ENCOURAGING LINKAGES BETWEEN SMALL AND MEDIUM-SIZED COMPANIES AND MULTINATIONAL ENTERPRISES

An overview of good policy practice by the OECD Investment Committee

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OECD member governments actively seek to support the development of small and medium-sized enterprises. The present document expresses the OECD Investment Committee's views on good policy practices to enhance the linkages between multinational enterprises (MNE) and SMEs.

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AN OVERVIEW OF GOOD POLICY PRACTICE BY THE OECD INVESTMENT COMMITTEE

The importance of linkages between SMEs and MNEs

Linkages between MNEs and SMEs are important in the context of investment for development. The so-called "spillovers" of know-how and technology from foreign-invested enterprises to the rest of the business sector is one of the main benefits of FDI to development. In most countries, SMEs account for the larger part of the domestic business sector, so overcoming the obstacles to linkages between large and small enterprises is of great developmental importance.

Maximising the economic and social benefits of linkages is an important related challenge. The ultimate benefits of MNE/SME linkages to the host country depend on the enabling environment for investment as well as the strategies of foreign-invested companies. Both host and home country authorities can play an important role in encouraging mutually beneficial linkages: they can help overcome information asymmetries; they can support SMEs' capacity to engage in linkages; and they can encourage MNEs to engage in partnerships with SMEs.

Information and matchmaking

Missing or incomplete information holds back many mutually beneficial partnerships between MNEs and SMEs. Authorities have a role to play in providing information and matchmaking services, including through national investment promotion agencies (IPA). They should consider taking steps to improve the flow of information about potential suppliers, purchasers and technology partners through national websites, business directories and business contact events.

Authorities may also consider more targeted approaches, such as working with MNEs to identify suitable local business partners and identify weaknesses that must be overcome for linkages to succeed. However, such approaches need to be carefully designed to maintain a level playing field among SMEs as well as foreign-invested enterprises.

Supporting SME capacities

To bolster SMEs' ability to enter into linkages with MNEs the most effective strategy is to create a healthy domestic enabling environment for investment. The *OECD Policy Framework for Investment* provides a good starting point for what governments may wish to achieve. A business sector with technologically advanced and internationally competitive SMEs, operating in a competitive environment characterised by the rule of law, is capable of delivering both linkages and their economic benefits.

While they should not substitute for broad-based policies aimed at creating a healthy investment environment, more targeted measures may also be called for. A strong case can be made for undertaking an effort to "lift" enterprises to the technological and educational level demanded by their potential partners. Other approaches have been attempted, such as interventions to overcome documented weaknesses in the

business environment. The examples include extra legal protection to the participants in linkages, and guaranteeing and speeding up commercial payments.

MNEs are willing to engage more deeply with SMEs in countries where they are treated with transparency and on the basis of the rule of law. An area of special concern is intellectual property protection. One the main benefits of linkages, technology transfers, is unlikely to materialise unless the MNE is assured of the continued control over its proprietary knowledge.

Encouraging MNEs to engage in linkages

Host governments have been relying on a mixture of "carrots and sticks" to induce foreign investors to form linkages with local firms and to enhance potential spillovers. Some inducements have taken the form of direct subsidisation of MNE affiliates, such as tax credits to foreign-invested firms that provide tangible benefits to domestic suppliers, or concessionary financing of selected activities.

Insofar as such measures are based on sound cost-benefit analysis and aim to address a lacuna between the societal and private returns to certain activities, they should be encouraged. However, they raise important challenges for the implementing authorities, including proper monitoring, assessment of the hoped-for benefits and the need to maintain a level playing field between competing enterprises. This is not least the case for specific industrial policy or other targeted measures, which by nature involve an element of discrimination.

Some countries have relied on performance requirements imposed on MNEs. The ones that are most pertinent in the context of linkages are local equity, technology transfer and local content requirements. However, the experiences with such measures, that effectively imply an additional taxation of foreign investors, have not been encouraging. For this and other reasons, several kinds of performance requirements are proscribed by WTO, and regional and bilateral investment agreements.

Many countries are increasingly relying on investment incentives with linkage-related conditionalities attached to them. No formal economic objection can be levied against subsidising business activities in proportion to their expected societal benefits and putting in place safeguards to ensure that the recipients fulfil their obligations. However, such practices are second best to removing the obstacles to MNE/SME linkages and leaving the actual forging of partnerships to commercial logic. They may moreover be fraught with problems of consistency and coordination, since much investment promotion and subsidisation is done at the sub-national levels of government.

ENCOURAGING LINKAGES BETWEEN SMALL AND MEDIUM-SIZED COMPANIES AND MULTINATIONAL ENTERPRISES

BACKGROUND DOCUMENT BY THE OECD SECRETARIAT[1]

Forging linkages between multinational enterprises (MNE) and small and medium-sized enterprises (SME) remains a priority for policy makers in many countries. For example, promoting linkages in developing countries was the special theme of UNCTAD's 2001 World Investment Report. OECD countries are also actively engaged in debating the issue, among themselves and with non-OECD countries in the context of the OECD Bologna Process on SME and Entrepreneurship Policies. The Second Conference of Ministers Responsible for Small and Medium-Sized Enterprises in Istanbul on 3-5 June 2004 considered, among other things, recommendations for facilitating SMEs' access to international markets.

The issue has also been recurrently raised by non-member partners in the context of the Investment Committee's various investment policy co-operation programmes, and has solicited demand for additional background analysis in the context of the Initiative on Investment for Development and its Policy Framework for Investment project.

The purpose of this document is to provide the Investment Committee with an opportunity to develop and communicate to its OECD committee and non-Member partners its views on policies to encourage and enhance the linkages between MNEs and SMEs.

I. The importance of linkages

Linkages, defined as channels through which enterprises influence each other's economic performance, between large and small companies are crucial to the success of a market economy. Linkages between MNEs and SMEs could be particularly important in the context of investment for development. As demonstrated by the Investment Committee's publication *Foreign Direct Investment for Development – Maximising Benefits, Minimising Costs*, the potential benefits of an MNE's presence in a developing economy go beyond the direct impact of its operations.

The so-called "spillovers" of know-how and technology from foreign-invested enterprises to the incumbent business sector is often one of the main benefits of FDI to development. If the linkages between the two categories of enterprises are strengthened, the benefits of direct investment in the host economy will most likely be boosted as well. In developing countries (as well as OECD countries), the incumbent business sector is largely comprised of SMEs. (For a discussion of how to define "SME", see Annex 1.) In other words, overcoming the obstacles to linkages between large and small enterprises becomes a particular developmental priority. At the same time, linkages alone are not conclusive evidence that spillovers have occurred or that local SMEs have benefited. For example, MNE affiliates may act as monopsonists in which case it is far from certain that their local suppliers benefit.

Recent business sector developments, especially the increasing reliance on "outsourcing", have both increased the importance of linkages and affected their sectoral composition. Much of the outsourcing has consisted of industrial companies hiving off non-core activities and sourcing them from outside service

[1] This background document was prepared by Hans Christiansen, Senior Economist, OECD Investment Division and Stephen Thomsen, external consultant to the OECD Investment Division.

providers. Consequently, the linkages between large industrial enterprises and smaller service vendors, including in the developing world, have gained prominence.

Box 1. SMEs in developing countries

Even discounting the large number of small firms operating in the informal sector, SMEs are a heterogeneous group, encompassing the self-employed and family firms, small businesses and medium-sized firms. Although SMEs as a group are generally considered to be a major source of job creation and innovation, a small number of relatively large SMEs contribute disproportionately to growth. Smaller firms are much less likely to engage in R&D, training or exporting than larger firms. In Africa, for example, "large firms (more than 100 employees) were estimated to account for a greater share of net job creation in Ghana (56 per cent), Kenya (74 per cent), and Zimbabwe (76 per cent) in the early 1990s than small firms in the formal economy".[2] For exports, while the average SME employs fewer than 10 people, the bulk of SME exports and international investment are by those SMEs employing more than 50 people.

Characteristics of SMEs by firm size (in developing countries):

	Small (<20)	Medium (20-49)	Large (50-249)	Very large (>249)
R&D expenditures (% of sales)	0.9	1.4	1.5	1.4
Any R&D expenditures (% of firms)	6.7	13.6	20.4	24.9
Formal training programmes (% of firms)	27.2	41.6	56.7	63.4
Exports (% of sales)	5.7	10.1	21.0	34.0
Any exports (% of firms)	12.6	20.9	39.6	56.8
Use of e-mail to communicate with suppliers and customers (% of firms)	36.0	46.9	55.4	58.9

Source: World Bank (2004) based on World Bank Investment Climate Surveys

Larger SMEs are also the most likely to form direct links with foreign investors. Smaller firms can nevertheless find supply opportunities and indirect linkages at lower tiers of the supply chain. For these linkages to arise, however, there must therefore exist a pool of these larger SMEs capable of providing the link between the MNE and the general population of smaller firms. Many developing countries have a polarised industrial structure characterised by both very large firms and very small firms. Indonesia and the Philippines, for example, are considered to suffer from this "missing middle", with two thirds of output produced by large firms while dynamic firms employing fewer than 100 workers contribute 8 per cent and 14 per cent respectively. This compares with more than 30 per cent in Japan and 40 per cent in Chinese Taipei.[3]

a) The nature of linkages

The most commonly considered kind of linkages between MNEs and SMEs is the one termed "backward vertical" – that is, which relates to the role of the SMEs as suppliers of input goods or services to MNEs. However, there are several other types. A list of the main kinds of MNE/SME linkages proposed by Smallbone (2003)[4] is:

- *Linkages with competitors*: foreign investors may set new standards for local firms to compete with.

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2 World Bank (2004), p. 64.

3 Smallbone (2003), p. 11.

4 This breakdown follows a tradition established in academic literature by John Dunning.

- *Forward linkages with customers.* Marketing outlets, such as petrol stations or restaurants, may be outsourced, and affiliates may form linkages with industrial buyers through value added after-sales services.

- *Backward linkages with suppliers.* New market opportunities for local firms are created when the foreign investor purchases components, materials and services locally. Such linkages range from arm's-length market transactions to deep, long-term inter-firm relationships.

- *Linkages with technology partners.* Some MNEs may initiate common projects with indigenous SME partners, including joint ventures, licensing and strategic alliances which are a potential source of technology and know-how for firms in the host economy.

- *Other spillover effects*. Inward investors may demonstrate new and better ways of doing things or trained personnel may leave the investor to work for a local firm or set up their own SME, thus creating human capital spillovers.

1) Linkages through competition

Linkages through competition tend to get overlooked in public debate, but they constitute one of the most important channels though which MNE presence can enhance the productivity of SMEs. The entry of new, large competitors into a national market puts incumbent enterprises under pressure to enhance their productive processes, distribution and marketing. It also provides information, through imitation of the competitors and tacit learning, on how best to accomplish this.

However, whilst the benefits of linkages through competition can be great, they do not occur automatically. Host country authorities have an important role to play in safeguarding a healthy competitive environment. To maximise the benefits of SME/MNE competition the maintenance of a level playing field is essential. Authorities must, on the one hand, resist the temptation to shield small and local enterprises against large competitors, and, on the other, prevent MNEs from abusing their position in the local market.

2) Forward linkages

Forward linkages are traditionally set in the context of SMEs acting as purchasers of the outputs of MNEs. The business transactions in this category are legion, ranging from small manufacturers buying their capital equipment from multinational enterprises, to retailers selling the merchandise of international brand producers, to small enterprises factoring their accounting and auditing to multinational professional services groups. While such transactions have usually included an element of training of the purchasers by the vendors, the actual linkages (business relationships over and above arms-length trade) have been mostly limited.

Business models have emerged in recent decades that give greater prominence to forward linkages between SMEs and MNEs. For example, in many countries small enterprises increasingly rely on leasing or factoring of machinery and office equipment instead of buying it outright. This creates a stronger link between the service providers and their clients, including an ongoing training effort and consultations in the context of upgrading and expansion. Perhaps even more importantly, retail trade and other parts of the service sector has seen a strong growth in the prevalence of franchises, by which small and new outlets "rent" the right to use the brand name of a large established enterprise. From the viewpoint of the owner of a franchise, this implies that the enterprises with which it engages in forward linkages have a direct impact on the value of its brand name. Such business relationships therefore often involve an element of direct cooperation and ongoing training efforts.

3) Backward linkages

Backward linkages – especially SMEs acting as subcontractors to MNEs – have traditionally been subject to the most intensive interest by scholars and policy makers alike. Recently, they have gained even more attention in the context of an ongoing debate about outsourcing of parts of MNEs' value chains to low-cost locations in non-OECD countries. In addition to the immediate benefits to host countries of outsourcing (e.g. job gains), supplier linkages with MNEs also create channels through which technology transfers, training, the sharing of business information, financial support and market opportunities can be passed on to SMEs. Smaller firms are not the only ones to benefit from linkages with MNEs, but many of the potential benefits are precisely those areas where the SME sector is thought to be at a disadvantage vis-à-vis other domestic enterprises.

MNEs often find it in their interest to enhance and compound backward linkages. As demonstrated by OECD (2002), MNEs' foreign affiliates generally seek local supplier relationships to reduce their dependence on intra-company trade and, over the medium term, are mostly successful. Where MNEs engage in a "traditional" efficiency-seeking strategy of allocating parts of their value chain to the cheapest production locations, relying on imports from MNE suppliers elsewhere may alleviate quality concerns but at the cost of inflexibility in delivery times. Proximity can lower costs by allowing for closer monitoring and greater flexibility in changing specifications and in developing new inputs.[5]

MNEs' global strategies evolve, and increasingly involve elements of market-seeking investment (producing locally for local markets – see OECD, 2005). This further strengthens the commercial case for forging backward linkages with local suppliers, which will be better placed to integrate themselves into a local value chain and to contribute to the production of products directed at local tastes. A further observation bears mentioning: a frequently voiced concern relates to the sustainability of SME/MNE linkages. However, in the case of backward vertical linkages experiences from developing countries show that these tend to grow stronger over time as MNEs gradually identify suitable partners and upgrade their capabilities[6]. Table 1 describes some of the measures by which MNE affiliates create and deepen linkages with local firms.

Following the shift away from vertical integration in many industries, effective supply chain management has become central to a firm's competitiveness. For this reason, MNEs often have a dedicated supplier development programme. In one survey, 16 out of 18 automotive MNEs and 8 out of 15 electronics MNEs had adopted a strategy of global supplier development.[7] In these sectors, foreign affiliates sometimes act as "talent scouts" in search of local SMEs capable of becoming global suppliers to the firm. Even for affiliates servicing the local market, such supplier development programmes have grown in response to the liberalisation of trade regimes over time as the need to be competitive in each market has increased.

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5 UNCTAD (2000), p. 3.

6 Empirical evidence is surveyed in OECD (2002).

7 Handfield and Krause (1999), cited in WIR01 p. 140.

Table 1. Measures by MNEs to create and deepen backward linkages

Finding new local suppliers	*Transferring technology*	*Providing training*	*Sharing information*	*Giving financial support*
• Making public announcements about the need for suppliers and the requirements that they must meet on cost and quality. • Supplier visits and quality audits.	Product technology: • Provision of proprietary product know-how. • Transfer of product designs and technical specifications. • Technical consultations with suppliers to help them master new technologies. • Feedback on product performance to help suppliers improve performance. • Collaboration in R&D. Process technology: • Provision of machinery and equipment to suppliers. • Technical support on production planning, quality management, inspection and testing. • Visits to supplier facilities to advise on lay-out, operations and quality. • Formation of "cooperation clubs" to interact with suppliers on technical issues. • Assistance to employees to set up their own firms. Organisational and managerial know-how and assistance: • Assistance with inventory management (and the use of just-in-time and other systems). • Assistance in implementing quality assurance systems. • Introduction to new practices such as network management or financial, purchase and marketing techniques.	• Training courses in affiliates for suppliers' personnel. • Offering access to internal training programmes in affiliates or abroad. • Sending teams of experts to suppliers to provide in-plant training. • Promotion of cooperative learning among suppliers.	• Informal exchanges of information on business plans and future requirements. • Provision of annual purchase orders. • Provision of market information. • Encouraging suppliers to join business associations.	• Providing special or favourable pricing for suppliers' products. • Helping suppliers' cash flow through advance purchases and payments, prompt settlements and provision of foreign exchange. • Long-term financial assistance through the provision of capital; guarantees for bank loans; the establishment of funds for working capital or other supplier needs; infrastructure financing; sharing of the costs of specific projects with suppliers; and leasing.

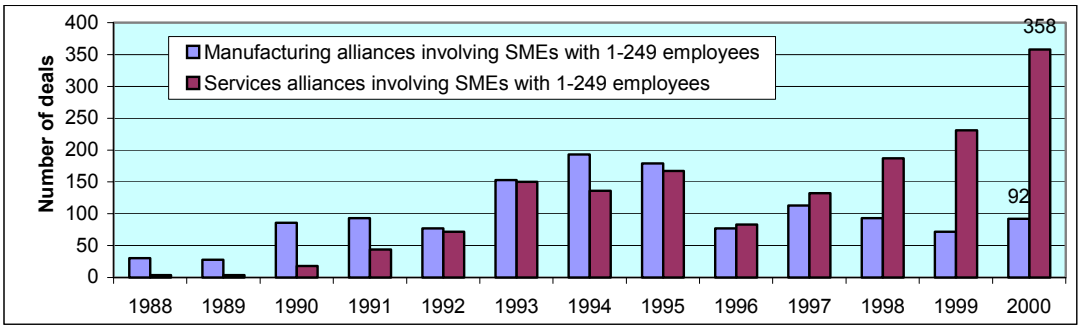
Source: UNCTAD (2001) and OECD Investment Division.

4) Technology and other partnerships

The recent and ongoing wave of global industrial restructuring, combined with technological advances have been a major driving force for the rapid development of strategic alliances and inter-firm networking (alongside with mergers and acquisitions). Opportunities have emerged for SMEs to become (1) partners in international strategic alliances; (2) members of globalised informal networks; and (3) participants in electronic networks (Sakai, 2002)[8]. For SMEs such arrangements can confer any of a variety of benefits including access to financial resources, pooled research efforts, product development and wider distribution channels.

Large firms are motivated to form alliances with SMEs. When faced with rapid changes in technologies and customer preferences, and shorter product life cycles, such alliances can help provide flexibility and fulfil other specific needs. Figure 1 shows the evolution of such cross-border alliances during the period 1988-2000. Moreover, a survey conducted in 2001 of more than 7,600 European enterprises revealed that about one-third of all SMEs reported an increasing number of international business contacts over the previous five years (Observatory of European SMEs, 2002).

Figure 1. Cross-border alliances involving SMEs, 1988-2000



Source: OECD Investment Division based on Sakai (2002).

Clustering and networking also facilitate the globalisation process for SMEs, and inter-firm networks offer the prospect to small firms to compete on a par with larger companies. Both clusters and networks can lead to greater specialisation among smaller firms, opening opportunities for economies of scope and scale.

b) Obstacles to linkages

SMEs generally have an interest in seeking closer linkages with MNEs – especially in the case of backward linkages, which involve entering into a supplier relationship with the larger enterprises. MNEs, as mentioned above, have also shown a keen interest in developing commercial relationships with smaller companies, but they need to be more selective. It is in their interest to cooperate with SMEs that operate at a sufficient level of sophistication and whose corporate profile fit with their own corporate strategies. Consequently, much of the debate about obstacles to linkages tend to focus on factors that may make SMEs *unable* to partner with MNEs, and that make MNEs *unwilling* to partner with SMEs.

[8] The source also discusses the role of SMEs as potential targets for M&As and subcontractors to MNEs.

Moreover, linkages can be held back by lack of information, search costs and uncertainty. SMEs and MNEs in search of commercial partners do not possess perfect information about their potential counterparties and mostly base themselves on readily available information.

1) SMEs' ability to forge linkages with MNEs

The factors that hold back SMEs' ability to forge linkages are mostly the same that may impede them from competing in the global marketplace more generally. Small enterprises do not differ in any fundamental way from other companies, and the quality of the general enabling environment for investment is crucially important for their ability to prosper – including in collaboration with MNEs. The implication is that factors identified in the Policy Framework for Investment (e.g. investment policy, trade policy, taxation, competition, corporate and public governance, infrastructure and human development) are a top priority for authorities wishing to enhance the linkages between SMEs and MNEs.

Many of the elements of a good enabling environment could even be more important to SMEs than other enterprises. Table 2 shows the relative important of various impediments to business operations according to the size of the firm. While there is little difference between small and medium-sized firms in terms of how they rate obstacles, there is a wide discrepancy between this group and larger firms. Small firms are far more likely than larger ones to be affected by the various possible impediments to their operations listed in Table 2, particularly in terms of financing, taxes and regulations and inflation. Only infrastructure is rated as less of an obstacle by smaller firms, perhaps partly because their smaller geographical market makes transport less important. Large firms tend to rate policy instability as their greatest concern, which accords well with surveys of foreign investors, most of whom fall within this group.

It should also be noted that in a world of internationalising SMEs an increasing number of SMEs are becoming MNEs as well. These enterprises tend to be more strongly discouraged by discriminatory and other ominous practices in host countries (e.g. un-transparent authorisation requirements) than their larger competitors.

Table 2. Perception of obstacles in the business environment by firm size*

Obstacle	*All firms*	*Small firms*	*Medium firms*	*Large firms*
Financing	37	39	38	28
Inflation	35	37	36	26
Policy instability	34	35	36	30
Taxes and regulation	34	36	37	21
Exchange rate	28	29	30	22
Corruption	28	30	27	23
Street crime	27	31	26	24
Organised crime	25	27	23	22
Anti-competitive practices	22	24	22	17
Infrastructure	17	16	17	18
Judiciary	14	14	14	12

*The figures in the table are the percentage of firms in each group rating a particular obstacle as major, based on a scale of one (no obstacle) to four (major).

Source: Schiffer and Weder (2001)

A recent overview of FDI for development (OECD, 2002) argued that there is a certain threshold in terms of education, technology, infrastructure and health below which host governments are unlikely to

benefit from potential spillovers.[9] Many least developed countries with low educational standards suffer from this knowledge gap, of which a lack of competitiveness on the part of local SMEs is but one manifestation. Where SMEs can establish links with foreign investors, a virtuous circle can sometimes be achieved in which foreign affiliates contribute to capacity building of local SMEs which in turn increases local absorptive capacity, leading to ever greater linkages.

A lack of local capacity underlies many of the complaints of affiliates that local firms are not willing or interested in meeting their needs. Local firms are said to fail to meet the following requirements: competitive price; quality control (low defect rate); time of delivery (keeping promises); flexibility and speed to change designs/production; ability to design parts and components; and long-term commitment.[10] Local firms are often allegedly more interested in serving local clients than in undertaking the substantial technological and managerial improvements necessary to become qualified suppliers to MNEs.

Moreover, a constraint that does seem to be particular to small and medium-sized enterprises is the access to finance. Small companies can offer little in the way of collateral and are often seen as a high credit risk by lenders. It has sometimes been argued that bank loans and similar may be an inappropriate way of financing small and new enterprises. Equity participation, providing the financer with a right to a share of potential profits in return for assuming the default risk, might help make funds more easily available to SMEs.[11]

Government regulations in markets abroad represent an even greater potential burden and help to explain why SMEs appear underrepresented in both exports and outward investment. Smaller firms also have fewer resources available to assess market potential in other economies. These firms tend to export to only one foreign market and, when they invest abroad, often locate within 100 kilometres of the parent company.[12] In spite of the tremendous growth in intra-regional FDI flows in recent years, a recent survey found that only three per cent of European SMEs had subsidiaries, branches or joint ventures in other countries.[13]

2) MNEs' willingness to forge linkages with SMEs

MNEs do not have an unlimited capacity to engage in linkages. Moreover, there is often a trade-off between the number of partner companies and the depth of the MNE/SME cooperation (sometimes referred to as the "quality of the linkage"). For example, an MNE can in theory trade at arms-length with any number of SMEs, but it faces a managerial constraint on the number of engaged partnerships in which it can engage.

MNEs' choice of local SMEs with which to operate – whether as subcontractors, franchise owners or alliance partners – depends on the competitive advantages offered by these enterprises. In other words, many of the factors bearing on SMEs ability to enter into partnerships with MNEs are important to the MNEs as well – which further compounds the importance of general policies to create a better, more competitive business environment in the host economy. Socially responsible enterprises will also wish to assure themselves that their partners operate in the formal economy, comply with legal and regulatory requirements and respect commonly accepted standards for labour, health and environmental performance.

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9 OECD (2002), p. 14.

10 Battat et al. (1996), p. 18.

11 "Better Financing for SMEs" is the topic of a Global OECD Conference to be held in Brasilia in March 2006.

12 Two thirds of US SME exporters, for example, export to only one market.

13 OECD (2004b), p. 14.

An additional concern for MNEs is to ensure that their linkages with SMEs do not give rise to unanticipated problems. This is largely a commercial issue, but a couple of regulatory challenges are frequently quoted as well. For instance, regulatory transparency is important. MNEs often foresee a degree of regulatory preference for small incumbent enterprises over foreign entrants, but if this rises to the level of ad-hoc interventions in response to domestic business or public pressures they will be less willing to contemplate a deep engagement with local businesses.

Intellectual property protection is also important – especially as regards maximising the benefits of linkages. Committed long-term relationships between MNEs and SMEs usually involve a transfer of technology and proprietary knowledge from the large to the smaller enterprise. Unless MNEs are given safeguards against intellectual "piracy" and illicit diffusion of their know-how, they will be reluctant to go down this road.

II. Encouraging linkages

The factors that contribute to successful linkages between SMEs and MNEs are basically the same that create a strong business environment and a sound investment climate. In this sense linkages can be said to be a consequence of their economic context rather than a driving force. That said, at any level of economic development an effort can, and should, be made to maximise the benefits of relationships between enterprises.

Given that both SMEs and MNEs have commercial incentives to engage in linkages, strategies to promote linkages must necessarily evolve around measures to overcome the obstacles. Following the previous section, the three main areas of action for host country authorities are (i) overcoming information barriers; (ii) enabling SMEs to becoming more attractive partners, and to benefit from the partnerships; and (iii) encouraging MNEs to forge linkages with local enterprises.

a) Information and matchmaking

Again, information barriers can discourage both SMEs and larger enterprises in their search for commercial partners, and hence authorities may play a useful role in providing information and matchmaking services. Investment promotion agencies (IPA) in most countries do both. IPAs have as their core business to provide information on the local market and on export promotion agencies (and hence provide links to local SMEs aiming to access foreign markets). The amount of information provided can vary from a simple list of potential local suppliers in a given industry to detailed electronic information exchanges containing information about prices, quality and even processes used by local firms. Most IPAs also engage in matchmaking between individual enterprises or act as intermediaries with specialised agencies providing a link between local SMEs and foreign investors. These and other relevant host country measures to encourage linkages are summarised in Table 3.

In the area of matchmaking there are also international initiatives. For example, UNIDO Subcontracting and Partnership Exchanges (SPXs) act as technical information, promotion and matchmaking centres for industrial subcontracting, OEM and partnerships between main contractors, suppliers and subcontractors. The SPX Network provides detailed, standardised, updated and certified data on approximately 20 000 manufacturing companies worldwide. To date, more than 60 SPXs have been set up with UNIDO's assistance in more than 30 countries. SPXs also organise "Supply Development and Upgrading Programmes" for clusters of small-scale suppliers and subcontractors to assist them in meeting the higher resolution quality requirements of major international contractors and buyers.[14] Such a database

[14] Liang Dan (2003), p. 83.

can be invaluable to investors but "maintaining a reliable, up-to-date broad-based database is difficult and costly and…unless it fulfils these criteria, its usefulness is limited".[15]

Table 3. Specific government measures to create and deepen linkages

Information and matchmaking	Technology upgrading	Training	Business interventions
Provision of information • Handouts and brochures • Constantly updated electronic databases • Linkage information seminars, exhibitions and missions *Matchmaking* • Acting as honest broker in negotiations • Supporting supplier audits • Providing advice on subcontracting deals • Sponsoring fairs, exhibitions, missions and conferences • Organising meetings, visits to plants	• Creating a proper framework for dealing with IPR • Supporting partnerships with foreign affiliates • Incentives for R&D cooperation • Technology arrangements as part of incentive packages	• Promoting supplier associations • Collaboration with the private sector for one-stop service, including training • Support for private sector training programmes	*Risk alleviation* • Legal protection against unfair contractual arrangements and other unfair business practices • Encouraging a shortening of payments delays through tax measures • Limiting payments delays through legislation • Guaranteeing the recovery of delayed payments *Subsidies to MNEs* • Indirect financing to suppliers channelled through their buyers • Tax credits or tax reductions and other fiscal benefits to firms providing long-term funds to suppliers • Co-financing development programmes with the private sector *Performance requirements* • Mandatory transfer of funds or benefits from foreign affiliates to local suppliers

Source: UNCTAD (2001) and OECD Investment Division.

b) Measures to enhance the capabilities of SMEs

As indicated earlier, the best thing host country authorities can do for SMEs' ability to enter into linkages with MNEs, and reap the maximum benefits, is to enhance the domestic enabling environment for investment. The *OECD Policy Framework for Investment* provides a good starting point for what governments may wish to achieve. A business sector with technologically advanced and internationally competitive SMEs, operating in a competitive environment characterised by the rule of law, will automatically deliver both linkages and their economic benefits. However, achieving this is for many countries, especially in the developing world, a long-term perspective, and they may wish to take remedial action with a more immediate effect.

Much of the effort has taken the form of a targeted effort to "lift" local enterprises to the technological and educational level demanded by their potential partners (some examples are highlighted below). Overall, a conclusion that offers itself is that such approaches have been most effective when anchored in

[15] UNCTAD (2001), p. 174.

competences already present in the local business sector and labour force. Conversely, attempts to "jumpstart" linkages in sectors previously alien to the domestic economy have generally met with little success.

Other approaches have included a direct intervention in business practices, benefiting SMEs as well as MNEs. The examples recorded so far include extra legal protection to the participants in linkages, and guaranteeing and speeding commercial payments (Table 3).

Technology upgrading and training

Many governments attempt actively to foster linkages by subsidises efforts to enhance the capabilities of local SMEs – and not infrequently MNEs as well. Economies often cited in this regard are Singapore, Ireland, Chinese Taipei and Malaysia (see also Box 2). Under Singapore's Local Industry Upgrading Programme (LIUP), the Economic Development Board provides financial and organisational support for an engineer or manager from a foreign affiliate to assist local suppliers over two to three years. The Programme has three phases: improvement of overall operation efficiency such as production planning and inventory control, plant layout, financial and management control techniques; introduction and transfer of new products or processes to local enterprises; and joint product and process R&D. Over two thirds of LIUP partnerships are in the electrical and electronics sectors.[16]

In Ireland, the National Linkage Programme performs the usual functions of market research to identify linkage opportunities, matchmaking and monitoring and trouble shooting, but its perceived strength lies in the support it provides to local suppliers. This includes business and organisation development to provide advice to SMEs to build their management, accounting, production, quality control and human resource systems, understand foreign firms' ways of conducting business, and develop business strategy and plans, as well as help for SMEs in accessing government assistance programmes to enhance their technical, financial and managerial capabilities.[17]

If Ireland and Singapore are generally considered as success stories, there are nevertheless certain key elements which need to be kept in mind by any government wishing to follow in their footsteps. Firstly, linkage programmes are expensive: the two countries spend over US$ 40 million each annually, for a population of under four million in each case.[18] Secondly, the Economic Development Board of Singapore and IDA Ireland have strong powers within the government to shape and implement policy in this area. Thirdly, both countries have a large pool of skilled workers and of small firms with the capacity to become suppliers to foreign affiliates. The success of these programmes depends in large part on the active and willing collaboration of existing investors. By providing financing and organisational support, the relevant government bodies reduce the perceived risks to foreign investors from engaging in capacity building among suppliers.

c) Encouraging MNEs to engage in partnerships

Host government policies to foster greater SME-MNE linkages combine investment promotion and regulation with capacity building and market reforms commonly associated with SME development. The first set of policies tries to influence investor behaviour while the second attempts to break down the obstacles faced by SMEs in linking with foreign affiliates. Host governments use a mixture of "carrots and sticks" to induce investors to form linkages with local firms and to enhance potential spillovers. In formal

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16 Battat et al. (1996), p. 33.

17 Based on Battat et al. (1996), p. 31.

18 World Bank (2004), p. 171.

linkage programmes authorities often include elements of direct subsidisation of MNE affiliates, such as tax credits to firms providing long-term funds to suppliers, or concessionary financing of selected activities (see also Table 3).

Box 2. Linkage programmes in Malaysia

In Malaysia, national and state governments offer numerous incentives to encourage linkages between foreign investors and local SMEs. The scope for linkages is one consideration behind the granting of "Pioneer" status which confers generous fiscal incentives.* Established investors can benefit from the Industrial Linkage Programme (ILP) and the Global Supplier Programme (GSP), both of which provide incentives to MNEs and SMEs. Under the ILP, investors can claim tax deductions for costs involved in providing support to local suppliers, including training, product development and testing, and factory auditing to ensure local supplier quality. The GSP is similar in some ways to Singapore's LIUP in that specialists from foreign affiliates are seconded for up to two years to local firms for the purposes of local upgrading. At the state level, the Penang Skills Development Centre encourages local firms to cluster around foreign affiliate customers and also devises training courses when skills gaps are detected, with foreign affiliates providing the necessary expertise.

According to UNCTAD (2001, p. 74), linkages with MNEs have contributed to the development of a local supply base in four main fields: metal stamping and precision tooling; contract manufacturing for assembly; the production of plastic materials such as casings for PCs; and packaging materials. The exact role of incentives is difficult to ascertain given that technological change and shortening product life cycles have also promoted greater local outsourcing. Indeed, most SMEs in these sectors have emerged as spin-offs from US-owned affiliates, as employees have left with technical and marketing expertise to set up their own companies, often encouraged and supported by the MNEs themselves.

Some investors concede that tax incentives, such as through the Pioneer programme, have influenced their decision to develop local SMEs as suppliers. Intel, for example, has developed a SMART model for supporting supplier development and upgrading. First, potential suppliers are selected based on the quality of their management, human resources, technical, materials and process capabilities and cost competitiveness. They are then provided with training and opportunities to supply the affiliate and ultimately, it is hoped, the global network of the MNE. Intel estimates that it received benefits worth US$ 50 million per year from participating in this programme.

Evidence of spillovers is not in itself proof that the incentives were an important consideration for investors or that the money dedicated to incentives was well-spent. Allocating resources to alleviate skills shortages can hardly be considered wasteful, especially when foreign affiliates are actively involved in training programmes. But tax deductions for firms with scope for linkages can be expensive in terms of foregone fiscal revenue, as the Intel example demonstrates. At the very least, programmes should involve active monitoring and assessment. In Malaysia, this has not necessarily been the case. One UNCTAD study finds that "the monitoring of various requirements appears to have become increasingly relaxed over time" , possibly as a result of heightened international competition for investment. And Jomo, Felker and Rasiah (1999) argue that there has been no systematic assessment of the effectiveness of incentives affecting linkages and technology transfer.

*Other criteria include value added, local content and technological deepening.

Source: MIDA, UNCTAD (2001, 2003)

Conversely, in the past when host governments routinely screened incoming investment, there was a tendency to rely on performance requirements such as local content requirements to force linkages. The trend in recent years has been to offer incentives to investors subject to the fulfilment of certain conditions, notably with respect to exports, employment or local content, as well as more pro-active promotional measures to encourage training and supplier upgrading. This sub-section considers how host government policies can contribute to fostering a climate where linkages and subsequent spillovers are maximised.

1) Performance requirements

In the past, governments tried to mandate linkages through local content, local equity or joint venture requirements and sometimes even direct technology transfer obligations. Such performance requirements usually had several, sometimes contradictory, objectives. Alongside with encouraging linkages and technology transfers they included local employment; export promotion and trade balancing; avoiding restrictive business practices; and a number of non-economic objectives as well.

Such requirements are not unproblematic. From an economic viewpoint they impose a burden on MNEs that is, at least, equivalent to additional taxation. They may deter investment altogether or make investors allocate only relatively unimportant aspects of its value chains to a given location. Moreover, a growing number of bilateral investment treaties (BIT) and free-trade agreements with investment content include provisions that rule out, or curtail, the use of performance requirements (Box 3).

Box 3. Performance Requirements in International Investment Agreements

WTO framework. The WTO's Agreement on Trade-Related Investment Measures (TRIMs) recognises that certain investment measures can restrict or distort trade and provides that "*no Member shall apply any TRIM that is inconsistent with the provisions of Article III* [National Treatment and Internal Taxation and Regulation] *or Article XI* [General Elimination of Quantitative Restrictions] *of GATT 1994*".[19] The Agreement's Annex contains an illustrative list of prohibited measures which include, *inter alia*, local content requirements and trade-balancing requirements imposed on an enterprise.

North American Free Trade Agreement (NAFTA). The investment chapter of this agreement provides that the parties may not, either in the pre or post-establishment phase, impose or enforce any commitment or undertaking requiring investors to export a given level or percentage of goods or services; to achieve a level or percentage of domestic content; to purchase, use or accord preference to goods or services provided in the territory; to restrict sales of goods or services; to transfer technology; or to act as exclusive supplier of good or services to a specific region or world market.

BITs and investment provisions in trade agreements. Provisions on performance requirements included in IIAs have been generally based on the TRIMs Agreement and NAFTA. Agreements such as Japan-Korea BIT prohibit additional measures such as requiring to locate the headquarters of the investor in its territory; to achieve a given level or value of research and development in its territory; or to hire a given level of its nationals.[20] Exceptions to the application of performance requirements may also be included in these agreements.

Incentive based performance requirements. There are cases where certain performance requirements are imposed upon enterprises as a condition to the receipt of particular advantages granted by governments. These performance requirements are not mandatory unless the enterprise seeks the particular advantages offered, nor are they typically subject to international investments agreements' disciplines. Some models, however, such as the U.S. model, include provisions that discipline certain types of incentive-based performance requirements.

[19] See TRIMs Article 2.

[20] See Japan-Korea BIT Article 9.

The most important performance requirements and their implications for SME linkages with foreign investors are described below. The discussion is limited for the moment only to mandatory requirements, often imposed as a condition for market access.

- *Joint venture or local equity requirements*. A number of countries restrict foreign ownership of local firms except for export-oriented investors. In this way, the host government expect to make FDI more palatable for local business interests, allows local investors to share in the economic rents from that investment (particularly when the investor is offered some form of market protection or given the right to exploit local natural resources) and encourages horizontal and vertical linkages between foreign and local investors. Horizontal linkages come through the joint venture itself, while vertical linkages derive from the greater familiarity of the local joint venture partner with local suppliers – although this latter point has sometimes been questioned.[21]

  The evidence on linkages suggests that joint venture requirements have been at best ineffective and at worst counterproductive. An overview of empirical studies on such requirements found that "direct evidence is not promising of [their]…use to try to enhance technology transfer, penetrate international markets, or even expand and strengthen backward linkages to the domestic economy".[22] Mansfield and Romero (1980) found that "parent firms transferred technology to wholly-owned subsidiaries in developing countries one-third faster, on average, than to joint ventures or licensees".[23] In a more recent example, when a major manufacturer of photo equipment invested in China it was allowed only one wholly-owned subsidiary, while the rest of its affiliates had to form joint ventures. Consequently, the company invested six times more in its wholly-owned affiliate than in the joint ventures, and the former ended up producing its most advanced technologies.[24]

  Moran (2002) argues more generally that "the technology employed in joint ventures has been found to be on average three to ten years behind the cutting edge of the industry and the amount of technical training provided to the local managers and workers is a fraction of that received in wholly-owned counterpart affiliates".[25] This deterrent effect on technology transfer is in addition to any dissuasive influence of such requirements on the decision of whether to invest in the first place.

- *Technology transfer obligations.* Like joint venture requirements, technology transfer obligations are partly an attempt to increase spillovers to local firms. Such obligations can take the form of mandatory technology sharing or a stipulation that technology can only be licensed. Sometimes objectives are achieved indirectly such as through weak enforcement of intellectual property rights. A recent UNCTAD survey concluded that "evidence on the effectiveness of technology transfer requirements is scarce and, where available, does not suggest much success".[26] Some empirical studies have found a negative correlation between technology flows and transfer

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21 See, for example, UNCTAD (2001), p. 167.

22 Moran (1998), p. 121.

23 Mansfield and Romero (1980), cited in Moran (1988), p. 122.

24 World Bank (2004), p. 172.

25 Cited in UNCTAD (2003), p. 27.

26 UNCTAD (2003), p. 29.

obligations and a positive one between such flows and both the competitive pressure in the local market and the level of education of the host country.[27]

- *Local content requirements.* Local content requirements are at the heart of interventionist policies to increase linkages between MNEs and SMEs. The more foreign investors are obliged to buy locally, it is argued, the more they will form linkages with local firms. Some authors argue that such measures can be useful in certain circumstances to promote the development of local SMEs and that they have had the desired effect in countries such as South Korea, Chinese Taipei, Brazil, Mexico and Thailand. It is noteworthy that putative success stories tend to involve markets with either high local capabilities or large internal markets and hence greater potential economies of scale.

  Criticism of local content policies is similar to that of infant industry protection more generally. An UNCTAD study found that "the prolonged use of local content requirements can lead to high costs, poor quality and a lack of long-term competitiveness in supplier industries". [28] Moran (1998) finds them to be both extremely costly and highly ineffective. As with other performance requirements, local content obligations also have a potential dissuasive impact on inflows of investment, particularly for export-oriented affiliates.

While mandatory performance requirements might arguably have yielded some positive results in a few countries with the size or absorptive capacity necessary to create competitive supplier industries, they are unlikely to produce the same results in the majority of developing countries. Indeed, the outcome is more often a high cost and inefficient local supplier industry. The dissuasive impact on FDI of such requirements is difficult to measure but could be significant, unless the host country is large enough to appeal to MNEs even with strings attached. This no doubt explains why the greatest number of performance requirements and other restrictions tend to be in larger markets.[29]

2) Linkage promotion through incentives

Following the less-than-impressive outcomes of performance requirements in the past, and their limitations through TRIMS and other agreements, host governments have not abandoned attempts to induce MNEs to strengthen their linkages with local firms. However, most investor obligations concerning suppliers are now part of a package deal in which MNE affiliates are offered incentives in return for fulfilling certain obligations. In most cases, obligations attached to incentives are permitted under international agreements (see also Box 3).

The use of performance-related incentives is not new. A 1987 study for OPIC found that already in the 1980s two thirds of performance requirements imposed on investment projects surveyed were tied to some form of incentive.[30] With the decline in mandatory measures, these voluntary agreements will have grown in importance.

Incentives are not always pecuniary. They sometimes take the form of preferential measures concerning e.g. import duties, expatriate personnel or majority ownership. In some cases, depending on the industry of the investor and the motive for investing, such additional measures might be an essential

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27 Ibid p. 30.

28 UNCTAD (2001), p. 169.

29 A survey by the European Round Table cited in UNCTAD (2003) found that the highest prevalence of requirements occurred in China, Iran, Pakistan and Malaysia.

30 Moran and Pearson (1987).

pre-condition for investing, making the voluntary nature of the arrangement more apparent than real. If, for example, the investor possesses proprietary technology which is central to its competitiveness, then it will prefer to retain full ownership of its affiliates. In this case, any incentive which allows full foreign ownership only under certain conditions will appear as a binding obligation rather than as an option. The same is true for an investor dependent on certain imported components. Granting duty exemptions subject to the fulfilment of performance criteria will appear from the point of view of the investor as mandatory rather than voluntary.

Under performance incentives, firms which, for example, export all or most of their output, undertake training or link with local suppliers obtain preferential treatment: majority or full ownership; duty exemptions or reductions on component imports or on imports of models not produced in the host country; fewer restrictions on key personnel; or greater scope for dividend payments to the parent. Where the incentive takes the form of a tax holiday or a reduction in the corporate income tax rate, it is usually offered to both foreign and domestic firms.

Incentives are most likely to achieve desired outcomes when they are aligned with emerging corporate strategies. A recent UNCTAD study found that "more attention needs to be given to policies that are in line with market forces and that build, in particular, on the mutual interests of both foreign and domestic firms to create and deepen linkages and foster competitiveness and economic growth."[31] The example of export-based incentives in South Africa demonstrates that the effectiveness of policies is likely to be context specific. When the effect is to push firms in directions where ultimately they would head anyway, the effect is likely to be to assist or even guide a process of restructuring. When there is no underlying corporate rationale for moving in that direction, performance incentives are unlikely to be effective.

d) Home country measures in support of MNE/SME linkages

The authorities in host countries have the most obvious reasons to encourage MNE/SME linkages, but home countries often find it in their interest to participate as well. On the one hand, MNEs domiciled on their territory reap commercial benefits from linkages. On the other, the Monterrey Consensus' emphasis on the role of international investment for development brings the issue to the forefront of many OECD countries' efforts to assist economic progress in the developing world.

Several channels are available to home countries. In the words of the so-called Sao Paolo Consensus, "[h]ome countries can assist in the collection and dissemination of information related to investment opportunities in developing countries. They can encourage technology transfer, provide various forms of financial and fiscal incentives and help mitigate risk, for example, by providing investment insurance against risks that may not normally be covered through the private insurance market."[32]

1) Promoting technology transfer

The issue of linkages involving technology transfer figures prominently in the debate, and is the touched upon by several international agreements. In the area of intellectual property, the TRIPs Agreement contains specific provisions for technology transfer. Article 66(2) requires developed country members to "provide incentives to enterprises and institutions in their territories for the purpose of promoting and encouraging technology transfer to least developed country members in order to enable them to create a sound and viable technological base".

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[31] UNCTAD (2001), p. 165.

[32] UNCTAD (2004), "Sao Paolo Consensus", p. 10.

The OECD Guidelines for Multinational Enterprises are government-backed recommendations of good conduct addressed to MNEs operating in or from signatory countries. Under the Guidelines, enterprises should: (1) encourage local capacity building through close co-operation with the local community, including business interests, as well as developing the enterprise's activities in domestic and foreign markets, consistent with the need for sound commercial practice; (2) encourage human capital formation, in particular by creating employment opportunities and facilitating training opportunities for employees; and (3) adopt, where practicable in the course of their business activities, practices that permit the transfer and rapid diffusion of technologies and know-how, with due regard to the protection of intellectual property rights. While these recommendations are not legally binding for companies, the Guidelines represent a political commitment on the part of adhering governments to promote good corporate conduct and include procedures for implementation and follow-up.

At the same time, the contribution that home countries and the enterprises themselves can realistically make is in large measure dependent on the regulatory and human capital environment of the host economy. Where SMEs operate at comparably high levels of technological competence, and where MNEs are comfortable with the regulatory protection of their proprietary knowledge, encouraging technology transfers is much easier than in economies that operate by lower standards.

2) Capacity building and linkage enhancement as official development assistance

As demonstrated in a recent joint report by the OECD Development Assistance Committee (DAC) and the Investment Committee, supporting the capacity of SMEs in developing countries is a high priority for the development agencies of OECD countries[33]. Official development assistance (ODA) is granted both to generic "supply side" support and to specific efforts to encourage SME/MNE linkages.

According to the report several development agencies, through their ODA programmes, support entrepreneurial education and vocational training as a means of strengthening SME activities. Moreover, many DAC members promote the expansion of business services in developing countries, especially for micro and small and medium-sized enterprises. DAC members have also set up facilities to establish or promote business partnerships between companies in industrialised and developing countries by providing information on foreign markets or matching firms with related needs or interests.

Multilateral development agencies have been particularly active in the area of linkages and building SME capacity. For example, the International Finance Corporation has 14 business linkage projects in operation and 30 more in the pipeline, including technical assistance to SMEs, market access; business development services and access to finance. These projects cover all aspects of supply chain management and distribution.

The Empretec Programme of UNCTAD has, since 1988, included 27 countries and more than 70 000 entrepreneurs through local market-driven business support centres.[34] Each national Empretec programme: identifies promising entrepreneurs; conducts training to develop business skills; assists companies to access financial and non-financial services; encourages networking nationally and internationally; helps to arrange mutually beneficial links with national and foreign companies; and puts in place long-term support systems to facilitate the growth and internationalisation of the venture. The UNDP has also developed initiatives to build capacity in developing country SMEs.

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[33] See *Investment for Development,* OECD (2005), Paris.

[34] See http://www.empretec.net/.

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ANNEX 1. COMPETING DEFINITIONS OF SMES

There is no single agreed definition of an SME. A variety of definitions are applied among OECD countries, and employee numbers are not the sole defining criterion. SMEs are generally considered to be non-subsidiary, independent firms which employ less than a given number of employees. This number varies across countries. According to OECD's *SME and Entrepreneurship Outlook 2005*, the most frequent upper limit designating an SME is 250 employees, as in the European Union. However, some countries set the limit at 200, while the United States considers SMEs to include firms with fewer than 500 employees. Small firms are mostly considered to be firms with fewer than 50 employees while micro-enterprises have at most ten, or in some cases, five employees.

Financial assets are also used to define SMEs. In the European Union, a new definition came into force on 1 January 2005 applying to all Community acts and funding programmes as well as in the field of State aid where SMEs can be granted higher intensity of national and regional aid than large companies. The new definition provides for a increase in the financial ceilings: the turnover of medium-sized enterprises (50-249 employees) should not exceed EUR 50 million; that of small enterprises (10-49 employees) should not exceed EUR 10 million while that of micro firms (less than 10 employees) should not exceed EUR 2 million. Alternatively, balance sheets for medium, small and micro enterprises should not exceed EUR 43 million, EUR 10 million and EUR 2 million, respectively. In addition to satisfying the criteria for the number of staff and one of the two financial thresholds, an SME must be independent; to this end, the new definition distinguishes between *autonomous enterprises*, *partner enterprises* and *linked enterprises*. Finally, the new definition, introducing precise financial thresholds for micro-enterprises, thus recognises the essential role of the latter in the economy.

The approach taken by the OECD, and in particular by the Centre for Entrepreneurship, SMEs and Local Development, and its two pillars -- the Local Economic and Employment Development (LEED) Programme and the Secretariat of the Working Party on SMEs and Entrepreneurship – is to work with both the national, regional *and* Community definitions and to attempt to achieve some degree of international comparability. In particular, for the purposes of this publication and for reasons of comparability and data availability, figures and tables, including those in the *Statistical Annex* are presented using two size classification systems: i) fewer than 9, 10-49, 50-99, 100-499, 500+; and ii) fewer than 9, 10-49, 50-249, 250+. Exceptions to these two classifications are detailed in the Statistical Annex.