How to build and effective policy framework for SMEs: a developing countries' perspective

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Executive summary

The twin process of globalization and liberalization, combined with rapid advances in information and communication technologies, are creating new dynamics of production, enterprise development and international competition. These changes call for a holistic and integrated approach to enterprise development, that addresses the multiplicity and interaction of factors that underpin the growth and competitiveness of enterprises. They also imply the need for countries to formulate enterprise development strategies which take into account the role of the private sector and role of the State, as well as the interaction between them.

However, all such activities, in order to have maximum usefulness and impact, will need to take place within a coherent policy framework. Experience has shown that, in the absence of a coherent policy environment, the globalization of production and the opening of domestic markets has had adverse effects on the enterprise structure and in particular on the SME sectors of many developing countries, especially LDCs. These consequences have led to a situation where SMEs have been often massively destroyed or are continually losing ground in terms of their competitiveness, giving rise to a missing or declining middle in the enterprise structure in these countries, accompanied by a corresponding expansion of the micro-enterprise or survival sectors of the economy.

Given the importance of SMEs, these trends can have serious implications for the economic and social development of these countries in terms of its effects on income and earnings distribution, the tax and consumption base and the ability of the economy to modernize and integrate itself into the global economy. The process may also become self-reinforcing, in the sense that reduced demand and falling tax revenue may inhibit the ability of the State to help deserving SMEs when such help is most needed in order to enable them to survive and to adjust successfully. Some external transitional help on the part of donor organizations to meet the cost of such SME support programmes may thus be needed.

As a matter of fact, too often initiatives towards the development and promotion of SMEs are overruled by other government bodies or fall prey to actual or alleged constraints, such as fiscal pressure, monetary considerations or shortages of foreign exchange. However, since macroeconomic policies to achieve stability through high interest rates or to promote competition through trade liberalization may be damaging for SMEs, careful tuning and timing of such policies may be necessary, so that viable enterprises are given time to adjust, together with measures to facilitate their adjustment, including their access to essential inputs. It is clear, therefore, that there is a need for ensuring coordination, coherence and complementarity in the design and implementation of instruments for SME development.

In particular, the establishment of SME support agencies and programmes need to go in parallel with efforts to improve the policy, legal and regulatory environment in which SMEs operate. This would imply, among others, reducing subsidies and other policy measures which favour large enterprises and discriminate against SMEs, simplifying regulations and administrative procedures for business start-ups and development and enacting new legislation to deal with gaps or inconsistencies in business laws. In the final analysis, evidence shows that improving such an environment may be more beneficial for SME development than specific support programmes. Based on this assumption, the paper identifies the regulatory environment as the first among the most effective entry points and mechanisms for a private sector development strategy, and subsequently explores the main elements of an action plan mostly focusing on meso and micro levels interventions.
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Second draft

Introduction

The Sao Paolo Consensus, adopted by UNCTAD XI in June 2004, states that "an enabling international environment is essential for developing countries and economies in transition to integrate successfully into the world economy. Equally important is the need for these countries to build stronger supply capabilities responsive to market demands, promote technology development and transfer, encourage enterprise networking, increase productivity and improve the competitiveness of their enterprises".

It is therefore clear that, as mandated by the Sao Paulo Consensus and previously by the Bangkok Plan of Action (adopted by UNCTAD X in February 2000), UNCTAD considers as a priority the task of strengthening the competitiveness of developing countries enterprises, as a pre-condition for developing countries to fully benefit from the potential opportunities opened up by globalization. In this respect, the present paper intends to contribute to the reflections initiated by the Committee of Donor Agencies for Small Enterprise Development to identify critical issues of concern or debate when reforming the business environment and the respective roles of governments, donor and the private sector.

In particular, this paper will outline a strategy promoting efficient private sector enterprises able to partner and compete in the global economy, and will show how reforming the business environment is an essential pre-condition for any SME policy to succeed. It will also provide a set of policy recommendations which will not present overall macro-economic, legal and regulatory prescriptions or the usual recommendations for investing in physical infrastructure and human development (health and education) necessary for private sector development. These pre-requisites are addressed in virtually every development report, but it is now commonly recognized that even if the macro-economic fundamentals are sound (fiscal balance, low inflation, realistic exchange rates) private sector development will not automatically take place, especially in the absence of micro-economic improvements and interventions.

1. The importance of policy coherence

The twin process of globalization and liberalization, combined with rapid advances in information and communication technologies, are creating new dynamics of production, enterprise development and international competition. These changes call for a holistic and integrated approach to enterprise development, that addresses the multiplicity and interaction of factors that underpin the growth and competitiveness of enterprises. They also imply the need for countries to formulate enterprise development strategies which take into account the role of the private sector and role of the State, as well as the interaction between them.

However, all such activities, in order to have maximum usefulness and impact, will need to take place within a coherent policy framework. Experience has shown that, in the absence of a coherent policy environment, the globalization of production and the opening of domestic
markets has had adverse effects on the enterprise structure and in particular on the SME sectors of many developing countries, especially LDCs. These consequences have led to a situation where SMEs have been often massively destroyed or are continually losing ground in terms of their competitiveness, giving rise to a missing or declining middle in the enterprise structure in these countries, accompanied by a corresponding expansion of the micro-enterprise or survival sectors of the economy.

Given the importance of SMEs, these trends can have serious implications for the economic and social development of these countries in terms of its effects on income and earnings distribution, the tax and consumption base and the ability of the economy to modernize and integrate itself into the global economy. The process may also become self-reinforcing, in the sense that reduced demand (compounded by the impact of higher interest rates of structural adjustment polices) and falling tax revenue may inhibit the ability of the State to help deserving SMEs when such help is most needed in order to enable them to survive and to adjust successfully. Some external transitional help on the part of donor organizations to meet the cost of such SME support programmes may thus be needed.

As a matter of fact, too often initiatives towards the development and promotion of SMEs are overruled by other government bodies or fall prey to actual or alleged constraints, such as fiscal pressure, monetary considerations or shortages of foreign exchange. However, since macroeconomic policies to achieve stability through high interest rates or to promote competition through trade liberalization may be damaging for SMEs, careful tuning and timing of such policies may be necessary, so that viable enterprises are given time to adjust, together with measures to facilitate their adjustment, including their access to essential inputs. It is clear, therefore, that there is a need for ensuring coordination, coherence and complementarity in the design and implementation of instruments for SME development.

In particular, the establishment of SME support agencies and programmes need to go in parallel with efforts to improve the policy, legal and regulatory environment in which SMEs operate. This would imply, among others, reducing subsidies and other policy measures which favour large enterprises and discriminate against SMEs, simplifying regulations and administrative procedures for business start-ups and development and enacting new legislation to deal with gaps or inconsistencies in business laws. In the final analysis, evidence shows that improving such an environment may be more beneficial for SME development than specific support programmes. Based on this assumption, the paper identifies the regulatory environment as the first among the most effective entry points and mechanisms for a private sector development strategy, and subsequently explores the main elements of an action plan mostly focusing on meso and micro levels interventions.

2. The regulatory environment for SMEs

Regulation is necessary for the private sector to operate efficiently. A simple, transparent, stable and enforceable regulatory environment forms the base upon which a dynamic enterprise sector can develop. Bannock (2002) highlights some of the difficulties that developing countries enterprises typically face regarding the regulatory environment. On the one hand they are faced with a heavy and costly regulatory burden that discourages especially smaller enterprises from even entering into the formal sector of the economy. On the other hand the regulatory system yields very few benefits to the enterprises as it does not provide a
clear framework in which business transactions can be enforced or in which property rights are clearly defined.

For example, the cost of registering a business in countries such as Nigeria and Senegal are almost equal to the annual GDP per capita in these countries. In Mozambique the cost of registration exceeds GDP per capita. By comparison, in the United Kingdom registering a business will take 1 week and it will cost about USD 40 (European Commission, 2002). In other words there is significant scope for reducing the number of procedures, time and costs needed to register a business. It would be useful to consider a single authority for one-stop-shop registration.

Another reason to be concerned is that complex and heavy regulatory frameworks are often associated with high levels of corruption. A study by Friedman, Johnson et al. (1999) shows that measures of regulation and corruption are positively correlated. This is also reflected in the figure below, which shows that in African countries the relative cost and length of time to register a business are positively correlated with the level of corruption in the country.

**Figure 1: The Corruption index* and the relative cost of business registration in Africa**

![Graph showing the Corruption index and the relative cost of business registration in Africa.](image)

* Note: The Corruption Index is inverted from the index published by Transparency International. Thus the larger the value of the inverted corruption index, the more corruption is present in the country. Source: Transparency International, www.gwdg.de/~uwvw/2002Data.html (18/3/03), Djankov et al. 2000 and Bannock et al. (2002)

**Policy recommendations:**

*Remedial action is needed on two fronts:*
• *Firstly, there is a need to simplify the existing business regulations to reduce the administrative burden that enterprises face. This can be achieved in a relatively short space of time if the government is sufficiently committed to the reforms.*

• *Secondly, there is a need to strengthen judicial institutions so that contracts can be enforced, property rights are respected and companies that default on their debts will go through an orderly bankruptcy procedure. While it is relatively easy to reduce the administrative burdens, changes in the legal system cannot be achieved over night, but instead they require a long-term commitment to gradually build up the capabilities of the respective institutions.*

3. Public-private sector dialogue

The most effective and also the most feasible long-term solution for improving the regulatory environment from the point of view of enterprises starts through public-private sector dialogue. Effective interaction and dialogue between the government and the private sector, including NGOs, plays a key role in creating a coherent policy framework and effective support measures and structures for the development of enterprises.

Some form of public-private sector interaction exists in virtually all countries at various levels of government, including regional and local administrations, and sometimes for particular sectors. However, in many developing countries, contacts between the government and the private sector are often informal, spontaneous, partial or unstructured. Further, they often lack transparency or clarity in terms of defining the objectives to be achieved, the issues to be addressed, including the particular needs of SMEs. Moreover, government-private sector contacts are often highly personalised or opaque, which can lead to undesirable results. SMEs usually have little trust in governments and see it as a source of problems because of burdensome regulations and inspections and unfair taxation rather than as a source of assistance.

Shortcomings in such interactions deprive the government of appropriate inputs for policy making and enterprises of inputs from the government for their strategic planning. Consequently, because of such shortcomings, it is not always evident that the process of policy and institutional development in support of SMEs in individual countries responds effectively to the needs and concerns of SMEs or takes sufficiently into account the difficulties or constraints faced by them.

Seldom are all members of the private sector represented in this dialogue. SMEs, women entrepreneurs, young entrepreneurs particularly feel neglected or unable to participate due to various constraints, including lack of information, shortage of resources, work pressure and various other obstacles. Moreover, the activities of the institutions or agencies that participate in this dialogue are sometimes heavily politicised.

**Box 1: The International Chamber of Commerce (ICC)**

ICC describes itself as the "voice of world business championing the global economy as a force for economic growth, job creation and prosperity". It has a broad international membership including corporations and companies in all sectors, national professional and sectoral associations, business and
employers federations, law firms and consultancies, chambers of commerce, as well as individuals involved in international business.

ICC plays an important role in business self-regulation by setting codes, rules and model contracts for its members. Its activities in this field include the ICC rules on arbitration, standard definitions of trade terms (Incoterms) and the Uniform Customs and Practice for Documentary Credits, which are used by banks all over the world to finance international trade. ICC’s voluntary codes cover marketing and advertising, the suppression of extortion and bribery, and sound environmental management practices.

As an advocate for international business, ICC promotes issues in the international arena that are important to its members. This includes working closely with international agencies, such as the UN agencies and WTO, and governments on issues that range from results of the Doha trade round, intellectual property rights, transport policy, trade law and environmental issues. For example, the ICC Presidency meets annually with the leader of the G8 host country to provide business input to their summits.

ICC also aims to promote the interests of businesses at the local level and to spread business expertise through its network of enterprises, including in developing countries. It has for example assisted Least-Developed Countries (LDCs), in cooperation with UNCTAD, to attract foreign direct investment by setting up the Investment Advisory Council and launching Business Investment Guides for some African countries. It has made efforts to mobilize business support for NEPAD activities and to organize regular regional conferences that focus on the concerns of business in Africa, Asia, the Arab World and Latin America.

Source: www.iccwbo.org (18/3/03)

**Policy recommendations**

Governments need to take an active role in promoting public-private sector dialogue by doing the following:

a. **Establish mechanisms for structured public-private sector dialogue**

This could take the form of consultative business councils, advisory panels, chambers of commerce and business associations. The criteria for an effective mechanism for public-private sector dialogue include:

- all relevant stakeholders are represented and the criteria by which they are chosen are transparent;
- the objectives and the agenda are clearly stated and relevant to the stakeholders;
- sessions are held regularly, or are called based on criteria that are transparent and accepted by all stakeholders;
- transparency on how and by whom the agenda is set, how representatives are selected, how often meetings are held;
- accountability / monitoring of progress or impact of dialogue;
- two-way street – as a forum for the government to sound out private sector on issues and also a route for the private sector to raise issues;
- dialogues are held at all levels: national, regional and local.
b. Promote training / capacity building

It is clear that without capacity building and training in "public-private sector dialogue" certain segments of the business community will not be able to adequately put forward the concerns and needs of the segment they represent. Such dialogue mechanisms exist in most East Asian countries and have reached a certain degree of regularity. However, even in East Asia, SMEs are quite often either absent or still under-represented in powerful business and trade associations lobbying the local authorities.

There is a need to encourage SMEs, rural, women and young entrepreneurs to engage in dialogue through business associations. Training provided by business development service providers is an important ingredient in this process.

A weak enterprise sector will generally also have weak representative bodies. Therefore, there is a need to strengthen the representative organizations through capacity building efforts. Here technical assistance could be provided by more established business associations or chambers of commerce. Best practices could also be learned through linkages with business associations and chambers of commerce in other countries.

c. Have a positive attitude toward public-private sector dialogue

Perhaps most importantly, the government should have an open and positive attitude towards dialogue with the private sector and genuinely be willing to take into account private sector views in policy making. For many governments this will require a change in culture from a more "administrative approach" towards a more "managerial approach" towards the private sector. It is important that the public sector on all levels comes to realize the benefits that the dialogue process offers, so that officials do not view it as an unnecessary bureaucratic burden.

This requires recognition that policymakers and their professional advisers (as well as executives of large enterprises) do not have a monopoly on perspective, understanding, knowledge and wisdom. In most cases first hand knowledge of market conditions will probably lie in the hands of small and medium sized -entrepreneurs, who form the bulk of the economy in any country. They will also have first hand knowledge of the impacts that government policies have on their business. Similar analogies apply to women entrepreneurs, rural entrepreneurs, young entrepreneurs etc. It is also vital to recognize that effective dialogue requires that the private sector also sees benefits in it - i.e. their views should have an impact on government policies. Otherwise both sides will view the process as a waste of time.

A positive attitude vis-à-vis public-private dialogue has been more the rule than the exception in most East Asian countries, due to the fact that the private manufacturing sector has been at least partly a creation of local public initiatives. Both foreign investors and large domestic firms have been involved in the decision-making process, by suggesting or influencing new policies and measures. The inclusion of SMEs in this process is more recent except in Japan and Taiwan POC.

d. Network with international business associations
It is important to note that the enterprises, including the SMEs, operate in an increasingly international environment in terms of trade and investment. If public-private sector dialogue mechanisms are to be effective and relevant they have to be able to operate in this environment as well. This can be accomplished through increased international cooperation between institutions that serve to enable public-private sector dialogue.

It would be useful to consider setting up an inter-regional chamber of commerce that includes chambers of commerce from countries at different levels of development. Such an institution would serve to:

- Increase chances for enterprises to realized trade and investment opportunities through networking, partnerships, and exchange of information on best practices for private sector development.

- Boost the influence of the private sector in policy issues related to foreign trade, investment etc.

- Provide support and strengthen the national mechanisms for public-private sector dialogue through dissemination of best practices and assistance in setting up effective mechanisms.

4. Business development services

An efficient local and central government, effective intermediary organizations, and the availability of support structures - namely for the provision of financial and non-financial services - are essential in steering enterprises to take what has been defined as “the high road to competitiveness”, rather than the “low road”, based on price competition and permanent cost and wage reductions. While successful East-Asian countries opted for a strategic mobilization of their domestic resources to pursue a catching-up industrialization strategy, most African and Latin American countries adopted a static approach and relied on their existing comparative advantages.

Building competitive advantages, rather than relying on comparative advantages, requires continuous investment, especially in skills, and sharing risks among public and private institutions. The new rules of international competition allow only flexibly specialized producers to compete in the global market place, on the basis of product-led competition (rather than price-led), just-in-time principles, teamwork and inter-firm cooperation (Best, 1990). SMEs, however, cannot afford to develop new technologies individually, find new markets, train workers and raise capital all at the same time.

Therefore, over the past decade, governments and international donors have increasingly turned their attention towards market-driven business development services (BDS), with the aim of assisting small enterprises to overcome market imperfections in accessing technology, information, and finance needed to operate more competitively and with greater efficiency in domestic and global markets. Training programmes to acquire better management and marketing techniques, services for technology diffusion and acquisition, and assistance in the identification of niche markets and alternative products have proven very effective in helping SMEs when those activities are too costly to be performed in-house. Such programmes are
better left to meso institutions such as business centres, business associations, NGOs, because they are closer to the clients and therefore, know better what SMEs need.

Under the new competitive conditions, in most developing countries the SME sector is affected by three major constraints: poor access to market, scarcity of intermediate suppliers and fierce domestic competition. Paradoxically, it has to produce almost everywhere at “third world prices but first world standards”, and it is therefore stagnating despite the abundance of entrepreneurial talents and skills (Albaladejo, 2002). Direct assistance through support services, but not necessarily provided by donors and governments themselves, can indeed correct major market failures and help to break the non-growth condition of small firms, significantly increasing their chances of survival and opportunities to compete.

In East Asia, a solid BDS sector (business development service) does exist in Japan and the newly industrialized economies (the Republic of Korea, Taiwan POC, Hong Kong, Singapore). It is also emerging in Malaysia and Thailand, with various interactions with the private sector, and with more (Malaysia) or less (Thailand) interactions with local public authorities. However, in Africa quality BDS are scarce and expensive, and their accessibility for the majority of SMEs is highly debatable. Additionally, as in other regions, small firms are traditionally reluctant and unlikely to pay for what they view as poor quality services that address needs which are still latent, or where the pay-off is perceived as of a medium term nature. This hampers the sustainability of intermediary institutions and creates the need for subsidization and support from the public sector.

Quite recently important developments and innovations have been adopted in the field of BDS, in an attempt to make them more cost effective and to reach a larger number of businesses in a sustainable manner. Early BDS interventions consisted of fact in costly and supply driven services offered by public agencies, that rarely managed to respond to the true needs of the SME sector or to exit from full subsidization strategies (UNCTAD, 1999). It is now recognized that modern and effective demand-driven BDS are required by the small enterprise sector, and accordingly most of the specialized government and donor agencies are engaged in the complete restructuring of the SME support systems. In particular, in 1998 the Committee of Donor Agencies for SME Development has developed a new strategy in the design and delivery of BDS to improve their impact and outreach, cost effectiveness and sustainability, and endorsed a series of principles of good practices.

Based on these principles, donors mainly recommend:

- Focusing on stimulating the demand for BDS services by sensitising SMEs to their benefits.
- Replacing the provision of direct services by government with the development of private intermediary institutions (BDS suppliers).
- Making targeted and time-bound use of subsidies.

The question of subsidies for training and advisory services has been the subject of wide discussions. There is no question that SMEs should be assisted in the most cost-effective and sustainable manner. However, if BDS are to service small enterprises this may be a less than realistic goal. For very small and micro businesses, there is a strong case for some form of subsidy to cover part of the cost, provided that there is a direct contribution from the participant, which shows his personal interest and commitment.
The application of the donors' principles above should therefore refer especially to the way in which objectives are pursued, and does not imply the abandonment of social objectives. In fact, cost-recovery may not be applicable, or nor even considered as a priority, when reaching the most disadvantaged entrepreneurs. These groups can be reached by private market BDS providers only through the use of donor or government funds, or through cross-subsidization strategies from richer to poorer clients.

In the case of donor participation, sustainability can be interpreted as reaching a point where there would be an end to donor involvement either through the commercialisation of services or through an appropriate arrangement for the replacement of donor support by other national or private resources. If this is not attainable, as it may be the case in some least developed countries (LDCs), there should be a clear understanding of the justification for longer-term support. In most cases, however, a strategy for the BDS to achieve sustainability should always be formulated, however recognizing that this may take a longer time and probably is not achievable in a period of less than ten years.

In this respect, it should be noted that cost recovery is easier for some services than others. Some BDS, such as marketing, technology acquisition and mastery, accounting and legal services, have clearly proven their financial viability. Other services, such as access to information and training, are not as profitable, because of free-rider effects or because the need for them is not clearly perceived. This means that the revenues earned by viable BDS may cross-subsidize a number of higher cost services which are less viable but which are believed to have a beneficial impact on participating enterprises, or on the market as a whole (UNCTAD, 1999).

Box 2: The Empretec Ghana Foundation

Empretec Ghana Foundation (EGF) was created in 1990 as a joint project of UNCTC (the United Nations Centre on Transnational Corporations) and UNDP (the United Nations Development Programme), Barclays Bank Ghana Limited and the Government of Ghana. Its primary objective is to “build high-quality, growth-oriented, internationally competitive entrepreneurs through training, business advice and access to technology and finance”.

In its start-up phase, it relied on only three professional staff and the services provided were limited to training. In 1994, Empretec Ghana was transformed into an independent foundation with a solid organisational structure in order to sustain the programme and started to deliver a wide range of follow-up advisory services to SMEs as well as the basic motivational training, aimed at improving the operational efficiency and profitability of the enterprises.

Between 1994 and 1997, the staff of EGF increased to over 60 and the funds generated internally rose substantially, reducing its dependency on donors’ aid. Today, the EGF is an established BDS supplier that is trying to achieve long-term financial sustainability through the delivery of relevant BDS products. SMEs now pay full costs for the services, and this allows EGF to achieve 60% sustainability.

Policy recommendations:

a. In principle, BDS support to SMEs should be provided by the private sector. The public sector should intervene in the case of an initially unfavourable cost/benefit ratio or in cases of 'free riders' (where public goods are concerned). In any event, mechanisms and structures should be conceived in a business-like manner.
b. In particular, where the market already demands BDS, government institutions should not be direct service providers but should make indirect use of local support structures. Where BDS are strategically important but not yet adapted to local needs, joint efforts by public and private institutions should provide effective institutional responses.

c. Private sector BDS providers should include representative organizations, such as chambers of commerce and business associations, but also private consultants.

d. The manner and scale of BDS interventions should always correspond to the ability of the beneficiaries to absorb the assistance they are offered, and should never be forced on recipients. Close attention must therefore be paid during the needs assessment phase when the manner and scale of the interventions are decided.

e. Firms should be stimulated to achieve continuous improvement through self-help and become less dependent on external support, thus developing an autonomous capacity to upgrade. In particular, entrepreneurs should be trained to conquer niche markets and compete on the basis of quality, design, and speed of innovation.

f. Bearing in mind the time pressures on SMEs, BDS must be brought as physically close and made as convenient as possible for the small-scale entrepreneur. This requires the maximum feasible vertical and territorial decentralization in organizing BDS. Approaches of recent years have concentrated on the creation of business support centers in various regions and localities of the country where they could be justified by the number of potential beneficiaries. In addition services can be more efficiently provided at a low fee to clusters of small businesses operating in close geographical proximity.

g. Generally speaking, they are one-stop centers where entrepreneurs have access to a whole set of services and inputs (i.e. entrepreneurship training, information, finance, quality control, networking, and business counseling) needed to grow their businesses and face increasingly competitive external pressures.

5. Access to finance

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 traditionally have faced difficulty in obtaining formal credit or equity. Commercial banks and investors have been reluctant to service SMEs for a number of reasons. Among them are:

- 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, inadequate financial statements or business plans makes it difficult for creditors and investors to assess the creditworthiness of potential SME proposals;
- High administrative/transaction costs of lending or investing small amounts do not make SME financing a profitable business.
5.1 Commercial banks

As a result, commercial banks are generally biased toward large corporate borrowers, who provide better business plans, more reliable financial information, better chances of success and higher profitability for the banks and have credit ratings. When banks do lend to SMEs, they tend to charge them a premium for assuming risk and apply tougher screening measures, which drives up costs on all sides. Commercial banks in developing countries and countries with economies in transition often prefer to lend to government and thus the public sector crowds out the private sector. Lastly, there is also the problem of insider lending and/or cronyism that diverts finance away from SMEs.

In recent years leading commercial banks particularly in OECD countries and Asia have been particularly successful in servicing the SME market. They have managed to increase the volume and profitability of lending to SMEs while driving down transaction costs and risks. Their strategy has been to improve their core competencies by adopting sophisticated credit techniques such as credit scoring, strengthening management and information systems and developing highly efficient automated processes, efficient marketing and distribution, and developing close ties to clients.

**Box 3: SME loan Hong Kong**

The bank has managed to cut costs of lending to SMEs and reduced the amount of bad debt by focusing on a very restricted set of reliable and timely data obtainable from the accounts receivable of any SME. It found that traditional sources of information, such as financial statements, cash flow projections and business plans are too static and outdated to be relevant in credit decisions. Instead it focuses on:

- Who are the customers of the SMEs?
- How much do SMEs sell to their customers?
- How much cash do SMEs collect from their customers?

Electronic means are used to capture on-going business information from SME borrowers in order to build a dynamic risk management and loan-servicing model for SME lending. Loans are extended against the cash flow and business performance and secured by accounts receivable. No collateral is required of the SMEs, but the bank insists that SMEs open their books to them at the very source – that is that the bank has basically the very same information as the SMEs at the same time as the SMEs. The administrative costs are very low, as the automated model allows the bank to concentrate only on loans that have proved to be problematic.

Source: SME loan Hong Kong.

One option for reducing the costs of lending to SMEs is a **guarantee programme**. However, designing a guarantee programme requires utmost care. To date most guarantee programmes have failed and only a few have been sustainable. Many of them have had poor results because they failed to reach the target audience usually due to slow dispersals. The lack of prudential lending resulted in moral hazard problems, some banks were reluctant to enter such programmes because of previous late payment by the guarantor in cases of default.

If guarantees are justified by severe market failures, then they should be partial guarantees so that risk is shared between the public and private sectors. Credit guarantee schemes have
played an important role in facilitating SMEs access to finance in Japan. There are over 50 credit guarantee corporations that provide guarantees for SMEs. The schemes have managed to keep the default rates very low (1.4 per cent) and thus subsequent loan recovery rates very high compared to many other countries. This is largely due to the highly developed database system that provides information on all clients and transactions (Hatakeyama in Levitsky, 1997).

5.2 Leasing

An alternative to a traditional bank loan, that has shown promise in many developing countries, is leasing. Perhaps the most significant benefit of leasing compared to traditional bank loans is that no prior collateral from the SME is required (as the equipment leased serves as the collateral). The lack of collateral is one of the obstacles to accessing finance in developing countries. There are also a number of other benefits to leasing, such as financing can reach up to 100% of the equipment value. The financing company is likely to have a better negotiation position with suppliers resulting in lower costs for the equipment as well as having expertise in specialized equipment that it could pass to the customer, and flexible contracts and short approval time. Nevertheless, there are also drawbacks. For example, missing a lease payment can lead to the re-possession of equipment and in turn leads to the termination of the SME's operations. Further, leasing caters only to a relatively narrow subset of financial needs that SMEs might have, such as financing the purchase of a machine or a vehicle, but is clearly not an option for less tangible and more complex financial needs of an enterprise.

**Box 4: Leasing in Uganda**

The DFCU Leasing is a private limited company and a subsidiary of the Development Finance Company of Uganda. It was established in 1994 to provide alternative medium term equipment financing to the private sector. The DFCU Leasing buys and owns equipment selected by the lessee and allows the lessee possession and use of the equipment on payment of monthly rentals. This includes plant, equipment, machinery, commercial vehicles and business cars. The lessees must be established businesses, which can demonstrate sufficient cash flow to make the monthly payments. Generally the equipment cost is in the range of Ush 25 million to Ush 500 million (approximately USD 15 000 – USD 300 000). Lease periods are normally between 2 and 5 years. A cash guarantee, typically 15-20% of costs, is required from the lessee. The lease contracts are typically flexible and payments can be structured to meet the particular needs of the lessee. There are also some tax benefits, depreciation allowances are claimed by the lessee and the payment of value added tax can be spread over the period of the lease.

Source: DFCU Leasing

5.3 Venture capital

**Venture capital** has the potential to provide an alternative to traditional bank loans for start-up firms or SMEs with high-growth potential. Venture capitalists are generally willing to accept high levels of risks (for high potential profits), do not require collateral nor charge interest payments and it is by nature long-term or at least medium-term capital, in contrast to short-term loans from banks. However, the conditions for establishing a viable venture capital
industry are very stringent. It requires a constant flow of high growth potential projects, well-functioning financial markets that provide exit opportunities to investors, entrepreneurs that are willing to sell significant equity to outsiders and also willing to be either acquired or participate in a public offering. Only a few countries, such as Israel, Taiwan POC, and the United States can claim any success in establishing a viable market for venture capital but they also have suffered severe setbacks in the past couple of years. In conclusion, although venture capital does have a number of features that would make it an attractive option to finance SMEs, there are several stringent conditions that will make it very difficult for venture capital to take hold in developing countries. Nevertheless, public-private sector partnerships to establish investment funds could be a useful option to expand financing to SMEs in developing countries.

Policy recommendations

To encourage commercial banks to lend to SMEs, central banks and designated financial service regulators must play a proactive role. Government and the central bank must set out a policy framework for channeling adequate funds to the SME sector. In clearly indicating the right direction to the suppliers of capital, regulators could explore set-aside mechanisms for SMEs (i.e. quotas and targets) but such targets have partly failed more than once in the past, Korea and Indonesia being examples. Certainly, increased transparency would influence the lending practices of commercial banks. The central bank could require, for example, disclosure of the composition of bank loan portfolios by different categories of borrowers. The Government/central bank might also consider a set of special measures for SMEs (guarantee programmes, more user-friendly and transparent disclosure systems, IT driven appraisal systems) to reduce the risks perceived by banks.

Box 5: Venture capital in Taiwan, POC

The most successful case in creating viable venture capital industries in developing countries is Taiwan, POC, where venture capital has grown to be a significant provider of capital for technology-based SMEs. By the early 1980s, it leveraged its success in becoming a low-end supplier of electronic parts to transnational corporations to become a hotbed of entrepreneurial activity. In 1983, after a visit by Taiwanese officials to the high-technology regions in the United States, the local government resolved to develop a venture capital industry and passed legislation extending a variety of incentives to individuals willing to invest in professionally managed venture capital firms. The most significant incentive was a 20 percent tax rebate for Taiwanese individuals provided they maintained their venture capital investment for at least two years. To be eligible for the incentives, the venture capital fund had to be approved by the government, and only experienced managers were able to receive approval (Kenney, et. al., 2001). This created a quality check on venture capitalists. All investments had to be in high-technology Taiwanese firms or in foreign firms that would transfer technology to Taiwanese firms. Investments in publicly traded securities, real estate, and retail operations were prohibited. To ensure probity in the system, the exact percentage of the tax rebate was decided by an outside accounting firm that evaluated the technological sophistication of the investment and its importance to the development of Taiwanese industry. To further the growth of the venture capital industry the government also invested funds in venture capital firms provided that private investors matched them.

Source: Dossani and Kenney (2002)
6. Financial and fiscal incentives

Start-up companies are perhaps the least-likely enterprises to receive financing as they lack collateral and a track record. The viability of their business plans is subject to huge uncertainties and potential profits only materialize after lengthy periods of time. Typically start-ups will have to rely on financing from friends and family, which of course constrains their ability to grow. It is thus safe to conclude that start-up companies especially in developing countries are confronted by a market failure with regard to access to finance. Therefore, financial incentives to promote start-up companies could be considered.

The World Investment Report of 2002 categorizes incentives that governments provide for investment into:

- financial incentives: grants, subsidized credits and insurance at preferential rates;
- fiscal incentives: tax holidays, reduction or exemption of taxes on profits, capital, labour, sales, value added, particular expenses, imports and exports; and
- other incentives: e.g. subsidized infrastructure, subsidized utilities, market preferences and various kinds of regulatory incentives linked to ownership and other preferential treatment.

Most government schemes combine elements of all three categories. It should be noted that in many cases government interventions have been inefficient and have had distortionary effects on the economy. Great care should be taken when designing incentive schemes, so that caveats – such as moral hazard problems, adverse selection – are avoided. Often public sector finance is best employed in combination with private capital and with private management of the pooled funds.

There is considerable debate over the relative effectiveness of financial vs. fiscal subsidies. Cash grants may be more effective as they cut the initial costs of an investment while a tax holiday kicks in only when an enterprise starts making profits. Thus, the financial incentives may have the advantage in promoting investments that are uncertain and long-term. However, in many cases it is easier for cash-strapped developing countries to give tax holidays. This however, works best to differentiate among countries that have already established enabling business environments. Thus, while developed countries are able to choose among financial and fiscal incentives, developing countries may have to rely largely on the latter.

7. Inter-firm cooperation

Inter-firm cooperation can help SMEs to overcome their traditional weaknesses, namely isolation, and the lack of economies of scale and scope. In particular, different forms of cooperation between firms - horizontal and vertical, arms-length and long distance, spontaneous and artificial, formal and informal - can raise the competitive potential of SMEs through synergies and collective efficiencies, which individual producers can never attain alone.

The competitive advantage of cooperating firms derives from two main sources: the extent to which the knowledge base of these companies deepens and broadens to include design, quality control and information related to markets and marketing; the establishment of linkages to a wider set of technology inputs and actors, both local and foreign. By enhancing technological capability and innovativeness, and increasing productivity and efficient
investment, inter-firm cooperation has become an important tool in meeting increasing global competition both in developed and developing countries (UNCTAD, 1997).

Inter-firm cooperation as described above is already fairly advanced in the East Asian region. Global production chains in automotive, electronics, electrical appliances, machine tools, chemical sectors, include TNCs and their affiliates, domestic conglomerates and other large firms (public or private), and SMEs. Korean and Taiwanese SMEs account for more than half of total exports, and a majority of them are independent global suppliers. This means that inter-firm cooperation takes place not only within national borders but also to a great extent across borders between suppliers and final buyers, which are often leading firms in North America, Western Europe and Japan. Linkages with universities and research centres and these leading firms also play an important role especially in the United States and Japan considering the number of East Asian engineers and technicians who were trained there. SME family business networks also play a major role in facilitating trans-Pacific inter-firm cooperation.

Inter-firm cooperation can take many forms, such as strategic alliances, networking and partnering, joint-ventures, licensing, franchising and subcontracting. It can be facilitated by physical proximity in clusters, industrial parks, technological incubators, and exports processing zones (EPZs). What is important for inter-firm agreements is that they are mutually beneficial and based on trust. For inter-firm cooperation to succeed, it must meet the following conditions:

- There must be clarity of motives and structures.
- There must be clear and reasonable targets.
- The potential partners must have good negotiation skills.
- The potential partners must be able to minimize the risk of conflict.
- They must develop an insight into their partners corporate and business culture.

7.1 Clusters and horizontal networks

Clusters have been defined as sets of economic actors concentrated along a sectoral value chain or agglomerations of specialized firms within a geographically delimited space. Clustering is therefore a spatial concept, while networking is most often used to describe formal and informal cooperation between firms, taking forms such as knowledge exchange, commercial relationships and strategic alliances. The two concepts often overlap, since one of the major characteristics of enterprise clusters is the existence of strong horizontal networks of small firms that result in flexible specialization and subcontracting arrangements.

Physical clustering is quite common in developing countries due to spontaneous agglomeration phenomena, as well as to earlier policies of creating what the British call “industrial estates” and the French call “zones industrielles” (UNCTAD, 1998). They are characterized by their different levels of development, and their ability to make a contribution to the industrialization process varies according to the extent to which collective efficiencies have emerged together with firm differentiation and specialization, after having accomplished the transition from craft to factory production. (McCormick, 1998). As an example, the case of the Nnewi cluster of automobile parts in Nigeria shows how firms located in a cluster with no infrastructure have been able to grow, export and upgrade, by grouping together and setting up common utilities, as well as partnering with foreign technology providers.
Box 6: The automobile parts cluster in Nnewi, Nigeria

The automobile parts cluster in Nnewi (Nigeria) is an example of an African cluster which has entered a phase of main technological change and export growth. Over the past 25 years, local traders in Nnewi have transformed themselves into manufacturers of automobile parts through close linkages to foreign technology suppliers, namely from Taiwan Province of China. Seventeen firms, ranging in size from 40 employees to 250, supply Nigeria and other West African markets with switch gears, roller chains for engines, auto tubes, batteries, engine seats, shock absorbers, foot rests and gaskets for motorcycles, as well as other parts. Most of these firms have the design capability to modify products and adapt the production process to the local market. Workers’ skills were acquired through learning-by-doing, especially during equipment installation and test runs, and through inter-firm linkages with foreign technology suppliers. Foreign experts came from Taiwan POC and Nigerian engineers studied under them. Firms in Nnewi grew despite major infrastructural and credit constraints. Electricity, for example, was only supplied through private generators, water was provided through the company’s boreholes, telephone service was poor and tariffs high, land was expensive and scarce, and banks were reluctant to extend credit. Despite all these limitations, Nnewi firms succeeded in innovating, growing and exporting to neighboring countries while other firms in Nigeria were folding up.

Source: Oyelaran-Oyeyinka (1997)

Not all clusters are innovative and dynamic, nor should they be considered as the panacea for achieving competitiveness. Some of them are caught in the spiral of stagnation and decline, some others never reach their potential and mature past the embryonic stage. While geographical proximity always brings along a minimal exchange of information, it does not automatically imply a process of collaboration, knowledge sharing or technology capacity building. Similarly, the presence of passive externalities such as the availability of an appropriate labour pool or the stimulus of emulation does not guarantee the presence of critical actors needed to form a dynamic system, nor intense formal and informal cooperation which leads to collective efficiency (UNCTAD, 2003b).

Clusters, however, permit focused interventions, allow information to be rapidly diffused and powerful demonstration effects to occur. Feedback between clients and their suppliers can be a source of both information and innovation. Therefore, in most developing countries there is a need to transform existing agglomerations into competitive clusters, reaping the benefits of both physical proximity and networking, thus generating possibilities for accessing new markets and resources, acquiring new skills and capabilities, and becoming internationally competitive.

Policy recommendations:

Clustering seems to have the potential to enable African countries to overcome some of the main barriers to industrial development.

Policy interventions, however, should be confined to revitalizing only selected clusters with high growth potential, and not supporting agglomerations of tiny firms in an indiscriminate manner. Experience shows that focused measures (e.g. the creation of technical schools, research centres, export promotion boards, quality certification institutes) and trigger mechanisms (e.g. strengthening business associations, subsidizing export initiatives, promoting brand names and new product/location images, establishing strategic alliances
among public and private actors) can play a role in stimulating and supporting change, tacit knowledge flows and interactive learning.

In practice, most common cluster promotion and upgrading initiatives are aimed at:

- promoting inter-firm networks, supply chains and sectoral clusters that reinforce knowledge, technology and innovation;
- enhancing the role for intermediary institutions - such as development promotion agencies and business associations;
- stimulating the emergence of institutional networks through regional alliances, formal and informal agreements;
- supporting the creation of a pool of skilled labour through training and stimulating the emergence of specialized and quality producers through assistance in standardization and certification.

With suitable help in the form of technological assistance, financial support and a stimulating environment, clusters can produce goods with a high technological content and become competitive on a global scale. In particular, the following good practices should be kept in mind when implementing cluster development programmes:

a. Initiatives should be defined and implemented with bottom-up involvement of the main local interest groups, both public and private. This requires consensus-building and concertation processes, involving workers and employers either directly or through their associations.
b. Recipients themselves should be in charge of the needs assessment process, and not just involved in the programme as end-users. A participative approach is essential if common strategic visions and alliances are to be created on a long-term basis.
c. “Social” innovation is required to help local actors face global changes. In general, obstacles to generating changes in attitudes, functions and distribution of power are much more difficult to overcome than strictly technical or technological problems.
d. The target of support measures should not be a single enterprise, but a network of enterprises. Providing common services has two main advantages: (i) it lowers transaction costs; (ii) it helps generate interaction between enterprises, improving their efficiency and maximizing the potential of the group through the development of mutual learning.

7.2 EPZs, industrial parks and incubators

Although clusters are the result of a spontaneous tendency of SMEs to locate close to each other, there are also organised efforts to set up clusters from scratch, mainly through EPZs and technopoles or science parks, which are artificial agglomerations of firms resulting from technology and export policies. Many African governments willing to promote industrial development have opted for such kinds of targeted interventions, but often for the wrong reason such as compensating for serious deficiencies in the business environment, or as an alternative to implementing longer-term and more comprehensive development strategies.

Technopoles, science parks, industrial corridors and technological incubators are usually created to establish spatial agglomerations of high-tech firms and organizations, ranging from large technology research hubs to small industrial estates. Often situated close to universities,
research institutes and scientific laboratories, they benefit from the technological advice and help of faculty members as well as the more practical administrative support services of the incubators and parks, and in many cases, the interaction with other scientifically or technically minded entrepreneurs.

Indeed, they can all be characterized by high rates of entrepreneurial activity and high-tech start-ups. Hewlett Packard and Apple started in science park locations. In many Asian countries such as the Republic of Korea or Taiwan, POC, science parks and incubators are increasingly catering to local suppliers, thereby helping to transform many of the enterprises into world-class suppliers.

### Box 7: Senegal, Société de Gestion du Domaine Industriel de Dakar (SODIDA)

SODIDA was created with German funding in 1978 to promote small industrial units in Senegal. It represents a good example of an industrial park in Africa. This initiative responded to the needs of the local entrepreneurs who were mostly working in the informal sector, and were suffering from a poor business environment and infrastructure, as well as a lack of access to market and credit.

SODIDA has two main functions: providing infrastructure and business development services. It offers a combination of services for enterprise creation that can be typically found in incubators or industrial parks. It offers suitable technologies, technical training and access to finance for start-ups.

SODIDA is the host to international programmes such as Enterprise Senegal, part of the UNDP/Enterprise Africa programme, and of several other SME development programmes supported by UNIDO, the ILO, the German cooperation, etc. Enterprise Senegal, called E2S (Enterprise Senegal SODIDA), was the first one to be implemented in the centre.

SODIDA, whose area covers 8 hectares and contains 67 buildings, generated a number of business successes, and some enterprises have already found new larger locations outside the estate. The success of SODIDA companies can be attributed to the services provided, but also to tax incentives and to the availability of transport infrastructure (motorway, Dakar airport and seaport). Because of its success and requests by the foreign and local investors who could not find any space available, a new project called SODIDA II is under construction. It will accommodate high tech firms using new technologies and SMEs. The American group Nitra Inc is financing SODIDA II and hopes to meet both the requirements for new technologies and the demands of globalisation. Up to 600 new buildings and 50000 new jobs are expected to result from this new initiative.


However, such constructed spatial agglomerations are often poorly managed, lack effective mechanisms to stimulate networking among the firms artificially clustered, and, even more importantly, they provide little contribution to the growth of the local productive capacity, due to their isolation from the surrounding economy. Therefore, they are often criticized for being expensive enclaves, absorbing a huge amount of public investment without contributing adequately to the growth of the local economy.

EPZs have been established to attract foreign firms through direct tax incentives, streamlining export regulations, facilitating business services and providing easy access to infrastructure and transport. In the last decades they have become a popular measure for industrial promotion in many developing countries, increasing from 175 in 53 countries in 1987 to 500 in 73 countries by 1995 (World Bank, 2003). Indeed, they have generated immediate benefits
in many host economies in South-East Asia and China through higher investment levels and job creation, and still represent an important tool for attracting export-oriented FDI (UNCTAD, WIR 2002).

Several export processing zones were constructed in Taiwan POC in the mid-1960s to support the emerging export-orientation of labour-intensive products. Not only foreign investors but also domestic firms and SMEs were encouraged to settle there. Due to their close location to sea-ports like Kaoshiung, the largest harbour of the island, their contribution to exports rapidly exceeded the initial investment. Such EPZs established strong links with more than 90 other industrial districts.

However, most EPZs have shown little potential to establish positive links with the local economy. They are often characterized by a very low degree of coordination and networking among firms located within the cluster, strict subcontracting relationships, and no backward or forward linkages with the local production system. In many developing countries they are locked into a downward spiral, due to low technology levels, low value added, low profitability, high levels of market uncertainty, and volatile investments (Frobel et al., 1987). Most often, the positive effects of a relatively high employment generating capacity are undermined by a high turnover rate, which limits skill development (mostly low-cost and female), while high export levels are undermined by the scarcity of foreign exchange.

In developing countries, most EPZs continue to follow the traditional enclave, assembly – for-export-only pattern (Lall, 2001). They do not cater to the needs of specific groups of industries, they have often no contacts with scientific centres of excellence and R&D laboratories, they are poorly designed, poorly maintained and heavily subsidized, and they are not promoted to prospective investors. The lack of critical scale is a major competitive weakness in developing countries EPZs. Thus, in most cases they have had a limited economic impact. Setting up subsidized EPZs is no longer a development option for most developing countries who join the WTO. According to WTO rules, many developing countries are obliged to eliminate most export subsidies and incentives as of 1 January 2003, with the exception of LDCs and of those countries that were granted an extension for the transition period.

Policy recommendations

a. Government efforts should not concentrate on backward regions with limited infrastructure and scarce availability of skilled human resources. Rather, EPZs and technopoles should be located close to commercial, industrial or scientific hubs, where the expansion of industrial production is already taking place in a competitive manner.

b. Targeted industrial development measures should be considered as a development catalyst for the rest of the economy. They should lead to better quality jobs in terms of wages and working conditions, and higher value added production in terms of productivity and technological intensity. They should be complemented by measures for developing well educated labour force and strengthening local infrastructure.

c. Innovative public-private sector approaches should be promoted. The government can provide infrastructure, but facilities and basic services in the EPZs should be administered by the private sector.
d. The successful promotion of industrial zones necessarily involves a wide range of factors, including finance, human resources, and technology, which demonstrates a clear need for effective coordination among ministries.

e. The interaction between the local industry and the local community as a whole is very important in order to generate positive externalities. Industrial zones must include local firms from a number of sectors so as to boost interaction with the main tenants and stimulate the local economy and create more jobs.

8. Foreign direct investment and backward linkages

From a developmental point of view, there is much potential for expanding the beneficial impact of foreign direct investment (FDI) all developing countries. FDI is still unevenly distributed (the world’s top 30 host countries account for 95 per cent of total world FDI inflows) and geographically concentrated (91 of the world’s largest 100 non-financial TNCs in terms of foreign assets are headquartered in developed countries).

FDI might represent more than a source of capital to host developing economies. It can entail the transfer of a variety of additional assets, such as production technologies, marketing techniques, information on market trends and organizational know-how. Therefore, FDI can play a crucial role in facilitating access to new and more diversified markets, technology and skills and thus building productive capacity.

However, the current experience suggests that the positive impact of FDI on host economies cannot be taken for granted. Case studies show that in the absence of linkages between foreign affiliates and domestic firms the benefits of FDI for host countries can be marginal or even negative (WTO, 2000). This is particularly the case when TNCs producing cheaper and high quality products confine competing domestic firms to less profitable market segments. Data also show that investment incentives, often used by developing countries to attract TNCs, can put local firms at a competitive disadvantage, at least initially (World Bank, 2003).

Inward FDI does not necessarily generate technological spillovers automatically, due to two reasons: the lack of skilled human resources and the limited absorptive capacity of local enterprises and/or the lack of real incentives for TNCs to encourage the diffusion of their technology to local enterprises. First, this means undertaking an in-depth analysis of a country's competitiveness and export potential, particularly niche markets. Second, since not all business linkages are equally beneficial for host economies, it appears crucial for developing countries to target “quality” FDI. This means targeting TNCs with a track record of forging linkages with local firms. Third, investment promotion incentives should be embedded in a comprehensive development strategy.

In this respect, there is a risk for many developing countries, especially LDCs, that they will become even more marginalized given the dynamics of international production, because they cannot meet the new requirements for attracting quality FDI. The main drivers of FDI location are changing rapidly and the traditional factors - namely, large national markets, the possession of natural resources and access to low-cost, unskilled labour – are constantly diminishing in importance, particularly for the most dynamic industries. Location decisions are based more and more on competitive advantages - as opposed to comparative - and on the
ability of host countries to provide specialised skills, infrastructure, local suppliers and institutions to use technologies efficiently and flexibly.

Evidence shows that simply opening an economy to foreign investors is generally not enough. To cope successfully with globalization and benefit from the increased flows of FDI, countries need to develop attractive configurations of locational advantages and to go beyond the first and second generation of investment promotion policies. Under the first generation, countries adopt "market friendly" policies and liberalise their FDI regimes by reducing barriers to inward FDI, strengthening standards of treatment for foreign investors and giving a greater role to market forces in resource allocation. Under the second generation, governments go a step further and actively seek to attract FDI by “marketing” their economies and eventually setting up national investment promotion agencies.

The third generation of investment promotion policies implies a pro-active approach towards FDI promotion and explicitly searches for ways to increase its benefits in terms of technology, skills and market access. Under the third generation, foreign investors are targeted at the industry/firm level in order to meet specific locational needs, in light of a country’s developmental priorities. At the same time, substantial efforts are made to enhance the productive capacity in particular industrial areas and related competitive advantages, thereby addressing one of the basic economic FDI determinants.

One of the most effective ways to implement the third variant of investment promotion strategies is to pay special attention to the amount and quality of backward linkages that foreign affiliates strike with domestically owned firms. In every country a large proportion of intra-industry transactions can involve linkages and result in sustained exchanges of information, technology, management skills and other assets. Backward linkages between foreign affiliates and domestic firms represent an important channel through which intangible and tangible assets can be passed on from the former to the latter. Therefore, they can be of particular significance to most developing countries, providing a means of diffusing valuable knowledge throughout their economies and increasing the dynamism and competitiveness of their domestic enterprise sector, thereby helping them to capture the opportunities for increased trade and investment brought about by globalisation and liberalization.

The developmental impact of sustainable business linkages is best highlighted by the experience of countries like Ireland, Malaysia, Mexico, the Philippines and Singapore. These countries upgraded their local productive capacities and enhanced their industrial performance by integrating their domestic enterprises into global supply chains of large foreign firms (UNIDO, 2002).

Furthermore, empirical surveys conducted in the Republic of Korea, Malaysia and Thailand in 1998-1999 show that local SMEs linked to foreign partners were able to survive the East Asian financial crisis far better than domestic SMEs without foreign links. This latter category of SMEs was adversely affected by the drastic collapse of domestic demand and the dramatic credit crunch. Linkages between SMEs and foreign firms had taken various formal and informal collaborative forms. During the crisis, foreign buyers kept reasonable levels of orders, and provided various forms of support like market diversification information, technology and training, on-the-job assistance, financial support or introductions to their own bankers. A case in point is the support Toyota gave to its local SME multi-tier suppliers and subcontractors (Régnier, 2000).
In developing countries many investment promotion agencies have repeatedly tried to link up local enterprises with foreign investors. These matching experiences usually fail because local SMEs are not partnership ready and TNCs do not have a long-term commitment to upgrading local partners through a deliberate programme for improving skills and transferring technology. Indeed, the quality of the domestic enterprise sector and the presence of skilled human resource are essential in making mutually beneficial linkages viable, and thus in attracting high quality FDIs. Strong local firms can attract high quality FDI; the entry of foreign affiliates, in turn, can feed the competitiveness and dynamism of the domestic enterprise sector.

Where the mutual self-interest of foreign affiliates and domestic firms with supplier capabilities automatically leads to the creation of linkages, little further encouragement by governments is needed. In many cases, however, there is a role for judicious policy intervention to promote the creation and the deepening of backward linkages with local suppliers, as a strategic tool for upgrading local supply capabilities. Experience shows that a successful business linkage programme involves more than simple matchmaking activities between large and small firms and depends on the commitment of all partners - governments, large firms, SMEs and their support agencies.

Governments, in partnership with TNCs, SMEs, and private business service providers, can intervene to encourage the creation and deepening of backward linkages by lowering the costs and increasing the rewards of linkage formation for both TNCs and local enterprises. The case of Morocco shows how effectively governments can promote the linkage process and persuade both TNCs and SMEs to sign tripartite agreements under which all stakeholders enter into firm commitments.

Box 8: The SME-TNC Charter in Morocco

In October 2001, several large national and foreign firms signed at the initiative of the Government of Morocco a Charter on a Partnership between Large Enterprises and SMEs. Under the Charter both large companies and SMEs adopt certain responsibilities toward the other partner to ensure the emergence of mutually beneficial linkages. In particular, the Charter aims at:

- Increasing the number of sub-contracts between large firms and SMEs that transfer elements of large firms' production processes and technology to SMEs.
- Improving SMEs' market access.
- Establishing a sponsorship between large enterprises and SMEs to allow SMEs to benefit from large firms' experience and to secure large firms' assistance and support for them.

SMEs agree under the Charter to conform to large enterprises' quality standards and regulations, restructure and adjust their production and marketing systems in accordance with the needs of their partner, put a management structure in place which is transparent and accountable and keep their knowledge on large firms' activities confidential.

Large enterprises commit themselves, amongst other things, to:

- assign a member of the management who is in charge of the partnership and acts as an interlocutor for SMEs;
- diffuse to their SME partners any information that is related to the activities of the partnership and to upgrade SMEs' production technologies and processes;
- support of SMEs' managers by providing them with advice, mentoring, training and technical assistance;
- transfer within the framework of a specific partnership programme production technology to their SME partners;
- help SMEs to get access to finance;
- facilitate access to their markets;
- encourage synergies and networks between SMEs.

Amongst the signatories of the Charter are companies like Microsoft, Royal Air Maroc, Vivendi Environment and the Groupe ONA. In the year 2002, a specific action plan had been announced to put the Charter into practice. The action plan envisaged, for instance, the establishment of a round table between large enterprises and SME associations, a streamlining of large enterprises' advertised tenders and an information campaign regarding the Charter's lines of action.

Source: www.charte-entreprises.ma (18/03/03)

As noted earlier a key element of linkage promotion activities is to identify those TNCs which are most likely to forge linkages with local firms and to attract these enterprises through investment promotion policies. TNCs are normally in a strong position to choose their counterparts. Experience shows that in developing countries one of the major problems in forging backward linkages - and therefore in attracting high quality FDI - is the absence of local enterprises which are considered ready to enter into partnerships with foreign affiliates. The decision to source locally in a host country depends on the cost, quality, reliability and flexibility of local suppliers relative to suppliers abroad.

Local capacity-building and skill development should, therefore, constitute a major element in a business linkage programme and complement the other main components of linkage promotion policies: identifying demand, targeting 'quality' FDI and matching potential business partners. The BDS described in the previous section can play an important role in getting domestic SMEs up to speed. But commercial BDS providers in developing countries are not particularly interested in providing business linkage services due to the lack of demand, and due to the difficulty to transform the three building blocks of business linkage activities (information, capacity building and finance) into profitable services (Albaladejo, 2002).

Policy recommendations:

a. **There must be commitment to and a clear understanding of the linkage process on the part of public authorities.**

b. **Linkages should be considered as part of the national development strategy together with a strategic analysis of export potential, institutional capacity-building and concertation, investment promotion initiatives and business development support.**

c. **Linkage programmes work best if they build effective networks among efficient public and private intermediary organizations (meso institutions) providing support in skill development, technology transfer and absorption and finance.**
d. Successful linkage programmes often require the support of the local government either in terms of subsidies for human resource development or financial and fiscal incentives for developing new products and processes, for investment in R&D and for participating in training and linkage programmes. An optimal subsidy/incentive package must be the subject of public-private sector dialogue and agreement.

e. Linkage programmes should be adjusted to the country’s level of development particularly in terms of human resource development and technological capability. They should be based on a comprehensive approach, which embraces in a holistic and systemic way all the various steps involved in the linkage process, namely:
   • identifying investment promotion measures with the final objective of enhancing local supply capacity and upgrading indigenous capabilities;
   • targeting key strategic sectors with high growth potential, as well as lead companies (both SMEs and TNCs) operating within those sectors;
   • securing the commitment of the government to allocate resources and to recognise the necessity for participation by the private sector;
   • identifying the linkage requirements of participating companies;
   • briefing participating companies on the type of skills required to establish linkages with TNCs and to complete the company selection procedure;
   • matching the linkage requirements of participating companies;
   • preparing SMEs to become partnership-ready through BDS;
   • supporting SMEs during the mentoring/coaching process by TNCs;
   • monitoring and evaluating the impact of the linkage programme.

9. Policy coherence: domestic polices and programmes to build capabilities as opposed to international rules and practices

The policy directions indicated so far for achieving competitiveness at the micro level need to be evaluated in terms of their consistency with international and regional agreements. For example, governments might be constrained in their ability to promote micro improvements by macro policies such as structural adjustment policies, Basel II Capital Accord, the WTO agreement on subsidies, among others.

The new economic model of trade liberalization, privatization, deregulation and foreign direct investment as advocated by the Bretton Woods institutions largely ignored the microeconomic conditions for SME development. The prescriptions of the Washington Consensus failed to deliver the expected results in terms of growth, productivity, equity, and environmental impact in most developing countries. This paper argues that one of the main reasons for such a failure is that development requires not only macroeconomic and political stability but also well-functioning markets and micro level institutions. Most international agreements, therefore, should take into consideration the need for policies both for institution-building and for microeconomic improvements in the areas of competition, technology and enterprise.

For example, public sector schemes to promote enterprise development could be prohibited under the WTO Agreement on Subsidies and Countervailing Measures (ASCMs). The ASCM section on non-actionable subsidies has lapsed. In some cases, this was the result of a decision
taken by the developing countries because they thought that developed countries would use them as “safe harbors”. This has created an environment that lacks legal security, as governments could be subject to procedural harassment, which could have a detrimental effect on public assistance for technology.

In this framework, some developing country experts have recommended that the transition period be extended for developing countries on export subsidies and that technology subsidies be reclassified as “non-actionable” exclusively for developing countries. It has also been suggested that special clauses for SMEs to be included in the WTO Agreements, as this sector is largely neglected in trade agreements and such clauses could be seen as non-distortionary horizontal policy measures. It should also be noted that there is rarely any contact between international negotiators and those policy-makers who are responsible for enterprise policies. Efforts should be taken to increase the interaction between different actors as well as the between the public and private sector with regard to WTO negotiations to ensure that national development strategies are not jeopardized during negotiations.

**Conclusions**

This paper has reviewed a wide range of policy areas in SME development and presents a set recommendations in each area. It many focuses on micro and meso level interventions, which correspond to the most effective entry points and mechanisms for a private sector development strategy and action plan. The sequence proposed is based on the assumption that the establishment of SME support agencies and programmes need to go in parallel with efforts to improve the policy, legal and regulatory environment in which SMEs operate. It also suggests that in many developing countries the issue of policy coherence needs to be seriously addressed.

**References:**


