UNITED
NATIONS

TD

United Nations Conference on Trade and Development

Distr.
GENERAL

TD/B/COM.3/75
26 January 2006

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Enterprise, Business Facilitation and Development
Tenth session
Geneva, 21–24 February 2006

PROMOTING TNC–SME LINKAGES TO ENHANCE THE PRODUCTIVE CAPACITY OF DEVELOPING COUNTRIES' FIRMS: A POLICY PERSPECTIVE

Issues note by the UNCTAD secretariat[*]

Executive summary

TNC–SME business linkages can be one of the fastest and most effective ways of upgrading domestic enterprises, facilitating the transfer of technology, knowledge and skills, improving business and management practices, and facilitating access to finance and markets. Strong linkages can promote production efficiency, productivity growth, technological and managerial capabilities and market diversification in local firms. The establishment of sustainable linkages, however, does not happen automatically as a direct consequence of the presence of TNCs, but requires the participation of all stakeholders: of Governments through supportive policies, as well as of TNCs and SMEs through their vision and commitment.

This issues note discusses what policy options are available and how an adequate policy framework could be set for the promotion of business linkages. The first section highlights the possibility for Governments to choose among different levels of policy intervention, according to the specific needs and conditions of each country. The second section deals with the need to adopt a systemic policy approach for linkages building, and with the implications of each type of relevant FDI or SME policy. The concluding section illustrates the preliminary findings of UNCTAD's research on best practices in the promotion of business linkages from a policy perspective.

[*] This document was submitted on the above-mentioned date as a result of processing delays.

Contents

I. INTRODUCTION

1. The São Paulo Consensus states that "an enabling international environment is essential for developing countries and economies in transition to integrate successfully into the world economy. Equally important is the need for these countries to build stronger supply capabilities responsive to market demands, promote technology development and transfer, encourage enterprise networking, increase productivity and improve the competitiveness of their enterprises" (para. 36).

2. During the most recent quadrennial work cycle (2000–2004), UNCTAD focused on issues related to how to increase the competitiveness of domestic firms in developing countries, in particular small and medium-sized enterprises (SMEs). The compendium entitled "Improving the Competitiveness of SMEs through Enhancing the Productive Capacity" (UNCTAD, 2005a) takes stock of the findings of a series of Expert Meetings organized on topics that are considered critical for SME growth, such as SME financing, technological upgrading, export competitiveness and local supplier development.

3. When inaugurating a new cycle of work in early 2005, the ninth session of the Commission on Enterprise, Business Facilitation and Development agreed that the internationalization of enterprises, especially SMEs, is an essential way to strengthen the competitiveness of developing country firms. This includes strategies addressing general structural weaknesses, but also specific measures to promote integrated forms of production and international distribution networks, such as SME–TNC linkages, clusters, global value chains and direct outward investment.

4. In developing countries, only a limited number of SMEs are well prepared for the new conditions and the increased competition of the global markets, and can thus benefit from globalization by directly investing abroad (UNCTAD, 2005b). Trade liberalization increases the ability of well-established foreign manufacturers and retailers to penetrate remote and underdeveloped markets, and makes it increasingly difficult for SMEs to survive or at least maintain their business position in the local and, if applicable, in the global market (UNCTAD, 2004).

5. An emerging opportunity to reap the potential benefits of global trade is represented by the integration of SMEs into international chains of production at various stages of added value, including through the establishment of linkages with larger firms and foreign affiliates. These linkages may represent the way for the SME sector, or at least for the segment of it with the highest growth potential, to access a series of critical missing resources, the most important of which are access to international markets, finance, technology, management skills and knowledge.

6. This is a major challenge for many developing countries, and both host and home country authorities have an essential role to play in making sure that mutually beneficial linkages are established: in broad terms, they can help to overcome information asymmetries, support SMEs' capacity to engage in linkages and encourage TNCs to engage in partnerships with SMEs (OECD, 2005). According to Lall (Lall, 1994), the development of local suppliers and subcontractors may generate a series of externalities (e.g. speed up the diffusion of technology, increase specialization and augment industrial flexibility); and this constitutes a valid case for promoting entire sets of related activities and policies.

7. This issues note has been prepared by the UNCTAD secretariat for the tenth session of the Commission. Its objective is to discuss what policy options are available for the promotion of business linkages and how the adequate policy framework could be set. It draws on a comprehensive synthesis report (Altenburg, 2005) and a series of country case studies on best practices in the promotion of business linkages, conducted in 2005 within the framework the GTZ–UNCTAD project entitled "Promoting Inter-firm Cooperation in the North-East of Brazil". The project is aimed at promoting the efficiency of the domestic enterprise sector through the creation and deepening of fair and sustainable business linkages between foreign affiliates and Brazilian transnational corporations (TNCs) and local SMEs.

8. The series of country case studies undertaken within UNCTAD's global survey include India (Narain, 2005), Malaysia (Rasiah, 2005), Mexico (Ruíz Durán, 2005), South Africa (Robbins, 2005) and Uganda (Zake et al., 2005), and will be published by UNCTAD in early 2006 (UNCTAD, forthcoming). They are aimed at identifying the underlying determinants of linkages formation and at better understanding under what circumstances the establishment of TNC–SMEs linkages becomes a key driver of economic growth and an effective channel for the transfer of foreign technology and knowledge. In particular, their ultimate goal is to identify effective strategies and policies aimed at exploiting TNC–SME linkages for the benefit of the host country.

9. This issues note is based on two main assumptions. First, the establishment of sustainable linkages does not happen automatically as a direct consequence of the presence of TNCs, but requires the participation of all stakeholders: of Governments through supportive policies, as well as of TNCs and SMEs through their vision and commitment. Secondly, the assessment of the effectiveness of targeted linkages promotion initiatives, and the identification of related best practices, cannot be done in an isolated manner, without understanding the underlying policy. Indeed, the main reasons for the success or failure of specific linkages promotion initiatives in a certain country can be totally misinterpreted if the full picture of the existing mix of relevant foreign direct investment (FDI) and SME related policies is not accurately drawn.

10. Thus, the central part of this issues note deals with the need to adopt a systemic policy approach for linkages building, and with the implications of each type of relevant FDI or SME policy. At the beginning, a more general section highlights the possibility for Governments to choose among different levels of policy intervention, according to the specific needs and conditions of each country, while a concluding section illustrates the preliminary findings of UNCTAD's research on best practices in the promotion of business linkages from a policy perspective.

II. DIFFERENT LEVELS OF POLICY INTERVENTION ON BUSINESS LINKAGES

11. It is widely acknowledged that the competitiveness and economic growth of developing countries largely depend on the ability of their industrial system to tap international sources of knowledge, and to absorb and use this knowledge in order to employ its resources more efficiently (Lall, 2002). Taking into account that the complexity of today’s patterns of global value chain integration is continuing to increase, and that barriers to entry in terms of capital, skills and technological infrastructure seem to be growing, many Governments and private sector representatives from developing countries agree that specific

institutions and selective industrial policies need to be set up to cope with the requirements of global integration.

12. However, some academics and practitioners challenge this view, indicating that industrial policies, especially if they are selective, "seem to be a gamble. The more ambitious the goal and the weaker the governance, the longer the odds of success. This suggests that selective interventions should be approached with caution" (World Bank, 2005). From this perspective, incentives aimed at encouraging investors seem to be more appropriate than compulsory measures, and it is argued that horizontal policies are better than highly selective instruments that benefit particular enterprises or subsectors.

13. Policies to promote business linkages can be considered an integral part of industrial policies, and as such can range from more passive initiatives, whereby existing foreign affiliates and domestic firms are matched and the process is facilitated, to an active engagement with targeting firms and subjecting linkages to specific conditions. The range of choices again depends on the overall economic and political objectives and the general level of economic development. A Government that wishes to support the development of specific industries with large learning spillovers might use a more targeted policy than a Government that primarily focuses on general economic improvement. Moreover, selective policies require a strong private sector where it is possible to choose "winners" that match the overall policy objectives.

14. According to the literature, there are four levels of policy intervention (figure 1*)*.

15. The *minimalist approach* focuses on the basic foundations of the investment climate, such as guaranteeing property rights, facilitating contract enforcement and removing administrative barriers to entry for investors. Domestic markets should be open up to FDI, and equal treatment for foreign and national investors should be ensured. It is expected that linkages will increase over time as the capabilities of the local entrepreneurs and workforce grow in an organic process of skill acquisition that does not necessarily require specific policy support (Moran, Graham and Blomström, 2005).

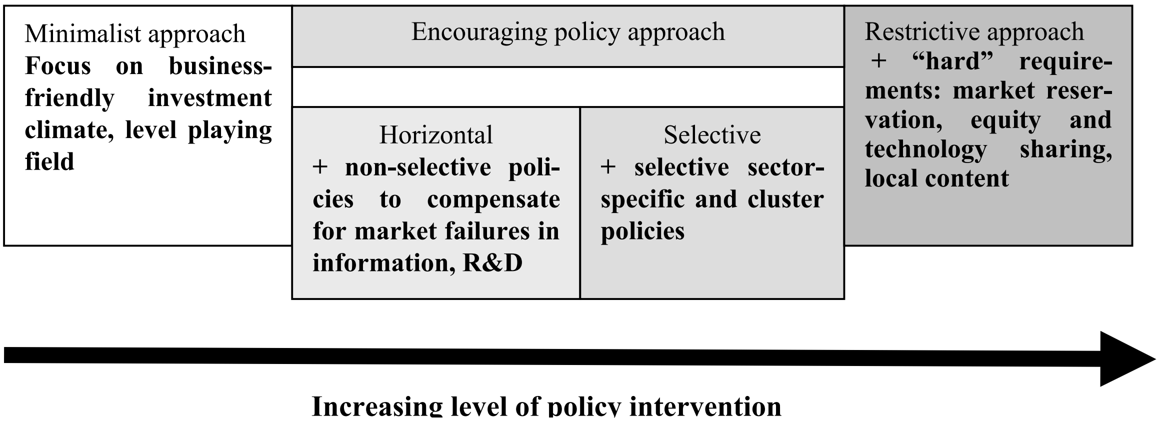
16. The *encouragement approach,* with a focus on *horizontal* policies, is slightly more interventionist, acknowledging the need to compensate for pervasive market failures. For example, SMEs may require specific support as they usually face many difficulties in accessing information and technology, with negative consequences not only for this group of firms but also for the nation's production system in general. According to this approach, however, policy interventions should be non-selective, for example offering credit guarantees or training and research and development (R&D) funds without differentiating among firms, regions or activities. Horizontal policies may also encourage TNC–SME linkage building. For example, subsidized credits to bridge the time lag between product delivery and payment by the customer ("factoring") may be helpful for small-scale contractors, who often face problems caused by delayed payments or unfavourable terms of payment.

17. Many industrialists advocate a more proactive *encouragement approach* that draws heavily on *selective* policies. This includes support for specific activities or groups of firms ("picking winners") that are considered to be of strategic importance. This strategic importance is mostly attributed to industries that are expected to create advantages in terms of innovation rents and technological spillovers (e.g. biotechnology or information and communication technology), and to promising clusters of firms. The idea is to invest in these emerging activities or clusters in order to enhance nascent industrial profiles, so as to reap

early mover advantages. Selective policies may, however, also be applied to achieve certain socio-political goals, for example the promotion of affirmative action.

18. While the previous approaches emphasize incentives to encourage investors to behave in a certain manner, the *restrictive approach* applies "hard" policy instruments such as market reservation for certain companies (e.g. SMEs, nationally owned companies or companies owned by certain ethnic groups) as well as requirements imposed on foreign investors with the aim of establishing a minimum national equity, certain local content, technology-sharing agreements or compulsory export targets (so-called trade-related investment measures).

Figure 1. Levels of increasing policy intervention



Source: Altenburg (2005).

19. It should be noted that compulsory "hard" policies of the last type are not in line with WTO stipulations and their scope is consequently largely reduced. Their abolition is partly due to their poor performance in most countries. Restrictive policies have shielded inefficient producers from (healthy) competition, and this has often led to decreasing international competitiveness and unproductive rent-seeking.

20. Some economists seem to consider domestic content requirement "to be an extremely useful and necessary tool from the point of view of developing countries" (Narain, 2005, p. 45). Others argue that "it is difficult to see how host countries that have FDI can tap its potential fully without such strategies as local content rules, incentives for deepening technologies and functions, inducements to export and so on (Lall and Narula, 2004), or that the abolition of trade-related investment measures is equivalent to "kicking away the ladder" for technological upgrading (Chang, 2004).

21. However, Governments do have possibilities to apply policies that contribute to linkage building. The following factors contribute to this:

- WTO rules do not prohibit all selective interventions, and some countries continue to impose certain restrictions on FDI. The Government of India, for example, has put a ceiling on foreign investment in infrastructure and other service sectors, including the retailing business (Narain, 2005).

- TNC operations usually require certain State commitments, for example specific “investments in infrastructure, tax incentives, financing through parastatal institutions and various forms of regulatory approval from environmental to business process approvals. It is these points of interaction that the South African government, for example, has used to ‘encourage’ TNCs to work with local businesses” (Robbins, 2005).

- Developing country Governments may take advantage of growing awareness in some industrialized countries of ethical business relationships in order to encourage TNCs to contribute to improved technology transfer (Robbins, 2005, p. 60).

- Bilateral and regional free trade agreements often stipulate differing regional trade rules. Countries thus have a choice whether they prefer more stringent or less stringent requirements in bilateral or regional trade negotiations. For example, regional trading blocs may agree on policies with regional content requirements (Ruíz Durán, 2005).

III. POLICY AREAS FOR LINKAGES BUILDING

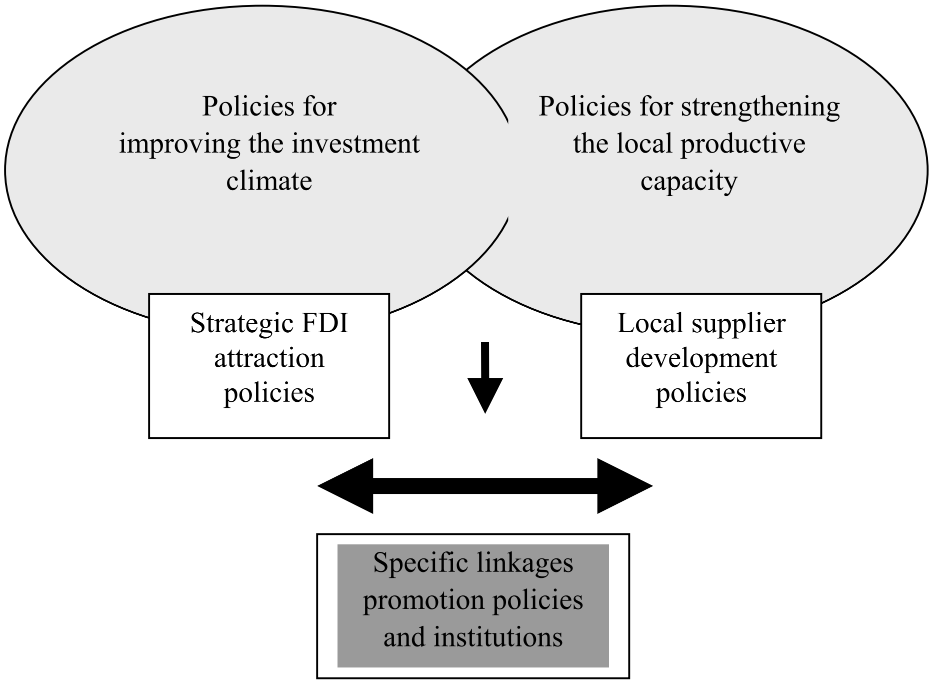
22. Four major policy areas can be distinguished that are especially relevant for building linkages: two of them are related to the FDI area (at a more general and a more specific level), and two are related to the SME area (also addressing a more general and a more specific level). As illustrated by figure 2, these are:

- "Improving the investment climate" and "attracting FDI strategically" on the FDI side; and

- "Strengthening the local absorptive capacity" and "developing domestic SME suppliers" on the SME side.

23. The promotion of business linkages is likely to be successful only if a systemic policy approach is adopted – that is, if all factors influencing linkages are targeted. The remaining question is then which agency or organization should focus on which area. Depending on the policy options chosen, the role of intermediary institutions such as business development services (BDS), investment promotion agencies (IPAs) and local economic development centres can and should also vary.

Figure 2. An analytical framework for the analysis of a systemic policy approach to linkages building



Source: based on a model presented by Altenburg (2005).

24. The following sections illustrate the main implications of the four relevant policy areas identified, and the way in which, if implemented in an integrated manner, they can be conducive to the creation of business linkages.

A. Improving the investment climate to facilitate business linkages

25. The literature on FDI places much emphasis on the relevance of a "conducive investment climate" as the basic precondition for foreign investment. There are many different definitions that assign similar structures to the investment climate present in a country, but all of them refer to external factors that the private sector faces for investment, or, ultimately, to the "institutions, policy, and regulatory environment in which the firm operates" (Dollar et al., 2003). The implicit assumption of such definitions is that the rule of law, equal treatment of local and foreign investors, low levels of corruption, simple administrative procedures and easy labour regulations constitute the key elements of a conducive investment climate and that governments willing to create it have to be aware of a number of key issues.

26. First, a stable and secure environment requires the clarification of land ownership and of other property rights, facilitation of contract enforcement, the reduction of crime and expropriation only with adequate compensation. Second, the improvement of the domestic regulation and taxation system, as well as of the regulation and taxation systems applied at the borders, is of concern to most business wanting to invest. Third, improving finance through establishing sound bank regulations, addressing information issues, strengthening creditor and shareholder rights and supporting the establishment and competition of

appropriate financial institutions support potential investors. Fourth, the provision of reliable and affordable infrastructure is a prerequisite for attracting investment.

27. A popular measure of the investment climate is the Index of Economic Freedom, which is published on an annual basis by the Heritage Foundation. According to this index, economic freedom is "the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself. When government coercion…starts interfering beyond the protection of person and property, it risks undermining economic freedom" (Heritage Foundation, 2005).

28. Indeed, the costs and risks of excessive or arbitrary government interference in markets may affect small informal businesses as much as (or even more than) foreign investors and large enterprises, because the former have less of a political voice, fewer possibilities to institute legal proceedings and the fewest internal resources to handle regulatory compliance burdens. For example, an empirical study carried out in eleven OECD countries found that administrative compliance costs per employee were over five times as high for the smallest SMEs than for the largest (OECD, 2005).

29. Heavy regulatory burdens and other constraints on private enterprises may therefore limit TNC–SME linkages in different ways:

(a) They may scare off foreign investors, both foreign and domestic. However, private investment as a share of gross domestic product (GDP) nearly doubled after China and India carried out investment climate reforms; in Uganda it more than doubled (World Bank, 2005).

(b) They may hold back the technological spillovers from FDI. For example, TNCs may not bring in their cutting-edge technology if the host country obliges them to take on a national business partner. In this respect, Rasiah (2005) emphasizes the detrimental effect of Malaysia's restrictive immigration policy on the country's prospects for making inroads in knowledge-intensive industries.

(c) They may create unnecessary entry barriers for new firms, thereby reducing competition and slowing down the turnover of firms that is crucial for productivity growth and competitiveness. Moreover, owners of SMEs often deliberately keep their business small and informal, partly to evade taxes, but also to escape bribery and arbitrary treatment by public servants. This, however, disqualifies them for most subcontracting relations with larger, formal enterprises.

Table 1. FDI inflows, Index of Economic Freedom and Ease of Doing Business Index for selected developing countries

Country	FDI inflows (million $) 2004	Index of Economic Freedom 2005, rank among 155 countries	Ease of Doing Business Index 2006, rank among 155 countries
China	60 630	112	91
Brazil	18 166	90	119
Mexico	16 602	63	73
India	5 335	118	116
Malaysia	4 624	70	21
South Africa	585	56	28
Uganda	237	74	72

Sources: UNCTAD FDI/TNC database (www.unctad.org/fdistatistics); Heritage Foundation/*Wall Street Journal*: 2005 Index of Economic Freedom; World Bank: Doing Business in 2004: Creating Jobs.

30. However, despite all this evidence and the plausibility of these arguments, high levels of economic freedom are not clearly correlated with high levels of foreign investment. Table 1 shows the levels of FDI inflows and positions in business climate rankings of the five countries represented in the UNCTAD survey as well as those of two other leading FDI recipients (China and Brazil). It shows for example that China, by far the leading destination for global FDI, only ranks 112th among 155 countries listed in the Index of Economic Freedom. Other leading FDI recipients also fare quite badly.

31. Obviously, with regard to attracting FDI, other factors are as important as, or even more important than, the level of regulation. Political stability, market size, economic growth, quality of infrastructure, technological capabilities, the overall level of education and the quality of the environment are other decisive factors. To achieve acceptable standards, for example with regard to health, safety, environmental protection and social cohesion, Governments set requirements whereby businesses and citizens have to comply with certain economically – and socially – desirable standards, and they often use a differentiated tax system as an incentive for compliance.

32. In general, countries that pursue a relatively proactive industrial and SME policy, thus interfering more in the allocation of private investment and therefore ranking low in the Economic Freedom Index, do not necessarily fare worse in terms of GDP growth and technological development than countries with a high level of "economic freedom" and minimalist FDI policies. In our country sample, India and Malaysia, for example, are clearly more successful in catching up with cutting-edge technological development than Mexico and South Africa, although the latter rank higher in terms of "economic freedom". Hence, it seems that deregulation and elimination of red tape are only part of the agenda.

B. Attracting FDI strategically

33. As argued earlier, global competition is increasingly dominated by TNCs, and these TNCs locate different functions of the respective value chains in different countries. At the

same time, most production lines are becoming much more knowledge-intensive and increasingly differentiated, and the different stages of the value chain turn out to be more complex. Each stage requires a different, often highly specific mix of production factors.

34. As new transport, information and communication technologies enable TNCs to separate and dislocate production processes, TNCs constantly rethink the complex matrix of price and innovation factors that guides their locational choices. From the point of view of developing countries, this new complexity makes the purposeful attraction of foreign investment that fits the national factor endowment and industrialization strategy a far more important, but also much more demanding, endeavour (Mytelka and Barclay, 2004).

35. Attracting FDI has become a key element of industrial policy in developing countries across the world. UNCTAD (1999, 2001) differentiates three generations of policies to attract investments: opening up to FDI; active marketing of a location through an investment promotion agency; and focused programmes to target specific subsets of TNCs.

36. Most countries have opened up their markets to FDI and guarantee equal treatment of national and foreign capital. India is one of the relatively few countries that still impose significant restrictions on foreign investors, but it is argued that substantial liberalization is very likely to occur within the next few years (Narain, 2005). Almost all countries have established IPAs to attract additional foreign investment. However, their budgets, the scope of activities and the quality of service differ significantly. Three differentiating aspects, described below, are especially worth highlighting.

37. Some countries use generous fiscal incentives to attract FDI. This applies especially to OECD member countries, but also to some large developing countries. The incentives include a reduction of standard income tax rates, tax holidays, accelerated depreciation, investment/reinvestment allowances and deductions from social security contributions. Brazil, for example, offered an incentive package worth $133,000 per job created for Renault and $340,000 for Mercedes-Benz, while India paid $420,000 in incentives per job to Ford (Mytelka and Barclay, 2004).

38. Most developing countries cannot participate in such costly locational tournaments. However, South Africa also offers a Foreign Investment Grant aimed at encouraging relocations of plants to South Africa. The grant covers equipment and management relocation costs. Moreover, a Strategic Investment Programme offers incentives to major investors whose activities are expected to create substantial positive impacts for the host country, for example in terms of foreign exchange earnings, increased exports and technological learning (Robbins, 2005).

39. Malaysia has also provided very generous tax and tariff holidays as well as subsidized and coordinated special industrial zones. Free Trade Zones and Licensed Manufacturing Warehouses, in particular, were crucial in the exports of manufactured goods, although their relative importance has declined since the late 1980s as tariffs facing most export-processing industries in the principal customs area have declined.

40. Other countries explicitly target specific sectors or even TNCs. The State Government of Penang in Malaysia, for example, played a very proactive role by “knocking on doors and extending special invitations” to FDI, which seemed to fit especially well in the development of the local enterprise cluster, with a special emphasis on the first set of TNC pioneers, which quickly made the location known worldwide.

41. Experience shows that the strategic attraction of FDI is far from an easy task. In South Africa, for example, efforts have been made to target FDI in specific sectors and to encourage domestic economic activities around these strategic firms. With the exception of the Motor Industry Development Programme, however, the results have been rather modest. In some cases it has not been possible to attract the envisaged foreign investments, while in others no substantial forward and backward linkages have been created (Robbins, 2005).

42. Finally, fewer countries develop an integrated strategy through their investment promotion agencies that combines marketing and company targeting with after-care and product development (UNCTAD, 2003). For example, Trade and Investment South Africa (TISA) seeks to establish linkages with larger foreign-based firms in order to find export markets for SMEs. TISA staff have a mandate to encourage TNCs that they deal with to source locally and work with the main national SME development agency to facilitate such opportunities (Lorentzen, 2005; Robbins, 2005).

C. Strengthening the local absorptive capacity

43. Evidence shows that even relatively advanced countries such as Mexico and Malaysia have enormous difficulties in exploiting the potential benefits of technological spillovers from foreign investment. To put it differently, the minimum threshold of absorptive capacity required to internalize the expertise potentially available in TNCs is not attained, at least not with regard to core functions of the value-adding process. What, then, is needed to increase absorptive capacity?

44. Unfortunately, it is not easy to disaggregate and operationalize "absorptive capacity" for the practical use of policymakers. Even at the firm level it depends on a complex set of skills and capabilities. Firm-level absorptive capacity is greatly dependent on interactions with the firm's environment, for example with the availability of educated people with management and engineering skills, the quality of the basic (e.g. roads, electricity) and advanced infrastructure (universities, diversified financial sector, specialized research and training institutions etc.), and the underlying incentive system of all the institutions involved. Improving the absorptive capacities of SMEs consequently goes far beyond SME policy per se. SME policy, together with technology policy, FDI policy, educational policies and so forth are closely intertwined and should be regarded as parts of an indivisible system.

45. To make things even more complicated, different levels of development require different sets and combinations of policies. Thus, as argued by Lall and Narula (2004, p. 43), "investment in absorptive capacities has differing returns at different stages of development". It has been previously observed that in simple agricultural activities or distribution services supplier relations with TNCs can be established quite easily, demanding much less than in manufacturing; that products for domestic low-income markets may require less sophisticated standards than production for exports to OECD markets; and that mastery of the garment business is easier to internalize than mastery of electronics production.

46. The relevant bottlenecks to be targeted by SME policy therefore vary considerably. In the case of spatially dispersed agricultural producers, the most appropriate policy focus may be on facilitating producer organizations and accompanying their negotiations with TNCs, while in the case of catching up with electronics production, specialized R&D and training offers in combination with entrepreneurship development programmes may be required.

47. Nevertheless, two core aspects that shape the absorptive capacities of countries and their SME sectors should be highlighted.

48. First, educational policy is a centrepiece of all strategies to increase absorptive capacities. The case of India's success in the information technology industry (and, increasingly, in other high-tech sectors such as biotechnology) has been largely driven by targeted educational policies. Investment in management capabilities is probably as important as investment in technological skills. TNCs in India and Malaysia, for example, have little difficulty in recruiting excellent managers and engineers. The case study of Penang shows that "indigenizing" the management of electronics TNCs was an important precondition for the subsequent evolution of a strong local subcontracting industry. Having educated people is also important for Governments, universities, business associations and the like, because these have a different role in monitoring the evolution of external knowledge, assessing their relevance for national development and designing policy strategies accordingly.

49. Second, incentive systems matter. High levels of investment in the different "ingredients" of absorptive capacities per se are not sufficient. What is more important is the intelligent interaction of different institutions and policies. For example, TNCs need to have appropriate incentives for local sourcing, research institutions need incentives to commercialize their findings, and public service providers must have incentives to behave as market agents. In this context, the existence of market-oriented intermediaries such as BDS, acting as intermediary support structures, is very important, not to say essential.

D. Developing domestic SME suppliers

50. The intensity of TNC–SME linkages and the ability of countries and individual firms to exploit these linkages for technological upgrading depend on several factors, for example the TNC's corporate strategy, which may be more conducive or less conducive to SME development, and the existence and efficiency of a set of supporting public policies for attracting FDI and facilitating linkage building and technology transfer. The most important differentiating factor, however, is the capacity of local SMEs to meet the necessary standards, supply reliably and absorb knowledge flows in order to upgrade technologically.

51. TNCs are usually very much interested in specializing in their core competencies, which are often related to specific know-how and abilities, for example product design, the creation of brand images, marketing or logistics. Most TNCs are keen to increase the economies of scale in this core business and accordingly tend to outsource non-core activities as far as possible. For example, most car makers have abandoned the production of auto parts and components to specialist firms and have therefore lost the relevant expertise; personal computer assemblers are also sourcing from specialist suppliers; breweries are not engaging in barley growing any more; and wholesale companies work through independent retailers.

52. In mature production systems, TNCs and other large companies are therefore closely interlocked with complementary manufacturing and service firms. In the resulting production networks SMEs may fulfil two very important functions.

53. First, SMEs may complement large firms in their value chains, exploiting advantages of flexibility and lower transaction costs due to close contact with customers and quicker decision-making, while large enterprises exploit different advantages of scale. Competitiveness is thus a question of having the right mix of small and large firms and an

adequate division of labour that combines economies of scale with flexibility and the advantages of specialization.

54. Second, SMEs may also be agents of change in the production system. Changing market conditions require continuous adaptation of industrial structures. New companies introduce new products and processes, while some established companies may be unable to compete and thus disappear from the market, making it possible for better-adapted firms to occupy their positions. SMEs continuously help to diffuse innovation and challenge old ways of doing business. Some of them grow into large enterprises, while some of the large ones may either fail or decide to shed activities and spawn smaller new companies. This process of entry and exit and growth and decline creates a healthy turbulence and implies a constant search for a more productive use of resources.

55. However, not all SMEs play these complementary roles and contribute to productivity growth and enhanced competitiveness of their production system or value chain. Especially in developing countries, the overwhelming part of micro and small-scale enterprises concentrates on a few activities characterized by low barriers to entry and therefore excessive competition, oversupply and low returns. These activities often involve low-quality mass products or services for the final consumer in local markets. Such SMEs do not generate significant innovations, create new markets or spur structural change, nor do they develop specialized competencies which complement large-scale production and create synergies.

56. This analysis is confirmed by the five country case studies. Each of the countries presents a remarkable productivity gap and a strong segmentation between the highly productive subsectors of the economy – consisting of TNCs and a limited number of efficient medium-sized suppliers – and a subsector of low-productivity micro and small enterprises which mainly cater for local markets. In South Africa, roughly 1.6 million micro and very small "enterprises" exist side by side, with only 65,000 medium-sized and large enterprises (Robbins, 2005). Ruíz Durán (2005) shows for Mexico that labour productivity in small firms is less than half that of large firms, and in the case of micro-enterprises it is one sixth. This is reflected in wage differentials: workers in larger firms earn almost double the wage of workers in small firms, and almost three times the wage of micro-enterprise workers.

57. All country studies indicate that TNCs, with a few exceptions, are reluctant to cooperate with the micro and small-scale sector. Interviews with TNC managers in Uganda, for example, reveal a number of shortcomings that are attributed to SMEs in that country: lack of quality; high production cost; unreliability; lack of business licences, receipt and invoice books, tax identification numbers, bank accounts, and fixed and traceable places of business; and limited access to funding and credit, and hence a preference for cash transactions, which are not acceptable to many TNCs (Zake et al., 2005). Consequently, many TNCs prefer either to import or to purchase from other TNC subsidiaries in the same country, or to produce the required inputs in-house rather than investing in local SME linkages.

58. In summary, it can be argued that the linkages based exclusively on low wages and labour standards do not foster technological learning and productivity growth, and thus rarely create a basis for sustained competitiveness. If Governments want to embark on a "high-road" strategy of technological upgrading that allows their economies to move into activities with higher returns, local SMEs suppliers must:

- Have the desire to succeed and a commitment to continuous learning;
- Achieve minimum efficiency standards and continuously improve these standards;
- Analyse their own strengths and weaknesses, and set forth strategies to enhance their comparative advantages;
- Identify suitable TNC partners, with which a sustainable linkage may be anticipated;
- Carefully negotiate contracts which are favourable in the long run, taking into account the fact that framework conditions and partner relations usually change over time;
- Be able and willing to transform themselves according to the needs arising in the partnership;
- Contribute specific assets to the TNC partners, for example not only familiarity with local politics and government regulations as well as knowledge of local markets, which may erode as TNCs learn to handle the local way of doing business, but also new advantages.

59. Many developing country SMEs are not able to meet these criteria. Thus, local capacity building and skill development should constitute a major element in a business linkage programme. BDS can play an important role in getting domestic SMEs up to speed. But commercial BDS providers in many developing countries are not particularly interested in providing business linkage services owing to the lack of demand and the difficulty in transforming the three building blocks of business linkages activities (information, capacity building and finance) into profitable services (UNCTAD, 2004). Thus, there is a short-term case for public intervention and support.

60. Public–private partnerships between the Government and TNCs can also help to develop local supply capacity through coaching and mentoring programmes. In these supplier development programmes, TNCs and large enterprises agree to assist their small suppliers in continuous upgrading of skills and technology. Indeed, an optimal subsidy/incentive package should also be subject to a public–private sector dialogue and agreement.

IV. BEST PRACTICES IN THE PROMOTION OF BUSINESS LINKAGES FROM A POLICY PERSPECTIVE

61. UNCTAD's global survey found a considerable variety of linkages and provided some very instructive case studies of successful development. The selected sample of countries encompasses the three major developing regions and includes countries of very different size, level of development and economic and technological dynamism. The sample is therefore appropriate for identifying a broad range of good policy practices that are representative of both low-income and more advanced countries, and these are highlighted below.

62. First, all country case studies in UNCTAD's survey show that both public and private effort requires **clear direction**. It is important to have a vision about important global trends in terms of technologies, markets and governance structures. The extent to which decision makers both in companies and in Governments understand present patterns of

industrial organization, recognize relevant trends and anticipate emerging technologies, markets and organizational structures is crucial for competitiveness.

63. Malaysia is one of those countries with a relatively clear policy focus, with FDI explicitly playing a prominent role within its industrialization strategy. According to Rasiah (2005), “FDI was targeted as a major plank to spearhead industrialization – initially to generate investment and employment, subsequently to expand exports and foreign exchange, and eventually to drive upgrading and linkages". Under its Second Industrial Master Plan (1996–2005), the Government committed itself to a “Manufacturing ++ Strategy" with a clear focus on technological upgrading and broader integration of SMEs into competitive areas. In particular, special programmes were introduced to help SMEs (a) to overcome size and scale constraints; (b) to minimize difficulties in accessing key information for business and investment decisions; (c) to reap benefits from R&D; and (d) to foster inter-industry linkages and promotion of ancillary industries. However, investment in R&D in particular has been far too low to achieve the envisaged transitions towards a knowledge-based society, and some elements of the strategy (e.g. venture capital financing and university spin-off programmes) have proved to be rather ineffective.

64. Second, the essence of a good linkages promotion policy lies in the **ability to attract important lead firms and to design policies that help to allocate investments accordingly** – for example, making early investments in skills that will be essential for future patterns of economic specialization in higher-value-added activities, tapping foreign sources of knowledge and absorbing them locally, supporting promising clusters and value chains, and identifying the right mix of liberalization and guidance. Strategic planning based on well-designed surveys, benchmarking studies and a continuous stakeholder help to identify such general trends, to uncover strengths, weaknesses, opportunities and threats in a dynamic perspective, and to design adequate proactive policies.

65. South Africa, for example, has adopted a strategic approach to industrial development and linkages creation. The most successful sector-specific policy has been the Motor Industry Development Programme, which helped to establish competitive and relatively integrated clusters of automobile companies. Since 2004, South Africa has also carried out Customised Sector Support Programmes in selected priority sectors, but these have turned out to be less successful than expected (Robbins, 2005). However, South Africa remains a good example of a country where strategic industrial orientation is mainly focused on technological upgrading and deepening, but has not excluded other major political objectives (i.e. South Africa’s Black Economic Empowerment policy). Additionally, once the consensus on strategic policy guidelines had been achieved, it was immediately reflected in public pronouncements and policy frameworks, as revealed by the fact that agencies active in different policy fields such as FDI and trade promotion, SME support and technology policy have all given a prominent role to linkage building (Robbins, 2005).

66. Third, besides a clear strategy and clarity in transmitting this strategy to the different societal actors concerned, **institutional coordination** is important. Since many different actors need to be involved in implementing a coherent industrial strategy (e.g. investment promotion and SME development agencies, chambers of commerce, universities and research organizations, and, last but not least, small and large enterprises), it is essential to improve information sharing and cooperation and to align these actors according to the strategy.

67. In this respect, evidence shows that the five policy elements highlighted in section 3 of this paper need to be integrated in a systemic framework, otherwise efforts will be wasted

in duplication and unproductive inter-agency rivalry, and it is unlikely that strategic goals will be achieved. Additionally, it shows that market-oriented intermediary institutions, such as business development services and local economic development centres, may be an essential tool for improving the integration of the support system.

68. For example, in South Africa the heads of 17 government institutions working in the trade and industry field have formed the Council of Trade and Industry Institutions with the aims of information sharing, building consensus, promoting joint activities and improving coordination. Moreover, there is a high-level dialogue with the private sector. This dialogue has been instrumental in creating a certain consensus between the Government and private sector role players about the need to work to improve the prospects of SMEs, both to improve the distributional effect (outcome) of economic development and because SMEs are recognized as central to the systemic competitiveness of the economy as a whole (Robbins, 2005, p. 29).

69. Finally, linkage initiatives should be **adjusted to the country's level of development,** particularly in terms of human resource development and technological capability. They should be based on a comprehensive approach that embraces in a holistic and systemic way all the various steps involved in the linkage process, namely:

- Identifying investment promotion measures with the ultimate objective of enhancing local supply capacity and upgrading indigenous capabilities;
- Targeting key strategic sectors with high growth potential, as well as lead companies (both SMEs and TNCs) operating within those sectors;
- Securing the commitment of the Government to allocate resources and to recognize the need for participation by the private sector;
- Identifying the linkage requirements of participating companies;
- Briefing participating companies on the type of skills required in order to establish linkages with TNCs and to complete the company selection procedure;
- Matching the linkage requirements of participating companies;
- Preparing SMEs to become partnership-ready through BDS;
- Supporting SMEs during the mentoring/coaching process by TNCs;
- Monitoring and evaluating the impact of the linkages programme.

V. Conclusions

70. The intention of this issues note is to show, as argued by Mytelka and Barclay (2004), that "the impact of FDI on future opportunities for catching up by developing countries is much greater than its importance as a source of capital. … The influence of transnational corporations on the opportunities for learning and innovation and thus growth and development in developing countries is unparalleled. … Therefore, the capital flow element in FDI is hardly its most significant attribute, nor from a dynamic perspective is it the major contribution that FDI might make to development …".

71. It is thus clear that the ability of Governments to integrate the FDI component into a broader development context has become crucial, as well as their freedom to implement an appropriate mix of general and specific policies. This paper shows that on the one hand, Governments should intervene with functional policies aimed at improving the investment climate and providing strategic guidance and policy coordination. It also shows that on the other hand, they should implement more specific measures aimed at targeting strategic FDI and strengthening the local absorptive capacity. Only then will specific linkages promotion policies and institutional mechanisms have a chance to succeed, if the ultimate objective is not to create ordinary matchmaking gatherings or a series of scattered business deals, but to overcome in the long term and on an equitable and sustainable basis the market failures which hamper the integration of domestic and foreign firms.

72. In this perspective, many gaps and controversial issues emerge from the analysis carried out in the paper and from the empirical evidence coming out of the findings of the country case studies. UNCTAD intends to actively address these in its future work, and to provide useful insights for both Governments and the development community.

73. First of all, there is the need to revise the concept of "quality" FDI, and incorporate issues related not only to employment generation and technological spillovers, but also to the long-term embeddedness of TNCs, as well as to the extent to which they establish mutually beneficial linkages with local suppliers. This implies adopting a qualitative rather than a pure quantitative approach, and assigning a prominent role to the opportunities generated for learning and innovation, the extent of networking and interaction with respect to the main actors in the domestic production system, and the number of partnerships established to carry out high-value-added functions such as R&D, design, quality control and certification.

74. Linked to that, there is a need to revise the existing competitiveness frameworks assessing the performance of domestic economies. As mentioned above, the relationship between the Index of Economic Freedom and economic growth is not straightforward, nor is the developing countries' catch-up process adequately reflected by existing publications on competitiveness. The importance of micro-level indicators should be also acknowledged, such as the performance of the SME sector, its trade performance, its participation in international production systems through TCN–SME linkages, the level and effectiveness of institutional coordination, the extent to which integrated development strategies are put in place, and the progress made in various areas.

75. Finally, there is a need to better understand, at a more operational level, what kind of institutional set-up and concrete mechanisms can be put in place in order to promote mutually beneficial linkages. The case studies show that there are a variety of initiatives, from purely donor-driven, private-sector-driven and government-driven programmes to programmes stemming from and aiming at public–private sector partnerships. In several publications UNCTAD has also documented the existence of totally independent supplier development programmes, carried out by TNCs in their own self-interest. What are less known, however, are the implications of their different ways of proceeding and the kind of impact that can be expected from each one of them.

76. All these issues will be debated during the Commission's session, with the final aim of identifying, on the basis of different country experiences, how to determine the appropriate level of policy intervention for linkages building, as well as what is the most effective policy mix according to the different stages of development and local absorptive capacity and what is the role of all the main stakeholders in the linkage formation process.

References

Alfaro, L. and Rodríguez-Clare, A. (2003). Multinationals and Linkages: An Empirical Investigation. Economia (spring 2004).

Altenburg, T. (2000). Linkages and Spill-overs between Transnational Corporations and Small and Medium-sized Enterprises in Developing Countries: Opportunities and Policies, in: UNCTAD, TNC–SME Linkages for Development, New York and Geneva 2000, pp. 3–61.

Altenburg, T. (2005). Overview on International Good Practices in the Promotion of Business Linkages, paper prepared for UNCTAD/DITE, forthcoming.

Altenburg, T. and von Drachenfels, C. (2005). A Critical Assessment of the “New Minimalist Approach” to Private–Sector Development. Paper presented at the 11th EADI General Conference, Bonn, 21–24 September.

Chang, H.J. (2002). Kicking Away the Ladder: Development Strategies in Historical Perspective, London.

Dollar, D. Hallward-Driemeier, M. and Mengistae, T. (2005). Investment Climate and Firm Performance in Developing Economies, Development Research Group, World Bank, Washington D.C.

Giuliani, E., Pietrobelli C. and Rabellotti, R. (2005). Upgrading in Global Value Chains: Lessons from Latin American Clusters, in: World Development, vol. 33, no. 4, pp. 549–573.

Heritage Foundation/Wall Street Journal (2005). 2005 Index of Economic Freedom, Washington D.C.

Hoekman, B.M., Maskus, K.E. and Saggi, K. (2005). Transfer of Technology to Developing Countries: Unilateral and Multilateral Policy Options, in: World Development, vol. 33, no.10, pp. 1587–1602.

Ivarsson, I. and Alvstam, C.G. (2005). Technology Transfer from TNCs to Local Suppliers in Developing Countries: A Study of AB Volvo´s Truck and Bus Plants in Brazil, China, India and Mexico, in: World Development, vol. 33, no. 8, pp. 1325–1344.

Lall, S. (1994). The East Asian Miracle: Does the Bell Toll for Industrial Strategy?, in: World Development, vol. 22, no. 4.

Lall, S. (2002). Linking FDI and Technology Development for Capacity Building and Strategic Competitiveness, in: UNCTAD, Transnational Corporations, vol. 11, no. 3, pp. 39–88.

Lall, S. and Narula, R. (2004). Foreign Direct Investment and its Role in Economic Development: Do We Need a New Agenda?, in: European Journal of Development Research, vol. 16, no. 3, pp. 447–464.

Laudridsen, L. (2004). Foreign Direct Investment, Linkage Formation and Supplier Development in Thailand during the 1990s: The Role of State Governance, in: European Journal of Development Research, vol. 16, no. 3, pp. 561–586.

Lorentzen, J. (2005). The Absorptive Capacities of South African Automotive Component Suppliers, in: World Development, vol. 33, no. 7, pp. 1153–1182.

Moran, Th. E., Graham, E.M. and Blomström, M., eds. (2005). Does Foreign Direct Investment Promote Development?, Washington D.C.

Morris, M., Robbins, G. and Barnes, J. (2004). What should be the Role of Government in Fostering Clusters? Paper presented at the 50th Anniversary Conference Reviewing the First Decade of Development and Democracy in South Africa, Durban, South Africa, 21–22 October.

Mytelka, L. and Barclay L.A. (2004). Using Foreign Direct Investment Strategically for Innovation, in: European Journal of Development Research, vol. 16, no. 3, pp. 531–560.

Narain, S. (2005). Business Linkages between SMEs and TNCs: The Case of India, paper prepared for UNCTAD/DITE, forthcoming.

OECD (2005). Encouraging Linkages between Small and Medium-Sized Companies and Multinational Enterprises, DAF/INV/WD (2005)12/REV1, Paris.

Rasiah, R. (2005). Strategies and Policies on TNC–SME Linkages: The Case of Malaysia, paper prepared for UNCTAD/DITE, forthcoming.

Robbins, G. (2005). Strategies and Policies on TNC–SME Linkages: The Case of South Africa, paper prepared for UNCTAD/DITE, forthcoming.

Ruffing, L. (2005). Business Linkages and Millennium Development Goals, UNCTAD, forthcoming.

Ruíz Durán, C. (2005). Strategies and Policies on TNC–SME Linkages: The Case of Mexico, paper prepared for UNCTAD/DITE, forthcoming.

Scott-Kennel, J. (2004). Foreign Direct Investment: A Catalyst for Local Firm Development?, in: European Journal of Development Research, vol. 16, no. 3, pp. 624–652.

Slaughter, M.J. (2002). Does Inward Foreign Direct Investment Contribute to Skill Upgrading in Developing Countries?, CEPA Working Paper 2002-08.

Smarzynska, B.K. (2002). Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages, in: World Bank Policy Research Paper 2923, 2002.

UNCTAD (1999). World Investment Report 1999: Foreign Direct Investment and the Challenge for Development, New York and Geneva.

UNCTAD (2001). World Investment Report 2001: Promoting Linkages, New York and Geneva.

UNCTAD (2003). World Investment Report 2003: FDI Policies for Development: National and International Perspectives, New York and Geneva.

UNCTAD (2004). Promoting the Export Competitiveness of SMEs, TD/B/COM.3/EM.23/2.

UNCTAD (2005a). Improving the Competitiveness of SMEs through Enhancing Productive Capacity, UNCTAD/ITE/TEB/2005/1.

UNCTAD (2005b). Linkages, Value Chains and Outward Investment: Internationalization Patterns of Developing Countries' SMEs, TD/B/COM.3/69.

UNCTAD (forthcoming). Best Practices in the Promotion of Business Linkages: A Policy Perspective.

World Bank (2003). Doing Business in 2004: Understanding Regulation, Washington D.C.

World Bank (2005). World Development Report 2005: A Better Investment Climate for Everyone, Washington D.C.

Zake, F. et al. (2005). Survey on TNC–SME Linkages: The Case of Uganda, paper prepared for UNCTAD/DITE, forthcoming.

* * * * * * * *