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ENHANCING THE COMPETITIVENESS OF SMES IN THE CONTEXT OF FDI IN DEVELOPING COUNTRIES

Issues paper by the UNCTAD secretariat

SUMMARY

This issues paper reviews the current mandates of UNCTAD in the area of enterprise development and internationalization. It suggests a series of topics which the Commission on Enterprise, Business Facilitation and Development might wish to take up during the next four years leading to UNCTAD XI. The four topics identified explore ways and means for Governments and international organizations to promote the survival and competitiveness of domestic firms, by targeting foreign investors who are likely to develop linkages, by use of innovative financial mechanisms, by adopting enterprise policies which are consistent with international commitments on trade and investment, and by assisting SMEs to acquire information and communication technologies to enter global markets.

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INTRODUCTION

1. UNCTAD's mandate on enterprise development originated at UNCTAD IX and was reconfirmed at UNCTAD X. The Plan of Action stated that:

. “*The survival and growth of SMEs in a globalizing world economy require the adoption at the national and international level of policies and programmes which allow them to compete both at home and abroad. At the national level, new supporting structures are needed, including programmes for entrepreneurship and innovative capacity-building and ability to meet new international standards for product quality, health and safety. A number of measures can be taken to increase SMEs' access to markets, finance, business skills and technology*.” (para. 82).

2. UNCTAD X noted that, to ensure that all countries enjoy the benefits of globalization, it is necessary to meet complex policy challenges which arise from the interdependence of trade, finance and investment. In particular, it is necessary for UNCTAD to better integrate its analysis of trade, investment, finance, technology and enterprise development in order to identify these challenges. In the area of enterprise development, UNCTAD should undertake a number of activities, including:

- Collecting and analysing data on best national practices stimulating enterprise development;
- Identifying ways and means for developing countries' SMEs to meet international standards, as well as to access and benefit from new technologies through networking and partnering;
- Analysing the links between SMEs and TNCs;
- Identifying mechanisms for financing SMEs;
- Enhancing the capacity and participation of women entrepreneurs in terms of running SMEs;
- Continuing the EMPRETEC programme to assist countries to build up entrepreneurial capabilities and innovative and competitive SMEs. (paras. 119 and 125 of the Plan of Action).

3. In responding to the recommendations of the Bangkok Plan of Action, the Commission on Enterprise, Business Facilitation and Development could through its intergovernmental discussions identify best practices and measures which would strengthen the competitiveness of SMEs in the global economy and build productive capacity in developing countries.

4. In order to assist the Commission in generating a coherent series of intergovernmental discussions that could review policy options and practical action to increase the competitiveness of SMES, the secretariat has elaborated a number of issues requiring the attention of Governments, the international community and UNCTAD. The Commission could chose among the various topics put forward. One of these topics for research, intergovernmental policy discussions and practical action is the topic of TNC-SMEs linkages.

5. In the interest of integrating the topics of investment, technology transfer and enterprise development, a round table on TNC-SME links was held in Bangkok during UNCTAD X. The main focus of the round table was on the various ways and means to deepen the quality of foreign direct investment (FDI) and the development impact of TNCs. TNCs, through their investment activities, can transfer technologies and improve the technical capabilities and the organizational and managerial skills of their business partners in host countries, enhancing the competitiveness of domestic firms.

6. Globalization and the new corporate production strategies of TNCs have opened up new opportunities for linkages between TNCs and SMEs, but the vast majority of SMEs remain de-linked from TNCs, missing these potential gains for technology transfer, access to markets, information and finance. Thus, it seemed appropriate to examine programmes and measures which could make SMEs more partnership ready in order to benefit from such linkages. The results of the secretariat research, workshop and expert meeting on this subject are summarized in this report. The Commission may wish to consider policy options to promote positive linkages arising from the Expert Meeting and explore further work in this area, particularly practical actions that can ensure that SMEs in developing countries are able to forge linkages with TNCs.

7. Other issues are put forth for the Commission's consideration as possible topics for future research and intergovernmental discussion. Some of these issues have been already identified in past expert meetings and/or are contained in the Bangkok Plan of Action. All issues are related to the central objective of increasing the competitiveness of SMEs.

Part I: Topics under consideration

8. The mandate for the Expert Meeting on the Relationships between SMEs and TNCs to Ensure the Competitiveness of SMEs, emanates from the Bangkok Plan of Action adopted at UNCTAD X. During subsequent consultations among Member States in Geneva on 31 March 2000, it was decided to convene an expert meeting on “the relationships between SMEs and TNCs to ensure the competitiveness of SMEs”.

9. The documentation prepared for the Commission on Enterprise, Business Facilitation and Development includes a report on the outcome of the deliberations of the expert meeting on the relationships between SMEs and TNCs to ensure the competitiveness of SMEs, held from 27 to 29 November in Geneva. The report focuses on government and corporate programmes to promote mutually beneficial relationships between TNCs and SMEs, as well as on possible further work to be undertaken by the secretariat.

Enhancing the competitiveness of small and medium-size enterprises

10. The Expert Meeting had before it a background paper entitled “Enhancing the competitiveness of SMEs through linkages with TNCs” (TD/B/COM.3/EM.11/2). The paper reviewed various types of linkages from the point of view of their effects on the development of the local economy, particularly in terms of transfer of technology. Moreover, it highlighted best practices identified at a workshop on “Technological and managerial upgrading of SMEs through linkages with TNCs”, which examined 26 Asian case studies (Penang, Malaysia on 8-9 August 2000). The Expert Meeting was enriched by 19 presentations and 35 contributed papers. Over 65 experts considered the role of government, the requirements of TNCs, and the contribution of international organizations in promoting linkages. During the presentations and discussion, the experts reviewed the various government and corporate programmes for assisting SMEs to become partnership ready. They suggested that the competitiveness of SMEs is best ensured through a set of measures which are undertaken within the context of public/private sector partnerships. Both Governments and TNCs have a role to play.

Issues raised at the Expert Meeting

11. The ability of countries and individual firms to exploit linkages varies greatly, depending on:

- The adoption of targeted foreign direct investment policies ;
- The attraction of TNCs with a corporate commitment to the development of the host country;
- The creation of public policies and support measures that assist SMEs so that they are capable of meeting the requirements of TNCs;
- The existence of SMEs which are able to meet TNC standards or at least have the potential to achieve such standards within a short learning period.

12. The UNCTAD secretariat's report observed that merely opening the door to FDI would not result in a country's economic development. As noted in the *World Investment Report 2000*, most developing countries have adopted liberal investment regimes and many have created investment promotion agencies. Yet the same 10 developing countries continue to attract the bulk of foreign direct investment inflows. Obviously, those countries that have liberalized investment policies but have not enjoyed any significant increases must refine their investment promotion strategies and identify their comparative advantages, possible niche areas and potential foreign partners. This more targeted investment strategy must be related to building the productive capacity of domestic firms. During the meeting the experts analyzed in detail the linkage programmes of a number of TNCs. These TNCs had certain characteristics in common such as a corporate commitment to the development of the local community and the host country. They often decentralized decisions to local affiliates and had a policy to hire local managers. These factors made it more likely that the affiliates would have the freedom and motivation to develop linkages with local SMEs.

13. Many experts felt that government can act as a catalyst for linkages by improving physical and educational infrastructure, particularly for the development of engineering and management skills. Government, working together with the private sector, could create support institutions (e.g. skills training centres) that facilitate the transfer of technology and provide appropriate skills training, thereby helping SMEs achieve the capability for continuous improvement. It was important for TNCs to assume a leadership role in these institutions to ensure that programmes, particularly for skills development, met their needs. In addition, Governments often facilitated such positive interactions by providing appropriate economic incentives to both TNCs and SMEs.

14. The experts noted that some TNCs had very elaborate programmes to upgrade local suppliers such as Intel's "SMART" approach while other TNCs had not yet realized that remaining competitive depended on those around them also being competitive. It was clear that globalization had changed the nature of TNC production and outsourcing networks. TNCs needed SMEs to implement their global strategies which depended on flexibility, total cost and speed. The good news for SMEs was that TNCs did not expect SMEs to meet their quality requirements immediately. During the Expert Meeting TNCs described what they looked for in an SME partner:

- Vision of the CEO
- Willingness to learn and to transform

- Sound financial management
- Quality of human resources
- Technical capability corresponding to TNCs needs
- Competitiveness potential (safety, quality, delivery, price).

15. Within the context of their supplier development programmes, TNCs undertook a phased upgrading of SME technological and productive capacities by facilitating access to TNC innovation centres and engineers and management consultants; assigning TNC staff to SMEs, mentoring and coaching their SME partners. TNCs also shared with SMEs relevant information on market trends and future plans so that SMEs could change direction with the TNCs. Most importantly, TNCs encouraged SMEs not to become overly dependent on them and provided them with additional business opportunities within their global network or through business matching, brokering of strategic alliances, trade fairs and road shows.

Areas for consideration and further action

16. There appear to be several levels where further action might be taken by UNCTAD. Firstly, in order to assist Governments to select policies and measures that insure TNCs are more likely to build linkages with the local economy, there is a need for a systematic country review to identify the various policies and incentives used by Governments to promote linkages. During the Expert Meeting it was thought that further study was necessary on the impact of economic incentives on linkages.

17. Experts were concerned that most of the examples of successful linkages came from Asia and they questioned how these experiences could be replicated in other regions. It was suggested that UNCTAD could conduct similar workshops to that held in Penang where TNCs and SMEs were brought together to exchange experiences on best practices. The experts were particularly interested in disseminating information so that positive supply chain development could be replicated elsewhere. However, it would be important to identify the starting point for developing such linkages in these regions. This would no doubt require the implementation of appropriate investment and enterprise policies and support measures. UNCTAD could also incorporate best practices so far identified into its technical cooperation programmes, particularly those practices that make SMEs more partnership ready.

Part II: Other topics requiring attention

A. Recent developments in innovative mechanisms for financing SMEs

18. The number one problem revealed by numerous surveys of SME entrepreneurs is access to finance. Despite their vast numbers and importance in job creation, SMEs traditionally have had difficulty accessing formal credit and equity. The key reasons for this are well-known:

- SMEs are regarded by creditors and investors as high-risk due to insufficient assets and low capitalization, vulnerability to market conditions and high mortality rates;

- Commercial banks are biased toward large corporate borrowers;
- Information asymmetry arising from SMEs' lack of accounting records and other financial documentation makes it difficult for creditors and investors to assess the creditworthiness of potential SME borrowers;
- The high administrative cost of lending/investing small amounts generally does not make SME lending/investing a profitable business.

Past solutions in the banking sector

19. The key problems which must be solved if long-term capital is to be made available are the provision of acceptable collateral or other mechanisms and the lowering of administrative/transactions costs. Many Governments and international financial institutions have organized programmes for subsidized credit and guarantees for SMEs. Recent experience with subsidized credit/guarantees reveals a number of drawbacks such as:

- Fostering a culture of non-repayment;
- Competing with commercial credit;
- Not being used for the intended purpose;
- Failing to reach the target group;
- Being disbursement oriented;
- Failing to achieve financial self-sustainability.

20. The most efficient way to encourage the development of SME loan capital is to improve existing financial institutions' ability to construct profitable SME lending programmes. The way to achieve this is by minimizing their risks and lowering their costs of lending to SMEs.

Ways to diminish risk

21. Financial institutions need to design, new, more flexible forms of collateral, especially for SMEs which have few fixed assets. More time could be spent analysing the firm's cash flow statement than its balance sheet. This would indicate the firm's ability to repay in the future. Banks need to focus more on the firm's track record. Financial institutions could also substitute other mechanisms for collateral such as group guarantees and peer pressure. Financial institutions could rely on business and business service providers to pre-screen/do due diligence on SME clients, thus reducing the bank's cost and risk.

Other ways to diminish transaction costs

22. A number of recent studies cite the limited technical capacity commercial banks have for credit evaluation of SMEs. Bank personnel therefore, need training in assessment methodologies which are easy and effective. More use needs to be made of the new automated systems for making credit decisions and monitoring the bank's portfolio such as credit rating, credit scoring and expense tracking. Technology can greatly extend a bank's reach with simple, standardized products. Recently, commercial banks in some developed countries have begun to offer a variety of products and services especially addressed to SMEs such as direct-mail offers of credit lines, business credit cards, and non-revolving lines of credit for business, most of which have a credit limit of US$100,000. Loans can be secured or unsecured, and if secured, banks may accept assets such as stocks and bonds, certificates of deposit, accounts receivable, inventory and equipment. Banks need to work out cross subsidization techniques which will allow them to

serve the entire spectrum of clients from marginal ones to well-paying ones. Credit information systems or external rating systems need to be developed to assist banks in making their decisions. SMEs themselves must present reliable and transparent financial information using a standardized reporting mechanism. Both banks and SMEs alike complain about the different ways of presenting financial information; a guideline on accounting by SMEs could improve the quality of financial information while cutting costs to users and preparers.

Other forms of providing finance or facilitating it: venture capital and leasing

23. SMEs need not only commercial credit but also longer-term finance such as venture capital funds. Bank credit is a very expensive way to finance companies in their first growth stage. Venture capital is more appropriate for several reasons. First, venture capital funds provide flexible, long-term equity capital which is customized according to the unique needs of each enterprise. It is patient capital in that it is available for more than one year. Second, it can often leverage loan capital. Third, fund managers often participate in the operation and administration of the enterprise, bringing their expertise. Working with the SME owner/managers can improve the efficiency of the firm. However, venture capital funds for SMEs must overcome many obstacles in order to realize the high returns that the investors demand. Among the factors which can seriously lower rates of return are small deal flow and deal size, the need for extensive business development services, and the difficulty in exiting when there is no stock market and/or few strategic investors. In this case the most likely exit route is a sell-back, and then the entire transaction begins to look more like loan finance. If a venture capital fund for SMEs is to succeed, it must have local staff who can work closely with the investee firm. Venture capitalists or their employees meet regularly with management and take positions on the boards of directors (when they exist). However, the local venture capital staff can usually not provide all the follow-up that SMEs might need and then it is important to identify local institutions which can provide the needed non-financial business services that SMEs often require.

24. Leasing can be used by mature SMEs in order to cut investment in fixed assets, particularly in sectors characterized by rapid rates of technological innovation. However, unlike venture capital, the SME must meet its lease payment or risk losing its equipment and ability to produce or provide services to its customers. Sometimes lease payments can be more expensive than bank charges.

25. Once the most suitable approaches to SME financing have been identified, financial institutions in developing countries should be assisted in implementing them through capacity building.

Areas for consideration and further action

26. The Commission might consider organizing an expert meeting which could discuss:

- Recent developments in innovative financing mechanisms and when they are appropriate for use by SMEs, depending on where the SME is in its life cycle;
- How banks in developing countries and countries with economies in transition can be encouraged to use these mechanisms;
- How venture capital funds can be organized for SMEs and how the obstacles to high returns can be minimized;

- How non-financial services should be combined with financial services in order to ensure repayment or maximize returns;
- To what extent these non-financial services would have to be subsidized;
- Ways and means to disseminate such techniques to financial institutions in developing countries.

B. Policy coherence and international commitments

27. The benefits of trade reform and liberalization are generally predicated upon the existence of a private sector (with a diversified manufacturing segment). In most developing countries and LDCs, the private sector remains narrow and weak. They lack the indigenous entrepreneurs (with the requisite capital) to pursue private-sector-led development. FDI has not been and cannot be the solution, chiefly because its developmental role is to catalyse domestic investment and capabilities rather than replace it.

28. SMEs are an integral part of all LDC economies, but many of these countries have overlooked the role of SMEs as an engine for economic development. The focus on poverty alleviation to mitigate negative social impacts of structural adjustment put the spotlight on the social benefits of SMEs, particularly in respect to the generation of low-capital-cost employment. The opportunities provided by the WTO system do not address the supply-side constraints in these economies, so that the issue of policy support and flexibility for SME development continues to be of importance.

29. In the final analysis, what is indisputable is that integration into the global economy and accessing the benefits from globalization presupposes that a platform for industry already exists.

30. It has been suggested that the adoption by developing countries of selective strategies to promote enterprise development and exports may no longer be possible as a result of the Uruguay Round, which prohibited their use. Certainly, the more generalized protection that provided a backdrop for targeted interventions in East Asia is no longer possible. In developing countries, Governments still have a large role to play in promoting economic growth and development. Many vital activities of the developing countries' Governments in the field of enterprise development and export promotion and diversification may therefore easily become a source of litigation and 'actionable' subsidies.

31. However, a counter-argument is that the new WTO rules give ample opportunity for countries to promote their manufacturing sectors. This assertion is based on the fact that WTO laws are in favour of advancing science and technology, and technologically advanced countries continue to promote their industrial competitiveness by subsidizing research and development, regional development and environmental protection.[1] In addition, firms can benefit from special incentives offered for locating in 'science parks' and industrial estates. Furthermore, WTO law is not inflexible with respect to tariffs (besides, many developing countries and LDCs bound their tariffs at rates far above applied ones). Moreover, safeguards and other measures allow countries to protect specific industries threatened by a surge in imports (for up to eight years) and to protect against all imports if they are at a level which jeopardizes their balance of payments (for an indeterminate period). Based on all the above, it is argued that there is no shortage of methods

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[1] Such subsidies are all permitted by the WTO

that can be used by less industrialized countries to promote their industries under the new WTO laws.

32. Accordingly, the situation may not be as hopeless as initially thought. Then again, this considerable scope for manoeuvre is dependent on the skillful use of the various ‘permissible’ subsidies, balance-of-payments clauses and non-trade-related measures, as well as creative interpretation of the new international trading rules. It would seem that the major challenge facing developing countries and LDCs is their ability to creatively and effectively deploy the available instruments for enterprise development and international competitiveness. Failure to do so will render the opportunities offered by the new trading system merely notional.

33. Similarly, coherence needs to be achieved between the rules and disciplines of other international or bilateral agreements (e.g. agreements under the ISO, Montreal Protocol on Ozone Depleting Substances, Framework Convention for Climate Change, Convention on Biological Diversity, Convention on International Trade in Endangered Species, Basle Convention on Hazardous Wastes, and investment treaties) and national enterprise development strategies and goals. The basic thrust of the rules and disciplines of these agreements (which may or may not overlap with the WTO) is that they create additional standards and technical or quality requirements (including limits on government support) that are not easy for SMEs in developing countries and LDCs to meet.

Areas for consideration and further action

34. Developing country Governments need to take account of the limitations imposed by international trade disciplines on domestic enterprise development policies and adjust accordingly. They also need to do so promptly in order to take advantage of whatever timebound differential or preferential treatment that they are accorded by international agreements. The objective of an expert meeting on this subject would be to assist developing countries to achieve coherence between their national policy framework for enterprise development and their obligations emanating from binding international agreements. The objective would also be to present examples of alternative measures to those outlawed by the new trade regime which will fulfil the development aims of domestic enterprise policies. Such a meeting would also be useful to developing countries in terms of helping them to identify domestic institutional and capacity constraints and technical assistance needs in policy design and implementation. This expert meeting could be organized jointly with the WTO.

35. A secretariat study on the interaction between trade and enterprise development policies is available, and from this study it will be possible to extract a negative/positive list of methods that can be used by less industrialized countries to promote their industries under the new WTO laws. Work has also been done in other parts of the secretariat on various aspects of WTO laws and on investment treaties. This could be supplemented by selected case studies on innovative ways that developing and developed countries have employed available instruments to support SME development in the new trading environment.

C. Transfer of technology: bridging the digital divide for SMEs

36. In his recent Millennium Report, UN Secretary-General Kofi Annan focused on the fundamental changes occurring in the information and communications industries (ICT) at near-lightening speed. “*It took 38 years for radio to reach 50 million people, 13 years for television*

and 4 years for Internet. 143 million people logged on to the Internet in 1998; by 2001 the number of users will climb to 700 million. The market for e-commerce was $2.6 billion in 1996; it is expected to grow to $300 billion by 2002."

37. The Secretary-General also noted that the digital divide is growing between developed and developing countries. There are more computers in the United States than in the rest of the world combined. There are as many telephones in Tokyo as in all of Africa. But if the gap can be bridged, the digital revolution can stimulate economic growth and development. *First*, it creates new economic sectors. *Second*, the capital that matters most in the digital revolution is increasingly intellectual capital, not financial capital.

38. *Third*, the digital revolution can transform and enhance other economic activities. For example, e-commerce including B2C and B2B will transform the way business is conducted. There are many opportunities for telemedicine and distance learning; for virtual banking; for checking weather forecasts before planting and crop prices before harvesting; and for accessing the world's largest library. The information technology sector, in short, can transform many if not most other sectors of economic and social activity.

39. Bridging the gap will not be easy for developing countries. Lack of resources and skills is part of the problem, inadequate basic infrastructure another, illiteracy and language a third, and of course, there are concerns about privacy and content.

40. The Secretary-General called upon countries to review their ICT policies and arrangements in order to eliminate all unsupportive regulatory environments and exorbitant charges. He also announced a digital bridge, the United Nations Information Technology Service (UNITeS), which is a consortium of high-tech volunteers who will work with developing country partners to strengthen capacities for applying ICT to human development, in particular in areas such as health, education, environment and small and micro enterprises.

41. Prior to this, the Commission on Science and Technology for Development considered the issue of the implications of information and communication technologies for development during its third session (May 1997). The Working Group established by the Commission concluded that, although the costs of building national information infrastructures and joining the global information infrastructure were high, the costs of not doing so were likely to be much higher.

42. For this reason the Working Group recommended that each country establish a national ICT strategy. While it judged that there are no "best practice" models for these strategies or one single technological pathway because of different national starting points, there is a common need to build new coalitions of resources to enable the business sector to play an increasing role in all aspects of ICT development. Likewise, the Secretary-General has suggested that public-private sector partnerships are necessary to bridge the divide.

43. In July 2000, the Economic and Social Council conducted a high-level segment on the role of information technology and issued a ministerial declaration on the subject. The ministers were also deeply concerned that, at present, ICT's huge potential for advancing development has not been fully captured. This reality gave rise to manifestations of the "digital divide". In this regard, the ministers thought urgent and concerted actions at the national, regional and international levels were imperative for bridging the digital divide and building digital opportunities. They recognized the major impediments such as lack of infrastructure, education,

capacity-building, investment and connectivity. The ministers echoed the need for national development strategies and national focal points. In particular it recommended national programmes which would:

- Promote access to ICT for all by supporting the provision of public access points;
- Bring down connectivity costs;
- Promote investment in the ICT sector.

44. It is relevant to the work of the Commission that the ministers called upon the international community *"to explore and define ways and means to strengthen the use of ICT in small and medium-sized enterprises in developing countries and countries with economies in transition as these enterprises constitute a major source of employment, and also to enhance their competitiveness in the emerging global economy."*

Areas for consideration and further action

45. The Commission may wish to devote its attention to the issue of promoting ICT among SMEs in developing countries. IT presents both opportunities and challenges for SMEs. First, the opportunities: IT offers considerable opportunities to SMEs to expand their customer base, enter new product markets, even global ones, and rationalize their business. Second, the challenges that SMEs will face in the future due to rapid IT developments are considerable. The internal barriers to SME adoption of e-commerce include limited understanding of the complexity of electronic operations, inadequate skills and high initial investment required to develop a viable e-commerce strategy. The external barriers include infrastructure access and costs. SMEs are also more vulnerable than larger firms to problems linked to authentication and certification, data security and confidentiality.

46. Practical measures need to be considered to assist SMEs to enter e-business, including special support services and public-private partnerships. In its previous considerations of e-commerce, the Commission has already covered the issues of human resources development and appropriate regulatory and legal instruments and identifying its trade policy implications and macroeconomic impact.

47. The Commission may wish to convene an expert meeting on special support services for SMEs that could be offered through existing UNCTAD programmes and in cooperation with other UN agencies and international organizations which are involved in the UN effort to bridge the digital divide, such as UNV and ITU and other appropriate entities. Such consideration might allow the Commission to identify ways and means in which the Commission could contribute to a comprehensive programme of action to be carried out through global ICT partnerships, as called for in the report of the Secretary General (E/2000/52, "*Development of international cooperation in the XXI century: the role of information technology in the context of a knowledge-based economy.")*

Other matters

48. In choosing among the various topics, the Commission may wish to evaluate which ones could be done within tight deadlines with existing secretariat resources and which lend themselves to collaboration with other agencies.

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