FOREIGN DIRECT INVESTMENT AND SME DEVELOPMENT: SOME POLICY ISSUES FOR TRANSITION AND DEVELOPING COUNTRIES

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1. INTRODUCTION

It is widely recognised that entrepreneurs and SMEs play an important role in economic growth and development, as well as contributing to poverty alleviation, for example, through the employment they generate. At the same time, the nature and extent of this contribution varies between countries, reflecting differences in economic, social and institutional conditions, and ultimately the competitiveness of the SME sector. In this context, many transition and developing countries, in particular, face a need to promote and strengthen the long term development of the SME sector, which requires access to market opportunities, as well as to new technology and management know-how, often in a situation of considerable resource scarcity.

The paper is concerned with one of the ways of contributing to strengthening the indigenous SME sector in a situation of resource scarcity. Specifically, the paper is concerned with the potential role of foreign direct investment (FDI) in relation to the long-term competitive development and internationalisation of the SME sector in transition and developing countries. Whilst this is not a new topic, a number of recent trends suggest there may be greater scope for developing such linkages in the future than in the past. These include the emergence of new sources of FDI in developing and emerging economies themselves (Svetlicic and Rojec, 2003); increasing signs of SMEs internationalising their operations rather than simply exporting from their domestic base, as well as a continued increase in outsourcing by MNEs. Whilst such trends undoubtedly present challenges to SMEs in transition and developing countries, they also present opportunities.

More specifically, the paper aims to contribute to the development of policies that can help to strengthen the SME sector in developing and transition economies, through promoting their integration into, and potential benefits from, the global economy. This involves firstly, policies to increase the attractiveness of transition and developing economies for foreign investors, who are willing and able to contribute (indirectly) to the strengthening of the capacity of the SME sector in these countries; and secondly, policies designed to strengthen the benefits of foreign investment to local economies through the facilitation of SME trade and investment linkages and building the capacity of local SMEs to take advantage of new market opportunities created. The challenge for govern-

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ments in all countries is to create a facilitating and supportive environment for SME development that enables SMEs to exploit the potential benefits arising from increasing internationalisation, whilst avoiding becoming protective or intervening in ways that displace, distort or crowd out market solutions and, ideally, helping to contribute to building market capacity.

As in developed economies, the SME sector in developing and transition countries is typically very heterogeneous with respect to its size and sector composition, as well as growth orientation. Although the details vary between countries, the SME sector in transition and developing economies includes petty traders; self-employed; and small business proprietors, many of whom operate at least partly in the informal sector; firms run by owners that may be better characterised as proprietors rather than entrepreneurs (Scase, 1997); as well as growth-oriented firms. Whilst the latter represent an important target group for policy makers, because of their leading role and disproportionate contribution to employment generation and economic development, the needs of other types of SME should not be ignored. Indeed, in relation to FDI-SME linkages specifically, a supply chain approach to policy, emphasising the interconnections between different types of enterprise could be rewarding, because of the importance of seeking to maximise the trickle down effects of any investment by, for example, a multinational enterprise (MNE). In this context, there may be opportunities for a wide range of small enterprises in the lower tiers of the supply chain.

In most countries, it is a minority of SMEs that make a disproportionate contribution to economic development and employment generation. However, in some transition and developing countries, there is evidence of a 'missing middle', which refers to the lack of a core of medium size, growth–oriented SMEs, between large firms on the one hand, and microenterprises and small firms operating mainly in the informal sector, on the other. Policies to encourage SME-FDI linkages may be one way of addressing this problem, thereby strengthening the economic structure and contributing to poverty alleviation, by increasing the multiplier effects of any endogenously stimulated growth through the economy.

In Asia, Indonesia and the Philippines have been identified as countries suffering from the 'missing middle' problem. In both cases, two thirds of output is produced by large firms, with dynamic firms employing less than 100 people contributing just 8% and 14% respectively, compared with more than 30% in the case of Japan and 40% in Chinese Taipei. In the former cases, the shortage of small local firms to act as subcontractors to inward investors limits the integration of the latter into the economy, thereby restricting multiplier benefits for the local economy.

The paper represents a review of existing literature and case material, rather than being based on original empirical evidence. Following the introduction, the rest of the paper is divided into two main sections and a conclusion. Section 2 reviews recent trends in FDI; the potential benefits of developing FDI-SME linkages, together with an assessment of the evidence of such relationships in practice. Section 3 considers the main policy implications of the analysis, paying attention to policy making in different contexts, including public policy makers in mature market economies as well as in developing and transition economies; but also business policy makers in FDI enterprises and SMEs in a developing/transition economy context.

2. SME DEVELOPMENT AND FOREIGN DIRECT INVESTMENT

2.1 Current Trends in FDI

The vast majority of FDI originates from the developed world, with the countries in the developed economies making up 83.0% of the world's total in 2005 (UNCTAD, 2006). Similarly, it is developed countries that remain the main destinations for FDI, accounting for 59.2% of the world's total, although the proportion destined for transition and developing countries has been growing: by six times between 1990-98, and from 18% of global FDI flows in the mid 1980s to 42% in 1998 (World Bank, 1999); fluctuating between 27% and 37% during the 2001-5 period (UNCTAD, 2006). Moreover, FDI inflows can represent significant sums for developing countries, several of which record levels of FDI that are large, when considered in relation to the size of the domestic economy (OECD, 2002). However, the distribution of FDI between developing and transition economies is very uneven. For example, despite an increase in volume, FDI to Africa and Latin America represents a smaller proportion of the world's total in 2001 than it did in the mid-1990s (Morisset, 2000; World Investment Report, 2001.

In recent years, MNEs have been increasing their level of outsourcing, although this often involves subcontracting out parts, components and services to a smaller number of key suppliers with whom they develop collaborative arrangements. Whilst this process of consolidation can result in MNEs taking first tier multinational suppliers with them into transition and developing countries, opportunities for local SMEs can exist at the second or third tier supplier level.

Traditionally, FDI has been seen to be the preserve of large firms, both in developed and developing countries. However, there is growing evidence of changes in patterns of foreign direct investment, involving a wider range of source and destination countries and the increasing involvement of SMEs as foreign investors, as well as larger firms and MNEs. Unfortunately, most official investment reports do not separately identify FDI activity by the size of the investing firm. Nevertheless, there is evidence that a growing number of medium sized firms, in particular, are internationalising their operations as a strategic response to increasing competitive pressure. In this context, internationalisation represents a means of reducing costs, as well as of opening up new market opportunities, thereby enabling them to combine greater flexibility with cost reduction (Majocchi and Zuchella, 2003).

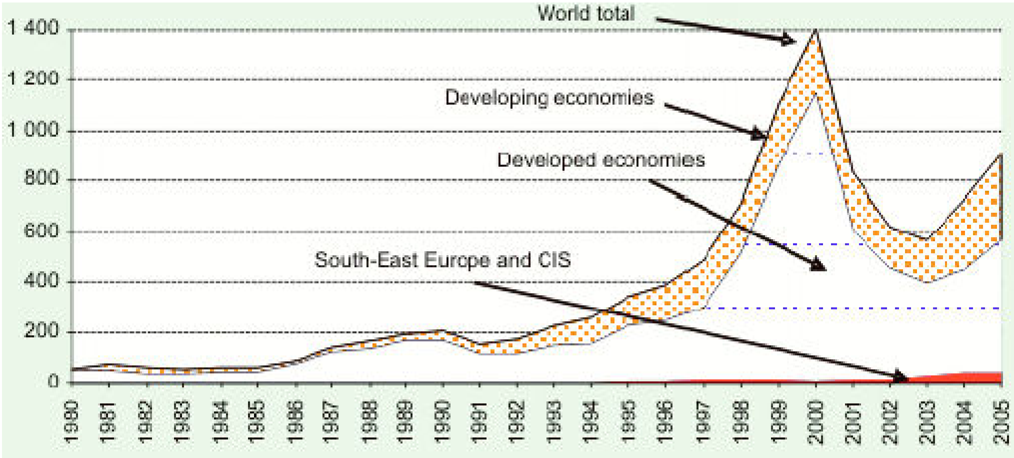

Figure 1: Global inflows of FDI 1980-2005 **(USD billions, by group of countries)**

Source: Division on Investment, Technology and Enterprise Development, UNCTAD, FDI Statistics web-site: http://unctad.org/en/subsites/dite/fdistats_files/fdistats.htm

This reflects the fact that globalisation is not exclusively a multinational or large firm issue, as a growing number of SMEs are looking to expand their markets internationally. In general, SME internationalisation is greater in smaller, open economies and less in larger, more self-contained economies, although there are exceptions. One of the best examples is Italy, where 70% of exports are contributed by SMEs (OECD, 1997). In addition, supply chains in sectors such as ‘high-tech’ and component manufacturing are becoming increasingly global in character, contributing to the development of new business opportunities for SMEs as potential suppliers world-wide, and opportunities for local SMEs in developing countries as second or third tier suppliers to main contractors.

One reason why the growing involvement of SMEs in FDI is important is because there is evidence to suggest that FDI by SMEs has some distinctive characteristics in comparison with FDI by larger firms, with potential positive implications for destination economies. For example, a survey of SMEs involved in FDI showed that more than half of their investment involved some form of partnership between the investing company and a domestic SME (UNCTAD, 1998). This is because it can be attractive for a foreign investing SME to work with an existing firm, rather than starting from scratch with a greenfield investment, with positive implications for the local SME, in terms of spillover effects.

One of the few studies which focused on joint venture activity and co-operation between SMEs in mature market economies (i.e. Belgian) and firms in developing countries suggested that a SME in an industrialised country may represent a better partner for a SME in a developing or transition economy than a MNE (Donkels and Lambrecht, 1995).

Essentially, this is because such a partnership is likely to represent a proportionately higher resource commitment in the case of a SME, which means that they are more likely to make efforts to ensure success. This suggests that a strategy of seeking to attract FDI undertaken by SMEs may be a rewarding one for transition and developing countries.

There is also the phenomenon of medium sized companies from mature market economies following larger firms investing abroad, as suppliers. Examples include medium-sized Finnish companies, which have internationalised following Nokia, setting up their own production units in countries such as China and Brazil as suppliers. 'Following major clients' was one of the motivating factors for investing overseas that emerged from a survey conducted among Taiwanese SMEs, alongside 'utilising local labour' and 'expanding markets (Kuo, Hsien-Chang and Li Yang, 2003). Although the evidence base is limited, such trends offer potential opportunities, as well as threats, for local SMEs in transition and developing countries. On the one hand, opportunities may exist for some local SMEs as suppliers to these inward investing medium sized companies, which for a few may represent a stepping stone into wider markets. On the other hand, by encouraging their existing suppliers to become global players, MNEs can help to raise the entry barriers for local SMEs, as potential suppliers, at least in the short term.

There is evidence that when SMEs invest abroad independently (i.e. rather than linked to the decisions of other firms within a cluster), they tend to invest in geographically close regions. The reasons include their more limited information fields and greater resource constraints compared with larger firms, but they can also be influenced by cultural and historical ties. This can be illustrated with reference to the results of a study undertaken in Austria's North East border regions, where a survey of 545 Austrian SMEs showed that 21 per cent had already started cross-border activities and a further 15 per cent expressed interest in doing so. The main motives for the cross-border activities identified in the survey were entry to new product and labour markets, gaining additional market potential and cost reduction. The types of co-operation that had developed included subcontracting, licensing and production partnerships; and to a lesser extent, various forms of direct investment, such as joint ventures, or acquisition of enterprises in neighbouring countries. Significantly, in most cases the partners of SMEs were local, i.e. within 100 kilometres (RWI, 2000).

In another study of Austrian and Danish SMEs, forging networks with East European partners was found to be a key driver, linked to a desire to open up new sales opportunities (Meyer, Tind and Jacobsen, 2000). Although SMEs can face resource-related constraints and knowledge gaps when seeking to internationalise, Austrian SME managers referred to building knowledge initially through exporting, which was then followed by FDI; in other words, a staged approach to internationalisation by SMEs, based on learning. These cases suggest there is a potential for policy makers in transition and developing countries working with an emerging trend to enable local SMEs to exploit the potential benefits for business development.

It should also be noted that a growing number of policy makers in mature market economies are recognising the need to broaden their previous emphasis on export promotion, to promote internationalisation of their companies, including SMEs, as a profitable route to business growth. Whilst this may be narrowly viewed, by some, as exporting employment, it may also be viewed more positively as part of a wider strategy of emphasising higher order competitive advantages focused on knowledge, thereby contributing to enhancing the longer term growth prospects of an economy. This can be illustrated with reference to Finland, where Finpro (the national export promotion agency) is actively promoting the internationalisation of Finnish companies, as part of a strategy of increasing their competitiveness, and thus the competitiveness of the Finnish economy. The approach reflects a commitment to the need for businesses to have global reach, particularly in the case of a country with a small domestic market. The case demonstrates that even in mature market economies, government has an important role to play in assisting firms to develop foreign markets, particularly SMEs, which often face resource constraints, particularly at the initial stage of market entry. There has also been an increase in FDI originating from other developing countries, which is geographically concentrated in some cases, e.g. South East Asia.

Central and East European countries (CEECs) have themselves started to become sources of FDI. Although internationalisation through outward investment has a relatively short history in CEECs, it has been increasing, facilitated by the liberalisation of foreign exchange and capital flows. Although still modest in scale, it has been suggested that outward FDI by businesses in transition countries is qualitatively significant. Nevertheless, in most transition countries, it is currently limited to a small number of investors consisting mainly of national champions seeking to become regional multinationals in order to overcome the constraints of a small domestic market. The process represents a bottom-up response to internationalisation forces by businesses, rather than a macroeconomic, government inspired or supported strategy. At the same time, by international standards, multinationals from transition countries are medium or small in size, in comparison with leading firms within the sector (Svetlicic and Rojec, 2003).

2.2. Potential Benefits of Inward Investment to SMEs in Transition and Developing Economies

Foreign direct investment is an integral part of an open, international economic system and a major potential catalyst for development. This has been recognised by OECD in a report, which focused on maximising the benefits for inward investment, while recognising the possible costs and ways of reducing them (OECD, 2002). The potential benefits of FDI for host economies include increasing the supply of capital; technology and knowledge transfer; the generation of employment and human capital; as well as the effect on enterprise development, through linkages and spillover effects. An additional source of capital is clearly important in countries where financial constraints act as a major barrier to development.

In principle, supplier relationships with inward investors offer business opportunities for local firms. For transition and developing countries, exploiting these opportunities can contribute to the development of a balanced structure of enterprise sizes in an economy, in which economies of scale are combined with the flexibility of small enterprises. New markets are opened up for SMEs, by firms, which offer regular payment for goods and services, and through subcontract type relationships, relief from development and marketing costs for their SME sub-contractors (Altenburg, 2000).

In terms of technology and knowledge transfer, FDI in developing countries can potentially contribute to the upgrading of local suppliers through technical assistance, training and the transfer of knowledge. It may also contribute to increasing the rate of adoption of new technologies by local industries, as a result of processes of imitation and competition. In terms of employment, inward investors can generate new jobs directly, but they can also contribute to raising skill levels, because their skill requirements may be higher than those required by domestic firms. At the same time, the extent to which MNEs actually facilitate such spillovers in practice has been shown to vary between sectors and contexts (OECD, 2002).

The potential benefits of FDI to host economies may be usefully summarised with reference to a framework developed by Dunning (1992), who identified five main types of linkage and spillover effects, by which the presence of MNEs can affect the development of businesses in the host economy, namely:

(i) *Backward Linkages with Suppliers:* This refers to the extent to which components, materials and services are sourced from within the host economy, since this can create new market opportunities for local firms. Such linkages can range from arms length market transactions to deep, long-term inter-firm relationships. The productivity and efficiency of local suppliers can benefit from this type of spillover, as a result of direct knowledge transfer, higher quality requirements and increased demand levels.

(ii) *Forward Linkages with Customers:* These can include marketing outlets, which may be outsourced. Examples include petrol stations and restaurant chains; and linkages with industrial buyers, through, for example, value-added after-sales services.

(iii) *Linkages with Competitors:* Foreign investors may set new standards in a developing economy, which local firms may seek to compete with. Although MNEs may hold a strong market position in relation to local firms, it should be noted that linkages with competitors may refer to second and third tier suppliers to leading inward investors, and not just linkages between first tier suppliers and the MNEs themselves.

(iv) *Linkages with Technology Partners:* Some MNEs may initiate common projects with indigenous SME partners, including joint ventures, licensing agreements and strategic alliances, which are an important potential source of technology and know-how for firms in the host economy. Whilst such co-operation may be a more common feature of mature market economies, the number of inter-firm technology agreements involving partners from developing countries rose in the 1990s compared with the 1980s (UNCTAD, 1998).

(v) *Other Spillover Effects:* These include demonstration effects, as inward investors demonstrate new and better ways of doing things to local firms, representing a source of, and stimulus to, innovation. They also include human capital spill-overs, when, for example, trained personnel leave the inward investor to work for a local enterprise and/or set up their own business.

One of the practical reasons why export-oriented FDI may have limited positive, or even negative, impacts on a local economy is that local suppliers can often find it difficult to meet the standards required or set by MNEs. This can be illustrated with reference to the Kenyan soap industry, in which Langdon reported the entry of foreign MNEs to be associated with low-cost mechanised production, which led to local firms being unable to sell their handmade soap products in local urban markets (Langdon, 1981; Blomstrom M. 1996).

2.3. The Impact of FDI on SMEs in Host Economies in Practice

The extent to which potential positive externalities from FDI are achieved in practice is likely to be affected by a variety of factors at the macro- and micro- levels, including the general climate for business development and the strategies used by individual MNEs. In this regard, it is important for policy makers to recognise that any investment by a foreign company has to make business sense, without depending on support from publicly funded initiatives. In addition, spillovers of technology and human capital do not necessarily follow from foreign investment, since these are affected by sectoral and domestic external conditions, together with the potential capacity of local SMEs to take advantage of any new market opportunities presented.

The evidence of positive spillovers is strongest and most consistent in the case of backward linkages, with local suppliers in developing countries. Positive benefits stem from the information, technical assistance and training provided by MNEs to help raise the quality of supplier's products and services. It has been suggested that some MNEs also help local suppliers to purchase raw materials and intermediate goods and to modernise or upgrade production facilities (OECD, 2002).

In general, human capital spillovers from FDI in developing countries appear to be mainly indirect, occurring more as a result of government policies seeking to attract FDI through enhanced human capital, than directly from MNEs themselves. However, human capital spillovers can occur where FDI involves the acquisition of a local firm by a foreign company. In this regard, Calagni (2003) describes the case of the takeover of Nigerian Breweries by Heineken, where she suggests a demand for higher product quality has contributed to an enhancement of human capital. As capital investment often follows acquisition in such cases, in order to upgrade equipment and machinery, many employees are likely to require training. Moreover, indigenous managers are likely to enhance their knowledge through interaction with foreign managers, with some possibly benefiting from spending working periods abroad.

A positive example of a location that has successfully developed MNE-SME linkages is Penang in Malaysia, which attracted its first MNE semi-conductor plant in the early 1980s, based mainly on its cheap, English speaking labour force. As a result, most of the global players in the electronics hardware industry are now present in Penang (Altenburg, 2000). Although few linkages were developed between inward investors and local SMEs initially, Altenburg describes a change in the pattern from the late 1980s, as a combination of technological change and shortening product life cycles encouraged MNEs to delegate more responsibility to local affiliates, with a need for quicker and more local supplies.

The result has contributed to the development of a local supply base in four main fields: firstly, metal stamping and precision tooling; secondly, contract manufacturing for assembly, as MNEs increasingly outsource standard assembly operations; thirdly, the production of plastic materials, such as casings for PCs; and finally, packaging materials. It is reported that many of the SME suppliers emerged as spin-offs from US MNEs, although a few suppliers grew from 'traditional, backyard enterprises' (Rasiah, 1998). It has also been suggested that the process of local backward linkages was helped by the fact that local firms were able to make incremental investments in the necessary equipment, as small initial contracts were used initially to test the capability and commitment of local SMEs.

The potential benefits of FDI in contributing to the development of the local SME sector, and particularly medium sized companies, can also be illustrated with reference to Singapore, which has been presented as one of the success stories with respect to the encouragement of inward investment as a means of developing SMEs. This has been achieved by encouraging the development of partnerships and linkages between inward investors and local SMEs (UNCTAD, 1998). Singapore has been an important base for multinational capital since the mid-1960s and by, the early 1990s, FDI accounted for more than 70% of manufacturing value added (Perry et al, 1997). Subcontracting and other supply opportunities for local companies have developed as Singapore has evolved from an export platform to a regional control centre for FDI in SE Asia. However, at the micro level, supply opportunities for local firms, vary with the specific strategies of individual MNEs. For some suppliers, a close relationship with the buyer is conditional on a willingness to participate in a rating programme designed to ensure continuous improvements, including cost reductions (Perry, 1999).

FDI has also made a significant contribution to the development of the 'high tech' cluster in Banglalore, through linkages between technology partners. In this case, the role of policy was to enhance the development of an initial clustering of research centres by contributing to the attraction of the city as a destination for inward investment. This was achieved through a combination of establishing a consistent policy framework, offering a degree of predictability for foreign investors and an active promotion programme to attract FDI.

Whilst there are 'a priori' arguments to support the potential role of FDI-SME linkages between enterprises as a development strategy in transition and developing countries, and some positive case examples, empirical evidence suggests that the potential benefits do not always materialise. For example, there is anecdotal evidence to suggest that some SMEs have experienced the negative effects of foreign companies seeking co-operation partners as a short-term expedient, faced with uncertain local market conditions. Such firms may experience few of the learning benefits and capacity building that is one of the justifications for this type of strategy in the longer term, from the standpoint of the partner in the host economy. One question that arises concerns the factors, which influence the ability of partner companies to co-operate effectively, with sustainable mutual benefits, particularly where the partners are drawn from different national and cultural environments. In this context, good practice illustrative cases are required in order to be able to analyse the key elements in successful partnerships of this type.

Since the mid-1960s, MNEs have played a key role in the development of the Irish economy, encouraged by an active promotional policy, with incentives for greenfield, export-oriented FDI. Since the 1970s, Irish policy makers have recognised the importance of integrating the growing multinational base into the Irish economy. Developing customer-supplier relationships with indigenous companies was considered important in order to maximise the wider contribution of FDI to the development of the manufacturing sector in Ireland. This was formalised into a National Linkage Programme in 1984.

A key point to stress from the Irish experience is the evolution of the approach over time, reflecting changes in the nature of multinational investment, changing international conditions and a maturing Irish supply base. Initially, the approach was focused on a Linkage Unit set up under the Industrial Development Authority (IDA). This Unit has sought, on the one hand, to identify potential sub-supply opportunities in inward investment projects and, on the other, to identify potential Irish suppliers with the required capacity and know-how (i.e. that were 'fit to supply'). To assist the process, the IDA's Linkage Unit developed a capacity building role to improve the operational practices and manufacturing performance of chosen suppliers. It is reported that between 1985 and1997, MNEs operating in Ireland increased their local purchasing of raw materials from £438m to £1831m and of services from £930m to £2bn, although it is not possible to say how much of this resulted from the linkage programme directly.

However, since the mid-1990s, two global trends have affected the Irish supply context, with implications for the role of the linkage programme. The first was a tendency for MNEs to move towards a global procurement strategy, which involved reducing the number of suppliers globally to a core group. The second involved increased manufacturing outsourcing, which was associated with shedding the low value end of the manufacturing process to low cost locations.

As a consequence, the Linkage Programme began to focus more on international supply opportunities for Irish firms, which coincided with the establishment of a new agency i.e. Enterprise Ireland. Enterprise Ireland works with indigenous industry to improve sales, export and profitability through a range of support programmes, with a worldwide network of offices providing a resource through which international supply opportunities can be identified. Alongside the changes in multinational investment, the indigenous Irish sector has matured considerably, with the emergence of some Irish MNEs, which has led to a new role for Enterprise Ireland, in terms of assisting these Irish MNEs to achieve their overseas objectives.

It must be recognised that some types of supplier relationship with MNEs can involve a high level of dependence of suppliers on the customers, with varying degrees of potential benefit for SME development. This is particularly the case in circumstances where there are few customers and a large number of potential suppliers, who can easily be substituted for each other, because they lack specific capabilities. Such conditions can lead to cut-throat competition between SME suppliers, who have to absorb risk and cost reductions, whilst purchasing firms benefit from specialisation and lower cost supply.

This raises the question of the rationale for outsourcing by large enterprises, since it has implications for the types of relationship sought with suppliers. In this regard, Altenburg (2000) has identified four main rationales for clients outsourcing products and services to suppliers, which have implications for the nature of the relationship with supplying companies and, in turn, their attractiveness from an economic development perspective:

(i) *Productivity gains*: Where suppliers are able to produce specialised inputs, the SME partner has a certain bargaining power. Such linkages are based on mutual specialisation, typically going beyond arms-length transactions. They may involve a long-term commitment on the part of the customer, with considerable transfer of technology and knowledge. At the same time, it has been suggested that for FDI to have a positive impact, the 'technology gap' between domestic and FDI enterprises must be relatively limited (OECD, 2002).

(ii) *Factor cost advantages:* e.g. lower wage costs. In such situations, the supplier is potentially much more vulnerable than where productivity gains is the main rationale, because price competition is typically fierce, with continued downward pressure on prices and costs.

(iii) *Numerical flexibility:* this involves occasional or overflow subcontracting, in response to demand peaks. In such circumstances, suppliers have to accept short-term contracts and face little security or stability.
(iv) *Functional flexibility:* This also involves responding to fluctuations in demand, but in this case through active, functional flexibility, based on a multi-skilled workforce and flexible equipment. Such circumstances are more favourable for the supplier than the case of numerical flexibility, although the supply base required is less commonly found in a developing/transition context.

Empirical evidence from the developed and developing world demonstrates that the positive spillover effects from FDI do not necessarily occur in practice, with outcomes influenced by the specific conditions pertaining in the host country (which includes the policy context), as well as the rationale for the foreign company making the investment. For example, in African economies, which are among the least industrialised and integrated with global markets, the potential benefits from FDI are enormous. At the same time, the lack of adequate infrastructure, human and social capital and political stability can represent a major barrier to the attraction of foreign investment, as well as to the development of positive spillover effects from the FDI that is secured (Calagni, 2003).

According to Calagni, one of the most negative features of FDI flows to sub-Saharan Africa is the low level of investment in local manufacturing, despite the fact that a number of African governments have sought to attract foreign investors through creating export processing zones. This involves investment in upgrading infrastructure, liberalising capital flows, eliminating restrictions on imports, tax concessions and a relaxation of labour legislation in some cases. However, the positive results are limited, with Pigato (2001) noting how the majority of African investment promotion agencies have struggled to transform themselves from regulatory bodies to promotional organisations that are at arms length from government, focused on facilitating investment. Apart from export processing zones, the other main target for FDI in sub-Saharan Africa is in natural resources, which has few linkage or spillover benefits to local economies.

Mauritius is an exception to the general pattern with regard to export processing zones in Africa in terms of attracting higher value added activities. However, some studies have emphasised the opportunity cost involved, in terms of tax concessions, as well as the emergence of duality in the indigenous sector, with some firms and labour being excluded. Financial incentives to FDI, whether in the form of grants or tax concessions, can represent a considerable burden to developing countries and are unlikely to represent a sustainable strategy for longer-term development. In other African countries, such as Kenya and Lesotho, there is evidence to suggest that export oriented companies have tended to import most inputs, thereby contributing little value added to the local supply base.

3. POLICIES TO PROMOTE FDI-SME LINKAGES

This review has demonstrated that for developing and transition economies, FDI represents a potential means of growing and diversifying the SME base and achieving greater integration within global networks. However, whether or not this potential is actually achieved in practice, depends on a variety of factors, some of which are under the influence of policy makers. An essential prerequisite in this regard is the creation of a facilitating environment for all businesses in transition and developing countries, since this is necessary in order to encourage both foreign and domestic investment.

One of the key factors that policy makers need to consider, in seeking to attract and exploit the potential benefits of FDI, is the large number of locations in the world with similar characteristics, which clearly affect the bargaining position of individual governments with potential investors. In the absence of other locational advantages, competition between places typically focuses on offering lower costs, which can contribute to the so-called ‘race to the bottom’. As with business strategy, competition between places based on non-price advantages is ultimately more sustainable than that based on price alone, which emphasises the importance of policies that seek to upgrade local economies in terms of infrastructure, human capital and a competitive potential supply base.

Key policy issues relate to creating the conditions to attract foreign investors in the first place, together with policies to encourage and facilitate different forms of co-operation between inward investors and domestic SMEs. Defining the role for policy to attract FDI includes promotional activities; creating an appropriate and effective legal and regulatory framework; capacity building programmes for potential suppliers that include training and quality assurance; and the wider role of business support services and other intermediaries, which might include partner searching facilities.

Backward linkages with suppliers have traditionally been seen as the main vehicle to promote technological and other spillovers from MNEs into host economies. In this regard, some governments have sought to impose domestic content requirements on inward investors in order to increase market opportunities for local firms. However, the increasing liberalisation of investment rules, combined with the practical problems of implementing such measures, and the possible disincentive effect on potential investors, means that such mandatory supplier requirements are declining in importance. Moreover, in a context where the competition for FDI is becoming increasingly fierce, there is a risk that mandatory measures may discourage MNEs from investing at all. As a consequence, the current policy challenge is to exploit the development potential of local supplier networks through voluntary means, although additionally some attempt to building the capacity of local SMEs to supply is almost certainly required, facilitated by intermediaries, as well as by active promotion. An example is the Uganda Business Linkages Promotion Programme, which was initiated in July 2003 by Unilever to encourage the development of linkages between MNEs, large local enterprises and local SMEs (UNCTAD, 2003).

Developing policies to encourage and facilitate SME development in transition and developing countries through FDI linkages ideally requires co-ordinated actions on a number of fronts, involving various partners. These include policy makers in developed countries; policy makers in transition and developing countries; donors and international organisations; FDI enterprises; and SMEs in transition and developing countries

3.1. Policy Makers in Developed Countries

Although the main policy changes required to increase the economic development benefits of FDI need to be made in host countries, policies in developed countries can also affect the nature and extent of these benefits, as well as the extent of the market opportunities for SME exporters from transition and developing countries in their markets.

Most governments in mature market economies have been involved in export promotion activity for some years, recognising the potential welfare gains for the economy as a whole of increasing foreign earnings. More recently, this support has been extended in some countries to the internationalisation of enterprises rather than just export activity. The development of FDI-SME linkages in transition and developing countries would be assisted if the provision of support for the internationalisation of domestic firms in developed countries included co-operation with business support agencies in transition and developing countries. This could help to facilitate partner searching and assisting firms to prepare to co-operate with local suppliers, including raising awareness and understanding of the local business culture; planning for co-operation; and training management and key staff.

Policy makers in developed countries also need to consider how overseas development aid (ODA) might be better used to leverage FDI through, for example, technical assistance or infrastructure projects and/or assistance for local SMEs to develop supply linkages with inward investors. Although concerns that ODA in support of private investment could divert limited ODA resources away from social and humanitarian projects must be taken into account, the potential synergies between ODA and FDI should not be ignored, because of their potential contribution to poverty alleviation in the longer term.

Another issue which policy makers in developed countries need to embrace is corporate social responsibility (CSR) and its implications for supply chain management, which is a global issue rather than confined to MNE activity in developing countries. In the USA, for example, supplier diversity has focused on access to procurement for minority owned enterprises, since the market opportunities offered by public and private sector procurement are seen to offer a means of diversifying minority owned businesses into higher value added activities. The capacity building programmes introduced by some US corporates offer some lessons for the development of FDI-SME linkages in a developing country context.

Whilst ultimately the responsibility for CSR rests with companies, governments have a number of roles to play, including an advocacy role. Beyond that, government influences the laws, which provide parameters within which company behaviour takes place; as well as influencing the international standards, which also guide corporate behaviour. There is an ongoing debate about whether responsible supply chain management is a cost, or a source of competitive advantage, for sourcing and supplying companies. However, there is more agreement about the need to establish appropriate rules and regulations, which are effectively implemented, to deal with supply chain issues, thereby emphasising a key role for governments.

3.2. Policy Makers in Developing and Transition Economies

To be effective, policies to encourage FDI-SME linkages need to be multidimensional. Firstly, policy makers in transition and developing countries need to pay attention to the broader business environment that affects both SME development and their ability to attract FDI; secondly, to making SMEs more attractive as business partners for inward investing enterprises; and thirdly, to a strategy for encouraging this type of co-operation. In this regard, Morisset (2000) has underlined the importance of reforms aimed at increasing macroeconomic stability, democracy and a commitment to economic reforms. Morisset (op cit) also stresses the importance of high profile publicity efforts, aimed at informing potential investors of improvements in the business environment, on the basis that potential investors need to have an up-to-date and accurate picture of the contemporary business environment, rather than one based on (negative) perceptions inherited from the past.

Clearly, if FDI-SME linkages are to be developed, policy makers in transition and developing countries need to commit themselves to the creation of a business environment that is conducive both to attracting FDI and to facilitating domestic entrepreneurship and SME development. In terms of improving the general business environment to attract FDI and facilitate domestic SME development, three main groups of measures may be identified:

(i) Improvements to the general macroeconomic and institutional framework, to increase institutional predictability, including:

- sound macroeconomic policies geared to high economic growth and employment targets and price stability;
- the development of secure and transferable property rights, together with systems to protect IPR and assure patents, trademarks and copyrights;
- the promotion of fiscal discipline, together with efficient and socially just social taxation systems;
- guaranteed rights for the repatriation of capital and profits;
- strengthening domestic financial systems, in order to make domestic financial resources available to complement FDI

(ii) The creation of a regulatory environment conducive to attracting FDI by:

- promoting transparency and non-discrimination with respect to regulatory actions and business practices
- strengthening efforts to consolidate good governance programmes and the rule of law, including stepping up the fight against corruption;
- promoting increasingly open foreign trade in order that the domestic enterprise sector can participate fully in the global economy, linked to efforts to increase competition in the domestic economy through an effective Competition Policy;
- enforcing principles of non-discrimination in the implementation of legislation at all levels of government.

(iii) Upgrading infrastructure, technology and human capital to a level where the potential benefits of a foreign corporate presence for the domestic economy can be realised through positive spillover effects. Specific examples include:

- relevant physical and technological infrastructure, which could be helped by allowing foreign investment in infrastructure through ODA;
- taking steps to ensure the provision of appropriate, high quality technology services, such as testing centres, research and development institutions and bodies to effectively regulate technical standards.
- Prioritising steps to raise the level of the basic education of the workforce;
- Re-assessing current incentive schemes in relation to the types of FDI best suited to local conditions.

Developing effective programmes, agencies and instruments to promote individual transition and developing countries to foreign investors is an important corollary to policies designed to improve the general business environment. Key priorities in this regard are firstly measures specifically focused on improving the attractiveness of the economy to FDI, such as upgrading infrastructure; removing restrictions on capital flows, and removing any restrictions on imports; and secondly, the establishment of FDI promotion agencies. International good practice suggests these should be at arms-length from government and focused on attracting and facilitating inward investment. They should aim to offer a 'one-stop' service to foreign investors; be staffed by people with private sector experience, including marketing specialists; be commercially oriented; and have targeting strategies, which should include medium-sized as well as large enterprises.

At the same time, there is also a role for specific policies aimed at encouraging and facilitating co-operation between local SMEs and foreign investors, such as by improving the flow of information about suppliers to potential purchasers and about supply opportunities to potential suppliers through the development of a national Website and/or business directories. The penetration and success of such initiatives is likely to be enhanced if they are introduced in co-operation with appropriate business support agencies and actively disseminated through various channels.

However, improving the flow of information about supply opportunities and persuading FDI enterprises to develop transparent and 'small firm friendly' tendering procedures are necessary but not sufficient conditions for increasing the volume of local supplies. This is because there is a dearth of SMEs in many transition and developing countries that are qualified, willing and able to meet the purchasing requirements of FDI enterprises. As a consequence, there is a need for programmes which aim to build the capacity of local SMEs, based on the 'fit to supply' principle. This refers to the need to assist local SMEs to upgrade in order to meet the demanding quality standards of MNEs, with respect to products and service delivery. Further steps designed to encourage the development of spillover benefits could include fiscal incentives to encourage training to be provided by MNEs for local staff.

Growth oriented small firms represent a potentially rewarding target group for capacity building initiatives, particularly in countries with a 'missing middle' in their enterprise size distributions. Capacity building programmes should include supply chain and cluster initiatives, which recognise the potential for developing tiers of suppliers to maximise trickle down effects, including to microenterprises as lower tier suppliers. In a developing or transitional economy, MNEs often bring first tier multinational suppliers with them, although these may in turn look for lower tier suppliers in the host country (such as for components or services). Moreover, cluster initiatives can provide an attractive environment for inward investors, as the Banglalore case demonstrates, as well as a potential export platform.

Policy makers should work with inward investing enterprises, donor organisations and other appropriate intermediaries to develop capacity building programmes for local potential SME suppliers, in order to facilitate the development of backward linkages and other positive spillover effects. Such programmes will need to pay attention to quality management, training and management development programmes. It is important to recognise that a number of governments have adopted special policies and programmes to promote buyer-supplier relationships between MNEs and domestic SMEs, not all of which have been successful. Such linkages cannot be artificially created, since they must be based on a business case and will not develop on a sustainable basis unless the inward investor judges local sourcing to be a viable strategy. The role of government, in this regard, is to facilitate the actions of other actors, namely FDI enterprises, local SMEs, business support intermediaries and the various providers of technology, education, training and financial services.

Continued attention to the development of an effective business support system is an important condition likely to influence the success of a capacity building strategy. It requires business support agencies, which are customer-oriented and which have a demonstrated capability of penetrating the SME sector. Most governments in mature market economies recognise that the international competitiveness of SMEs depends in part on an effective business support system, although the respective roles of the public and private sectors, in this regard, varies between countries. The general case for state intervention is often based on deficiencies in the markets for information, advice, workforce and management training and finance, as far as small firms are concerned. In a transition and developing context, it is typically necessary for government to intervene in order to contribute to the development of high quality business services, although the nature of the intervention should help to build market capacity in the longer term and not crowd out private sector service providers. An example is the use of accredited private sector consultants to deliver business advice, rather than government advisers. Continued attention also needs to be paid to improving access to finance for SMEs to enable them to undertake any upgrading required to meet the quality standards demanded by inward investing companies.

3.3. FDI Enterprises

Clearly, the policies and actions of FDI enterprises are a potentially determining influence on the nature and extent of the linkages that develop with local SMEs. In this regard, FDI enterprises should be encouraged by governments in both source and destination countries, to actively investigate the scope for maximising local sourcing in host economies and fostering the involvement of local SMEs in various forms of inter-firm co-operation, working with national and regional authorities, donor organisations and other intermediaries, as appropriate. Although such a strategy must ultimately be based on a business case, MNEs and other FDI enterprises should recognise that corporate social responsibility applies to their international as well as to domestic activities.

Some key principles and potentially transferable practical experience can be drawn from the experience of the corporate sector in the USA with respect to supplier diversity programmes aimed at domestic ethnic minority owned enterprises. Analysis of the activities of some of the leading US corporates in this regard (e.g. Ford, JP Morgan Chase and Unisys) highlight three main elements:

- *A commitment to outreach activities* in the sense of providing information about supply opportunities to the target group (i.e. minority businesses), including activities which facilitate networking (e.g. seminars, 'meet-the-buyer' events.

- *A commitment to developing long term relationships with suppliers*, as well as a willingness to engage in initiatives which aim to increase the technical and financial capability of potential suppliers, at different levels of the supply chain e.g. through mentoring programmes to help potential second and third tier suppliers to increase their capability to meet the growing demands placed by Ford on their first tier suppliers.

- *Embedding good practic*e in the corporation, since the sustainability of supplier diversity or local supplier initiatives depends on securing management acceptance at all levels of the purchasing organisation; communicating its goals throughout the organisation; introducing a system to track supplier performance. On the basis of

US experience with minority enterprise programmes, this requires strategic commitment from the top down in the purchasing organisation, but also from key stakeholders, including first tier contractors over which the purchaser can exert considerable influence.

3.4. SMEs in Developing and Transition Economies

Finally, although policy is important in providing a facilitating framework, ultimately entrepreneurship and competitive business development depends on the motivation, skills and commitment of individual entrepreneurs. In this context, it is important to recognise that whilst inward investment offers potential business opportunities to aspiring suppliers in host countries, it also represents a major challenge for them, because MNEs are a demanding customer group. As a consequence, entrepreneurs in developing and transition countries must be willing to commit themselves to providing high quality products and services, as well as to understanding the needs of multinational clients, recognising the improvements they may be required to undertake with respect their current operations and make the necessary efforts to achieve the required results.

In short, entrepreneurs in developing and transition economies interested in supplying inward investing firms, either directly, or as second or third tier suppliers, must be willing to commit themselves to learning and upgrading; to commit themselves to supplying products or services to a consistently high quality; to recognise any improvements they may be required to undertake; and to invest the resources needed to achieve the required upgrading.

4. CONCLUSION

Although the paper was not written with Bulgaria specifically in mind, the development strategy outlined for contributing to the development of a more competitive SME sector is applicable in the Bulgarian context. In a mature market economy, such as the UK, it has been estimated that two thirds of the total number of SMEs are in supply relationships with other businesses, including many large corporates. Indeed, one of the factors contributing to the growth in the number of small firms over the last 30 years has been an increase in outsourcing activity by large enterprises.

In comparison, SMEs in a country such as Bulgaria face far fewer opportunities in the domestic market to supply large firms. As in other transition, or emerging market, economies, the collapse of the state owned enterprise sector and a lack of large privately owned enterprises results in fewer supply opportunities. In such conditions, inward investment must be seen as a source of potential market opportunities for Bulgarian SMEs, which policy makers and other stakeholders in national and regional economic development should recognise. In this context, an integrated economic development strategy would seek to maximise the opportunities for FDI-SME linkages, as a means of strengthening and diversifying the country's SME sector.

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Научни достижения: има публикувани над 100 статии и книги по въпросите на развитието на МСП и политиката в подкрепа на МСП; представени над 200 доклада на национални и международни конференции; участие в редица изследователски проекти за МСП във Великобритания и в други страни с развити пазарни икономики; от 1993 г. проф. Смолбоун участва (включително като координатор) в проекти, изследващи развитието на МСП в страните в преход.

Професор Смолбоун е изпълнил успешно редица проекти за предоставяне на консултантски услуги в сектора на МСП на Европейската комисия, централните правителствени отдели и правителствени агенции във Великобритания и други страни (Полша, Латвия, Китай). От 2000 г. проф. Смолбоун е действащ консултант на Организацията за икономическо сътрудничество и развитие по различни теми, свързани с развитието на МСП в икономиките в преход. Той също така е експерт към Програмата на ООН за развитие и на Икономическата комисия за Европа към ООН и Организацията за сигурност и сътрудничество в Европа като външен експерт. От юли 2005 г. проф. Смолбоун работи по проект в Китай, финансиран от правителството на Великобритания, включително като съветник на Китайската комисия за развитие и преустройство.

Ръководи и няколко проекта, в които участват и български партньори.