Promoting TNC-SME linkages: the case for a global business linkage fund.

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ABSTRACT: A global business linkage fund (GLF) in a nutshell

The **objective** of the GLF would be to improve the social dimension of Foreign Direct Investment (FDI) by providing opportunities to sustain people's livelihoods in developing countries, especially of poor people.

The **reasoning** behind the GLF is that it is expected

- To raise (leverage) FDI in developing countries. Cheap linkage possibilities should pull FDI into developing countries by increasing the private and social rate of return of such investments.
- To make FDI work for host-country development, in particular for the poorest, by stimulating SME performance through benefiting from reciprocal externalities through linkages with TNC affiliates.

The suggested **methods and instruments** are as follows

- Donors will support financially the creation of a GLF to promote linkages between TNCs and SMEs. Current bilateral funds addressing business linkages include a £18 million fund by UK DFID and a €40 million fund by Germany GTZ (around £25 million).
- There should be clear criteria governing when private firms can draw on the fund. This can include
  - that intervention in linkage creation should achieve development objectives,
  - that it provides public goods that address market failures
  - and that it be demand led.
- In practice it may be difficult to score top marks on all criteria. Some flexibility in achieving all criteria (subject to minimum) could be balanced with sufficient private sector interest. A steering committee would represent interests of civil society, business and developing country government.
- Activities include supplier development through certification, general training, infrastructure development, provision of information, etc. These activities, which feature public goods aspects, are conducive to linkage creation but they are relatively costly for, and discriminate against, smaller firms; hence the focus on SMEs. Activities can be done by businesses or through linkage support organisations.
- It would address well established TNCs as well as new TNCs who may have relatively poor information about local sourcing opportunities and by financing part of finding and developing local supplies could help to attract FDI. There could also be rules that ensure that poorer developing countries have more "right" to draw on the fund (this needs to be defined but rules should be more flexible than inefficient, fixed time periods).

The following elements enhance **political feasibility**

- Some developing countries have continued to resist implementing the requirements of the TRIMs agreement. The WTO Doha mandate acknowledged this by urging the positive consideration of possible requests for extension of implementing TRIMs. The availability of a business linkage fund would offer developing countries gains to offset whatever costs countries might expect from abolishing TRIMs. This would address "special development needs" and as such may help WTO negotiations. One could go one step further by conditioning the use of a fund to abolishing TRIMs.
- The Doha mandate urged that negotiations on investment "reflect in a balanced manner the interests of home and host countries." While there are requirements for host-country governments, there have been no requirements for home country governments or TNCs. A business linkage fund could be made available helping predictability of aid flows: firms can use the fund for project that meet certain criteria.
- At a general level, governments around the world have repeatedly endorsed the Millennium Development Goals. Promoting business linkages would aim to help achieving those goals.

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1 Introduction

More and better linkages between Small and Medium-Sized Enterprises (SMEs) and affiliates of Transnational Corporations (TNCs) can potentially improve development, especially for the low-income groups within developing countries. Linkages with other firms help SMEs to learn new and better production methods and can help to increase SME employment. For their part, TNCs often rely on good quality and timely local supplies. Well-developed suppliers can stimulate more investment and help to improve the developmental impact of Foreign Direct Investment (Te Velde, 2002b). Thus, it is time to assess initiatives that promote linkages, and to scale up successful initiatives. This note suggests that one such route can be the inclusion of a linkages fund based on sound principles.

The early 1990s saw an emerging literature showing the benefits of business linkages within clusters. More recently the emphasis has shifted to how clusters are inserted within global value chains (Humphrey, 2001). This can be done by developing linkages across and within countries. This note focuses on linkages within countries. There are many different types of business linkages within a country: horizontal and vertical linkages, which in turn can be subdivided into backward and forward vertical linkages. This note confines itself to *backward vertical linkages within countries* between affiliates of TNCs and SMEs. Lall (1980) and UNCTC (1981) define eight different types of backward linkages via sub-contracting: informational, technical, financial, procurement, locational, managerial, pricing and other.

The structure of this note is as follows. The following section will provide the theoretical background to looking at TNC-SME linkages. Section 3 considers the role of industrial policy, trade policy and donor agencies and international organisations in TNC-SME linkage creation. Section 4 provides some evidence on linkage creation. Section 5 provides some examples and challenges in linkage promotion. Section 6 concludes with a proposal for the establishment of a fund for linkage creation to enhance the development dimension of agreements on investment.

2 Why TNC-SME linkages?

Why consider TNC-SME linkages? It is often argued that TNC-SME linkages are important for pro-poor growth. This section examines TNC-SME linkages from three different angles: SME performance, performance of TNC affiliates and FDI and development.

2.1 SME performance and TNC-SME linkages

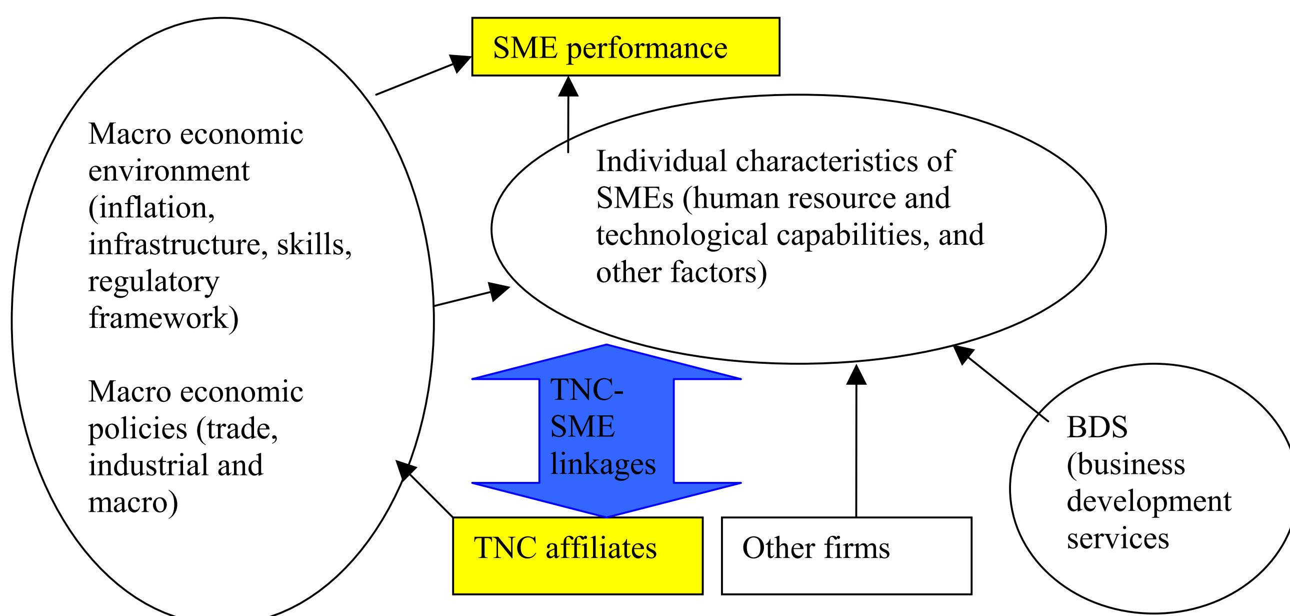
There are many factors that directly or indirectly drive the performance of the SME sector. Linkages between SMEs and TNCs form only one part of the puzzle. Chart 2 contains a summary of how TNC-SME linkages might ultimately determine SME performance, defined in terms of productivity, employment or other.

Broadly speaking, SME performance is the result of the interaction between macro economic environment (including type of sector or industry) and policies on the one hand and individual characteristics of SMEs on the other. Individual characteristics consist of human resource capabilities (skills and education of workers), technological capabilities (R&D, capital investment, engineering skills) and other factors (size and ownership of firm, sector of operation generally, type of activity).

The development of capabilities inside SMEs depends on various factors, among them the macro-economic and regulatory environment, SME specific support services, and business linkages. SME support services include quality control services, provision of training, and financial loans. The regulatory framework is important as certain regulations are relatively more costly for smaller firms.

This note focuses on business linkages. SMEs can learn through business linkages (learn-by-linking): through other firms they can improve their practices in areas such as technical requirements, health, safety and environmental practices. Large firms set the standards according to which smaller firms supply them. Larger firms are frequently required or stimulated to adopt better quality standards from their home base. Research has shown that some types of linkages are more beneficial than others, and that some firms are more likely to gain than others, e.g. firms that have an initial absorptive capacity. Different firms follow different "cumulative learning" processes.

Chart 1 SME performance and TNC-SME linkages



2.2 Performance of TNC affiliates and TNC-SME linkages

Affiliates of TNCs increasingly depend on good quality and timely supplies, with local firms in a position of advantage. Dicken (1998, p.230) argues that "The general trend is for greater proportion of inputs to be sourced from supplier firms. Some of these purchases will be, as it were, 'off-the-shelf' or 'catalogue' sourcing from independent suppliers at the arm's length market price. However, an increasingly significant proportion of such purchases is made on the basis of longer-term relationships whereby a customer firm *subcontracts* certain tasks to independent firms"

In practice, outsourcing practices will differ in multinational, industry and host country characteristics (Lall, 1980). There are various decisions TNC affiliates need to make. First, will they produce in-house, either within the affiliate or as part of the global production network owned by the TNC, or will they outsource and focus on their core competencies? Secondly, if they outsource, will they source locally or internationally? Local sourcing can be done from large firms which could be foreign owned (e.g. foreign auto assembler and foreign component producers in Brazil) or SMEs. The benefits from local sourcing could be availability of timely supplies, and this is of increasing importance in a world with just-in-time production methods. Hence, geography is important and hence linkage creation depends on location of suppliers relative to TNC affiliates.

TNCs depend on good quality supplies, and sometimes TNCs locate where such supplies are available – so called sticky places in slippery places (Markusen, 1996). For instance, Wheeler and Mody (1992) find that availability of specialised support services (local supplies) is one of the (many) determinants of inward FDI. It is also possible for a TNC to learn from specialised knowledge and design in SMEs (who may supply more than one TNC) in which case there is talk of reverse engineering. This is more likely to happen in clusters, particularly complete clusters which include all activities (design, component, production, assembly etc.) in a supply chain. TNCs can draw on specialised SME services and other supplies, hence learning is more likely to happen if there are several TNCs in an industry.

The development of the SME sector in Singapore, for instance, was found to be an important locational decision for TNCs. Chew and Yeung (2001) argue "Perhaps this interactive transfer of technology and knowledge is one of the best way for global TNCs to exploit economies of global production and for SMEs and their home regions to achieve their developmental objectives".

The dependence between TNCs and SMEs will not be the same in all sectors. In a buyer-driven world (e.g. role of retailers in the market for vegetables and textile sand clothing) cross-border linkages are frequently one-way. However, generally the quality of TNC products depends on the quality of its inputs. The better the performance of the suppliers the better the performance of the TNC affiliate. Recently, retailers have become under increased pressure to improve the quality of their imported products (vegetables and clothing) and to improve the conditions under which these products are produced (environmentally and socially).

2.3 FDI and development and TNC-SME linkages

The debate on FDI and development is extensive. TNC-SME linkages form an integral part of it on two accounts: 1) well developed SMEs attract more multinationals wanting to exploit TNC-SME linkages (see previous section); and 2) FDI is likely to have more beneficial impact on development with more and better linkages between TNCs and local firms (e.g. Te Velde, 2002b)

Table 1 shows the standard areas where FDI has an impact. FDI is likely to have a better impact on host-country development when TNC-SME linkages are well developed, by leading to 1) more employment and higher incomes in SMEs 2) capital investment 3) improved market access and 4) technology transfer. Desirable outcomes are not inevitable but more likely. There could also be negative effects if SMEs are locked into relationships which generate few externalities and which are uncertain and volatile.

There have been many studies that have found that foreign owned firms have spillovers (see review in Te Velde, 2002b) on productivity and wages of local firms. However, what is less clear from that literature is how such spillovers occur and whether and if so what type of policies can help to maximise such spillovers. It is usually emphasised that spillovers can occur through demonstration effects, training and competition. It is likely that many of such spillovers are implicitly realised through direct linkages, i.e. direct business to business contacts, but this is not explicitly demonstrated.

Apart from stimulating *average* host-country development, linkages between TNCs and SMEs can help development especially of *low-income* workers. In this sense, improved linkages can help to reduce income inequality and poverty.

Table 1 Foreign Direct Investment and host-country development

Impact Area	Static effects		Dynamic effects		
	Indicators	**Differences between foreign and local firms**	**Potential dynamic benefits of FDI**	**Potential dynamic costs of FDI**	**Indicators**
Employment and Income	• Employment generation inside foreign firms • Wage levels for staff with given characteristics	Foreign firms are larger and pay higher wages (especially for skilled employees) than local firms.	Provides employment and incomes directly.	May indirectly crowd-out other employment by replacing existing employment or pushing up factor prices; may lead to increased wage inequality.	• Long-run employment generation inside firm and in suppliers and buyers • Long-run wage development in foreign firms and spillover effects on wage levels in other firms inside or outside sector
Physical capital	• Fixed capital formation • Financial transfers	Foreign firms tend to be more capital intensive	Stable source of external finance, improving the balance of payments, and potentially raising fixed capital formation.	May pre-empt investment and opportunities of domestic firms.	• Long-run relationship between FDI and domestic capital formation
Market access	• Share of inputs imported • Share of output exported	Foreign firms tend to be more trade intensive	Firms can gain access to export markets by using global networks of multinationals.	Multinationals can maintain tight controls of export channels.	• Long-run relationship between exports and FDI, and between imports and FDI
Structure of factor and product markets	• Concentration in product and factor markets • Profit margins	Foreign firms can often be found in sectors with 'barriers to entry'.	Entry by foreign firm may lead to more competition. This may reduce product prices.	The entry of foreign firms can lead to further concentration and market power. This may raise prices of own and other products.	• Long-run relationship between FDI and profitability
Technology, skills and management techniques	• Skill level of employees • Training budgets • Output per employee • R&D budgets • Types of technologies used	Foreign firms are more skill intensive, tend to use more up-to-date technologies and train more.	Provides up to date techniques, skilled personnel and advanced management techniques, raising the return to skills offering additional incentives for education. Positive spillover effects on domestic firms through backward and forward linkages, demonstration effects and human resource development.	Spillovers are not automatic or free. Reliance on foreign technology and skills may inhibit development of local capabilities. Increased linkages raise dependency of domestic firms on multinationals.	• Intra and extra-sectoral spillover effects on productivity in other firms. • Share of inputs sourced locally • Supplier development • Upgrading and long-run development of technology, training and skill levels in foreign firms
Fiscal revenues	• Fiscal payments • Grants to foreign firms	Tax holidays or outright grants are sometimes offered to foreign firms	Multinationals can raise fiscal revenues for the domestic government through the payment of taxes in case of new economic activities with more value added.	If multinationals crowd-out domestic firms, fiscal revenues may actually be lower through the use of special tax concessions, eventually leading to an erosion of the tax base. Special tax concessions are an implicit subsidy and in case of lack of transparency can lead to rent-seeking behaviour.	• Long-run fiscal payments through foreign firms and through a change in economic activity more generally.
Political, social and cultural issues			Foreign firms can expose host country to other norms and values, e.g. environmental management, ethics.	Foreign firms may lead to political, social and cultural problems, by imposing unacceptable values (labour and environmental standards) interfering with political regime, and are said to exacerbate existing problems of corruption.	

Source: building on UNCTAD (1999)

3 Promoting TNC-SME linkages

TNC-SME linkage creation is determined by several economic and policy factors (Belderbos et al., 2001; Dicken, 1998; Dunning, 1993, Lall, 1980; and others). These affect the 'demand side' of linkages (corporate strategy and location of TNCs), the 'supply side' of linkages (technological capabilities of local firms) and the incentive framework (including the policy and regulatory framework). This section presents a simple summary of factors behind linkages creation including industrial policy (3.1), trade policy (3.2), and discusses the role of donor agencies. (3.3) and evaluation issues (3.4). We do not discuss in detail the role of TNC strategies.

3.1 Industrial policy

Industrial policy may affect linkage creation on both the demand and supply side. On the demand side, rules of ownership can influence the degree of local involvement (e.g. joint venture), which in turn may affect the sourcing decision. Industrial policy can also affect the type of investor. A tax incentive, for instance, may attract an investor solely interested in exploiting that tax incentive but not in the availability of local supplies. However, industrial policy is more likely to affect the supply side of linkage (SME development) or the market structure governing linkages.

Good quality and timely supplies require an efficient SME sector. The factors behind SME development were presented in chart 1. There are various tools that have been developed to stimulate industrial development. The increasing dependence on market-based approaches to private sector development across the world does not imply that there is no role for government. On the contrary, the market can fail to allocate resources efficiently under monopolies, in situations with interdependencies between economic agents external to the market mechanism, where there are public goods or common resources, and in other situations. This is often due to undefined property rights, and existence of significant information and transaction costs.

In industrial development, public intervention (such as provision of public goods and regulation) is required to overcome market failures particularly related to skills, capital technology and provision of information. For instance, firms do have insignificant incentives to provide general training (firms cannot capture all benefits of general and certified training) and are more likely to offer training specific to the firm's needs, but with only limited use elsewhere. This would be suboptimal to the host country. In another example, considerable uncertainty surrounds the implementation of new techniques in the field of energy saving (the so-called energy-efficiency gap), and hence [subsidising the] installation of such techniques with positive returns may yield beneficial demonstration effects which cannot be appropriated in monetary terms by actions of private firms.

Public intervention can be through co-ordination bodies, such as Skills Task Forces which try to match supply and demand of skills (e.g. public private partnerships in Malaysia, see Te Velde, 2002a); rule setting and enforcement, such as quality control services, or taxation and subsidies to internalise positive externalities (e.g. in the market for skills or technology). Governance structures can be seen as public goods: once they are provided firms can use them without other firms preventing the use of the same structures.

Governments have also tried to develop clusters of firms in key sectors by identifying supply gaps or making it easier for businesses to communicate with each other. Clustering is often used as a tool to internalise reciprocal externalities: firms learn from each other in a way that is not easily captured by the market mechanism, hence government intervention is required. As an example, special capital funds have been set-up to stimulate development of [promising] SMEs and clustering. It has been traditionally difficult to direct formal credit to SMEs, partly because of the high transaction costs and perceived high risk. For examples of clustering and government intervention see Humphrey and Smitz (1996) and Fisher and Reuber (2002).

Finally, there have been attempts to stimulate linkages through brokering and linkage programmes (see UNCTAD 2001). The market may fail to lead to such linkages because there is imperfect information: TNCs may not know that good local supplies are available, or they do not know what the actual quality of the supplies is. The provision of information on the presence and quality of suppliers and sourcing opportunities can be seen as providing a public good as long as such information is available publicly.

Table 2 Promoting TNC-SME linkages; illustrative but incomplete list of policies

	Industrial, Trade and Macro Economic policies		**Other relevant factors**
	Industrial policies	*Trade and macro economic policies*	
***Demand* for linkages by TNC affiliates**	• Tax (e.g corporation tax) structure affects choice of technology (JIT) and motive for investing • Other incentives • Rules on ownership structure	• Favourable trade policies and EPZs are likely to favour inputs from abroad • Competition policy limits take-overs and internalisation of operations	• TNC strategies, parent-affiliate relationships and role of affiliate • TNC affiliate characteristics (technology, size, age, mode and motive of investing) • Some sectors or types of technologies are 'linkage' intensive • Specialisation and economies of scale lead to concentration on core competencies
***Supply* of linkages by local firms**	• R&D encouragement • Training programmes • Clustering by developing key sectors and identifying supply gaps • Venture capital funds	• Reliable infrastructure (utilities and telecoms) • Good quality and appropriate education and skill formation • Financial market development	• 'Presence' of local suppliers • Potential supply constraints if demand is growing rapidly • Characteristics of local firm (quality, reliability, flexibility, scale and cost)
***Market structure* governing linkages**	• Linkage programme (brokering to developing SME suppliers) • Develop co-ordination and associations of suppliers	• WTO rules and TRIMs	• 'trust' or 'social capital' • regulatory framework

3.2 Macro-economic and trade policies

Trade and macro-economic policies also affect linkage creation. We have listed a few in Table 2. Policies and regulations at the macro level can be aimed at improving the competitiveness of the SME sector. A competitive sector is more likely to create linkages and learn from such linkages. Measures include the provision of appropriate infrastructure such as good roads, efficient telecommunications and well developed IT facilities. Efficient regulation is also important, as much regulation is particularly costly for the SME sector due to the fixed cost compared to firm size. A well functioning capital market is another important factor in a competitiveness economy and SME sector.

Box 1 Bolivia: linking trade capacity and supply side capacity

The Andean Trade Programme (ATP, part of the Andean Trade Programme and Drug Eradication Act or ATPEA) has recently replaced the expired Andean Trade Preferences Act (ATPA from 1991) to further increase market access of Bolivian products (an increase of 700 products) in the US market (around 30% of Bolivian exports to the US fall under ATPA), at least until December 2006. It attempts to provide incentives to diversify Andean economies away from narcotics.

Amongst many new products, ATP now offers opportunities for Bolivian textile manufactures, as it will allow quota-limited (but increased) and duty-free imports of clothing made in Bolivia from Andean fabric (quota capped at $250 million dollars compared to a current $40 million of Bolivian imports) or other fabric dyed and finished in the US (quota free). It has been estimated that this could create up to 40000 jobs.

However, there are only few Bolivian companies that have the capacity to make use of this incentive. One source mentioned that this applied to just 10 companies. If Bolivia wants to fully benefit from the tax-free entry exporters must invest in updated technology and improve workers' training in order to comply with stringent US buyers' (large sourcing companies) requirements. An active competitiveness strategy for the textile and clothing industry is required.

Another route is attracting FDI. The Bolivian government is actively trying to interest US textile/clothing firms to invest in Bolivia through creating tax fee zones (export processing zones) and other firms. However, unless an attempt is made to create linkages between local firms and US investors (or other foreign investors), local firms (and potentially the local economy) are unlikely to benefit much because firms in EPZs often have few linkages with the local economy. The textiles and clothing sector has the potential to create opportunities for poor workers.

There is some action at top government level to co-ordinate various ministeries such as Economic Development and External Trade. This is not trivial and appears to be a one-off co-ordination to make use of ATP. It would be useful if trade and supply side capacity were effective, appropriate and sustainable in delivering the right mix of good quality textiles and clothing for exports to the US. Above all, this requires continuous communication among various ministeries responsible for trade and competitiveness (including training, technology, cluster development, etc.). Bolivia is only just learning how to react to sudden trade incentives and how to make trade opportunities work for development, especially the poorer segments. There are real challenges ahead.

Sources: US embassy in Bolivia and personal communication with officials in various ministeries.

An efficient import procedure that makes importing easier will help the development of the TNC affiliate. However, at the same time it could lead to reduced linkages with local firms. Some countries apply a low or zero tariff rate (or duty drawback) on imported raw materials in order to attract export-intensive investment (such as assembly operations, garments, etc.). While this may help to attract investment (and

productive capital goods) it is unlikely to promote business linkages within the host-country. Linking the objectives of trade and investment policy with the policy initiatives to upgrade the existing supply-side capacity may also help to attract those types of investments for which linkage opportunities exist (see box 1).

The nature of linkages between TNCs and SMEs is subject to WTO rules. Existing GATT/WTO agreements related to investment under the WTO include Trade Related Investment Measures (TRIMS) and the General Agreement on Trade in Services (GATS). Under the 1995 TRIMS agreement countries are banned from imposing certain performance requirements on the operations of TNCs, including local content and export performance requirements. Many governments have used local content requirements to promote backward integration and localisation of value-added. The TRIMS Agreement in 1995 banned performance requirements and gave transition periods to developed countries (two years), developing countries (five years) and least-developed countries (seven years).

Countries had to notify the existence of any remaining TRIMs under Article 5.1 of the Agreement. Many local content requirements can be found in the automobile industry but also in other industries. At least eight countries have requested and obtained an extension to the transition period until December 2003 (some had requested a longer period). A review of the agreement is scheduled.

Table 3 Local content requirements: notifications to WTO and extensions

Local content in automobile industry	Argentina, Chile, Ecuador, Indonesia, Mexico, Philippines, South Africa, Thailand, Uruguay, Venezuela
Other local content	Barbados (pork processing), Costa Rica (general), Cuba (various), Cyprus (cheese and groundnuts), Dominican Republic (general), Egypt (general), India (consumer goods), Indonesia (boilers, soyabean and fresh milk products), Malaysia (general), Nigeria (general), Pakistan (general), Peru (fat and milk products), Philippines (coconut), Poland (cash registers), Romania (general), South Africa (telecommunications, tea and coffee), Thailand (various), Uganda (general)
Extensions of transition period under Article 5.2 – until December 2003	Argentina, Colombia, Malaysia, Mexico, Pakistan, Philippines, Thailand, Romania

UNCTAD (2001) and WTO

Local content requirements and other performance requirements are being phased out over time. This is partly because of less-protectionist policies by developing countries, and partly because of obligations under the TRIMS agreement. However, performance requirements still exist, see Table 4.

Table 4: Score (1-6) of presence of performance requirements

	1992	1996	1999
Argentina	1	0.5	0.5
Bangladesh	1		
Brazil	0.5		
China	4	3	3.5
Colombia	1	1	1
Ecudaor	1	1	1
Egypt	2	1	1
Ghana	1	1	
Guatemala	0.5	0.5	
India	3	1.5	1
Indonesia	3	1	1
Iran	4.5	3	3
Kenya	2		
Korea	3		
Malaysia	3.5	2	2.5
Mexico	2	0.5	
Nigeria	3		0.5
Pakistan	3	3	3
Philippines	2	1	1
Sri Lanka	2	1	1
Syria	2	2	3
Taiwan	1	1	1
Thailand	2	1	1
Zimbabwe	3		
Average	1.61	0.89	0.82

Source: ERT 2000, scores were counted and weighted by ERT.

There is a debate on the effects of performance requirement (Moran, 1998; UNCTAD, 2001; Kumar, 2001). On the one hand, it has been argued that such requirements lead to inefficient outcomes when TNC affiliates are forced to use more expensive and lower quality local products. This can ultimately lead to the closure of TNC affiliates and negatively affect the decision to invest. On the other hand, some have argued that with imperfect information, requirements can force the affiliate to use unexplored local capabilities. Some studies show that requirements have helped the development of supplier industries, at least under certain conditions such as an unprotected market. The debate is still proceeding. However, what is notable is that only one least developed country (Uganda) and no developed countries have notified the use of TRIMs. To some this has suggested that performance requirements were potentially important for countries with an emerging manufacturing sector, i.e. current extension seekers but in theory many countries in the future.

While TRIMs deals with FDI in goods produced for trade, the GATS deals with FDI in services (mode 3, commercial presence). GATS is based on a positive list approach. Countries can decide which service sectors to commit. Once a sector is committed, horizontal (all sector) market access and national treatment principles apply, unless otherwise notified. Hence a country can decide what service sectors to open up for FDI and on what terms. There appear to be no restrictions on the use of local content requirements under GATS, although they should in principle be consistent with the national treatment principle. Unlike TRIMs, the basic principles in GATS specify that it is not allowed to require employment by nationality - unless notified. In practice many countries restrict employment by nationality.

The Doha Development Round which began last year includes work on investment that is relevant to local content requirements and hence linkage creation. The Decision on Implementation related issues and concerns urges the Goods Council to consider positively possible requests for extension by least-developed countries of the seven-year transition period given to them under the TRIMs Agreement to eliminate inconsistent TRIMs. Negotiations on trade in services are ongoing in the GATS. One of the areas which may affect local content requirements is whether offers regarding horizontal issues will include restrictions on use of local content.

But negotiations on a wider agreement on investment are also provisionally scheduled and in principle could deal with issues such as local content requirements. Negotiations will take place after the Fifth Session of the Ministerial Conference in Cancun next year on the basis of a decision to be taken, by explicit consensus, at that session on modalities of negotiations. The aim of the negotiations is to provide a transparent framework in which investment can take place. But the ministerial declaration also recognises the needs of developing and least-developed countries for enhanced support in technical assistance and capacity building in this area; and that any framework should reflect in a balanced manner the interests of home and host countries. The special development, trade, and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable members to undertake obligations and commitments commensurate with their individual needs and circumstances.

While there are some countries that are pushing for an Agreement on Investment (e.g. EU, Japan, Korea) often based on a GATS bottom-up approach, others are against (India) or do not directly see the benefit (many LLDCs) of certain rules on investment. The debate is related to the following questions:

- To what extent would a new agreement “reflect in a balanced manner the interests of home and host countries.” Will there be requirements for host countries, as well as home countries and TNCs?
- Will there be a positive list according to GATS where countries can opt to include sectors, or will there be a more inclusive approach?
- Will there be a state-firm, or only state-state dispute settlement mechanism?
- Will there be rules on both market access and post-establishment?
- How will the [development] needs of developing countries be addressed?
- Would a multilateral agreement add anything to the web of existing bilateral and regional agreements on investment?
- Are countries sufficiently informed about their own interests to negotiate an agreement effectively?

3.3 Aid donors and multilateral organisation

There are various aid donors and multilateral organisations that in one way or another have the objective to contributing to the development of the private sector, or the SME sector in particular, in the developing world. This may directly or indirectly affect SME development. We focus here on selected donors that target linkage creation directly.

The UK Department for International Development has launched several business challenge funds in the past few years, see http://www.challengefunds.org/. Amongst these, the Business Linkage Challenge Fund (BLCF), managed by Deloitte and Touch, aims to promote business linkages involving two or more business with at least one in eligible countries. Private enterprises are invited to submit concept notes. Full applications are assessed by a panel of experts. The programme has a value of £18 million over five years, and has so far committed £6.1 million for 26 projects leveraging £11 million. It receives around 50 concept notes per successful bid, which means either that there are many bad-quality concept notes or more positively that the panel makes awards only to high quality projects. Eligibility criteria are

- Improvement of the incomes and livelihoods of poor people
- Extent of new private sector resources mobilised
- Likely sustainability of project
- Enhancement of competitiveness
- Replicability
- Degree of innovation

The German Gesellschaft fur Technishe Zusammenarbiet (GTZ) initiated a fund in 1999 to finance public private partnerships (PPPs), see http://www.gtz.de/ppp/. In the first three years of the PPP programme (1999 - 2001), GTZ participated in PPP projects with a total of around €40 million, while the private sector committed around €60 million. GTZ argues that it has the relevant experience in areas that may not count as the core business of private companies, but which are nevertheless often decisive for their economic success. These areas include elements in human resources development in industry, capacity-building in agriculture, vocational training, environmental and social standards, technology transfer, financial services, infrastructure, and social initiatives/social services. Projects in developing and transition countries of European companies or their affiliates are judged on the following criteria:

- Development-policy benefit
- That he contributions of the partners complement each other efficiently
- That without the support of GTZ, the company would not be able or willing to implement the project
- That the contribution of the private company consists of at least 50% of project costs.

Various multilateral and regional organisations can also be involved in promoting linkages, either directly or indirectly, and we focus on UNCTAD, UNIDO and CDE. UNCTAD devoted its World Investment Report 2001 to promoting business linkages (UNCTAD, 2001). UNIDO is also involved in linkage creation, see e.g. UNIDO (2000). It has launched a Partnership Programme Approach bringing together experts from various sectors and backgrounds. One of its projects involved the automotive component industry in India, which aims to create a pool of competent and competitive domestic component suppliers, which may promote linkages between domestic firms and foreign affiliates (Fiat, Ford). Training is a major element of the programme, and social and environmental concepts are being introduced.

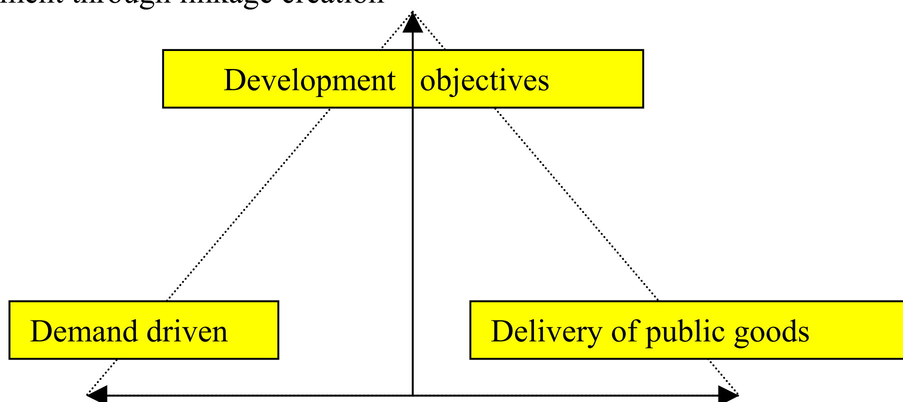
The Centre for the Development of Enterprise is financed by the European Development Fund (EDF) under the Cotonou Agreement, see http://www.cdi.be/. It brings together the European Union and the 77 ACP (African, Caribbean and Pacific) countries. The CDE does not provide direct financing (credit or investment) for projects, but finances pre-and post-investment technical assistance activities to companies in the ACP, such as identification of projects and potential partners, operations prior to the implementation of a project, financial and legal structuring of projects, project start-up and development.

CDE's contribution is in the form of advice, technical assistance or subsidy, while the beneficiaries are promoters and/or companies of an ACP country or a European Union Member State, acting either individually or jointly, wishing to undertake an industrial project in an ACP country. CDE's contribution is limited to a maximum of €150,000 per project, per year. In addition, the cumulative amount of all contributions to the same project/company must not exceed €300,000 and must be less than 20% of the total investment, except in the case of pilot projects. The annual budget is around €20 million , but it is unclear how much directly benefits linkage creation.

1.4 Evaluation of support schemes

The evaluation of aid/public support programmes for linkage creation boils down to measuring the score according to the following three criteria: demand, delivery of public goods and demand driven. See chart 2 below.

Chart 2 Business Linkage Evaluation Triangle: 3-D Criteria for matching aid and investment through linkage creation



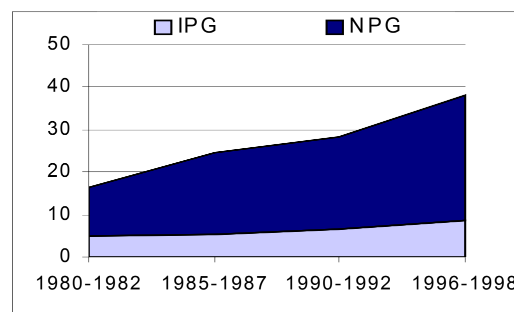
Development objectives. Donor countries around the world have pledged to achieve the Millennium Development Goals. The most important of these seems to be the reduction of poverty over the period of 1990-2015. This is not a short run objective, and hence there is room for debate on how to achieve it. Nevertheless, any linkage project would need to be assessed according to some pre-set criteria such as quality and type of employment, number of SME start-ups, etc. The real challenge in order to evaluate projects is to provide the strategic counterfactual: how many linkages, jobs, etc. would have been created without support? An impact assessment should consider

scale (outreach), efficiency (could fewer resources be allocated differently while having the same impact?), effectiveness (does a project have the required effect) and sustainability (can the results be sustained), see Gibson (2001).

Delivery of public goods: The provision of public goods can overcome market failures by addressing externalities in TNC-SME linkages (e.g. information provision to create linkages which can reap the benefits of reciprocal externalities). It is desirable for the projects that they focus on public goods aspects of TNC-SME linkage creation for two reasons: 1) to avoid unfair competition amongst firms (if private goods are provided the firm could have created linkages on its own or through contracted firms (subsidiarity) and 2) the provision of public goods implies that all firms benefit, which avoids unfair competition with private BDS providers and linkage creation firms (though they can be scarce in LLDCs). In effect, public involvement is required to provide public goods which can overcome obstacles for private firms to engage in effective and sustainable linkage creation. Since the firm has some but not sufficient incentives to acquire such services it is likely that it will also contribute some but not all of the finance.

In the context of aid for public goods, it is clear that that aid has increasingly been used to provide public goods, national (with spillovers predominantly inside borders) as well as international (with spillover effects across borders), as chart 3 indicates.

Chart 3 Allocation of aid commitments to provision of public goods, as % of aid



Source: Te Velde *et al*. (2002) based on ODA commitments in DAC-CRS

Demand driven: Involvement in linkage creation is usually on the supply side (skills, technology or business linkage information), and a challenge is not to distort the market potentially compromising sustainability. This can only be done by stimulating those activities/sectors that are (will be) in demand.

Very often the private sector is not a friend of more regulation or stricter rules, unless it provides a workable and predictable future. Hence, a programme that is flexible in use is more likely to be successful. If helpful, flexibility and business friendliness can be introduced in various ways:

- It is possible to weight the individual criteria (projects that improve development outcomes but which have few public goods aspects could be chosen against projects that provide public goods with few development benefits) – but a certain minimum standard on each of the criteria seems important

- The rules and criteria could be made tighter depending on the rate of successful applications; i.e. if the market is not too thin (sufficient bids). Of course when certain minimal objectives cannot be achieved and there are no bids by business, the scheme cannot work.
- Management of business linkage fund by business

It may be too soon to evaluate existing programmes according to the criteria set out above. Having said that, there are various evaluation techniques (see e.g. Oldsman and Hallberg, 2002) which can be used during programmes, apart from the vast literature on aid evaluation. Evaluation depends on the formulation of a strategic counterfactual, and evaluation techniques differ in the way they select controls used to separate project effects ('treatment' effects) from other factors. There can be experimental design with random assignment of controls and treatment groups, quasi-experiments with constructed controls (partly based on regression analysis), and ex post evaluation using regression analysis and expert judgement. The strength of causal inferences that can be drawn from the analysis depends on how well the particular approach deals with the validity of controls: are controls exactly the same except for the fact that they have not received treatment (e.g. support in linkage creation)? While such evaluation still needs to be done in many cases, successful evaluation would underpin a useful structure of thinking about linking aid and investment.

4 Evidence on TNC-SME linkages

There is a growing body of evidence on linkage creation between TNCs and SMEs (UNCTAD, 2001, 2000a). The following are general conclusions

- Many studies indicate that foreign firms engage less in local sourcing than local firms: evidence supports this hypothesis in Nigeria, Ireland, Republic of Korea, India, Hungary and Costa Rica.

- Linkage creation varies by sector. Linkage creation was very limited in the textile and garment sector, 5-10% of output (Morocco, Dominican Republic and Costa Rica).

- Linkage creation in the primary sector is also limited partly because the large TNCs extract natural resources directly and this is a capital intensive process. Nevertheless there are still some opportunities: The Peruvian mining industry sources USD 1.4 billion of which USD 800 million is local.

- Local sourcing in the electronics industry is more developed, although it depends on the host country: 28 per cent (of output) in Mexico, 40 per cent (of exports) in Thailand and 62 per cent (of exports) in Malaysia.

- Many automobile producers have located in developing countries, and this has also attracted foreign component producers. "Local" sourcing stood at 76 per cent (of output) in Brazil (1996), 20-25 per cent (of output) in Thailand, 30-40 per cent in Malaysia (1996) and 40-50 per cent in China.

- One study examined subcontracting in developing countries on the basis of survey responses by 112 affiliates around the world. He concluded that sub-contracting in

Africa played a minor role, but this was based on the response of just three African affiliates (Halbach, 1988). Wignaraja and Ikiara (1999) found that in a sample of five foreign and 36 local firms in Kenya, none of the TNC affiliates engaged in sub-contracting.

While it must be stressed that evidence in least developed countries is very scarce, generally, linkage creation varies by sector, level of host-country development and firm strategy. There is also some evidence that policy can play a role, although again it must be stressed that much evidence cannot inform us on the role of policy independent from other factors i.e. trade policy (incentives for export oriented TNCs which can import cheaply abroad, in Central America) or industrial policy (national linkage programmes in Ireland and Singapore). Partly as a result of the NLP Linkage programme in Ireland, but also because TNCs were present in the market for a longer time, Irish raw material purchases rose from 1988 to 1998, from 15.4 per cent to 21 per cent in non-food manufacturing and from 13.2 to 22.8 per cent in electronics (Ruane and Gorg, 1998).

5 The case for a global business linkage fund.

This section argues that it could be useful to consider the establishment of a global business linkage fund (GLF). We focus on the objective, background, methods and political feasibility.

The **objective** of the GLF would be to improve the social dimension of Foreign Direct Investment (FDI) by providing opportunities to sustain people's livelihoods in developing countries, especially of poor people.

The **reasoning** behind the GLF is twofold. First, it is expected that the (possible) availability of good quality supplier goods and services will raise FDI in developing countries. Cheap linkage possibilities should pull FDI into developing countries by increasing the private and social rate of return of such investments (section 2.2). Second, we have also argued in section 2.3 that better linkages should lead to more favourable effects of FDI on host-country development, in particular for poor people and for SME performance. SMEs and TNCs can both benefit from exploiting reciprocal externalities through linkages.

The suggested **methods and instruments** are as follows. Donor governments will support financially the creation of a GLF to promote linkages between TNCs and SMEs. Current bilateral funds addressing business linkages include a £18 million fund by UK DFID and a €40 million fund by Germany GTZ (around £25 million). A concerted effort could be significant. Dealing with global issues such as FDI and global investment rules may require a global approach, although delivery can be local (accounting for local needs).

The fund could be administered by organisations such as UNCTAD, which has expertise in the area of TNCs, WTO issues, SME development, and TNC-SME linkages and is used to working with a range of actors, including business. UNCTAD has many developed and developing country members and has contacts with a network of Investment Promotion Agencies in developing countries, which could work on "after care" programmes for TNCs. UNCTAD could draw in expertise of

other organisations active in the debate on FDI and SME performances such as ILO and UNIDO. A steering committee could include the above and also civil society with knowledge of corporate social responsibility issues.

There should be clear criteria governing when private firms can draw on the fund. We advanced three criteria in section 3.4, that

- intervention in linkage creation should achieve development objectives,
- intervention provides public goods that address market failures
- intervention be demand led.

In practice it may be difficult to score top marks on all criteria. Some flexibility in achieving not all criteria could be balanced with proof of sufficient private sector interest. The criteria are similar to those used for bilateral funds (see section 3.3): development objectives in the UK supported fund are improvements in livelihoods of the poor in the UK fund; the German fund support activities that are consistent with German development policy. German support requires that PPPs go beyond the core of the business and hence are likely to have certain public goods aspects. The UK supported fund requires that there are no harmful effects on other firms which is more likely if there are public good aspects or if interventions are demand led. Finally, the scheme could require private sector contributions (as in both the German and UK supported schemes), particularly when interventions have few public good aspects, or it could require adherence to certain codes of conducts if this helped achieving the overall objective.

Activities supported by the fund could include supplier development through certification, general training, infrastructure development, provision of information, etc. These activities, which feature public goods aspects and address market failures (see section 3.1), are conducive to linkage creation but they are relatively costly for, and discriminate against, smaller firms; hence the focus on SMEs. Activities can be done by businesses or through business associations. Basically, a TNC affiliate may want to scope the possibility of linkage creation and this can be done by the affiliate itself or by business associations and if such a scoping exercise has public, developmental benefits it could be financed (in part) by the GLF. Then if local suppliers need upgrading, and the provision of public goods (certification, general training,etc.) could lead to linkage creation then this could again be financed by the GLF.

The fund would address well established TNCs as well as new TNCs who may have relatively poor information about local sourcing opportunities (see e.g. the Irish experience in the previous section). Financing part of finding and developing local supplies could help to attract additional FDI. Hence, this would address market failures in industrial development related to the provision of information. There could also be rules that ensure that poorer developing countries have more "right" to draw on the fund (this needs to be defined but rules should be more flexible than inefficient, fixed time periods).

There are certain elements to the idea of the establishments of a GLF that may make it **politically feasible.** Some developing countries have continued to resist implementing the requirements of the TRIMs agreement (see section 3.2). The WTO Doha mandate acknowledged this by urging the positive consideration of possible requests for extension of implementing TRIMs. The availability of a business linkage fund would

offer developing countries gains to offset whatever costs countries might expect from abolishing TRIMs (as sometimes indicated by a preliminary reviews of TRIMs). This would address “special development needs” and as such may help WTO negotiations. It is possible to go one step further by conditioning the use of a fund to abolishing TRIMs.

The Doha mandate also urged that negotiations on investment “reflect in a balanced manner the interests of home and host countries.” While there are requirements for host-country governments, there have been no requirements for home country governments. A business linkage fund could be made available helping predictability of aid flows: firms can use the fund for projects that meet certain criteria.

Many (bilateral and multilateral) agreement related to FDI include at most voluntary commitment by TNCs. If it was in the interest of achieving the overall objective, it could also be possible to link the GLF to business codes and standards.

At a more general level, governments around the world have repeatedly endorsed the Millennium Development Goals. Promoting business linkages would aim to help achieving those goals.

There are potentially **negative aspects:**

- Host country SMEs and home country TNCs are most likely to gain, while previous suppliers to TNCs are disadvantaged (which could include SMEs in home countries or other TNC affiliates potentially in other developing countries).
- Without extensive evaluation of similar existing initiatives on their effectiveness, efficiency, sustainability, public goods nature etc. it is difficult to be sure that significant new initiatives in this area will be effective in improving the livelihoods of poor people in developing countries.

6 Conclusions

More and better linkages between Small and Medium-Sized Enterprises (SMEs) and affiliates of Transnational Corporations (TNCs) can potentially improve development, especially for the low-income groups within developing countries. Linkages with other firms help SMEs to learn new and better production methods and can help to increase SME employment. For their part, TNCs often rely on good quality and timely local supplies. Well developed suppliers can stimulate more investment and help to improve the developmental impact of Foreign Direct Investment

This note argued that it is time to assess initiatives that promote linkages, and to scale up successful initiatives. We suggested that one such route could be the inclusion of a global business linkage fund (GLF). The GLF would help to pull FDI into developing countries by increasing the private and social rate of return of such investments. It would also make FDI work for host-country development, in particular for the poorest, by stimulating SME performance through benefiting from reciprocal externalities with TNC affiliates. A GLF is likely to raise the development dimension of FDI. As such it is also likely to improve the development dimension of WTO agreements.

Full appreciation of the opportunities that a GLF could offer requires further work:

- Full evaluation of existing linkage programmes. This will involve creating an understanding of the process of linkage creation and the role public actors should have and have already had, and what how and why business currently do.
- An inquiry of the feasibility and relevance of a GLF with policy makers in developed and developing countries.

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