content dynamics in Africa in light of the economic and political economy perspectives outlined. The concluding section highlights key findings emerging from the analysis and suggests possible future research avenues.

## **What is local content?**

Local content is the extent to which foreign producers of goods and services procure inputs in the form of goods and services from the local economy. In the case of extractives, this can be inputs at different stages of the investment cycle (prospecting, feasibility phase, establishment, operations and decommissioning) and it can be inputs of different kinds (engineering services, maintenance, equipment, catering, security, transport, training, etc.). Local content in extractive operations ranges from almost zero in some developing countries to an average of 45-75% in more advanced resource-rich economies (Ado, 2013).

MNCs create local content as part of their sourcing strategies and in response to public policy. As has previously been the case with manufacturing and services, natural resource extraction has recently witnessed a profound international disintegration of value chains (Morris et al. 2011b). This disintegration, which some refer to as 'outsourcing', takes place to reduce costs, spread risks, obtain the benefits of specialization and tap into the resources and capabilities of other firms (BSR 2011; Singh and Bourgoignie, 2013). Hence, we have seen a significant restructuring of extractive MNCs where they simultaneously focus on core activities such as management, finance and technology and at the same time shed non-core activities such as prospecting, operation, catering,

transport, HRM, etc. As the boundaries for outsourcing in the industry expand, so the value of MNCs' procurement increases (UNCTAD 2005; Urzua 2007; Mjimba 2011).<sup>3</sup>

Governments across the world can promote local content in various ways. Local content policy is particularly widespread in industries such as defence, wind turbines, automobiles, oil and gas and, more recently, the mining and construction industries. The issue of local content has, as Ado (2013) reports, become increasingly important and developing countries have introduced a tide of local content requirements and rules in recent years, indicating a significant change in policy toward more restrictive approaches to foreign investors (UNCTAD, 2013). Across Africa, mining codes and oil and gas concessions contain more or less elaborate provisions for local ownership, hiring and procurement, all aimed at mitigating the inherent enclave nature of much extractive activity (Todaro, 2013). Among the measures employed to create local content are rules stipulating percentages for local procurements; tariffs, taxes and pricing aimed at facilitating local content; licensing and concessions dependent on ability to create local content; local firm reservations for certain inputs and services; requirements on service provision, etc. (Hufbauer et al, 2013). Local content can be promoted both *directly* and *indirectly*.

Indirect measures focus on activities to enhance the competitiveness of local supply industries such as supplier development programmes, and information dissemination (UNCTAD, 2010). Direct measures include import tariffs, local content requirements in general legislation and specific concessions. These can be restrictive measures such as percentage limits on imports, mandated local suppliers, and penalties if local content is not achieved; or facilitating measures like subsidies for local content, supplier development programmes and improvements to infrastructure. Local content policy is very much a question of finding a balance between restricting and facilitating measures. Being too restrictive may raise input costs (or undermine quality) to an extent where the investment is rendered unprofitable. Too much subsidy without enforcement may lead to waste of scarce public funds and limit the transfer of technology and capabilities.

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<sup>3</sup> While local content is typically part of the procurement function of MNCs, it is sometimes construed as CSR; as ways of involving local communities and being a good corporate citizen in the various locations they operate. This article will not deal with this kind of local content provision.

## **Perspectives on local content**

Much of the academic literature on local content is based on economic logic: the point is to ensure that rents from foreign-controlled extractive operations stay in the host country<sup>4</sup> so as to promote local economic development and produce spillovers from extractives to other industries. However, there is another perspective on local content that focuses not on economic welfare and efficiency but on political economy and the processes in which these practices are ingrained. Below we contrast the economic and political economy perspectives on local content with a view to developing a conceptual framework that can guide the subsequent analysis of local content practices in Mozambique, Tanzania and Uganda.

### **The economics of local content**

In parallel with the growing interests in local content measures, a burgeoning economic literature has emerged that focuses on the conditions and effects of local content in African extractives and how it should be promoted (see Morrissey (2012); Kazzazi and Nouri (2012) and Hansen (2014) for overviews). Liberal trade economists generally view local content measures as welfare reducing as they distort trade and FDI (Grossman 1981; Ado 2010). Warner (2010) argues that local content rules may significantly affect MNCs' net present value (NPV) calculation and internal rate of return (IRR) and that local content requirements will eventually reduce overall trade and FDI. A recent conservative estimate suggests that local content requirements of all countries affect 2% of global trade across all sectors and reduce it by USD 93 billion annually (Warner 2010; Hufbauer et al, 2013). Furthermore, it is argued that local content requirements may be harmful to the local investment climate as they fundamentally alter the competitiveness of domestic players over foreign players, thus potentially leading to economic inefficiencies.

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<sup>4</sup> Rents are payment to a factor of production in excess of its opportunity costs i.e. beyond normal profits. Rents can be obtained by the firms involved in the activity (e.g. if they have monopoly) or they can be obtained by external stakeholders such as governments, employees, politicians and bureaucrats. Rents can be obtained through legal means such as tariffs, taxation, royalties and contracts, but they can also be syphoned through means such as protected monopsonies, monopolies, favoritism and corruption (see Khan 2000a; 2000b; Kaplinsky 2005 and for local content see for example Altenburg and Melia, 2014).

However, proponents argue that local content, when designed the right way, will support local industrial development through the difficult transition phase from hitherto protected economies toward economies integrated in the global economy. The collateral effects of FDI – so called spillover effects – may lead to upgrading and learning of local industries by exposing them to global competition and standards (Morrissey, 2012). Proponents of local content point to the fact that most advanced countries, while in the early stages of their industrial development, employed protective measures including local content (Chang, 2002; Whitfield et al. 2015). According to this logic, local content can assist the development of weak local industries, facilitate technology transfers and thereby close the huge technology gap between many of these countries and the more developed countries. This furthermore potentially increases domestic production and job creation. The justification for such measures is that infant industries need to be protected and that the market power of MNCs needs to be curbed or ‘directed’ towards developing linkages. Ado (2013) summarizes the argument in favour of local content succinctly as being related to 1. Protecting infant industry; 2. Curbing market power of foreign industry vis-a-vis local industry; 3. Providing social compensation to and working in harmony with local communities suffering the environmental and social costs of exploitation; and 4. Protection of strategic sectors.

Economists are well aware that local content requires some fairly demanding conditions to be fulfilled to succeed. In particular three factors are emphasized by the literature: 1. Appropriate policies; 2. Appropriate institutions; 3. Local industry capability.

### ***Appropriate policies***

Local content rules can be quite demanding and should therefore be introduced in a transparent and gradual manner that allows local and foreign firms to adapt. Often, local content policies focus on placing demands on foreign investors rather than on developing the technological, commercial, organizational and absorptive capacity of local industry and/or the local business environment required for local content (Hufbauer, 2013). Moreover, rules should treat investors equally to avoid distorting competition and should not (as is often the case) be introduced ex post and in an arbitrary manner that ignores the time horizon of local content investments. It is also a problem that local content rules are often formulated as intentions and vague objectives so that investors become uncertain because of regulators’ high level of discretion. As local content rules may have large hidden costs (e.g. in the form of foregone investments) or visible costs (e.g. in the form of tax

exemptions and subsidies), it is vital that they are subjected to rigorous cost benefit analysis, something that is rarely done (Todaro, 2013) - or done due to the ex post and arbitrary manner in which rules are often implemented.

### ***Appropriate institutions***

From a classic economic perspective local content arises from a contract-based market exchange between two private entities. To succeed, this requires institutions to facilitate and support contracts, including institutions that can reduce information asymmetries (e.g. providing information about quality and skills of local suppliers); reduce monitoring costs (e.g. transparent accounting and reporting rules); and reduce costs of contract enforcement (e.g. efficient courts and judicial procedures). As the contractual environment throughout much of Africa is generally extremely weak (e.g. measured through doing business indicators), extractive MNCs and their local content activities are often poorly monitored so that local content activities essentially become 'window dressing' (Buur et al 2013).

### ***Local industrial capability***

From an economic perspective, it is not enough to have the right policies and the right institutions in place. (Diyamat, 2011; Hufbauer, 2013). If there is no local industry, local content does not make sense. Hence, local content policy needs to take into account the actual state of local industry as well as provide measures for developing local industrial capacity. The problem in large parts of Africa is partly that capable local supply industries are virtually non-existent and partly that the technology and organizational gap, in respect to MNCs, is too large to bridge. Due to that gap local firms are typically only able to make inputs requiring low technological and organizational skills such as catering, transport and security. The weak local capacity implies that developing local content in the best of cases would be a very long-term process (Amendolaigne et al. 2013; Merlevede et al. 2011).

### **The politics of local content**

Classic economic perspectives on local content focus on efficiency and welfare maximization. Deviations from efficient policies lead to welfare loss. Thus, failure to benefit from local content policies will be due to the fact that policies deviate from the Pareto optimality. Governments need to adopt the right kind of policies and make sure that the conditions for local content to succeed



are in place, including institutions to back the policies up and making sure that local industry has the capabilities required to link up to foreign MNCs. However, a competing understanding views local content through the lens of politics. It focuses on the institutions through which politics is conducted in African resource-rich countries and the relationship between political and economic elites of African societies (see Khan 2010; Whitfield et al. 2015).

A political economy along these lines related to local content focuses on the way rents are used by patrons to satisfy and to award clients and thereby maintain power (Buur 2014; Altenburg and Meia 2014; Altenburg 2011; Whitfield et al. 2015). Rents are important because what sets most African countries apart from other developing countries is the lack of African domestic capitalists who can formally fund the political system through taxes (Khan 2010; Whitfield et al. 2015). As Whitfield et al. (2015 Introduction) argues: “the small size and limited capabilities of black African capitalists, and the fact that they did not dominate the key exporting sectors of the economy, shaped the political settlement in ways that took on path dependent trajectories in the post-independence period”.<sup>5</sup> This predicament has had important consequences for how patron-client relationships operate and rents are generated. The fact that the total production and productivity in most developing countries is extremely low has the important implication that the formal economy cannot sustain their political settlements. Only a fraction of domestic production is taxed because much of the economy is outside the ‘formal’ capitalist sector. Hence, political settlements must be achieved through other means.

A political settlement approach as promulgated by Whitfield et al. (2015) focuses on two cardinal axes of analysis: the first axis is the structure of the ruling coalition supporting the elite in power and how contested it is internally and in relation to excluded factions; the second axis is the relative political influence and capabilities of domestic capitalists. A stable political settlement distributes rents and access to resources to actors in ways that do not threaten political stability and fuel violence by excluding powerful factions.

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<sup>5</sup> ‘Political settlement’ is shorthand for the set of institutions and power relations that characterize social order in a particular country, and that create benefits for different classes and groups in society in line with their relative power (Khan 2010). At any particular point in time, the political settlement reflects a kind of equilibrium, as the distribution of benefits reinforces the distribution of power in society. Contestations about rents are intense because the formal economy alone cannot fund the ruling coalitions.

Ruling coalitions in African countries are typically fragmented and are striving to maintain power through patronage organized both through the formal state budget and informal means. So the appropriation and allocation of rents is usually crucial for regime survival as system maintenance and consolidation depends, to a large degree, on its ability to distribute rents to constituencies. The informal and rent-based nature of political settlements thus complicates the targeting of local content provisions based on mutual interests between the political leaders and domestic economic entrepreneurs and makes it difficult to enforce their implementation. Political elites get their funding and revenues from the largest firms (often between 3-400 larger firms like in Uganda and Tanzania, see Therkildsen forthcoming) related to the banking, telecom and trader import/export sectors, where the most important sources of political financing are generated in and around politically protected monopolies.

Local content rules in such situations are used by ruling elites – assisted by bureaucrats loyal to them - as instruments to maintain power by awarding contracts, jobs and opportunities to financiers of the ruling coalitions, rather than promoting development of local enterprises by SMEs. In other words, contracts to local firms tend to be awarded for the wrong reasons from an economic efficiency perspective. Actually, local content contracts are in many respects becoming the next frontier in rent-seeking activities in East Africa. Whereas taxation and royalty payments are subject to increasingly strict international rules and to pockets of local efficiencies (Lundstøl, 2012), local content remains a fairly unregulated arena, making it highly susceptible to the kind of rent seeking that underpins ruling elites' ability to maintain power. Elites use local content policies for maintaining legitimacy and building support in various ways: jobs created at local companies and in local communities become an asset that can be used to generate political benefits; and rents are acquired and distributed to consolidate the authority of ruling elites and to ensure their survival in power (see Buur et al. 2013). Due to the weak position of the local capitalist class, local content easily results in the promotion of inefficient and inexperienced but politically well-connected firms. Local content in these circumstances is unlikely to be pursued with a view to promoting economic efficiency.

So low absorption capacity by domestic economic entrepreneurs hinders linkage formation but not only because they have few capabilities; more importantly, we argue, because such

entrepreneurs have limited political importance the ruling elites have little motivation to support them and their linkage development. This has important implications for how we understand appropriate policies and institutions. Recent studies suggest that despite corruption, appropriate policies are developed and institutional capacity indeed is created when it matters for the ruling elites and their political survival. Generally, tax authorities, Investment Promoting Agencies (Pitcher 2012) and petroleum institutes (in East African countries) (Buur et al. 2013.) have been set up and function well throughout Africa as revenues and investments matters to political elites. The real issue is that if implementation of industrial policies for linkage development mattered for the ruling elites then 'pockets' of institutional and governance efficiency would be created and supported.

In sum, the economic perspective points to the importance of measures to promote local content and improve local industrial capacity, whereas the political economy perspective points to the likelihood of such measures being captured by patrons for political purposes.

### **The dynamics of local content in three African countries**

We move now to illustrate some of these points by analysing local content policies in Tanzania, Uganda and Mozambique. We first examine the nature and success of local content practices in the three countries and then discuss how these practices can be understood.

#### **The surge in extractive FDI**

All three countries have seen a huge surge in extractive FDI. Historically, large investments in gold and uranium have been undertaken. More recently, coal, nickel and iron have attracted FDI. Most attention has been devoted to recent discoveries of huge offshore natural gas reserves off Mozambique and Tanzania, as well as oil in Uganda and Kenya. These are pulling mega-investments to East Africa, which have raised rent expectations as well as hopes for reaping the spoils of linkage formation in the form of job creation, technology transfer and industrial upgrading.

In all three countries, it has been of paramount importance that the mistakes of previous rounds of extractive FDI are not repeated. In Tanzania, the perception is that the country saw too few benefits from the first round of extractive FDI, which took place from the mid-1990s in the wake of

the Structural Adjustment Program liberalizations in the 1980s. Moreover, tax breaks and ambiguous and unfocused local content policies left too few lasting development benefits from extractive FDI, which amounted to more than USD 1.1 billion in 2012, (the highest in East Africa). These investments were overwhelmingly in gold, diamonds, nickel, uranium, coal, iron and natural gas. The Tanzanian government is determined that the coming round of extractive FDI in sectors such as gas, iron and coal will be better aligned with Tanzania's development objectives and the country is formally improving its mining codes and legislations accordingly (Hansen 2014).

Mozambique's history of natural resource extraction is more recent than Tanzania's. In addition to hydroelectricity, the country is endowed with an abundance of important minerals and natural resources including gas, coal, gold, titanium, ilmenite, zircon, rutile, marble and a variety of precious stones and other metals. From 1997 until 2009, mega-projects (aluminum, heavy sand, coal and gas) have generated FDI inflows amounting to approximately USD 8.4 billion (USAID, 2012: vii) and they have created a very different dynamic with regard to SME development than the Tanzanian gold investments did (see Buur et al., 2013). This, however, pales in relation to future investments in gas and liquefied natural gas (LNG) facilities, which are expected to exceed USD 50 billion over the next 10 years (Ledesma, 2013; Besseling, 2013). Mozambique is now expected to become one of the world's largest producers of LNG aimed at the Asian growth markets. Based on estimates that the discoveries hold at least 100 trillion cubic feet of natural gas, Anadarko (USA), together with ENI (Italian state company), are currently in the process of designing facilities involving at least two on-shore LNG 'trains', with the capacity to expand to ten trains (NORAD, 2012: 13; Ledesma, 2013; Besseling, 2013).

In Uganda, there is some mining, and oil has been explored since 2006. The government has signed production sharing agreements with three large companies: French Total, British Tullow, and the state-owned Chinese company CNOOC. They expect to start pumping the first oil around 2017. Expectations among both Ugandan citizens and the government about future revenues and subsequent national wealth are high. In its national development plan, the government expresses its wish to use oil revenue for the benefit of economic diversification, technology upgrading and general development. The government has also focused on local content provision.

## **Local content policies and programmes**

In Mozambique, new legislation for gas and coal is being developed and new tax regimes have also been approved (including an as yet unenforced capital gains tax (CIP 2013)) , but so far no local content or technology transfer clauses have been directly proposed. However, measures for local industry development have been adopted. Following in the slipstream of mega-investments since the mid-1990s and the attempt at creating linkages related to the MOZAL aluminium smelter, Mozambique has developed an organisational and institutional setup for SME development. The most important of these, at least by name, are the “Industrial Policy and Strategy” from 2007 and the related “Strategy for the Development of Small and Medium Size Enterprises in Mozambique” from the same year (Krause and Kaufman 2011: 29).

Generally, the Tanzanian FDI and mining legislation has adopted a liberal approach to foreign investors, with few formal restrictions related to ownership and local content. But the government is currently revising legislation for minerals, FDI and oil and gas in order to ensure much more local content and technology transfer, e.g. through local content requirements and supplier development programmes. According to the 1998 Mining Act, certain parts of the exploration cycle are reserved for companies that are solely owned by Tanzanian citizens. Second, there are provisions to promote backward and forward linkages. The 2010 Mining Act further stipulates that MNCs seeking prospecting and mining licenses are expected to draw up lists of goods and services that can be provided by local firms. Moreover, there are provisions to facilitate the establishment of training institutions to develop industry-supporting skills, as well as to encourage foreign investors to contribute to the development of skills and capabilities. However, it is noticeable that there are no mandatory provisions for the creation of backward and forward linkages in the Tanzanian legislation. The existing provisions are vague and non-binding, and the process of forming linkages is largely left to market forces (Mjimba, 2011; UNECA, 2013).

In Uganda, policies for local linkage formation are recent and the extractives industry is relatively narrow. The policy framework for local linkage formation can be considered to be in place. The National Oil and Gas policy of 2008 sets the broad framework. In line with the overall Vision 2040, the goal is to use Uganda’s oil resources to reduce poverty and promote the country’s socioeconomic transformation. Some of the sub-objectives of this overall goal are to ensure national participation in oil and gas activities and to enhance the development of Ugandan citizens

with skills to participate in the oil investments. To enact the policy, there are different bills, laws and acts. The most relevant bill for local content is the Petroleum Exploration, Development and Production Bill (2012), in which there are no provisions for mandatory linkages or indications of percentages of local content. However, a number of requirements are listed. For example, license applicants need to come up with plans for local employment and training, as well as proposals for the procurement of goods and services in Uganda (RoU, 2012: 20).

### **Challenges of local content**

While there is no doubt that consideration of local content has been growing in the three countries, the measures adopted are still rudimentary and they are being implemented in a context that makes their success illusive.

If the hallmarks of good industrial policies are targeting, prioritizing and enforcing conditions for productivity, then the policy and strategies adopted in Mozambique are rather vague. The industrial policy suggests that “the Government does not want to ‘miss anything’” (Krause and Kaufman 2011: 28) and the African Peer Review Mechanism (APRM 2009: 165) specifically lambasted the lost opportunity for providing clear strategic guidance on how such investment could be used to boost economic development in the future. The Mozambican SME strategy, in contrast, was elaborated by external consultants, with donor assistance and some consultation with the Confederation of Economic Associations, as well as the Ministry for Trade and Industry. While defining priorities and objectives for SME development and proposing a certain sequencing of actions with the establishment in 2008 of an Institute for the Promotion of Small and Medium-sized Enterprises (IPEMA), the strategy does not seem to have had much impact so far (Krause and Kaufman 2011: 30). IPEMA is supposed to drive the implementation of the SME strategy, but it relies largely on external funding. Interestingly, donor organisations, while supportive of IPEMA, have largely continued to focus on running, establishing or renewing their own organisations and institutional linkage programs such as the World Bank “Project for Entrepreneurial Development” (PODE), which operates its own matching grant scheme for co-financing training sessions, consultancies and export promotion, and is keen on linking Mozambican enterprises to present mega-investments. In 2009 the Bank added the “New Mozambique Competitiveness and Private Sector Development Project”, whose USD 25 million budget is far bigger than the budget of IPEMA.

Part of the problem of local content promotion in Mozambique is related to the underdeveloped private sector. The enterprise structure is highly skewed, consisting of: 1.) a few big enterprises, in part owned by foreign capital and in part by the state or members or close affiliates of the Frelimo top elite; 2.) a few formally registered SMEs owned by both foreign and domestic capital that have had little clustering effect; and 3.) a large stratum of informal micro-enterprises (sometimes referred to as SSMEs) owned by domestic entrepreneurs, which make up 98.6 % of all enterprises (Krause and Kaufman 2011: 13-14; Sutton 2014). The skewed nature of the enterprise structure characterised by the 'missing middle' of SMEs, which are of little political and economic interest to the ruling political elite, has severe consequences for linking up to the present wave of mega-investments in natural resources. These offer few prospects for growth for micro-businesses and very limited intra- and inter-firm and sector linkages with strategic clustering and networking. The SMEs that have emerged as part of mega-investment linkage programmes have more often than not been new enterprises established for that purpose by the political elite or persons closely related to the ruling elite, so the space for the few competitive formal SMEs who can qualify as the business partners of mega-investments is extremely limited (da Costa 2012). As a consequence most of the 'local inputs' – backward linkages created - are provided by foreign firms and service providers that have become localised by operating through local firms or having a Mozambican partner as a local figurehead.

Tanzania has been unsuccessful in its attempts to foster linkages between foreign firms and local industry. While the growing FDI inflows have offered many benefits to Tanzanian development in terms of exports and technology transfer, Tanzania has not been able to reap the full potential of these investments, and linkages in extractives remain weak and shallow where backward linkages are usually provided by foreign firms and service providers (Hansen, 2014). The largest FDI sector is in gold mining, which has failed to produce broad and deep local horizontal and vertical linkages and local jobs. In their pursuit of greater efficiency, reduced costs, risk diversification and asset augmentation, MNCs are indeed fostering many linkages with supplier and service providers, although these are mainly foreign firms. The high standards required provide prohibitive entry barriers for a local industry that rarely has the capacity or the strategic vision to contract with extractive MNCs.

The reasons for the lack of linkages are numerous. Most importantly, the mining regulation lacks the specific targets, monitoring mechanisms, incentives and sanctions needed to reach the overall development objectives related to dealing with the weak local industry capacity (Mjimba, 2011). This is because those that should be protected and targeted by providing specific rent opportunities are of little importance to the survival of the ruling CCM coalition. There is therefore little interest in dealing with the problems related to the institutional environment surrounding extractive FDI. This in turn has serious repercussions for how FDIs engage with potential domestic linkage partners and undermines efforts to form linkages with local industry as it constrains the development of viable local supplier firms (Perkins and Robbins 2011). It furthermore renders contract-based collaborations between MNCs and local firms difficult to establish and maintain due to uncertain and inefficient contract enforcement. The industry structure in Tanzania is, as in Mozambique, characterized by a 'missing middle,' that is, very few SME enterprises. Instead Tanzania is dominated by informal micro-enterprises and a handful of relatively large conglomerates that are politically well connected and well protected behind tariff and non-tariff entry barriers.

In Uganda, as with the other two countries, much of the challenge lies in weak local capacity. In Uganda manufacturing has grown, but from a very low level – in 2010 it accounted for 8.5 % of GDP, not much higher than the level achieved in 1960. Manufacturing is overwhelmingly characterized by informal small enterprises with very few employees and low levels of technology. Interviews with representatives of government, multinationals and local companies clearly showed that there was a lack of local capacity in Uganda and that it would be very difficult to implement specific requirements of local content, for example a rule that there should be fifty per cent of local equity, which had been debated in parliament but not enacted. A recent report commissioned by Uganda's Petroleum Department estimates the share of total foreign investment in the petroleum sector that is retained in Uganda (and therefore can be used as a proxy for local content in service etc.) to be around 14 per cent (RoU, 2011b). This suggests that local inputs are more often than not provided by foreign firms and service providers. Indeed, so far there have been few successful initiatives to promote local capacity or transform the economy (Kjær and Katusiimeh, 2012). Infrastructure remains highly inadequate, and the challenges the emerging oil industry faces will be on the implementation side, especially with regard to the big gap between



what the foreign companies demand and the local ones supply (Shepherd, 2013). Hence, so far there has been no effective industrial policy (Kjær 2013). The worry on the part of the oil companies is that they may not be free to choose the best sub-contractors because, according to the Petroleum Exploration, Development and Production Bill, the Minister can decide to withdraw or refuse to issue a license for the sub-contractor (interview, Total, June, 2013).

### **The political economy of local content**

An important explanation of why local content policies and practices often fail to be implemented in the three countries is that they become mired in political processes in general and the ruling coalitions' pursuit of power in particular.

In Mozambique, key Frelimo elites have been known to win contracts as a way of making sure that economic opportunities are restricted to a fraction of members of Frelimo and don't benefit or assist opposition forces (Weimer et al. 2012). This includes the capture of the local content market in services and linkages by Frelimo members closely related to the governing coalition of President Guebuza. The capture has created a series of monopolies that has blocked further development of an SME base that MNCs can link up to since the mid-2000s (Buur 2014). So while the emerging extractive economy is on a scale far exceeding anything experienced so far, the Frelimo ruling elites, are positioning themselves to control and benefit from it exclusively. The SMEs that were created during the first generation of linkage programmes in Mozambique in connection with MOZAL (Castel-Branco and Goldin 2003; Krause and Kaufman 2011), as well as the various companies aligned to the Frelimo elite that emerged after the liberalisation of the economy during the early 1990s, often in joint ventures with foreign companies, have 'captured' the local content market in services and linkages.

This created bottlenecks around 'point resources' and key service domains related to consultancies, transport, finance and currency, and import and export (Buur 2014). These bottlenecks have also been monopolized by Frelimo elites and trade houses that operate in cartels and monopsonies. While this form of 'linkage patronage' initially allows the MNCs to become linked into the political elite it also becomes costly over time as the lack of competition drives up operational costs (Buur 2014). In fact as a result some investors recently began to divest their

interests (Rio Tinto in coal and Statoil in gas), but this simply made space for Asian investors to take up the still lucrative assets.

In Tanzania, the organization of power around the CCM has consistently been able to deliver stability and legitimacy, while being less successful in creating the conditions for the development of productive sectors (see e.g. Therkildsen, 2011; Therkildsen and Bourgoignie, 2012; Cooksey, 2011b). This stability can be explained with reference to the ability of the government to form coalitions of the major interests within the ruling party, as well as coalitions with major social interests (Therkildsen, 2011; Therkildsen and Bourgoignie, 2012). However, while the government has promoted stability, it has also, as demonstrated above, been unsuccessful in promoting linkage development in Tanzania. One reason is that the interests of private enterprises have been weakly represented in the political process. This is partly related to the ethnic dominance of Tanzanians of Indian and Arab origin in the formal private sector, which has made the government (out of ideological reasons) unwilling or unable to adopt private sector-friendly policies in the past (Therkildsen and Bourgoignie, 2012). A second reason is related to the survival of a dirigiste mindset from the post-independence Ujamaa period, which still plays a large role in political thinking, if not rhetorically, then in practice. Cooksey (2011b) argues that there is “a ‘control mentality’ among government officials, lack of empathy for business needs, deficiencies in the legal system and pervasive corruption”. Many fear, ahead of the mega-investments, that contracts will be awarded to clients of the political elite rather than to the most effective and qualified firms, and that linkages will be captured by political interests that will use them to reward supporters, buy off opponents or generate funds for re-election. While it cannot be documented that ruling elites are awarding themselves contracts, Cooksey (2011a) reports on widespread rent-seeking, capture and corruption in the earlier Tanzanian gold-mining management. However, he also observes that these seem to be a largely un-coordinated activity and that it is difficult to find evidence that political elites use gold-mining rents for political patronage or that the rent-seeking activity is organized at the central level.

In Uganda, where oil is not yet being pumped, there has been great controversy over the recent Petroleum Exploration, Development and Production Bill, one indication of the general fear that potential benefits from the oil sector will be disproportionately accessed by members of the ruling

elite (Kjær, 2013). During the process of drafting the bill, the power to negotiate, grant and revoke licenses in the oil sector (to all main contracts and sub-contractors) was given to an independent authority. However, this was changed on the president's initiative and placed in the hands of the relevant minister, something which is widely interpreted as being an indicator that the ruling elite will be able to decide who gets licenses. There are already examples of ruling elites benefiting from linkage activities in the oil sector. For example, the president's younger brothers' private security company has provided most of the guards in the oil area. A loyal ruling party member is director of a new training institute in the petroleum sector. Some opposition members go as far as to say that oil in Uganda is a 'Museveni family business.' (*The Observer*, Dec 11, 2012: "We lost oil vote but not the war"). As a concerned employee in one of the multinational oil companies said: "What do I do if the supplier I have chosen because it is the best company is overruled by the minister and he forces me to use a bad company?" The general experience of elite use of public resources as patronage thus helps create general anxiety about the usage of oil resources (Tangri and Mwenda, 2013).

## **Discussion**

As demonstrated above, in all three countries, local content has moved to the fore of economic development debates as huge mineral, oil and gas deposits have been opened for exploration. In all three countries, programmes to ensure local content have been introduced. But in all three countries we also see how local content policies have failed to deliver on their promises so far. Policies have at best created shallow local linkages and linkages to local 'middlemen' and seem to lead to much more expensive, and at the same time less reliable, local inputs. Much of the so-called local inputs are in fact inputs provided by foreign firms and service providers, sometimes disguised as local firms by having a local figurehead. Where local content exists, it is mainly local firms delivering at inflated prices. Little or no upgrading of local firms seems to take place and the capabilities developed do not lead to the development of new activities. The welfare loss from ineffective or captured local content practices is difficult to estimate, but there is no doubt that costs in terms of foregone investments, waste and diversion of rents to unproductive purposes is substantial. This diagnosis from Uganda, Tanzania and Mozambique essentially reflects experiences from most other sub-Saharan countries, except maybe Botswana and South Africa

(Kaplinsky and Farooki, 2011; Hansen, 2013; Buur et al 2013); local content has proven ineffective and has at best produced shallow linkages with little industrial development potential.

This begs the question of why these countries seem destined to fail in creating local content, and thus, in a broader sense, to mobilize extractive FDI for industrial development. Here we presented two competing interpretations, an economic and a political. From an economic point of view the diagnosis is clear and solutions are straightforward: the problems are ill-conceived policies, institutional failures and lack of local industrial capability. Governments should focus on improving the contractual environment, and develop higher transparency in the local content area. In a longer-term perspective, governments should invest in developing local supply industries and absorptive capacity through training and education programs and other supplier development activities.

We argue that it is too simplistic to diagnose the apparent inefficient local content practices as a technical problem that can easily be rectified. Local content cannot meaningfully be analysed solely in terms of economic and institutional efficiency. We also need to analyse local content policies and practices as functions of internal political dynamics in African states and to understand that political outcomes of local content practices are as important as economic outcomes. The political perspective leads us to see that local content is part of the rent-seeking, legitimization and maintenance activities of ruling coalitions, and is generally becoming a key ingredient in patronage. In fact, we argue that the abovementioned reforms and measures to improve the efficiency of local content are at odds with the internal political dynamics of these countries. This may explain what puzzles many outside observers, namely why African governments simply do not implement the right policies to benefit from extractive FDI.

The reason is that the economic and institutional efficiency logic is intertwined with the political logic related to the political survival of the ruling elites. Where pursuit of economic efficiency would dictate open tenders, these are not taking place, because processes that cannot be controlled by them would prevent elites from generating rents from the allocation of contracts. This was already seen during the first phase of local content development related to the MOZAL smelter in Mozambique, where all evaluations point to local content contracts being based on political interference. Moreover, open tenders may allow rents to be redistributed to groups

unrelated to the ruling elite, allowing for competing centers of power to emerge that may eventually challenge the positions of ruling elites. This was seen in Mozambique, where the opposition to Frelimo so far has evolved in and around the Beira (central) and Nampula (northern) transport corridors (see Weimer et al. 2012).

Where pursuit of economic efficiency would tie local content to world market prices (allowing for a premium on local produce), such measures are not implemented. If local firms were, indeed, competitive, this could significantly reduce the rent seeking related to local content and increase the long-term benefits significantly. The pursuit of economic efficiency would dictate long-term investments in the development of technological and organizational capabilities of local supply industries, but such investments, as we have suggested, are not undertaken because such measures would not be seen as benefiting ruling elites in the short term and could even, in the long term, pose a threat to established positions. Instead, quasi-monopolistic positions are awarded to politically well-connected trade and economic houses. Everything that moves economic transactions outside the political sphere will be at best ignored, at worst resented.

The political perspective offers us what at first can be seen as two partly competing interpretations of local content practices. On the one hand, political dynamics of system maintenance and legitimization may explain why local content is becoming such a salient policy area in the three countries. On the other hand, the lack of domestic entrepreneurial classes may explain why local content is mainly confined to political elites and not to the broader economy.

Being one of the unregulated spoils of extractive development, local content is becoming a key arena of rent-seeking activity, especially as other arenas of rent seeking are becoming increasingly constrained (e.g. because aid funds are being reduced or because tax policies are becoming professionalized and institutionalized). Especially in Africa's client-patron based forms of polities, local content offers new opportunities for patrons to allocate rents to their key financing constituencies as part of securing their own survival. Hence, even though the African local content practices appear economically defunct – as they either reward local entrepreneurs with weak (or no) capabilities, or more often reward economically expensive monopolies – still, they serve a political role that cannot be ignored. Any attempts to promote local content specifically and industrial policy generally must take into account the political realities of Africa.

Even though new opportunities in service delivery and local content provision are available from the present wave of mega-investments, and various investment promoting agencies and linkage mechanisms with funding behind them are trying to open up space for newcomers, the successes have so far been limited. This is not only because domestic capitalists have generally low capabilities, it is also because the SME entrepreneurs are politically weak. They are simply not part of the ruling elite. Any attempt at opening up the space for SME newcomers outside the ruling elites that have already been accommodated would require changing the present distribution of rent opportunities, and this is notoriously difficult (see Whitfield et al. 2015). This is both because ruling elites rely on the accumulation of rents and because they attempt to control the accumulation process and make sure accumulation stays within the ruling coalition and/or that accumulation among capitalists outside the ruling coalition does not undermine the political survival of the ruling elite. This strategy seems to be the one pursued by ruling elites in our three African countries.

## **Conclusion**

The question is what can be done to harness the development potential related to local content in a situation like this. Where the pursuit of economic efficiency would hold that an overhaul of the contractual environment would be the starting point of any reform, this will not happen because the present institutional environment offers rent-seeking opportunities for ruling elites in connection with the awarding of permits, contracts and jobs that form part of sustaining the ruling elites' survival.

The crux of the matter is that we know too little about how local content can be designed under such political circumstances and we know far too little about how different forms of politicization and patronage affect linkage development. It is a balancing act between ensuring that local content does not violate fundamental strategies of foreign investors such as the need to create efficiency and reliability, and making sure the focus is on building the capacity of local domestic industry capabilities. Close networks and relations between political and technocratic elites and international business are inevitable in countries with a very limited private sector and a recent history of state-led development. Furthermore, such relations may be the foundation for a greater ability in the future to manage the resources and build competitive local firms (see Niño and

Billion 2013). Or alternatively, such monopolisation could form the basis for future conflicts and the development of inefficient, resource-driven economies. It cannot be decided in advance which road will be taken. Nonetheless, one thing that is certain is that the tendency for linkage formation to be politicized and driven towards what we have called 'linkage patronage', with consequences for realizing the potential of linkages in extractives, seems to be persistent.

Overall we conclude that local content is becoming an important practice in African extractives, here analyzed through the lenses of three East African economies: Tanzania, Mozambique and Uganda. We also conclude that these countries have experienced and are facing huge problems in making local content work effectively. Experiences from many countries suggest that local content violates abstract notions of competition and efficiency. As shown in our three cases, the design of local content must take into account not only the industrial and economic context in which they are introduced, but also the political context.

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