

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

**DEEPENING DEVELOPMENT THROUGH
BUSINESS LINKAGES**

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**UNITED NATIONS
New York and Geneva, 2006**

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UNCTAD/ITE/TEB/2006/7

PREFACE

This survey presents a series of good practices in promoting business linkages. It is based on the widely held view that business between small and large enterprises, particularly transnational corporations (TNCs), can contribute both to the competitiveness of the enterprises involved and to the growth and development of the host countries. However, it is also based on the assumption that the establishment of a critical mass of sustainable linkages does not happen automatically as a direct consequence of the presence of TNCs, but requires the participation of all stakeholders: Governments through supportive policies, as well as TNCs and SMEs through their vision and commitment.

Evidence shows that a number of countries have deepened the development impact of foreign direct investment (FDI) through measures that stimulate large and small enterprises to work together. This survey identifies possible options for developing countries wishing greater benefits from FDI. It also represents a step forward in the overall work that UNCTAD has undertaken to deepen the understanding of the nature of business linkages, their critical success factors and policies to promote them. In particular, this publication intends to show how the linkage process can be driven by different actors, namely by Governments through public-private sector partnerships, by individual TNCs through stand-alone supplier development programmes, and by bilateral donors and international organizations through technical assistance projects, as well as by civil society.

Given the space limitations, this paper does not attempt to cover SME policies or FDI policies in general. These are subjects in their own right, and are dealt with by other UNCTAD publications. Instead it focuses both on the intersection of these policies in the form of TNC-SME linkages and on the mechanisms countries can put in place to achieve a better integration of domestic and foreign companies on a long-term basis. In doing this, the paper also shows that successful linkage initiatives have rarely been replicated and essentially remain isolated phenomena. Only in one case, that of Penang, in Malaysia, was there a significant scaling-up of the linkage process because of the active role and long-term vision of the Government.

The main lesson to be learned from the experiences presented in this paper is that in order to stimulate replication it is necessary not only to spread best practices, but also to have the active support of the Government. As a matter of fact, the assessment of the effectiveness of linkage promotion initiatives, and the identification of related best practices, cannot be done in an isolated manner, without understanding the policy background underlying them. Experience shows that the success or failure of specific linkage promotion initiatives and their impact on development can be totally misinterpreted if the full picture of the existing mix of relevant FDI and SME-related policies is not accurately drawn.

Following its tenth Conference in Bangkok (2000), UNCTAD began an extensive exploration of the impact of business linkages on development. Afterwards it sponsored roundtables, workshops and expert meetings which pulled together the existing evidence on both the process and its impacts, and it devoted the *World Investment Report 2001* to this issue. Later it made a video, *Business Linkages for Sustainable Development*, with the help of

the Penang Development Corporation and SEBRAE, the Brazilian Small Enterprise Development Agency, to further policymakers' and the business community's understanding of the linkage process.

In 2004, a *Roster of Good Practices in the Promotion of Business Linkages* was elaborated. In an effort to show how the private sector can contribute to development within normal business operations, the roster aims to highlight concrete options for transnational corporations' engagement. This is particularly relevant since most development experts realize that the private sector must play a central role in the linkage process, but that replication of successful corporate initiatives is quite slow, and corporations themselves often struggle with the issues of good corporate governance and corporate social responsibility.

Subsequently, UNCTAD prepared a *Linkages Promotion Toolkit* in order to assist practitioners and stakeholders, including international and bilateral donors, investment promotion agencies and business development services providers in the concrete implementation of programmes aimed at creating and strengthening TNC-SME linkages. The toolkit is the result of lessons UNCTAD learned from the technical assistance projects carried out in this field.

Finally, as a follow-up to the activities already undertaken and to the present publication, UNCTAD will carry out further work on the different institutional mechanisms conducive to linkage creation, with the aim of identifying effective strategies for establishing TNC-SME linkages to the benefit of the host country. In particular, the findings of a global survey, including the cases of India, Malaysia, Mexico, South Africa and Uganda will be published in 2006. The ultimate goal is to identify the underlying determinants of linkage formation and better understand how TNC-SME linkages can become a key driver of economic growth and an effective channel for the transfer of foreign technology and knowledge.

Lorraine Ruffing, former head of the Enterprise Development Branch at UNCTAD, conceptualized and drafted this paper. Many people contributed generously to the elaboration of the case studies, including Boonler Somchit of the Penang Skills Development Center, SY Foong and SH Wong (retired) of Intel, Malaysia, Andre Van Heemstra and Jacques Ferrière (on secondment to UNCTAD) of Unilever, Nick van Rensburg of Zimele, Anglo American, Vicky Schreiber of Poema, George Manu of Creative Squares, Inc, and Busi Bango of Empretec Zimbabwe. The editorial assistance of Toni-Lee Capossela greatly improved the manuscript. Tatiana Krylova, Head of the Investment and Enterprise Competitiveness Branch, UNCTAD, provided encouragement and general supervision, Fulvia Farinelli and Mike Pfister made useful comments, while Rosalina Goyena and Julie Menzli-Henshaw produced a much visually improved document.

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I. Introduction

It is sometimes said that development strategies change as often as Paris fashions. Over the years the United Nations has spawned a number of development strategies, starting with the First Development Decade, which have been explored in Louis Emmerij et al, *Ahead of the Curve: UN Ideas and Global Challenges* (Emmerij et al. 2001). Mr. Emmerij and his colleagues found that “very few ideas are very new” but which ideas go forward and which fall by the wayside is largely a question of “atmospherics”. If the current focus remains on the private sector’s role in development, the “atmospherics” might allow developing countries to implement policies to support their local enterprises so that they can compete in the global economy. This is not a return to import substitution policies but rather designing new policies that infuse FDI into local business development.

UN development experts were definitely on track in the 1970s when employment creation and poverty reduction moved to centre stage with the ILO’s basic needs strategy. Basic needs were defined in terms of food, housing, clothing and public transport. Employment was both a means and an end. This was in contrast to the 1960s, when it was believed that with economic growth everything else, including social advancement, would be attained. This idea resurfaced again in the 1980s, and employment and basic needs were sidelined in favour of controlling inflation, balancing budgets and trade, and optimizing interest rates. The Washington consensus held that employment creation should be left entirely to the private sector. The objective was to strengthen the private sector as the main actor

of growth and development through tax reform, liberalization of trade and finance, privatization, deregulation and strengthening of property rights. This was a revised version of the trickle down economics of the 1960s. Proponents of the Washington consensus were embarrassed by the fact that by 1997 seventy developing countries had per capita incomes lower than in the previous decade. But there were countries and territories, particularly in Asia (i.e. Malaysia, Singapore and Taiwan, Province of China), which did not follow orthodox prescriptions and enjoyed enviable economic and social results (Emmerij et al. 2001).

In particular, these countries followed a policy strategy aimed at attracting FDI while promoting local enterprises. Stimulating business linkages was an important part of some strategies for building local enterprises that could compete at home and abroad as well as meet employment goals.

While it is generally accepted that SMEs are the backbone of the domestic economy, contributing to jobs and income and hence to poverty reduction, few Governments in developing countries have framed policies to enhance their growth or survival. It is easy to find statements of commitment to private sector development, but coherent and fully worked out policies developed in consultation with the private sector are generally absent.

Globalization, trade liberalization and foreign direct investment (FDI) have provided few opportunities for SMEs in most developing countries and, in fact, a growing number of SMEs find it more and more difficult to survive within their own national borders.

During the 1990s, FDI increased dramatically, reaching a record high of \$1.3 trillion in 2000. In many developing countries, where it is almost impossible to access long-term finance at reasonable interest rates, FDI is considered one of the most important sources of capital injection. When deeply rooted in the host economy, FDI can facilitate the upgrading of domestic enterprises, providing them with access to markets and technology. It seems, however, that the role of FDI or TNCs in building local supply capacity has not been sufficiently highlighted to make it clear to all what big business can do under the right conditions.

Although some developing countries have been successful in attracting FDI, they have not always been able to ensure that FDI strengthens local enterprises. FDI can result in a crowding out of access to finance, abusive transfer pricing that minimizes tax payments, foreign exchange instability, and labour and environmental problems. Even when FDI does not have these negative effects, it can add little to local development if there is a lack of adequately skilled human capital, absorptive capacity in local firms and/or incentives to transfer technology to local firms.

There is therefore a need to combine SME support policies with FDI attraction policies. Well designed SME and FDI policies can ensure that FDI works for local enterprise development. If FDI is grounded in business linkages, it can open markets, facilitate access to finance, and transfer technology to local enterprises. Governments can use FDI to improve the capacity of local enterprises through business linkage programmes or supplier development programmes similar to those of Ireland, Malaysia, Singapore, and Taiwan, Province of China, to name a few of the success stories (UNCTAD, 2001).

The current dynamics of global production favour the creation of business linkages between transnational corporations (TNCs) and their suppliers. TNCs are concentrating on their core operations and outsourcing others. The decision to source locally depends on the cost, quality, reliability and flexibility of local suppliers relative to suppliers abroad. Normally, local sourcing should lower costs, allow for closer monitoring, and give greater flexibility in changing specifications and in developing new inputs.

In the case of the Asian tigers, they did not have large natural resources or large internal markets but they had a competitive advantage in terms of the ability to provide special skills, infrastructure, and suppliers who could use technology efficiently and flexibly. Large companies not only look for efficient and flexible SME partners but they also use these partners to gain insights into fast-moving technologies, close the gaps in their understanding or develop devices that may boost the long-term use of their products.

This presents an opportunity for business linkages between TNCs and local SMEs provided the local SMEs are partnership-ready. However, the vast majority of SMEs remain de-linked from TNCs, missing these potential opportunities. Many TNCs assert that there is a lack of suitable local SME partners that could meet their corporate standards or international product standards. For most local SMEs, “partnership readiness”, a prerequisite for mutually beneficial linkages with TNCs, often remains an elusive objective because SMEs lack information, experience, contacts and, above all, the human and financial resources to implement the management and technology changes needed to do business with TNCs.

The challenge for developing countries is to ensure that such linkages occur and contribute to the growth and the competitiveness of SMEs and the development of the economy as a whole. To this end, a set of specific policies and programmes is required, as well as the cooperation of various development actors in implementing them.

This publication begins by reviewing three important elements for private sector development that are critical for a linkage strategy. It then reviews case studies of successful linkage programmes in Africa, Asia and Latin America. There are many types of business linkages and many different programmes to promote them. This publication deals almost exclusively with the promotion of backward linkages—that is, where TNCs source parts, components, materials and services from suppliers in the host economy (Altenburg, 2000). Supplier linkages range from arms-length market transactions to very close, long-term, inter-firm cooperation. This latter linkage provides the best chance for building a dynamic SME sector. Six case studies of backward linkages are presented in order to cull these “good practices”. The publication then identifies critical success factors garnered from the five case studies. Lastly, it concludes by giving some practical advice to the promoters of business linkage programmes.

II. Critical elements for private sector development

a. An enabling business environment

Regulation is necessary for the private sector to operate competitively and in the public interest in terms of consumer and environmental protection. A simple, transparent, stable and enforceable regulatory environment forms the basis for the development of a dynamic enterprise sector. However, many SMEs in developing countries face heavy and costly regulatory burdens that discourage them from even entering the formal sector of the economy.

SMEs in poor countries face more administrative and judicial procedures, more delays in terms of time and higher costs than SMEs in rich countries (World Bank, 2005). The table below illustrates the regulatory burden that enterprises face in developing countries when registering a business as a limited liability company in terms of the number of procedures, the time, the cost and the minimum capital required.

Both heavy regulation and weak property rights exclude the poor from doing business. Often the regulatory system of the formal economy does not provide a clear framework in which business transactions can be enforced or in which property rights are clearly defined.

Table 1: Starting a business

Regions	No. of procedures	No. of days	Cost % GNI/N	Min. capital %GNI/N
OECD				
Australia	2	2	2.1	0
Denmark	4	4	0	49
New Zealand	2	12	0.2	0
Sweden	3	16	0.7	37
United Kingdom	6	18	0.9	0
United States	5	5	0.6	0
AFRICA				
Angola	14	146	884	64
Ethiopia	7	32	77	1821
Malawi	10	35	141	0
Nigeria	10	44	95	59
South Africa	9	38	9	0
Uganda	17	36	131	0
Zimbabwe	10	96	305	53
ASIA				
Cambodia	11	94	480	394
Hong Kong, China	5	11	3.4	0
India	11	89	49.5	0
Malaysia	9	30	25	0
Singapore	7	8	1.2	0
Thailand	8	33	6.7	0
Viet Nam	11	56	28	0
L. AMERICA				
Argentina	15	32	15.7	8
Bolivia	15	59	174	4.6
Brazil	17	152	12	0
Chile	9	27	10	0
Costa Rica	11	77	26	0
Peru	10	98	36	0
TRANS. ECON.				
Belarus	16	79	35	44
Poland	10	31	21	238
Russia	9	36	6.7	5.6
Uzbekistan	9	35	17	22

Source: World Bank and International Finance Corporation, Doing Business in 2005, Oxford University Press.

Hernando De Soto has written eloquently about “dead” capital in his book, *The Mystery of Capital*. He estimates that the poor are sitting on US\$ 9.3 trillion worth of real estate which they do not legally own and thus cannot use as collateral (De Soto, 2000). The table below indicates the difficulty in registering a land title in selected OECD and developing countries.

Table 2. Registering property (in 2004)

Regions	No. of procedures	No. of days	Cost % property value
OECD			
Australia	5	7	4.5
Denmark	6	42	0.6
New Zealand	2	2	0.2
Sweden	1	2	3.0
United Kingdom	2	21	4.1
AFRICA			
Angola	8	335	11
Ethiopia	15	56	11
Malawi	6	118	3.5
Nigeria	21	274	27.2
S.Africa	6	20	11.3
Uganda	8	48	5.5
ASIA			
Cambodia	7	56	4
Hong Kong, China	3	56	2
India	6	67	14
Malaysia	4	143	2.2
Singapore	3	9	1.5
Thailand	2	2	6.3
Viet Nam	5	78	5.5
L. AMERICA			
Argentina	5	44	8.8
Bolivia	7	92	5.1
Brazil	14	42	2
Chile	6	31	1.4
Costa Rica	6	21	3.6
TRANS. ECON.			
Belarus	7	231	0.2
Poland	6	204	1.6
Russia	6	37	0.8
Uzbekistan	12	97	11.8

Source: World Bank and International Finance Corporation, *Doing Business in 2005*, Oxford University Press.

If developing countries want SMEs to thrive, regulatory burdens in these two areas must be simplified and reduced. This can often be done by creating a one-stop shop for business registration and a land registry. However, simplification is often opposed by the Government itself because it cuts down on licensing fees and for some Governments the opportunity to extract bribes.

There is much empirical evidence that complex and heavy regulatory frameworks are positively correlated with high levels of corruption. The relative cost and length of time involved in registering a business are positively correlated with the Corruption Index published by Transparency International (UNCTAD, 2003). But more importantly, heavy and expensive regulations keep businesses in the informal sector, where they will be denied access to courts, banks, export possibilities and business partners.

This publication features six case studies from Brazil, Malaysia, Malawi, South Africa, Viet Nam and Zimbabwe. Brazil presents the toughest environment for SMEs in terms of number of procedures and days, followed by Zimbabwe and Viet Nam. We shall see in section IV how the business environment shaped or limited the linkage process.

b. Access to finance

Once an enterprise is formally organized, it should be able to access business and financial services necessary to strengthen and/or expand the business. Finance has been identified in many business surveys as the most important factor determining the survival and growth of SMEs in both developing and developed

countries. Despite the importance of SMEs to the economies of both developing and developed countries, SMEs have traditionally faced difficulty in obtaining formal credit or equity.

Unfortunately, this problem hardly gets a footnote in the recent reports on Africa, even though large companies operating in Africa know all too well the problems their potential suppliers face.

...despite the misperception that capital shortages are holding back development, banks across east, west and sub-Saharan Africa are actually flush with money. Yet they refuse to lend it to those who can do the most with it: millions of disenfranchised, small-scale African entrepreneurs who could lift Africa out of poverty if given half a chance (Hoffman, 2005).

Commercial banks and investors are reluctant to service SMEs for a number of reasons:

- SMEs are regarded by creditors and investors as high-risk borrowers due to insufficient assets and low capitalization, vulnerability to market fluctuations and high mortality rates;
- Information asymmetry arising from SMEs' lack of accounting records, financial statements or business plans makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals;
- The high administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business (UNCTAD, 2002).

Overcoming the traditional reluctance of commercial banks to lend to SMEs requires pressure from the very top, namely from the central bank, which needs to set out a policy framework for channelling adequate funds to the SME sector. Most central banks are reluctant to get involved because they believe that their main duty is to ensure monetary and financial stability, and they do not see their role in development per se.

Carefully designed and monitored set-aside mechanisms, increased transparency, and public disclosure of the composition of bank loan portfolios could influence the lending practices of commercial banks. Governments/central banks could promote special measures for SMEs, including guarantee programmes combined with IT-driven credit appraisal systems to reduce the risks perceived by banks.

Another way to reduce the transaction costs and risks of commercial banks in dealing with SMEs is for banks to team up with business development service (BDS) providers. The BDS provider can often do the pre-screening, assuring the bank of a flow of high-quality clients. The BDS provider can also help ensure the success of the business by providing critical services such as accounting and business plans. Lastly, the BDS provider can monitor business performance to ensure that the SME will be able to make repayment.

In effect the BDS provider may become an “unofficial” guarantor for the bank without actually providing a loan guarantee. For a bank that deals with SMEs, there is a clear incentive to help its SME clients avoid some of the typical management and market difficulties that could undermine their business and jeopardize repayment of loans. Some banks provide additional consulting and advisory services to their clients that are similar to those of BDS providers. However, in many cases this could be costly for the

bank, since it might not have the necessary in-house expertise to deal with SMEs. A partnership with a BDS provider is therefore a natural way forward, as the latter can provide these services at lower cost. There are also obvious advantages for the BDS provider, as it can sell its services to SMEs more easily if there is the possibility of accessing finance.

In the case studies, we will see that SMEs' ability to upgrade technology depends on their access to finance and that most had to rely on internal sources or the usual family and friends. If adequate external finance had been available, linkages might have been more widespread.

c. Public-private sector partnerships

The ability of SMEs to compete in the global market place depends on their access to certain critical resources such as finance, technology and managerial skills. The Government, SME support institutions and TNCs can facilitate access to these critical factors. But TNCs may often be the best source of new technologies and management know-how.

The intensity of TNC-SME linkages and the ability of countries and individual enterprises to exploit them for technology upgrading vary greatly, depending on three factors:

- The existence and efficiency of supporting public policies and measures that increase the competitiveness of domestic SMEs and facilitate skill development (technical and managerial);
- TNC corporate strategies that are conducive to local enterprise development;

- The existence of SMEs that have the potential to meet TNC standards within a short learning period.

As the global economy becomes more open to international business transactions, countries increasingly have to compete for FDI. Many of them have relaxed restrictive FDI policies, but merely opening the door to FDI will not result in the country's economic development. Governments must determine the sectors and niches in which their national competitive advantages lie and then attract TNCs that are willing to assist in developing them.

While many developing countries focus on a combination of low factor costs to attract FDI, such as labour and natural resources, as well as general infrastructure, these basic and generalized factors are usually not sufficient to sustain long-term competitiveness. In order to achieve technological upgrading, advanced and specialized factors of production must be developed that will encourage TNCs to transfer their technology to local enterprises. These include specific human-capital formation in engineering, science and business studies.

It is commonly believed that the type and strength of linkages established depend on the technological and other resource capabilities of local enterprises. Special support measures and programmes can nurture these capabilities. Such interventions can best succeed when they respect the principle of subsidiarity, i.e. allowing each partner to undertake what it can do best, and when they are embedded in a coherent policy framework that fosters investment, competition, technology transfer and SME development (Committee of Donor Agencies for Small Enterprise Development, 2001).

Given the market failures that afflict SMEs, there is a strong rationale for intervention. Moving towards more active intervention requires a high degree of administrative efficiency in government and a low degree of cronyism and corruption. Because the Government obviously cannot do everything, support measures should, wherever possible, be offered by private entities which operate at a decentralized level and are thus close to the customer (SME).

In other words, it must be clearly understood who can do what best among the various development players, including Governments, meso level institutions and TNCs. The general consensus in the international community favours minimal public sector intervention that is restricted to improving the macroeconomic, administrative and regulatory framework for private-sector activities, providing the basic logistics infrastructure and education, and stimulating a market for business service providers.

Notwithstanding this, there is a “public good” component in the process which might need subsidization if SMEs are to be made partnership ready. TNCs pursue different corporate strategies that are usually closely related to their economic motives for operating in the host country. In the past, foreign investors, operating in relatively closed domestic markets, developed substantial supplier linkages not only because host countries imposed domestic-content requirements but also because quality requirements were less rigid. By comparison, investors seeking resources or focused on export-oriented industries created few linkages.

Beside the locational motives for investing in a given developing country, many other aspects shape corporate strategy and TNCs’ willingness to develop linkages with local SMEs. These include the degree of technological sophistication of the TNC and the economies of scale attained, the length of time operating in a host

country, the geographic proximity and transaction costs between the TNC and its affiliates, the TNC's market position, for example whether it operates in price-sensitive markets or enjoys high innovation rents, and the trade policies of the host country, i.e. whether inputs can be easily imported.

The TNC's willingness to develop linkages is also influenced by its corporate culture which, in turn, reflects cultural features of the TNC's home country. For example, several studies have shown that United States and European electronics and computer companies have used South-East Asian affiliates for specialized production in a global division of labour, therefore beginning a process of systematically upgrading the technology, improving quality control and diversifying managerial responsibilities in their subsidiaries. Japanese TNCs, on the other hand, have maintained higher value-added operations in Japan, while transferring only lower-end processes to their foreign affiliates (UNCTAD, 2000).

Governments can enlist the support of certain TNCs in building linkages because many profit-seeking TNCs are concerned with the issue of corporate social responsibility (CSR) since they live in a media-driven world. They understand that they need an implicit license to operate in their societies. The social contract stipulates that with power and rights go certain responsibilities. Some TNCs interpret the concept of CSR in a broad sense, that is, they understand and accept obligations not only to shareholders but also to other stakeholders such as employees, suppliers, customers and even competitors, local communities and Governments. Stakeholder theorists point out that many parties affected by corporate activity may have neither the economic ability to signal

their needs through market mechanisms nor the political power to ensure their representation in government. These situations can, therefore, invoke the subsidiarity principle where both an enterprise's capability and its impact on those around it become critical factors in determining the nature and the degree of a corporation's responsibilities.

**Box 1: Key Features of TNC strategies
that deepen linkages**

- Investment driven by the search for strategic capabilities and assets rather than for cheap natural resources, low wages or protected local markets.
- Business models based on networking and inter-firm cooperation.
- Decentralized corporate decision-making and empowered local management to authorize independent sourcing and new product development.

When TNCs were asked what they looked for in SMEs, the most important criteria for partnering was “attitude”. The CEO of the SME must have the will to succeed and the will to transform. Furthermore, the SME must have its own strategy or vision for the future, as well as good financial management (UNCTAD, 2000). This leads us back to the need for good business development support services in order to make SMEs “partnership ready”.

III. Case studies: Promoting business linkages between large and small enterprises

As mentioned earlier, the terms “partnerships” or “business linkages” are used to cover a wide variety of relationships. This section concentrates on backward linkages between large and small enterprises where the TNCs source parts, components, materials and services from SMEs and thus are more likely to have a profound development impact. The case studies were chosen with several criteria in mind:

- They illustrate a backward linkage;
- They are based on a profit-driven business strategy as opposed to a philanthropic motive;
- They are long-term and have already demonstrated positive development impacts;
- They are sustainable in the future;
- They are replicable.

Some of the case studies describe initiatives that involve partnerships between the Government and private sector TNCs. Others deal with initiatives undertaken solely by a TNC. And still others involve cooperation between a TNC and civil society or bilateral donors or international organizations.

The case studies demonstrate what Robert Davies, CEO of the International Business Leaders Forum, calls a “step change in imagination in how TNCs engage with local producers, build local entrepreneurial capacity and work with civil society organizations” (Maitland, 2005). Most TNCs have yet to make this “step change” and continue to cherry-pick among SME partners in their home

and host countries. While the case studies demonstrate best practices in the linkage programmes of the selected TNCs, the choice of the TNCs does not signify blanket endorsement of all the operations of any one TNC. Even the pioneers in this study that have well articulated corporate strategies and corporate ethics find implementation a continuous challenge and lapses are inevitable among their affiliates and subsidiaries. Better mechanisms for good corporate governance are still evolving.

**Penang, Malaysia: A smart public-private partnership
An example of a government-led initiative**

*by SY Foong, Intel, Malaysia, and Boonler Somchit, Director,
Penang Skills Development Centre*

Background

The first case study – that of Penang, Malaysia – is an example of public-private sector partnerships which evolved from a public-private sector dialogue that has long been promoted by the Penang State Government. Penang is one of the 13 states of the Federation of Malaysia and has a population of about 1.2 million. The governments, at both federal and state level, played a catalytic role in the economic transformation of Penang by adopting a pro-business stance. They fostered a conducive environment for the development of the manufacturing sector through vision, pragmatic policies and transparent incentives.

The linkage process, described in this section, transformed Penang from a sleepy agricultural economy and trading station to the Silicon Island of the East. In 2000 the manufacturing sector was the main engine of growth and accounted for 45 per cent of the State's GDP as compared with 13 per cent in 1970 while the contribution of the agricultural sector dropped from 20 per cent to 2 per cent. During the same period unemployment went from 16 per cent to 4 per cent.

In the words of Chief Minister Dr. Koh Tsu Koon, the economic transformation of Penang was based on the three “I’s”: institutions, infrastructure and incentives.

First “I”: institutions

The Penang Development Corporation (PDC), established in 1969, is the principal development agency for the State. The PDC pioneered the concept of free trade zones (FTZs) to encourage foreign investment in export-oriented activities. It acts as a one-stop shop that interfaces between potential investors and the local authorities and local business community. It advises investors on how to get started in Penang by providing assistance in planning, siting the plant and submitting applications to various departments, as well as finding suitable local partners. All proposals are reviewed within three months of receipt, correspondence is replied to within seven working days, and feedback on complaints is given within 21 working days.

PDC has created two free industrial zones and five industrial parks, covering an area of 2,370 hectares. It has helped global players, such as AMD, Dell, Fujitsu, Hewlett-Packard, Hitachi, Intel, Motorola and Fairchild to locate subsidiaries in Penang and to create strong linkages with local SMEs in a wide range of industries, including electronics, engineering, metals, plastics, packaging and textiles/apparel. As mentioned above, PDC created two FTZs and five industrial parks. Both SMEs and TNCs were encouraged to locate in them, creating clusters where linkages were facilitated.

Another key institution is the Penang Skills Development Center (PSDC) (see box below). The existing labour pool, comprising school leavers with an average of 11 years of formal education and graduates from technical institutes, colleges and universities, did not have the skills that were demanded by industry. Their skills needed further fine-tuning through on-the-job training or in specialized training centres such as PSDC. This unique institution pools resources from the private sector, government and academia. It is a good example of subsidiarity. It received modest initial support from the State government and is now managed by a management council drawn from the private sector. The 94 corporate members of PSDC contribute experts, training materials and equipment so that the Centre can provide state-of-the-art training for a variety of engineering, technical and management skills.

Box 2: The Global Supplier Development Programme of the Penang Skills Development Center

PSDC was established in 1989 in order to resolve the mismatch between the skills industry needed and the skills the labour force possessed. While Malaysia was turning out an educated labour force and many engineers, it was not providing its workers with the skills they needed to function on the factory floor. There was a technology gap between industry standards and academic/commercial training. PSDC also resolved a second problem – each TNC could not train all its many vendors, and so collective efforts made sense.

The Government supported specialized skills training by providing facilities such as land and buildings for the skill centres and modest grants for initial operational costs. It also gave incentives to the private sector to send workers for retraining. So while TNCs were pushing SMEs for training, PSDC was pulling SMEs to train.

PSDC started off in 1989 with 32 courses for 559 participants; by 2002 it offered 353 courses to 6,253 participants and had trained a total of over 75,000 workers. PSDC is a non-profit society with 94 enterprises as members, is exempted from income tax, has a capital grant from government and is financially independent for daily operations. It is governed by a management council composed of industry (15 enterprises from Bayan Lepas), government (five agencies) and academia (one university). It meets quarterly and through its chairman guides the PSDC executive director and staff. PSDC relies on industry partnerships to share experts and training programmes and to contribute the machinery necessary to conduct practical courses.

During the last five years it has focused on vendor development programmes, the most significant of which is the Global Supplier Development Programme. The programme was officially launched by the Minister of International Trade and Industry in 2000. Its objective is to assist local companies to become world-class global suppliers in services and materials. The mission is to develop and upgrade the capabilities of local companies through training and linkages with TNCs. This is the programme that makes promising SMEs “partnership ready.” SMEs that want to enter business linkages or take advantage of the TNCs’ vendor development programmes can enrol in this programme as a first step.

The training is divided into two streams: manufacturing and services. Courses are offered in three areas: core competencies; intermediate systems; advanced systems.

Core competencies cover the basic business and organizational skills that SMEs need to understand and work with large companies. The systems courses introduce trainees to the latest technologies used by potential partners so that they can move up the technology ladder.

Once an SME has been through basic training, it is selected to enter a TNC's coaching and mentoring programme. The linkage is supposed to transfer additional skills and technology and monitor progress. After an agreed period of coaching and mentoring, the SME either enters the TNC's supply chain or is dropped.

The Global Supplier Development Programme is a deliberate process to which all the partners are committed. This is not a simple matchmaking exercise using a data base to pair up partners as is so often the case. In fact matchmaking hardly figures in the strategy. Instead it is a serious alignment of philosophies, needs and capabilities of the partners that can take months and years. In the words of one PDC official, "we are glad the TNCs and SMEs decided to play the game and they played it so well".

Second "I": Infrastructure

The Penang Government has put great emphasis on ensuring good transportation facilities and links, utilities and other physical infrastructure for the business sector. Penang International Airport, the second largest in Malaysia, has been upgraded with improved facilities and a new air cargo complex. In addition, the Penang port is a major regional hub with modern facilities for both international and coastal vessels, including a deep water wharf, a new container terminal and a bulk cargo terminal. Penang is at the intersection of the North-South and East-West highways and is served by the national railway line, thus ensuring quick access to Kuala Lumpur,

Singapore and Thailand. Adequate electric power is supplied via the National Grid System and by two power stations within the State. Penang Water Authority supplies water meeting WHO standards.

Recognizing the critical value of information and communication technologies, investments in IT have made the telecommunications infrastructure and services in Penang one of the best and most modern in the region. Penang.Net is the State Government's farsighted strategy to strive for a smart partnership between a private-sector-led consortium of technology and telecommunications providers and the State Government to develop Penang into an IT state through a high-bandwidth infrastructure.

Third "I": Incentives

Various attractive tax incentives are provided for approved projects in order to ensure that start-up and operating costs are competitive. Both local and foreign enterprises benefit from tax holidays, investment tax allowances and reinvestment allowances. It is important to note that the incentives are for TNCs and SMEs alike. There are special incentives for increasing local content, hi-tech industries, industrial buildings, and R&D activities. There are a number of incentives for training and training facilities which are considered an investment. TNCs and SMEs are encouraged to invest in training by the double deduction allowance whereby they can deduct from their income double the cost of training. A one per cent tax on wages helps finance the Human Resource Development Fund, which gives grants for skill development, training equipment and an apprenticeship programme. SMEs also

get special prices to acquire IT equipment and grants to invest in design.

Without the incentives it would have been difficult to convince top TNC management to invest the time and effort in coaching and mentoring rather than changing partners whenever they found better ones. SMEs also needed the incentives since it was not easy to obtain bank finance in order to maintain their cash flows so that they could meet TNC requirements. In particular, pioneer status and investment tax allowances enabled SMEs to upgrade technology and invest in R&D. Penang managed to maintain fiscal balance despite the generous incentives and had the resources to invest in its people and infrastructure.

Intel: Pioneer of the Smart Approach

Intel arrived in Penang in 1972 and was one of the original eight pioneers (Agilent, AMD, Osram, Bosch, Clarion, Hitachi, Fairchild, Intel) attracted to the FTZ by PDC. It currently employs 8,000 workers. Intel's stated objective for supplier development was *to demonstrate its commitment to grow Malaysian based suppliers by continuing its efforts to nurture existing and potential new suppliers*. Its local managers have crafted a supplier development programme called the "Smart Approach" to achieve this objective. Intel has been chosen by the *Financial Times* as the best employer in Asia. The FTZ of Bayan Lepas is a hotbed of both competition and cooperation. A number of other TNCs have developed supplier programmes that are strikingly similar to the "Smart Approach".

Intel looks for the following four qualities in potential suppliers:

- Competitiveness: safety, quality, delivery, price;
- Capability: technical, materials, process;
- Stability: vision, finances;
- Resourcefulness: management, human resources, training.

TNCs such as Intel are in a strong position to choose their partners. They look for SMEs that can meet their corporate requirements as well as international standards on crucial production issues such as price, quality, delivery, health, labour and environmental standards. SMEs, on the other hand, are less than “partnership” ready. It is unrealistic to think that in a world of giants, SMEs can become partnership ready without assistance.

Intel uses the following five steps in its smart approach to selecting and nurturing its suppliers.

First, Intel identifies or sources suppliers who are willing and able to meet its requirements. Because Intel has “indigenized” its managerial work force, it is easier for them to evaluate potential suppliers. In fact 98 per cent of the CEOs of the foreign companies in Bayan Lepas are locals. SMEs are given both time and assistance to meet Intel’s requirements.

Second, Intel matches its business needs with the capabilities of the potential suppliers and provides them with initial training. Intel collaborates with external skill centres to develop supplier capabilities. It uses the Penang Skills Development Center and participates in its Global Supplier Development Programme and the National Institute of Occupational Safety and Health for contractor safety certification training. It also shares its internal

training courses and access to its innovation centres, engineers and consultants with its suppliers. It assigns Intel staff to SMEs to share know-how and engages in a phased upgrading of technology from SME plant layout to design capability, flexible manufacturing and ISO certifications.

Third, it gradually allocates tasks or contracts on the basis of an SME's abilities and increases these contractual opportunities as the SME grows in its abilities.

Fourth, it continually refines the SME's capabilities and promotes continuous improvement through coaching by setting up supplier briefings, contractor dialogues, business technical reviews and one-on-one sessions between Intel senior management and SME managers who evaluate and benchmark progress.

Fifth, when the SME is mature and it is able to supply other parts of Intel's global supply chain, it becomes a global supplier. Intel insists that their SMEs have a diversified customer base and are not totally dependent on Intel. It propels local suppliers to the international scene by organizing road shows for selected suppliers, facilitating strategic alliances and fielding local suppliers for international projects. In this last stage of the smart approach, the SME is often called upon to supply the solutions for Intel's technical problems, thus becoming a "total solution supplier". Part of the agility gained by the SMEs comes from the fact that Intel also shares its "technical roadmap" with its suppliers so that they can pre-position themselves and get ready for change. This requirement on multiple business partners and sharing the roadmap

allowed many SMEs in Barbados to survive Intel's move from Barbados to Costa Rica. The approach has sometimes had a downside for Intel because their diversified SME partners cannot always take on additional work from Intel.

Impact

The smart public-private partnerships between government, TNCs, SMEs and their support institutions have yielded impressive results for the development of Penang and its SMEs. Together the partners have created a diversified, vibrant economy with growth rates of over 8 per cent and have achieved the first Millennium Goal — a decent standard of living. Their success shows that the most effective strategy for poverty reduction is job creation.

A number of the SMEs such as LKT and Eng Tek which have been through the Intel supplier development programme have become transnationals in their own right. Eng Tek was recognized by Money Asia as the best SME in Malaysia, and LKT has won numerous awards for product, vendor and supplier excellence. Both SMEs are listed on the Kuala Lumpur stock exchange. They became, through the smart approach, “best-in-class” technology corporations.

At the end of this process, SMEs are able to meet stringent health, safety and environmental standards, are able to respond to multiple and sudden changes, are able to give 24/7 coverage, are competitive from a total cost perspective and are able to support a global network and total solutions. As mentioned earlier, a number of other transnationals in Bayan Lepas are using the same approach as Intel.

This “copying” has allowed the linkage process to be scaled up so that it produces a growing core group of competitive SMEs that are able to dynamize the entire SME sector.

Partnerships and the smart approach have had a positive effect on enterprise creation and growth, employment and the fiscal stability of the State government. Between 1970 and 2002, industrial enterprises increased from 31 to 731; and jobs from 84,000 to 150,000.

Critical success factors

In distilling the “Penang experience”, the following critical success factors emerge:

- Long-term commitment by both government and TNCs;
- Targeted FDI strategy to attract TNCs with a positive corporate philosophy and willingness to delegate to local managers to develop linkages;
- Establishment of public-private sector dialogue;
- Formation of meso institutions, i.e. skill centres, such as PSDC;
- Selective rather than indiscriminate support for SMEs;
- Systematic supplier development programmes vs. less structured ones;
- Appropriate use of economic incentives.

Penang is a unique example where the Government was able to marry its policy objectives for job and export creation with the objectives of foreign investors. The TNCs took advantage of the enabling business environment and infrastructure and at the same time saw that it was in their business interest to work with the SMEs. The economic incentives diminished the pain of investing in skills development and SME coaching. It also was a collective effort that offered some economies of scale to each TNC. In the long run, the strength of their SME partners became a competitive advantage.

Unilever Vietnam: Going it alone
An example of a private sector initiative in the food and
personal care industry

by Jacques Ferriere, UNCTAD
(on secondment from Unilever)

Background

Unilever was attracted to Viet Nam in the early 1990s for a number of reasons. Growth rates then exceeded 7 per cent per year, there was political stability, and literacy was high (over 92 per cent). Viet Nam also had an impressive record in reducing poverty. Only 37 per cent of its population of more than 81 million lived below the poverty line. In addition it was increasingly more open, and foreign direct investment was growing at 3 per cent per annum.

Nevertheless, the negotiations to enter Viet Nam were lengthy, slowed down by a negative social and political attitude toward the private sector, a dual pricing structure for foreigners, regulations and policies that continually changed, and excessive bureaucracy.

In this regard Unilever did not enjoy the active government support that the eight original pioneer investors in Penang received or the government indifference that Anglo-American faced in South Africa. Nevertheless, it knew it was important to build trust with the Government and to prove to it that Unilever was in Viet Nam to stay and to share.

This philosophy encouraged it to work with local enterprises and suppliers despite the fact that the SME sector in Viet Nam was small and vulnerable. SMEs were heavily dependent on local and central officials. Most were producing low-entry-barrier, low-margin products in garments and footwear. With increasing trade liberalization fostered by AFTA and WTO, they faced a more competitive market particularly from Chinese exports. In addition Unilever's potential partners seemed to lack a code of business principles and strategic vision.

Despite this difficult environment, Unilever completed negotiations with the Government and began operations in 1995. Unilever Vietnam is composed of three separate companies operating at four sites: Lever Vietnam JV, Elida P/S and Unilever Best Foods VN Ltd. It invested over \$100 million to rebuild two existing plants and build two new ones. It also upgraded nine main contract manufacturers and numerous suppliers, and created an extensive distribution network for its products.

Manufacturers and suppliers needed special help to make the massive jump to work with a transnational like Unilever. Nevertheless, Unilever was motivated to work with them in order to keep its operations slim, cost-effective and flexible by outsourcing. In increasing the capabilities of the local enterprises, Unilever knew that it would be increasing its own competitiveness.

To strengthen its local partners, Unilever used a step-by-step approach. In step one it carefully selected its partners. In the second step it treated the local enterprises as preferred business partners. In the third step it upgraded their technology through its Manufacturing Sustainability Improvement Programme.

Manufacturing Sustainability Improvement Programme

Unilever's Manufacturing Sustainability Improvement Programme focused on improving a number of key aspects:

- Plant hygiene and good housekeeping
- Management systems
- Equipment maintenance
- Processing
- Quality assurance and product safety
- People
- Cost control
- Continuous improvement
- Security and confidentiality.

Unilever provided contract manufacturers with both training and access to technology in order to improve the above aspects. Transfer of technology was achieved through the supply of world class equipment, full time hands-on technical support and supervision, access to Unilever's Innovation Centers and training in quality and hygiene, safety and productivity. Its experts told local enterprises what they needed in terms of modern plant and equipment and how much they needed to invest and taught them to

invest only what was needed to grow gradually. Unilever provided in-house training since it did not have the benefit of a cooperatively managed training centre such as the Penang Skills Development Center.

Regarding its suppliers, Unilever adopted a similar approach. It provided training in the above-mentioned areas and audits to improve customer service, quality and safety. Unilever specialists were also available to upgrade technology. For both the contract manufacturers and suppliers, loan guarantees were provided by the fact that Unilever guaranteed a certain volume of sales.

Besides producing its usual line of personal care products, Unilever was also open to the introduction of new products based on local culture and tastes. One of its contract manufacturers had a unique product: Quoc Duong “Pha Quoc” fish sauce. The company had a prestigious source of raw materials—an abundance of good anchovies—and was experienced in processing them. It also possessed 90 per cent brand recognition. Unilever Best Foods NV Ltd. invested \$650,000 to build a bottling plant, expand Quoc Duong’s fishing and fermentation capacity, develop operational and management skills, and protect its intellectual property against counterfeits.

Impact

During the linkage process Unilever built up a healthy supply chain of growth-oriented contract manufacturers, suppliers and distributors. As a result, by 2001 contract manufacturers accounted

for 48 per cent of Unilever Vietnam's total production volume. Unilever was able to source 40 per cent of its raw materials and 80 per cent of its packaging from local enterprises. They benefited in terms of increased turnover and employment. Unilever's employment policy to recruit, develop and retain local talent clearly benefited 7,500 Vietnamese workers (5,500 of these were new jobs) in its four plants and nine contract manufacturers.

Duy-Tan, a supplier of bottles, increased its total turnover from \$900,000 to \$6.67 million and employment from 160 to 664 between 1996 and 2002 through its association with Unilever. By becoming part of Unilever's distribution system, the Hoang Phong Distributor increased turnover from \$4,920 million VND to \$45,800 million VND and employment from 10 to 55.

The transfer of technology to local enterprises enabled them to comply with international product quality standards and obtain ISO certifications. Since they were competitive in terms of costs and quality, they were also able to enter export markets and diversify their business partners and thus avoid total dependence on Unilever.

Unilever gained additional capacity with low capital investments, cost competitiveness and a nationwide distribution reach. It was able to pull ahead of its competitors because of local sourcing, which gave Unilever a competitive advantage in price.

Total turnover of its four main plants was \$4,000 billion VND and taxes were \$400 billion VND (2003). Unilever was recognized as a model investor by the Government.

In terms of corporate social responsibility, when it undertook programmes for the community it did not stray from its business model. Unilever knows that it is a business, not a charity, but it was willing to share wealth with the local community. It has invested more than 50 billion VND in various social and community programmes over the last 10 years with a strong focus on health, hygiene and education programmes. For example it supported a programme to improve the oral care of 10 million children.

Critical success factors

When the Chairman of Unilever Vietnam was asked in 2004 about critical success factors he identified four of them:

- Vision and commitment
- Commercial sense
- Utilizing local cultural traditions
- Being in it for the long term.

Unilever officials know that linkages are a part of normal business operations. They have a choice of sourcing internally or externally or in the host or home country. Their global sourcing strategy *committed* them to striking mutually beneficial partnerships with local enterprises if they made *commercial sense*. Unilever invested in a network of local contract manufacturers and suppliers and distributors over the *long term*. Their competitors had a more global and less local approach to the Vietnamese market and were less successful.

**Zimele - Anglo American, South Africa:
Going it alone**
An example of a private sector initiative in the mining industry

by Nick van Rensburg, Director, Zimele

In this next case study we see that business linkages are not the exclusive domain of the semiconductor industry. Backward linkages have been developed in many other sectors, including mining, food and personal care products, textiles and automotive accessories. It is also possible to develop company programmes in the absence of the comprehensive public-private sector partnerships we saw in Penang. In many instances Governments are unwilling or unable to participate, yet a formal linkage programme still makes business sense to some TNCs.

Within South Africa, there is a strong movement for black economic empowerment. Corporations are supposed to devote 1 per cent of after-tax profits to local economic development. Anglo American is supporting black economic empowerment through enterprise creation. Commitment to local supplier development starts with top management, who know that they are accountable for social impacts but are also driven by strict commercial principles. They pledge: *“We will seek to make a contribution to the economic, social and educational well-being of the communities associated with our operations including through local business development”*.

This pledge was fulfilled with the creation of Zimele, which evolved out of the Anglo and De Beers Small Enterprise Initiative established in 1989. In 2000 a separate corporation was created called Zimele which in Zulu/Xhosa means “to stand on one’s own feet”. Anglo American recognized the potential for increasing efficiency through greater SME outsourcing. Zimele has an investment fund of \$2.3 million, its own Board and three permanent staff. Through Zimele, small specialist companies provide inputs more competitively, thus reducing Anglo’s costs.

Zimele’s programme has three main goals:

- To proactively seek out opportunities for black owned/managed SMEs to supply non-core services to Anglo Group companies;
- To support SMEs more broadly, including those with links to Anglo Group companies, through the provision of finance, technical assistance, business planning services and the transfer of skills;
- To look for investment opportunities.

Zimele has two main areas of activity: procurement and business development services. The entire Zimele programme in fact developed out of Anglo American procurement opportunities. In procurement, Zimele identifies opportunities with the Group’s purchasing departments, and sources the needed goods and services from SME companies. These SMEs have to meet the test of commercial viability regarding quality, price and delivery.

Through creative procurement, Zimele sets targets for local managers and lead contractors. It gives SMEs “bite size” tenders and provides prompt payment.

For those SMEs wanting to take advantage of Anglo-American procurement opportunities, Zimele provides business development support services in terms of business skills, strategies and systems.

Linkages process

Zimele’s objective is to promote long-term sustainable SMEs that make money. Zimele wants to work with the right people—that is with entrepreneurs with passion. It intensively nurtures (mentors) its entrepreneurs/ investments through the “incubator” approach, which transfers business skills and good business practice. SMEs interface with all Anglo’s functional areas, including top executives, line management, business development managers and networks, and business intelligence.

Most important are the business development officers (BDOs) within the Anglo Group, who provide support. Through the BDOs, Zimele can provide a range of support services including:

- Access to Anglo procurement programmes
- Secretarial, accounting, legal and tax help
- Business skills and proposals
- Financial and administrative systems for proper control
- Strategic planning and alliances.

In addition to seeking out specific opportunities for SMEs to supply Anglo American, the BDOs and Zimele core staff look for investment opportunities for Zimele. It provides finance through loans and by taking a minority stake (20 per cent) of up to \$350,000 per company. The latter is most important, since Zimele comes on board as a partner/shareholder that shares the SME's risk.

However, SME shareholders must also make their own capital commitment. Over time the capital dependency is reduced as Zimele looks for an exit strategy. As a shareholder, Zimele sits on the boards of the various SMEs and so can act as a force for good corporate governance, as well as protect its investment.

Impact

Through Zimele, Anglo American has 'institutionalized' its approach to supplier development. Over the years this has enabled Anglo American to spawn or strengthen a number of successful SMEs. During 2004, Anglo American's divisions collectively spent \$800 million on goods and services from SMEs (\$440 million in 2003). Since its creation in 1989 Zimele has invested in over 100 companies and has exited from 70 of them. The survival rate for SME partners is 90 per cent. This is significant, since the average life of an SME is six years.

In 2004 Zimele had investments in 27 businesses that employed over 2,000 people. Investments were divided into loans (72 per cent) and equity (28 per cent). Zimele recovered 85 per cent of its total direct costs through its investment portfolio. The SMEs

provide mining systems, piping systems, concrete, lighting (for mines), transformer oil, chemicals, recycling, conveyor belt services, health and safety products, on-highway diesel services, salvage management, engineering services and rail repair.

While Zimele classifies these as “non-core” activities, they are closely tied to its business operations and are technically more demanding than, say, providing food or cleaning services. In discussing whether this company model is replicable, the Zimele managers stressed that economies of scale are important. Twenty-seven companies represented the minimum number needed to make the investment fund profitable enough to cover costs. Zimele invests in around 15 new businesses every year.

Critical success factors

The success of Anglo American’s Zimele model depends on the following critical elements:

- Encouragement of long-term economic empowerment and wealth creation;
- Development of sustainable, commercially viable businesses;
- Investment in small businesses through equity and loans;
- Minority stakes of up to 20 per cent with a clear exit strategy;
- Focus on the creation of successful enterprises, not on jobs;
- Sustainability and commercial viability as evaluation criteria.

What we see in this case study of Zimele is that Anglo American developed this programme in the absence of the tailored policies existing in Penang. As a result Anglo had to take on many of the roles played by the partners in Penang. It had to be its own development corporation and skills centre. To substitute for the missing economic incentives to SMEs, it also had to assume the finance role. Yet it received no big tax incentives. It is a heavy burden for any company to “go it alone”, but Anglo American has done it in a way that benefits both shareholders and stakeholders in the long run.

Poema: From Trash to Treasure
An example of a civil society initiative

by Vicky Schreiber, Bolsa Amazonia, Para, Brazil

Background

Poema is a programme of the Department of Environment at the Federal University of Para, Brazil. It was established in 1992. Its three objectives are:

- To promote a sustainable development model;
- To protect Amazon biodiversity;
- To empower local communities by creating economic activities.

Initially it assisted poor rural communities of the Amazon to improve basic living conditions by providing water, sanitation and power generation. Through its work with these rural communities, Poema realized that they would remain impoverished and the environment degraded unless their economic conditions improved. Because the communities relied on agro-extraction, Poema decided to establish value-added production centres in order to increase local incomes. These value-added centres are small-scale production areas where primary industrial transformation takes place; the semi-processed material is then transported to larger factories for further processing.

The coconut production chain

In its initiative commercializing coconut fibres for the automobile industry of Brazil, Poema forged a number of partnerships or strategic alliances between the producers' cooperatives of Para, SMEs and DaimlerChrysler.

Initially the University of Para, Poema and DaimlerChrysler carried out joint research funded by \$1.4 million from DaimlerChrysler to determine which forest products could be transformed into industrial products with higher value added.

They found that coconut and curaua had the greatest potential. Coconut fibre has been used in vehicles since 1940 for internal trim in door panels, luggage compartments, roofs, and sun visors. If coconut could be substituted for polyurethane in these products, they would be recyclable and hence more environmentally friendly. DaimlerChrysler has a record of promoting the sustainable use of natural fibres such as coconut, sisal, flax and hemp for industrial applications around the globe.

In 1993 the Praia Grande Community of the municipality of Ponta de Pedras on Marajo Island came to Poema seeking solutions to the lack of local employment opportunities. Through the partnership between Poema, DaimlerChrysler and the Praia Grande Community, a pilot project was started to collect and process the discarded coconut husks. A local producer's group was formed with legal representation.

To guarantee supplies from the producer's group, Poema assisted with organization and capacity-building. The participants promised to use sound agricultural techniques that preserve biodiversity and the ecosystems of the Amazon.

The pilot initiative was scaled up to include other communities in the highly degraded regions of North-eastern Para. In the majority of these communities, the primary industrial processing takes place in situ, with the extraction of the fibre and processing of the husk to produce thick plaited ropes. These ropes are then delivered for further processing.

Going up the value chain with SMEs: The linkage process

Poema and DaimlerChrysler worked to establish an SME called Pronamazon in 1993 to further process the fibre, producing and commercializing final products, using appropriate technology in compliance with the standards of the automobile industry. Thus, a micro enterprise was linked into the DaimlerChrysler supply chain. Agricultural implements and even spare parts were used in Pronamazon's simple processes. Today Pronamazon employs 10 people and its current production levels are 4,000 head rests and 1,000 sun visors per month for use in commercial vehicles made by Mercedes Benz in São Paulo. In a community seeking to improve local employment opportunities and with limitations in terms of energy supply, this small scale and type of industry was the most suitable.

The creation of Pronamazon was made possible with the support of rural credit programmes from the Amazon Development Bank (BASA) and ongoing commitments from local government. Its success marks the turning point for the development of other sustainable items made of coconut fibre.

As a result of this success and growing demand for “sustainable” inputs, another SME, Poematec Ltda. was founded in 2001 in the industrial area of Belem to produce headrests, car seats and other upholstery items from coconut fibers and latex. Poema became involved in setting up Poematec in order to ensure that smallholders could strengthen their link-up to the global supply chain and receive the technological, commercial and environmental knowledge necessary to compete.

DaimlerChrysler invested \$4 million so that the factory uses the most advanced technology in the field of fibre transformation. Additional support came from the state, municipal governments, the Federal Agricultural Technical College and the Amazon Development Bank to provide land, buildings and funds for the plant. Poema provided business support and training. Local partners and Poema monitor production to maintain high standards.

The factory has 56 employees and the capacity to produce around 100 metric tons of finished components per month, which corresponds to an input volume of 45 metric tons of coconut fibre and 35 metric tons of natural rubber per month. Semi-skilled trades are involved, and processes are mechanized to achieve this

production capacity and meet industry standards. The plant operates with close to zero waste, built-in recycling and sale of sub-products from processing. At present, attempts are under way to certify the company according to international quality standards for environmental performance and working conditions.

Due to a global and national economic slowdown, targets for the production and sales of the main product, seat cushions, were not achieved, and as a result the company has diversified, obtaining contracts with other car manufacturers. For example, Poematec has been working closely with Volkswagen to develop upholstery products for new vehicles, and Ford has shown interest in developing similar initiatives in the State of Bahia. Geotextiles are being developed through a contract with the Vale do Rio Doce Company to reclaim lands around open-pit mining sites, and garden products are now being exported to the United States.

Continued commercialization of Poematec's products has been facilitated by the creation of Bolsa Amazonia, a regional programme that promotes the commercialization of sustainable Amazonian products produced by agro-extractive groups of the Amazon regions of Bolivia, Brazil, Colombia, Ecuador, Peru and Venezuela. It was created by Poemar (Poema's legal form) in partnership with UNCTAD in 1998 at UNCTAD's Summit in Lyon. Bolsa Amazonia acts as a reliable broker between different market agents to establish economic relations and to speed up business.

Impact

Poema has managed to achieve a number of successes within the same project. First, it has put together a coconut production chain consisting of eight producers' cooperatives, two SMEs (Pronamazon and Poematec) and DaimlerChrysler. Second, it has demonstrated the possibility of using renewable forest products within the industrial production chain. Third, the end products are cost-competitive in the international market, as well as environmentally friendly. Before this linkage between the rural communities, local SMEs and DaimlerChrysler, the bark of the coconut was considered trash, and it has now become treasure. Income from fibre operations supports 2,000 families, and 100 new jobs have been created.

Agro-forestry models have shown a 300 per cent increase in the coconut harvest in combination with cash crops, also preventing soil degradation. Formerly, small farmers would have needed an average of 25 hectares for conventional cultivation; they now require only two hectares to achieve the same yield.

The local communities have also developed their organizational, entrepreneurial and production skills. They have learned to comply with international product quality standards, as required by new markets, especially export markets.

DaimlerChrysler has gained access to a renewable raw material that uses only a limited amount of resources. In addition, it has been able to reduce its costs, as coconut fibre components are easier to dispose of than the conventional synthetic substitutes.

Critical success factors

First, the strategic partnership involving the Federal University of Para, Poema and DaimlerChrysler allowed the creation of SMEs and the move up the value chain from trash to automotive parts. When dealing with isolated producer groups and start-up SMEs, the role of each partner, particularly Poema, was fundamental to overall success. The partners provided the organizational and technical input to scale-up the pilot initiative linking smallholders to SMEs to TNCs.

Second, at the heart of the project's success was the training provided to both the producers and the factory workers. Producers had to be trained to run their associations. They and the factory personnel had to be trained to produce standardized and homogeneous products and apply sanitary and security norms. In the process, they have also developed the capacity for innovation. New applications are constantly found, demonstrating the infinite possibilities of coconut fibre, for example in insulation material, adobe, motorcycle seats and plane seats.

Third, the linkage process succeeded and was sustained because the economic and cost requirements were met, as well as the social and environmental objectives. In order for DaimlerChrysler to make this shift to natural components, these natural products had to be competitive. In the words of one expert, DaimlerChrysler found the sweet spot between commerce and philanthropy.

Fourth, given uncertain market trends, the SMEs could not depend on one major buyer, so production and outlets had to be diversified. Poematec is doing this by allying itself with trading groups such as Bolsa Amazonia which can be instrumental in helping SMEs reach new markets with new products.

Federal government policy did not play a strong role in the success of this initiative. More important was the regional and local governments' aspirations for development. However, without the driving efforts of civil society, these aspirations would have remained unfulfilled. The example could be replicated with the existence of committed NGOs and willing TNCs.

The Malawi Cotton Seed Treatment Programme **An example of a bilateral donor initiative**

by George Manu, CEO, Creative Squares, Ltd.

Background

This case study highlights a private-sector-led partnership involving a bilateral donor in Malawi, a low-income developing country. From a development perspective, it provides a rare example of an international donor using a challenge fund to engage the private sector in the process, not only sharing risks but also leveraging considerably more funds for investment and development.

In 2003, the UK's Department for International Development (DFID) approved a grant for the Malawi Cotton Seed Treatment Programme (MCSTP), following an application by the Great Lakes Cotton Company Limited of Malawi (GLCC), a private cotton ginning firm, in collaboration with several partners in the country. The latter comprised other private sector companies engaged in ginning (Clark Cotton), chemicals production and distribution (Syngenta and Chemicals & Marketing), as well as the Ministry of Agriculture and the National Association of Smallholder Farmers in Malawi (NASFAM).

The DFID grant was made through its Business Linkages Challenge Fund (BLCF) – an £18 million (US\$ 34 million) competitive matching grant scheme established to support

links between businesses, between business and government, and between businesses and intermediaries. Accordingly, the BLCF allocated £295,000 in September 2003 when the project started, with the Great Lakes Cotton Company (the promoters) and partners expected in turn to contribute £1,319,000 over the three-year duration, thus yielding a leverage ratio of about 1:4.5.

The cotton industry in Malawi had been in decline for several years. By the 2002/2003 season, annual national crop production was down to less than 16,000 metric tonnes. In contrast, neighbouring countries such as Zambia and Zimbabwe were experiencing a boom from their smallholder sectors, and world production was also increasing. International cotton prices had recovered, rising from an average of US\$ 0.40 per pound in 2002 to about US\$ 0.53 per pound in 2003.

Linkage process

Against this background, the MCSTP was set up to improve cotton seed varieties and establish plants to produce higher yielding and better quality pre-treated seeds. These seeds, along with pesticide chemicals, would then be sold at subsidized prices to farmers who, in return, would contract to sell their cotton crop exclusively to the ginners involved in the programme at fixed prices. An important development in the implementation of the project was the establishment of a Cotton Development Association (CDA), whose members were made up of the afore-mentioned project partners. In July 2004, the Government of Malawi accredited the CDA, thereby formally recognizing it as the focal point for the cotton sector in the country.

Under the umbrella of the CDA, the project promoters embarked on a nationwide smallholder farmer registration programme. In 2004, the first year of the scheme, 210,000 farmers were registered, of which 118,000 planted the pre-treated seeds. In 2005, the number of farmers planting was expected to rise to 180,000. For the farmers, registration provided access to a new variety of seeds which were pre-treated, as well as pesticides and spraying equipment, all supplied through the ginning companies in the CDA and sold at subsidized prices. These subsidies were expected to be phased out over time. In return, the farmers signed a contract to sell their produce exclusively to the CDA ginnerers at prices determined by the latter.

Another key strategy in the linkage process was the employment of extension workers. By the end of 2004, the two ginnerers (Great Lakes Cotton Company and Clark Cotton) had recruited and trained some 400 extension workers and about 50 supervisors. They were used to mount a sensitization campaign of the MCSTP, complemented by radio programmes and Ministry of Agriculture vans to disseminate information. In addition, the farmer registration exercise was carried out by the extension workers, who also directed and monitored the use of pesticides and rented out the spraying equipment. The other main tasks of the extension workers consisted in selling seeds and buying cotton from the farmers.

In respect to the latter, the extension workers provided a ready market for the farmers. The CDA partners point out that prior to the establishment of the association, farmers had to travel long distances to markets and had to wait 2 to 30 days for payment.

Now, thanks to the extension officers, there are about 250 markets, all located within the farming areas, and there are plans to expand the number to 360 in 2005. Thus, not only are farmers much closer to their markets but they are also paid in cash without delay. The involvement of the National Association of Smallholder Farmers in Malawi (NASFAM) as a partner has helped the project succeed, as has collaboration with Government. This partnership has provided access to farmers nationwide and at the same time stemmed much of the criticism and suspicion that might otherwise have been levelled at the project promoters (Great Lakes Cotton Company) and the other private sector firms in the consortium, all of which are foreign-owned and controlled by parent companies elsewhere.

Crucial also was the procurement and installation of seed treatment plants by Great Lakes Cotton and Clark Cotton in strategic cotton-growing areas of the country. These have now been used successfully for two consecutive seasons.

Impact

Midway through the project, the results achieved have been highly positive. In a single season, the annual production of cotton in Malawi increased by more than 265 per cent from about 16,000 metric tonnes in 2002/2003 to 43,000 metric tonnes in 2003/2004; it is expected to reach 60,000 in 2004/2005. This has translated into remarkable income and profits for the ginning companies and, to a lesser extent, the farmers. The total value of exports of lint by the CDA partners (essentially Great Lakes Cotton and Clark Cotton) rose from US\$ 6.95 million in 2003 to US\$ 16.26 million in 2004 (plus US\$ 1.01 million from other parties), with the forecast for 2004 estimated at US\$ 19.3 million. At the same time,

the incomes of smallholder farmers involved in the linkage have gone up by 56 to 100 per cent. To the extent that the smallholder farmers involved in the project are direct beneficiaries (numbering 118,000 in 2004 and 180,000 in 2005), with many living below the poverty line, this initiative could well turn out to be a sterling case of pro-poor growth.

The linkage has also generated employment. Smallholder farmers typically employ casual labourers known locally as ganyu. In 2003/2004, it was estimated that some 10,000 ganyu were employed during the season. In 2004/2005, that figure is set to rise to 35,000. On top of these are the 400 or so extension workers and 50 supervisors mentioned earlier. Moreover, it is estimated that 180,000 smallholder farmers are presently involved in the MCSTP (up from 118,000 in the previous year), all direct beneficiaries of the project.

There is no doubt that the MCSTP has transformed the cotton industry in Malawi – and with tremendous effect. From the establishment and accreditation of the CDA as a focal point and lobby group for the sector, to the provision of trained extension workers through whom improved variety seeds and sprayers are channelled, to the setting up of markets close to farmers, through to the installation of seed treatment plants, the industry has gone through a major change process in a relatively short period of time. Add to this the novelty, particularly in this part of the world, of public and private finance working together and sharing the risks for development in a private sector partnership, the whole case assumes greater significance, particularly in its demonstration that business linkages can be an effective tool for private sector development and economic growth.

Critical success factors

The positive impacts were the result of several factors. The case shows that a challenge fund approach can be a powerful mechanism not only in fostering business linkages, especially in risky ventures where the private sector is not able or willing to go it alone, but also in leveraging considerably more funds for investment and development. In this particular linkage, for every US dollar of public funds (in DFID grant), the private sector put in US\$ 4.40. When the promoters were asked if they would have gone ahead with the project without the DFID grant and involvement, the response was categorically in the negative. An important lesson is that a donor's grant can be the catalyst for the linkage process. In this context, the MCSTP shows the importance of selective interventions that innovative international donors can undertake in ventures like this.

Other key factors for success were the involvement of local partners and a business association to act as a lobby group and focal point for enterprises. Involving NASFAM and the Government right from the outset significantly shortened the timeframe for the diffusion and adoption of innovations. It was also the most effective way to insert smallholders into the supply chain and upgrade the technology used. Furthermore, the need to invest in *training and infrastructure* (both hardware and software) and to take a long-term perspective in engaging in developing countries cannot be overemphasized.

A key challenge in the near future will be to sustain this initiative beyond the three-year grant period, when the promoters plan to phase out the subsidies on seeds and chemicals. Critical too will be the need to ensure that greater benefits accrue to the smallholder farmers: although their incomes have gone up and even doubled in some cases, many of the farmers involved in this linkage presently still earn less than US\$ 1 a day from cotton farming.

Stand up and Go: Empretec Zimbabwe and Delta Corporation An example of an international organization initiative

by Busi Bango, Director, Empretec Zimbabwe

Background

The Stand up and Go Programme was created in 1995 to build entrepreneurship among Zimbabwe's youth. The main partners were Empretec Zimbabwe and the Delta Corporation, a beverage company listed on the national stock exchange. Empretec Zimbabwe was created in 1992 as a business development service provider. It was initially funded by UNDP and installed by the former UN Centre on Transnational Corporations (UNCTC), now a part of the UN Conference on Trade and Development (UNCTAD).

As noted in the opening section, FDI does not always produce positive results if it is not rooted in the local economy. In response to UN criticism that much FDI was shallow and footloose, TNCs replied that they found it extremely difficult, if not impossible, to work with local enterprises. They suggested that the Centre design a programme that would make SMEs stronger and more reliable business partners.

UNCTC took up the challenge to design a programme that would strengthen local enterprises and enable them to link up with the TNCs. What TNCs were looking for were local enterprises with a good track record and innovative production and management systems. Field research showed that, while business partnerships were negotiated on the basis of production volumes and product

quality, it was the behaviour and personal conduct of the entrepreneur that reinforced the confidence of the TNC in the small firm's ability to deliver. This led UNCTC not only to focus the programme on developing the technical and managerial skills of SMEs but also to develop a training component that would both alter the behaviour and improve the performance of the entrepreneur.

UNCTC came up with an integrated capacity-building programme, promoting the creation of sustainable business support structures that could help entrepreneurs build innovative and internationally competitive SMEs. The dream of most donors is that, once they stop funding a particular activity, it will continue. Institution-building ensures that this is more likely to happen. UNCTC's programme was started in Latin America and called Empretec, which is short for "emprededores" (entrepreneurs) and "tecnologia" (technology).

Since Empretec's inception in 1988, it has become operational in 26 countries. It has trained about 70,000 entrepreneurs in more than 2,700 workshops. National programmes have been funded mainly by UNDP, the Inter-American Development Bank and several bilateral donors such as the Danish International Development Agency, the Italian Department for Development Cooperation, the Swedish International Development Agency, the UK Department for International Development and the US Agency for International Development. It has also received assistance from various national banks and ministries. Empretec Zimbabwe is currently part of UNCTAD's Empretec network.

Empretec Zimbabwe's mission is to build and nurture a community of high-quality, growth-oriented and internationally recognized men and women entrepreneurs in a commercially viable manner. Throughout its years of operation, Empretec has been instrumental in the development of some of the most successful entrepreneurs in Zimbabwe. It undertakes a number of activities to fulfil its mission and prepare SMEs for business linkages. It:

- Identifies promising entrepreneurs;
- Conducts training to develop entrepreneurial traits and business skills;
- Provides state-of-the-art follow-up advisory services to enhance productivity, competitiveness and modern business practices;
- Encourages the exchange of experiences and networking among programme participants locally and internationally;
- Helps to arrange mutually beneficial partnerships with national and foreign companies.

The last activity was compatible with Delta Corporation's corporate strategy. In 1995, Delta, a major conglomerate in food and leisure sectors in Zimbabwe, started a programme to support SMEs called Stand Up and Go. Delta's interest lay in its desire to play a major role in developing the youth of Zimbabwe. The programme was called Stand Up and Go because it targeted young people with no tertiary education and no work experience. The idea was to expose young people to entrepreneurship training and assist them with access to finance and identification of business opportunities.

Due to the deteriorating economic environment in Zimbabwe, the Delta Corporation also needed to find ways to reduce its cost base, focus resources on its core business and increase outsourcing to SMEs. Delta wanted to move out of a number of activities through subcontracting in such areas as office and premises cleaning, catering services and grounds maintenance, all of which presented business opportunities within Delta for the participants. Delta's senior management worked with its procurement department to identify SME outsourcing opportunities. Each business unit was free to pursue the business linkages and outsourcing opportunities best suited to its needs.

Linkages process

Since Empretec Zimbabwe was a natural partner for this initiative, Delta invited Empretec to administer the programme. Delta agreed to finance 3-4 Empretec entrepreneurship development workshops at which at least 25-30 participants would be trained.

The first step was to identify youth with potential. Participants were recruited through the local media. Advertisements were placed in the daily newspaper and there was an overwhelming response (300 applicants for the 75 slots). Delta used its own criteria to identify and select participants considered fit for the programme. The participants had to go through an interview with Delta executives. Once the participants were identified, they then went through the Empretec screening. The entry point for business training was entrepreneurship training, which would modify participants' behaviour and help improve their business performance.

The most promising graduates of the basic entrepreneurship training were offered the opportunity to subcontract with Delta. Delta executives played the role of mentors for those who were afforded the business opportunities previously run by Delta. Delta

took a hands-on-approach to engaging with SMEs, providing SMEs with access to its advanced business systems and processes, and working closely with them to ensure they were able to use them. Delta provided management support and access to capital equipment at no cost. Delta also made business loans available at less than market interest rates to those participants who met three criteria:

- Adequate “business readiness”
- Bankable business proposal
- Willingness to repay the loan.

Impact

By 1997, a total of 250 jobs had been created. Delta managed to outsource cleaning, catering and laundry services, and its hotel division had outsourced housekeeping and food and beverages.

The Delta Corporation continues to do business with 26 entrepreneurs who participated in the programme. Delta maintained its position as a leader not only in beverages but also in the development of the private sector. SMEs gained access to wider corporate markets, leading to higher turnover and continued contracts with the Delta Corporation. Sixty-five per cent of all the beneficiaries of the programme are still in business. A number of them have changed businesses, while several have also expanded

their original businesses in terms of turnover, asset investment, geographical spread and markets.

More than 75 per cent of the original trainees are still in touch with Empretec and participate actively in Empretec initiatives. The Stand Up and Go Programme earned Empretec recognition as a BDS provider of high repute capable of running and managing a high budget programme.

Critical success factors

The experience in Zimbabwe demonstrates that prior to the linkage process, it is necessary to strengthen entrepreneurial skills through a business development programme. Careful participant identification and recruitment are key factors that ensure a programme of this nature succeeds. Advertising in the local media allows for a wider selection pool, but also implies higher risks of gathering bad apples. The target group, consisting of very young, virgin entrepreneurs, was high risk. They did not know the implications of being in business, had no credit history or experience, and attached no price to reputation in the case of default. However, coupled with the rigorous Empretec selection criteria and the Delta process of selection, the risks of recruiting the wrong participants were reduced.

The programme could have had more impact if it had spread to other corporations. Possibly, other corporations were not willing to innovate and invest in high-risk entrepreneurs because the business environment continues to be very difficult. The 65 per cent

enterprise survival rate could have been higher. Many of the entrepreneurs struggled with various aspects of business management. The mentoring by Delta executives helped mitigate the negative effects of the lack of management skills. However, the situation could have been improved if the participants had availed themselves of additional follow-up services in business management. But then, lack of demand is a classic problem for business development services.

IV. Lessons learned from the six case studies

All case studies show that **first** and foremost advocates of business linkages should be clear in terms of what they are promoting—viable commercial ventures or acts of philanthropy? Discussions and initiatives promoting “partnerships” have covered a wide variety of relationships, and the distinction between commercial ventures and philanthropy has become blurred. Many philanthropic acts that have nothing to do with a TNC’s business strategy are being promoted as partnerships and/or business linkages. Providing health care, education or safe drinking water to local communities is not usually undertaken as a “commercial venture”, although it might make sense in terms of corporate social responsibility. There are exceptions such as HIV/AIDS, where the disease is a threat to a large company’s productivity. However, company programmes are usually restricted to employees and their families and are not open to suppliers or the general community. Giving general as opposed to selective support to SMEs in terms of setting up business centres or skill centres can also make business sense if they are created and run cooperatively with other partners (principle of subsidiarity) and the TNC’s own suppliers benefit directly as well as other SMEs.

Second, promoters should continually press for better enabling business environments. Administrative and regulatory burdens weigh more heavily on SMEs and ensure that they remain in the informal sector, where they will find it difficult if not impossible to access partners, finance and global markets. In the case studies, some of the participants in the linkage process function under very difficult circumstances. Both the process and the outcomes could have been enhanced by better business environments (Brazil, South Africa, Viet Nam, Zimbabwe).

Third, commitment and vision on the part of all stakeholders is best developed by public-private sector dialogue. Another reason why the Penang experience is unique is because few Governments engage in regular and extensive public-private sector dialogue as in Penang. Here policies and programmes were developed in consultation to respond to public sector and private sector needs. When the Chief Minister called a meeting in the Penang Development Corporation, the local CEOs attended en masse.

Usually there is a disconnect between a Government's programmes for attracting foreign direct investment and its programmes for strengthening SMEs. These two policy areas need to be brought closer together through dialogue, and there needs to be closer cooperation and less competition between investment promotion agencies and business service providers. The Government must identify what economic sectors it wants to strengthen, depending on where it might have a competitive advantage. It must then identify those TNCs with the right corporate strategy and track record in terms of supply chain management and direct its investment promotion programmes to them while at the same time strengthening its domestic enterprises. As was seen in the previous section, only Penang followed a targeted approach. In the other instances it was a case of working with whatever TNC was currently operating in the host country.

Fourth, it is necessary to engage with local partners and/or meso institutions so that SMEs in the targeted economic sectors can be strengthened to participate in the linkage process. Otherwise, a very heavy burden rests on the TNCs, as in the cases of Anglo American and Unilever, and scale-up is difficult. Meso-institutions such as PSDC and Empretec can set up skills-development and mentoring and coaching programmes in partnership with the

business community and ensure that SMEs live up to commitments for continuous improvement. They can also ensure that the TNCs transfer skills, technologies, market information and other business contacts. The latter is important, since the SME should not be dependent on just one TNC partner.

Fifth, meso institutions should be run by a coalition of stakeholders and not solely by the Government. If the private sector participates in management, the institutions will provide SMEs with what they need in order to do business with TNCs. Such partnerships relieve Governments in developing countries of the need to shoulder the entire financial and management burden of the meso institutions.

Lastly, economic incentives are sometimes necessary to scale up best practices, but they must be used sparingly by government in order to maintain fiscal stability. In the case of Penang, what the Government gave up in corporate taxes, it made up in individual income taxes. In the absence of access to credit and equity, economic incentives can help SMEs maintain their cash flow so that they can invest in themselves. The effectiveness of incentives should be evaluated to ensure that their benefits outweigh their costs. They must also comply with trade and investment rules. Since the Penang incentives were “horizontal” in nature, they also complied with trade rules.

The question that arises is: will developing countries be able to follow the example of Penang and support their SMEs through local content rules, export promotion programmes, etc.? As more countries fall under WTO disciplines, particularly the Agreement on Subsidies and Countervailing Measures, it might be difficult for countries to build up local supply capacity if it hurts another country’s trade prospects. So far no developing country has been

sanctioned for supporting its SMEs, but any tightening of WTO rules and disciplines, for example in the post-Doha negotiations, could reduce the scope for the use of certain measures designed to promote SMEs, and options for the use of alternative policies and instruments may need to be explored.

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