

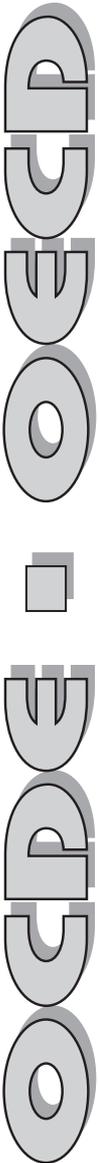
ENHANCING THE COMPETITIVENESS OF SMEs
IN THE GLOBAL ECONOMY: STRATEGIES AND POLICIES

Workshop 4

**ENHANCING THE COMPETITIVENESS
OF SMEs IN TRANSITION ECONOMIES AND
DEVELOPING COUNTRIES IN THE GLOBAL
ECONOMY AND THEIR PARTNERSHIP WITH
SMEs OF OECD COUNTRIES**

Conference for Ministers responsible for SMEs and Industry Ministers

Bologna, Italy, 14-15 June 2000



FOREWORD

This background report has been prepared by the Secretariat of the Private Sector Development Unit of the OECD Directorate for Financial, Fiscal and Enterprise Affairs, within the framework of the Centre for Co-operation with Non-Members. It draws from papers prepared for the OECD by a number of experts, particularly David Smallbone (Middlesex University Centre for Enterprise and Economic Development Research). It has also benefited from the substantive comments of David O'Connor (OECD Development Centre), Thomas Andersson (OECD DSTI), Marie-Florence Estimé (OECD DSTI) and Luigi Corbò (Italian Institute for Industrial Promotion, IPI).

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Executive Summary

1. This background paper is concerned with the potential role of different types of co-operation between SMEs in OECD and non-member countries, the pre-conditions for developing framework conditions conducive for the development of SMEs and effective partnerships between them as well as role of policy in encouraging and facilitating this process.
2. Increasing globalisation forces are affecting firms of all sizes, although they present particular challenges and opportunities to SMEs, because of a variety of size-related characteristics. In this context, increasing competitive pressure is one of the key drivers encouraging some SMEs in OECD countries to look for international partners in order to reduce costs and/or to facilitate the development of higher order competitive advantages, by focusing on those types of activity where the potential flexibility that small size offers can be exploited to best advantage.
3. For SMEs, in non-member states, international co-operation offers new potential market opportunities as well as access, in certain circumstances, to new technology and management know-how. At the same time, developments in information and communications technology represent an enabling factor in the external environment for SMEs at a global level, making it possible to combine product/process specialisation and low cost operation, with access to electronic networks and information databases. In addition, the advent of Internet based E-commerce offers vast potential opportunities for SMEs to expand their customer bases, enter new product markets and rationalise their businesses.
4. Although cross-border partnerships between SMEs in OECD and non-OECD countries offer certain potential advantages, efforts to promote such co-operation are unlikely to be effective on a large scale without the appropriate policy, institutional and technological conditions being fulfilled in the countries concerned. Such conditions include: the provision of effective business support services to facilitate the development of appropriate partnership arrangements; the availability of long term finance to support these arrangements; and creating an appropriate and effective legal and regulatory framework that includes adequate legal safeguards for intellectual property rights, brand protection and local contract enforcement. Moreover, if the potential for business-to-business E-commerce is to be fully exploited, governments will need to develop appropriate policy frameworks, communications infrastructures that incorporate the expansion of bandwidth, whilst also promoting universal access to ICT.
5. In this context, the main policy recommendations to encourage and support cross-border co-operation between SMEs are: to raise awareness among SMEs of the potential benefits offered by such partnerships; to foster business to business contacts by supporting SME participation in appropriate international fairs and the creation of appropriate databases; to review existing legal frameworks from the point of view of encouraging foreign co-operation with domestic SMEs; to take steps to support the development of international networking capacity; to offer specialist advisory and training support to help firms exploit the Internet for searching for partners; to develop cross-border partnership support programmes; and to facilitate linkages between support organisations and diaspora communities, that often represent significant social capital in relation to the development of cross-border partnerships.
6. In brief, the challenge for governments is to create a facilitating and supportive environment for SME development that enables SMEs to exploit the potential benefits and/or cope with any additional costs or threats from increasing internationalisation forces, whilst avoiding becoming protective. In this context, encouraging and facilitating inter-firm co-operation may be one of the ways of helping domestic SMEs overcome some of the internal resource constraints, although an informed policy stance needs to be based on a recognition of the potential pitfalls of such a strategy for SMEs as well as the potential gains.

Introduction

1. In OECD countries, it is generally recognised that SMEs play an important role in economic growth and development, with a particular contribution in terms of employment generation. In transition and developing economies (T&DEs), countries such as Chinese Taipei, Korea and Poland¹ (Polish Foundation for Enterprise Development, 1999) demonstrate a strong SME contribution to development, although in other countries in this group the sector is less developed with fewer SMEs able to grow. Whilst such a situation reflects a variety of problems and constraints on SME development, co-operation with foreign partners offers some advantages as a development strategy, although its limitations and potential disadvantages also need to be recognised. For SMEs in OECD Member countries, such co-operation can also be attractive in certain circumstances. In this context, this paper considers the forces influencing co-operation between SMEs in OECD Member and non-member countries, the conditions, which need to be met to encourage and facilitate it and the potential role for governments in the process.

2. One of the growing influences on the environment in which SMEs are operating is internationalisation. Although increasing internationalisation forces are contributing to changes in the external environment for firms of all sizes, they present particular challenges and opportunities for SMEs because of a variety of size related influences. Since internationalisation -forces are associated with an increasing interdependence between national economies (such as with respect to markets, patterns of supply, capital and production systems), governments have an interest in seeking to exploit the potential that such interdependence offers, as well as trying to better deal with the related competitive pressure on businesses and jobs, if the SME sector is to fulfil its potential role in national and international economic development.

3. In OECD countries, the last two decades have seen a marked increase in the international activities in firms of all sizes. Facilitated by continuing developments in transportation, information technology, financial systems and other factors, both large firms and SMEs have increasingly become involved in international operations in order to exploit new markets and new sources of supply. Schmidt (1996) refers to the increasing number of SMEs that are managing their operations on a global basis. This is supported by evidence showing the percentage of US based small companies operating in international markets increasing from 20% in the early 1990s to more than 50% (Hitt and Barkhus, 1997). More generally, the OECD (1997) report that internationalised SMEs account for approximately 25-30% of the world's manufacturing exports, with their export contribution to GDP representing 4-6% for OECD countries and 12% for Asian economies.

4. Whilst referring only to exports, these figures indicate that internationalisation is no longer the exclusive domain of large corporations. A growing number of SMEs, increasingly view their 'market' as international rather than narrowly in local, regional or national terms. In general, SME internationalisation is greater in small, open economies and less in larger, more self-contained economies, although there are exceptions. For example, France and Italy are reported to have 30% and 70% of exports respectively contributed by SMEs, while in the small open economies of Malaysia and Australia, the contribution is less than might be expected (OECD, 1997).

5. Moreover, SMEs are not restricting their international activities to exporting. This is illustrated by the rising trend towards the adoption of other forms of international market entry and development, such as FDI, strategic alliances, licensing, joint ventures and similar modes of co-operation (Oman, 1984; Young, 1987). Internationalisation has also reduced the importance of national boundaries to the supply chain, with the result that all forms and sizes of enterprise are now increasingly linking up with foreign enterprises to form cross-border partnerships and clusters (Ohmae, 1995). At the same time, it must be

¹ Korea and Poland both became members of the OECD in 1996.

stressed that it is estimated that only about 30-40,000 of SMEs are truly global in their operations (in the sense of being active in multiple countries and/or across different countries), with those based in OECD Member countries representing the majority.

6. The emerging global economy of the 21st century, and its effects on SMEs, poses new challenges for governments in all countries. In OECD countries, most governments recognise the importance of the SME sector to economic development in policy terms, although the emphasis varies between countries. On the one hand, the role of government in terms of policy includes direct support measures (such as interventions designed to support export promotion). On the other hand, more importantly, it includes the whole range of policies concerning the economic, legal and regulatory environment in which SMEs operate, as well as in influencing the operation of markets in order to avoid market failure from a SME standpoint. In addition, a growing number of OECD governments are recognising the potential benefits of encouraging and promoting inter-firm collaboration through a variety of network initiatives.

7. In a T&DE context, an important potential role for government is to help SMEs gain greater access to international markets, technology and know-how and finance, in order to facilitate their growth and better withstand increasing competitive pressures for which firms may not be well prepared. The potential welfare gains to the economy as a whole, that can accrue from having a strong SME sector, may be used to justify measures designed to help these firms to achieve their potential economic contribution.

8. The challenge for governments is to create a facilitating and supportive environment for SME development (OECD, 1999), that enables SMEs to exploit the potential benefits and/or cope with any additional costs or threats from increasing internationalisation forces, whilst avoiding becoming protective. In this context, encouraging and facilitating inter-firm co-operation may be one of the ways of helping domestic SMEs overcome some of the internal resource constraints. At the same time, such a policy stance needs to be based on a recognition also of the potential pitfalls of such a strategy for SMEs balancing the overall impact of any intervention. Additionally putting in place a framework for the design of more effective overall policies to improve the climate for small businesses can increase the competitiveness of SMEs in the global economy and at the same time can upgrade their capacity to engage in cross-boarder partnerships.

9. In this context, the general objective of this workshop is to address to following questions:

Are SME partnerships between OECD and non-member countries an effective response to the threats and opportunities encountered by increasing internationalisation/globalisation? What are the most propitious conditions, which give rise to SME partnerships? Is there a need for more broad-based policies to improve the overall business environment for small businesses? Is the emerging experience of OECD countries effective “good practice” example, or are there other examples of strategies and policies, which might prove more appropriate? What should be the role of government in relation to inter-firm collaboration between SMEs in OECD and non-OECD member countries? What practical programmes are there to promote SME partnerships?

1. Types of Cross-Border Co-operation Involving SMEs

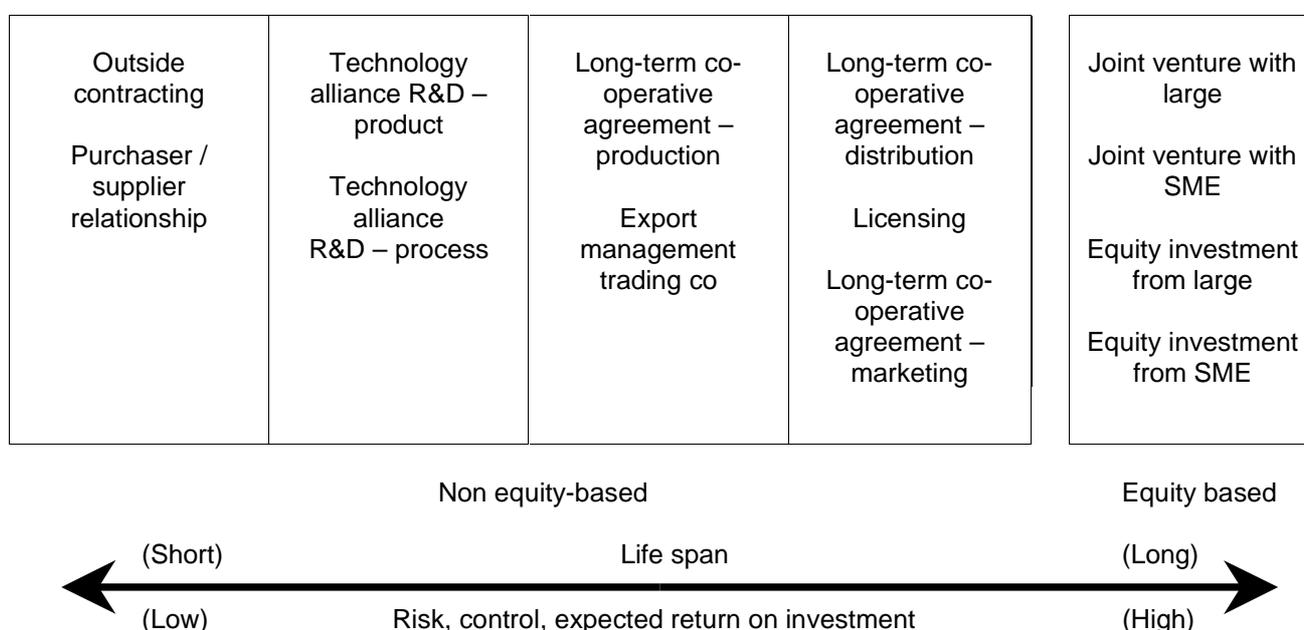
10. Before discussing the various enabling and constraining forces influencing the role and development of cross-border partnerships for SMEs in OECD Member and non-member countries, it is necessary to explain the different types of partnership arrangement that can exist.

11. Changes in the global business environment are being reflected in the types of strategy used by firms to respond to them. Structural changes in the OECD economies are adding to the pressure on firms to cut costs which, combined with the high costs of social welfare and associated labour on-costs, have made

many OECD enterprises increasingly uncompetitive. As a result, rather than simply engaging in international trade, deeper forms of integration are being sought in order to minimise costs, as part of a trend towards international production (see Dunning, 1995).

12. International production inevitably leads to the development of cross-border production operations, including partnerships of different types, such as subcontracting, joint ventures and franchise arrangements. Weaver (2000) has described a constellation of SME based alliances, representing a variety of structured agreements that establish exchange arrangements between participating firms (see Figure 1). Whilst some may represent long term co-operation, others may have a limited life, according to the circumstances which led to their creation. Moreover, whilst some links may be between two SMEs, others may involve some form of partnership arrangement with larger companies. Both types of linkage may be appropriate in different circumstances (e.g. in different sectors), although it may be argued that co-operation with between SMEs may offer a greater chance of a balanced interdependence relationship developing than a more dependent one.

Figure 1: A Constellation of SME-Based Alliances



Source: Weaver (2000)

13. Within the context of a variety of inter-firm linkages, co-operation ties involve more than the links created through ‘normal’, arms-length transactions, since they involve a commitment to mutual development and a willingness to accept some degree of involvement of one firm in the operation of another. In this context, ‘relational contracting’ may be distinguished from arms-length competitive contracting (Perry, 1999, p28). Whereas the latter has a focus on satisfying immediate supply requirements, relational contracting is concerned with securing longer term advantage through information sharing and co-operation, by involving suppliers in, for example, new product/process design. Clearly, the latter offers considerable potential value added to subcontractors compared with the former.

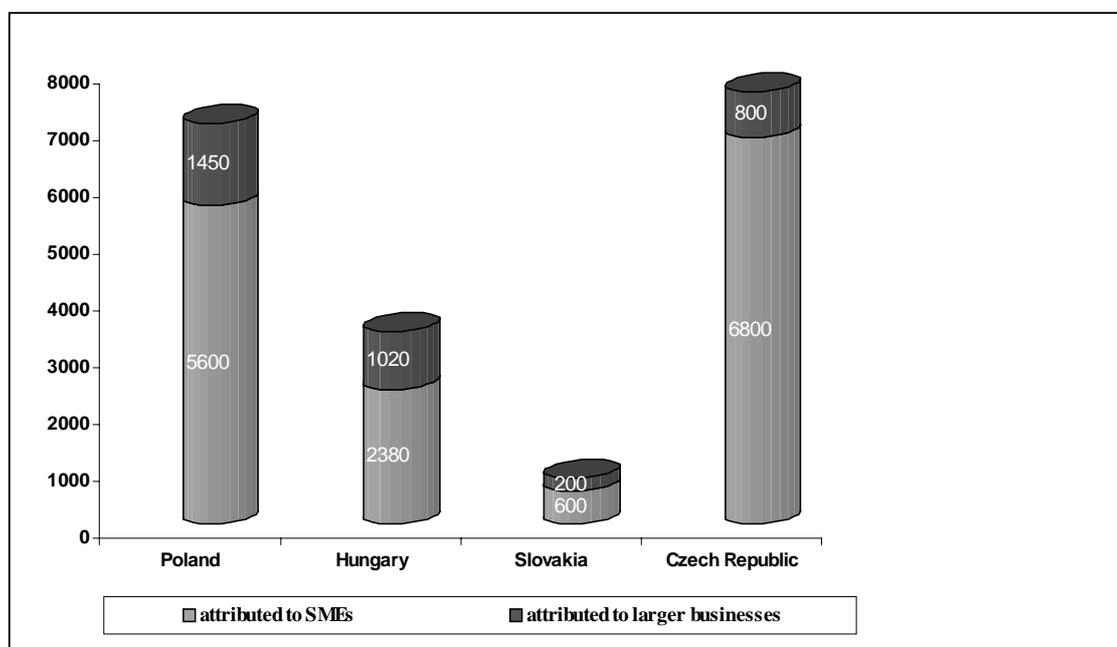
14. Other forms of co-operative arrangements, such as joint ventures, involve ownership ties; in this case, by two or more firms controlling a third party enterprise. A joint venture represents a form of co-operation with a typically narrow and sometimes short-term focus, although wider co-operation may stem from it.

15. Franchising may also be considered as an example of an organisational network. Franchising is of interest because it provides a way of overcoming distance barriers to interaction, enabling the internationalisation of elements within the service economy. Franchising can provide self-employed and small firm proprietors with access to a wider organisational resource base, provided they comply with the production and management systems set by the franchisor. At the same time, as in the case of subcontracting, the extent to which franchising offers a co-operation relationship that involves reciprocal learning and some degree of independence for the franchisee varies (Felstead, 1991), with implications for policy makers seeking to encourage co-operation partnerships.

16. Strategic alliances, with SMEs and/or large firms, represent another form of inter-firm linkage which are often seen as a response to the pursuit of business expansion in environments that are characterised as uncertain and unstable (Contractor and Lorange, 1988). This helps to explain the use of this type of co-operation by foreign firms seeking to enter markets in 'early stage' transition economies, whilst offering firms in the destination economy firms access to wider resources.

17. The effectiveness of cross-border SME partnerships of different types has been in evidence in recent years. For example, the economic success of the southern provinces of China from 1980s onwards largely came about because of the highly efficient cross-border SME alliances and joint ventures involving mainland Chinese businesses and Hong Kong-based SMEs (Ze-wen *et al*, 1991). The links forged between Singapore and parts of Malaysia and Indonesia have helped both regions to prosper (Ohmae, 1995). In Europe a large number of cross-border partnerships have also emerged involving German (see chart 1) and Austrian SMEs working with SMEs in several of the post-Communist economies, such as Poland, Hungary and the Czech Republic², as well as between Greek and Bulgarian SMEs (Labrianidis, 1999). In this context, faced with rapidly changing international market environments, co-operative inter-firm activity may be viewed as a rational strategy for SMEs seeking to respond with limited internal resources.

Chart 1: Number of active businesses with German participation in the Visegrad States



Source: Kaufmann/Menke, (1997), Institut für Mittelstandsforschung, Bonn.

² Czech Republic became a member of OECD in 1995, Poland and Hungary joined in 1996.

18. At the same time, it is important to stress that cross-border partnerships must not be seen as a panacea for SMEs facing increasing internationalisation forces. Some SMEs in non-OECD countries have already experienced the effects of foreign companies seeking joint venture partners as a short-term expedient, faced with uncertain local market conditions. Such firms may also experience little in terms of the learning benefits that are one of the prime justifications for this type of strategy in the longer term. This is suggestive of a role for policy in seeking to develop partnership arrangements that clearly involve mutual and some lasting benefits for both partners (whether or not the particular partnership is long lasting).

2. Forces Influencing Cross-Border SME Partnerships in both OECD and Non-Member Countries

19. This section considers the enabling and constraining forces influencing the circumstances in which cross-border co-operation between SMEs in OECD Member and non-member countries may be an appropriate development strategy. In assessing the role of these influences, it is important to consider the issues from the standpoint of SMEs in both OECD and non-OECD member countries.

2.1 *Increasing Competitive Pressure on SMEs*

20. One of the key drivers encouraging some SMEs to look for international partners is increasing competitive pressure. International competition is increasing in most product and service markets in OECD and non-OECD countries alike, encouraged by mechanisms such as the WTO and GATT, as well as regional trading agreements such as NAFTA, MERCOSUR and the EU Single Market project. Whilst increasing international competition affects firms of all sizes, there are size-related characteristics that can affect the ability of SMEs to identify and respond to such changes.

21. Compared with larger firms, SMEs typically have less ability to influence external relationships with customers, suppliers and factor markets. As a result, their ability to survive and grow depends on their flexibility to respond to external environmental change forces. With a more limited internal resource base compared with larger firms (particularly with respect to management and financial resources), co-operation with other firms or external organisations, represents a potentially important strategic response. For example, SMEs that wish to enter foreign markets, can establish formal links with local SMEs which have more of an idea of local market conditions and potential distribution channels, as well as more experience of dealing with other aspects of the local operating environment. In addition, SMEs under threat in their own traditional markets from lower cost producers abroad can react pro-actively by sourcing from foreign firms through joint ventures, franchising and licensing operations.

22. The forces of internationalisation and globalisation are pressuring firms of all sizes, including SMEs, to improve their competitive position. Pressures to defend profit margins, cut costs, innovate and adopt the most efficient technologies are becoming increasingly important. Just as larger enterprises have in the past reacted to these pressures by developing cross-border sourcing patterns and partnerships in order to reduce production costs (Dunning, 1995), some SMEs are now following a similar route for similar reasons. In principle, SMEs in non-OECD member countries with lower production costs can be beneficially matched with SMEs in OECD countries that possess higher level technical, marketing, and selling skills.

23. However, it must be stressed that this type of international networking offers SMEs in OECD Member countries more than an opportunity to reduce costs through outsourcing. It also allows these firms to develop the type of higher order competitive advantages that are less readily copied by competitors

(Porter, 1990), by focusing on those types of activity where the flexibility that small size offers can be exploited to best advantage. This is associated with access to higher value added activities in which innovation and product differentiation are emphasised in the firm's competitive strategy. Unlike large enterprises, which may be able to rely on internal economies of scale, SMEs often need to seek economies of scope as part of their competitive strategy, generated through linkages and partnerships. Thus in principle, co-operation and increasingly international co-operation, offers SMEs a means of competing in increasingly competitive markets using strategies that enable them to combine the flexibility with cost reduction.

24. Increasing competitive pressures are not only impacting on individual SMEs but also on existing clusters and SME networks. For example, in the northern Italian regions where hitherto the specific form of partnership was local, there is growing evidence of pressure to increase competitiveness through developing cross-border partnerships which can take advantage of lower production costs outside Italy (see, for example, Cossentino *et al*, 1996). As Cooke and Morgan (1994, p 106) point out, "the region's local sub-contracting networks, a source of strength in the past and a core feature of the Emilian model, are beginning to unravel as production is shifted to lower-cost regions and countries." In addition, Garmise (1995, p 154) states, the "...increase in mergers and acquisitions, minority shareholdings, contractual agreements, and joint ventures...(.) undermines the co-operative, horizontal subcontracting relationships existing among Emilian entrepreneurs".

25. Clearly, local SME based networks, which in the past have been seen as model types by some policy makers, are facing new sources of competitive threat requiring new types of strategic response. Although the full importance of the specific changes affecting these networks have yet to be determined, it would seem that the successful adjustment of existing industrial districts and local networks in OECD countries is likely to increasingly incorporate some form of international ties.

2.2 *New Market Opportunities for SMEs in Non-Member Countries*

26. Although a number of studies have considered international partnership arrangements as growth strategies from the standpoint of SMEs in mature market economies, less attention has been paid to the needs and interests of SMEs in developing and transition economies in this respect. A combination of the effects of trade liberalisation on the level of competition in domestic markets, combined with limited purchasing power in the home market, can be a key driver forcing growth orientated SMEs to develop or increase their foreign market sales. For example, in surveys undertaken in the Baltic States in 1995 and 1997, the small size of the domestic populations, combined with low purchasing power, were important 'push' factors (in Estonia particularly) encouraging manufacturing SMEs to develop foreign markets (Smallbone *et al*, 1996; 1999).

27. In such circumstances, subcontracting and other forms of collaborative arrangement with foreign firms offers certain advantages compared with other strategies, since they can reduce market entry costs and barriers, with lower associated business risks. The survey results showed that the most frequently mentioned advantage of subcontracting by the managers of those SMEs involved was a greater continuity of sales revenue, compared with more arms-length relationships with customers, which helped to ease pressure on their cash flow. Other commonly identified advantages included 'less need for marketing' and 'knowledge transfer'.

28. At the same time, it must also be recognised that in some circumstances, this type of 'co-operation' can involve a high level of dependence associated with a narrow customer base, leaving subcontractors vulnerable to the purchasing decisions of contractors to switch sources of supply. The potential benefits to subcontractors are also affected by how much knowledge and/or other resources are

actually shared. The study concluded that “whilst subcontracting offers SMEs in transition economies a strategy for entering and exploiting foreign markets with lower entry thresholds than direct exporting, it is important that SME managers and their advisers recognised the need for the subcontractor’s position to evolve over time, if its foreign market presence is to be sustainable” (Smallbone et al, 1999).

29. Implicit in this conclusion is the idea that there is a potential role for policy to assist firms in transition economies to manage their ‘partnership’ relationships, in an attempt to ensure that the potential advantages of such arrangements are emphasised and the disadvantages minimised. In this respect, one role for policy could be to encourage the development of ‘relational’ rather than ‘competitive’ contracting type arrangements, as described in section 1.

2.3 Access to New Technology and Management Know-How for SMEs in Non-Member Countries

30. One of the key constraints on the development of SMEs in T&DEs is access to technology and management know-how. Whilst this partly reflects limited access to finance, there are additional dimensions. For example, in the transition economies of Central and Eastern Europe and the former Soviet republics, a combination of out-dated equipment and a lack of market-orientated management knowledge and experience are key constraints on the development of private sector SMEs, particularly with respect to their competitiveness in foreign markets. In such circumstances, co-operation with a foreign firm may offer a potentially attractive development strategy, in order to access the technology and knowledge base of firms in OECD countries. In this sense, it may be considered to be a factor encouraging the development of certain types of partnership arrangements between domestic SMEs and those in OECD Member countries, as one of the means for narrowing the knowledge and technology gap.

31. The potential contribution can be illustrated with respect to an example of a joint venture³ from Ukraine, where the development of a private SME sector is still in its infancy (Klochko and Isakova, 1996). The firm in question currently sells welding equipment, both domestically and world-wide, through a joint venture with Czech and Swiss partners. The original business concept was for a manufacturing enterprise, since the enterprise was started by a group of Ukrainian engineers who initially focused on producing cutting equipment. However, undercapitalisation contributed to early cash flow difficulties, leading to a cessation of in-house production. The firm currently focuses on selling a range of products from the technologically sophisticated products of its Swiss partner to more basic equipment, bought-in from Ukrainian sources. Asked to assess the joint venture, the Ukrainian entrepreneur referred to his previous lack of management and marketing skills as underpinning the initial attractions of the joint venture from his point of view, although the experience in practice had also contributed to an upgrading of products as a result of technical collaboration. Whilst the case demonstrates a successful joint cross-border collaboration between SMEs, it also demonstrates some of the potential constraints faced by SMEs in transition economies in entering such partnerships in terms of financing.

32. One study specifically concerned with joint venture activity between SMEs in developed and developing countries focused on international co-operation involving Belgian SMEs (Donkels and Lambrecht, 1995). While highlighting the advantages of such arrangements for the Belgian firms in terms of overcoming the psychological, cultural and administrative barriers to developing sales in such markets, the potential advantages to SMEs in developing countries, in terms of the acquisition of technology, technical and management skills was also recognised. In addition, it was emphasised that such knowledge

³ This is based on a case study undertaken in Kiev in 1999, as part of a project: Identifying the Support Needs of Small Enterprises in Ukraine, Moldova and Belarus: Developing a Policy Agenda’, funded under the TACIS (ACE) Programme (contract no T95 4139R).

transfer is more likely to occur in joint ventures than in looser forms of co-operation, because of the need for close personal contacts for these processes to be facilitated.

33. The study also noted that a SME in an industrialised country may represent a better partner for a SME in a developing country than a multi-national company, (MNC), who often co-operate with local partners mainly to observe requests for local content issued by host governments. Since the joint venture will represent a proportionately higher commitment (in terms of time and money) to a SME than to a MNC, it is argued that they are more likely to make every effort to ensure that it is a success. Hence, one of the key policy messages that can be drawn from this work is the need for advice concerning possible selection criteria for partners and the merits and pitfalls of the different types of partnership arrangement that can be negotiated.

2.4 *International Outsourcing by Large Enterprises*

34. One of the factors that has contributed to a growth of international ‘co-operation’ links involving SMEs is the outsourcing practices of large firms. Encouraged by a need to reduce costs and to achieve greater flexibility, and facilitated by an increasing liberalisation of trade, this process has contributed to new international supply opportunities for SMEs. Indeed, in some countries, such as Japan, the management of SME suppliers has been seen to be one of the *critical* factors behind the successful operations of many of the largest and most reputable companies (Nishiguchi, 1994).

35. This can be illustrated with reference to the automotive industry. The recent establishment by the three largest automotive companies in the USA (Ford GM and Daimler-Chrysler) of an online exchange to source parts and components for their vehicle production sites,⁴ is just the latest example of a globalising trend whereby SMEs in non-OECD member countries are invited to access market opportunities relating to the very largest enterprises in the OECD countries, possibly working in co-operation with SMEs in OECD Member countries. Working in partnership, SMEs located close to the automotive companies will be able to exploit their knowledge, distribution channels, local connections and marketing skills, while SME producers in non-OECD countries will bring to the partnership their ability to make inputs, sub-assemblies and components at low costs.

2.5 *Developments in Information and Communications Technologies*

36. One of the key enabling, change factors in the external environment for SMEs at a global level is developments in information and communications technology. The introduction of so-called “flexible technologies” in the 1970s and 1980s reduced the minimum efficient scale of production in many traditional industries, increasing the scope for SMEs to profitably engage in small production runs (see, for example, Piore and Sabel, 1984). However, it can be argued that technological developments in information and communications technology in the 1990s offer even more dramatic effects. SMEs now have the possibility of combining product and process specialisation and low cost operation with access to electronic networks, that can reduce the barriers effects of distance, as well as access to information databases that potentially offer a levelling of access to knowledge and technology.

37. The advent of Internet-based E-Commerce offers vast potential opportunities to smaller firms to expand their customer base, enter new product markets and better rationalise their business. Moreover, the increased risk and uncertainty in this new emerging environment means that enterprises must be highly adaptable if they are to survive. Since adaptability and flexibility are characteristics often associated with

⁴ Reported in the The Guardian, February 26, 2000.

SMEs, it can be argued that the successful exploitation of technological change represents a potentially enabling factor for SMEs in the new global environment.

38. At the same time, even in advanced industrial countries, adoption of these new technologies is only part of the story, since it is the use made of E-Commerce technology that influences its real impact on business activity. Although SMEs increasingly use the Internet for a variety of commercial and production-related purposes, they typically reveal a limited understanding of the complexity of E-Commerce. This can result from a lack of awareness of its potential, inadequate ICT skills and a lack of strategic planning of the longer term development of their business.

39. For SMEs in T&DEs, these developments in technology offer new opportunities for SMEs to compete on global markets. However, in practice these firms are often not well placed to exploit these potential opportunities, because of the difficulties they face in developing the marketing, distribution and after-care servicing for their new, lower cost products and services. However, in such circumstances, a cross-border partnership arrangement with an SME specialised in these areas of the value chain, may offer an attractive growth strategy.

40. The development of the Internet and the associated development of E-Commerce offers the potential to radically change the nature of business to business as well as business-consumer relationships, with new potential for facilitating cross border, inter-firm co-operation. The Internet offers a readily available and low cost mechanism for linking SMEs in OECD and non-OECD member countries, facilitating the easier and efficient management of cross-border partnerships. For example, supply chains involving all buyers and sellers in the vertical value chain of an industry are increasingly being linked by “Extranets” that allow multiple companies to work with the same data base in areas as diverse as engineering designs, new product development and inventory control and accounting.

2.6 *Changes in the Supply of Finance*

41. Although SME owners in many countries often experience difficulties in accessing sufficient finance, the growing business and political importance of the SME sector in OECD countries is encouraging the development of deeper institutional support structures offering finance to SMEs, supplemented by an increasing mobility of capital. In OECD countries at least, these developments may be considered an enabling factor for SMEs seeking to develop cross-border partnerships.

42. By contrast, in non-OECD countries, the supply of finance to SMEs is typically much more restricted. For example, the slow reform of the banking system is limiting the supply of finance to SMEs in the transition economies of Central and Eastern Europe and in many developing economies also, SMEs face imperfect financial markets.

43. At the same time, advances in technology and information systems management mean that traditional suppliers of capital (such as banks) have greater potential scope to “downscale” and profitably manage smaller individual loan sizes, with implications for the service they can offer to smaller enterprises. In addition, as experience in some countries shows, leasing companies, debt factoring organisations and other mechanisms are increasingly filling the remaining niches in the SME financial support infrastructure. Although SMEs often need help in accessing sources of finance and certain types of firm still face major financial barriers, more generally growth orientated firms in OECD countries typically face greater opportunities for accessing the finance they need to achieve growth than they have in the past.

2.7 *Increased Policy Priority for SMEs*

44. Although there are variations in levels of commitment and approaches used, there are few governments in the world that do not have some form of promotional or support policy for the SME sector. Moreover, a growing number of policy programmes recognise the potential benefits of encouraging SMEs to collaborate with other firms and external organisations, as a means of increasing flexibility and widening their resource base. In policy terms, the inter-firm co-operation that is implicit in the industrial districts of Northern Italy features prominently (e.g. Pyke, 1992), and the Danish Co-operative Network Programme is also much promoted (e.g. Pyke, 1994). However, while local sub-contracting and partnerships might be preferred by governments from the point of view of local job and wealth creation, some governments are also recognising that cross-border linkages are inevitable if SMEs in their own country are to survive and grow.

45. For example, in Japan, the over-heated economy of the 1980s forced the Japanese government to support many SMEs in developing cross-border partnerships in order to be able to source much cheaper inputs and components from SMEs in the East Asian dynamic economies. First tier suppliers in the Japanese automotive complex - the Toyota model - were particularly interested in restoring profit margins in this way since their ability to pass on price increases to their large vehicle assembly customers was not an option (Whittaker, 1997).

46. In the declining West Midlands region of the UK, SMEs in the engineering industry are being offered support to develop cross-border linkages with similar SMEs in the industrial heart-lands of the former Communist economies. This initiative is being undertaken in order to shore up the competitive position of West Midlands SMEs, which are now increasingly uncompetitive because of high local labour costs.

47. In addition, the political dimension of SME cross-border alliances and partnerships has been recognised by various international organisations. For example, the EU is actively encouraging and supporting cross-border SME partnerships as a way of promoting EU industrial integration and balanced regional development, through programmes such as MEDA, and through the Phare and Tacis programmes in terms of co-operation with transition economies.

Questions for Discussion:

Are there other forces at work that might encourage SME partnerships to emerge? What forces exist which undermine the creation of SME partnerships, and why might they arise? How might these forces be countered and/or facilitated through policy intervention? Are these forces likely to continue in operation for the foreseeable future? Are they manageable by national governments to any significant degree? How might national governments respond to the dilution of localised networks and local SME partnership arrangements thanks to globalisation and increased competition, such as is occurring in northern Italy?

3. Pre-Conditions for Developing Effective SME Cross-Border Partnerships

48. Although changes in the external environment can be said to have increased the potential benefits from cross-border partnerships involving SMEs, and whilst some attempts have been made to encourage their development, efforts to promote such inter-enterprise co-operation are unlikely to be effective without the appropriate policy, institutional and technological pre-conditions in the countries involved. Moreover, promoting and establishing partnerships is only part of the policy agenda, since it is also important to establish the conditions to encourage and facilitate partnerships that are effective and mutually beneficial

for all partners. Policy-makers in OECD and non-OECD countries still have a challenge to ensure that such pre-conditions become a reality.

49. The rationale for policy to encourage and support cross-border partnerships between SMEs is based on a combination of 'market failure' arguments and those concerned with the potential welfare gains that can accrue to national economies from having a more competitive SME base.

50. Although the various enabling forces described above offer potential opportunities and benefits to SMEs to engage in cross-border partnerships, the limited internal resource base of SMEs can affect their access to the information, knowledge and other resources that are necessary for these opportunities to be exploited.

51. As a consequence, the markets for information, advice, consultancy, training and finance do not always work perfectly as far as SMEs are concerned, for a combination of supply and demand side reasons. This can place them at a disadvantage in comparison with larger firms, which provides a rationale for the state to take steps to contribute to the development of a level playing field for businesses of different sizes.

52. It can also be argued that the potential benefits of a competitive SME sector to national economies in terms of employment generation and economic development mean that there are potential welfare gains for public policy seeking to influence the development of a more competitive SME base. Since it is argued that cross-border partnership arrangements can (in certain circumstances) contribute to maintaining and/or improving SME competitiveness in the face of changing external conditions, there is an 'a priori' case for policy support to influence and help to shape this process. Since the potential benefits to participating firms can vary according to the type of partnership arrangement employed, government has a potential role to play in helping firms to develop value added partnership activities.

3.1 The Provision of Effective Business Support Services

53. The external business support infrastructure has an important potential role to play in facilitating the development of appropriate partnership arrangements between SMEs and in helping each partner to fully capitalise on the potential benefits from such co-operation. For partnerships to be both effective and mutually beneficial, there is a need for both partners to be adequately prepared, briefed and trained in the skills required to make them effective. To fully exploit the potential of such partnership arrangements, SMEs may also require access to a wider range of support from a combination of public and private sector sources.

54. There is a role for business support services to provide information and help firms to identify suitable partners.

55. In this context, it is important that the support structure for SMEs is both efficient and sensitive to the limited ability of most SMEs to pay for advisory services and technical support. At the same time it is critical that any public sector intervention focuses on the public good aspect of the service and avoids crowding out of private businesses services. It is also essential that public and private sector services work together to provide the infrastructure to facilitate the development of effective cross-border partnership activities. The EU, within the framework of its Phare Programme, has just finalised an evaluation of programmes in support of SMEs and has identified a range of recommendations on how to design and implement effective support programmes in the future (EU Phare, 2000). The World Bank and the International Finance Co-operation have also been actively promoting support programmes particularly to upgrade, strengthen, and expand the pool of local suppliers to foreign businesses (FIAS, 1996). A good example is the local industry upgrading programme (LIUP) in Singapore.

3.2 *The Availability of Long-Term Finance*

56. The development of SME partnerships is dependent upon there being a suitably supportive financial structure. Whilst the international trends with respect to SME financing are generally positive, there is considerable variation between countries that may affect the ability of SMEs to develop effective partnerships. Partnerships involve trust building, finding and keeping appropriate partners, and the creation of mutually beneficial business relationships, which in many cases develop over a period of time. To support this, a greater risk bearing and longer term approach to SME funding is required which allocates sufficient capital resources to SMEs involved in partnership-building measures in the anticipation of a suitable long term return. Conventional short-term providers of finance are often unwilling to assist with the creation of SME partnerships.

57. These requirements are increasingly accepted by the international financial institutions (IFIs). The EBRD for example, states in a recent strategic paper (EBRD, 2000) that the bank is committed to exploring possibilities of building partnerships, promoting company-to-company linkages between countries and to foster forward and backward linkages on a sectoral basis. Similarly the Inter-American Development Bank (IDB) as well as the Inter-American Investment Corporation and Multilateral Investment Fund, stresses the importance of promoting enterprise links within its future approach to fostering Entrepreneurship (Inter-American Development Bank, 2000).

3.3 *The Legal and Regulatory Environment*

58. Creating an appropriate and effective legal and regulatory framework is an important pre-condition for the establishment of a legitimate private sector. It is particularly important with respect to cross-border partnership in two main respects: firstly, inadequate legal safeguards, since ineffective or highly corrupt enforcement regimes may act as a disincentive to foreign SMEs to invest and co-operate with domestic firms; secondly, they are also likely to influence the types of partnership arrangement that foreign firms are willing to engage in.

59. In this context, some T&DEs particularly, still do not have adequate legal safeguards for intellectual property rights, brand protection and the local enforcement of international contracts. Quick and easy systems of legal redress must be available in the event of contract non-performance by either side. Commercial laws that govern issues such as investment, contracts, the rights of legal persons, intellectual property, monopolistic practices, corruption and bribery are fundamental to the development of a SME sector. Simple and transparent customs procedures and fair business taxation are important elements in an external environment that is likely to encourage a foreign SME to engage in a partnership arrangement with a local SME, such as licensing, subcontracting or franchising.

3.4 *E-Commerce Policy Framework and Communications Infrastructure*

60. Some SME in non-OECD countries supplying OECD markets are already adopting a business-to-business E-Commerce capability. This requires the adoption of sophisticated capabilities by the local financial and IT sectors, together with the legal and regulatory environment that can permit electronic commerce.

61. The specific pre-conditions for SME partnership through E-Commerce include: firstly, the development of the appropriate policy frameworks; secondly, the development of a communications infrastructure that incorporates expansion of bandwidth; and thirdly, promoting universal access to information and communication technology. Measures that lower the cost and increase the quality and

availability of telecommunications and Internet services can help facilitate the access of SMEs to these important means of cross-border economic participation.

62. Regional variations in the quality of the ICT infrastructure within non-OECD member countries may limit the extent to which cross-border co-operation with foreign SMEs is practical across the country. This may be illustrated with reference to some recent survey results from Belarus, where although 1 in 6 surveyed firms reported Internet connections, these were almost entirely focused on the capital Minsk, rather than in the peripheral region centred on Mogilev.⁵ Similarly, the lack of access to ICT structure is seen as a critical bottleneck for further SME development, highlighted in a recent strategy paper by the United Nations Conference on Trade and Development (UNCTAD, 1999). Overall, access to ICT networks and services and the use of ICT equipment in developing countries and countries in transition are still very limited compared with industrialised countries.

3.5 *The Role of Social Capital*

63. Value added partnerships involving SMEs (such as relational subcontracting) involve trust, co-operation and teamwork, reflected in what some authors describe as 'social capital'. In this regard, it is important to note that social capital exists in the form of family and kinship ties, such as those, which grew up between mainland China and Hong Kong in the 1970s and 1980s. As Stiglitz (1999) notes, more co-operative business relations between and within SMEs need not be bought with financial capital, but by co-operative business structures (e.g., partnerships) which promote the investment of "sweat equity".

64. Indeed, kinship and personal contact networks are said to shape the growth paths of the majority of overseas Chinese-owned businesses. Perry (1999) for example, refers to the use of inter-personal trust replacing the close management supervision and detailed planning that usually accompanies entry into foreign markets, greatly simplifying international expansion for Chinese businesses. From a policy perspective, it is important to recognise the potential resource that such informal cross-border links between ethnic minority entrepreneurs represents.

65. Thus a major contributory factor behind some of the most important SME partnerships is the role of the diaspora community. Ethnic and kinship ties very provide the motivation for establishing co-operative arrangements, and the "glue" which binds together effective SME partnerships. It reduces the effort and risk involved in cross-border business operations, allowing both sides to concentrate on what each does best, such as accessing finance, producing, distributing, marketing or designing.

Questions for Discussion:

How has the policy, technology and strategic environment changed for SMEs with regard to their ability to develop and sustain cross-border relationships? What have been the most important changes in the last three years? What specific constraints and impediments currently exist that keep SMEs in your country from developing cross-border partnerships? How might the critically important principles which underpin SME partnerships - trust, mutual benefit and a longer-term growth perspective – be promoted?

⁵ These data are drawn from a survey of 168 Belarussian SMEs undertaken in 1998/9 as part of an INTAS funded project: 'Small Firms and Regional Economic Development in Ukraine, Belarus and Moldova' (INTAS UA 95-266).

4. Encouraging and Promoting Partnerships between SMEs in OECD Countries and Non-Member Countries: Policy Implications and Recommendations

66. In considering the role of governments in relation to the development of partnerships between SMEs in OECD and non-OECD countries, it is important to stress that such arrangements represent one strategy for retaining or improving competitiveness, that may be appropriate and successful in some circumstances, provided certain conditions are met.

67. In this context, policies to encourage and promote partnerships between SMEs in OECD and non-OECD member countries should aim to facilitate the development of mutually beneficial co-operative arrangements, appropriate to the needs of participating firms. In this respect, these policies will need to be selectively targeted on growth-orientated firms that are seeking either to enter or increase their penetration of foreign markets and/or to seek to increasingly internationalise their supply base, whilst lacking the internal resources to achieve this independently.

68. Since the nature and extent of such opportunities typically vary between sectors, it is likely that this will involve a degree of sectoral targeting, although the specific sectors targeted may vary between countries. In view of the fact that many SMEs operate exclusively on short-term planning horizons, one of the criteria for offering technical support or other resources to help SMEs participate in partnership arrangements should be a demonstrated strategic capability.

69. In this context, the main policy recommendations to encourage and support cross-border SME partnerships are:

4.1 *Raising Awareness of the Potential for Cross-Border Partnerships*

70. Whilst it is important that the potential pitfalls of joint ventures and other forms of inter-firm co-operation are emphasised as well as the potential advantages, there is merit in increasing the level of knowledge among growth oriented firms of the international opportunities offered by this type of business strategy. This can be achieved through the production and distribution of promotional literature and other material, made available to firms through the business support infrastructure.

71. It is also important to provide exemplar cases to demonstrate the benefits to be gained from solid partnerships. Highlighting demonstrator cases in promotional literature and organising study tours and exchange visits can be usefully employed to show entrepreneurs the experience of other SMEs with respect to cross-border partnerships.

Policy Recommendation: "Promote awareness of the opportunities presented by different types of international co-operation arrangements"

4.2 *Fostering Business to Business Contacts*

72. The most immediate and widespread technique used to stimulate SME partnerships is simply to bring potential SME partners together. Information failures often mean that potentially good SME partners have no knowledge of each other's activities and potentials. UNIDO's long-running SPX programme is an example of a tool to support SMEs operating in developing countries wishing to internationalise and move into cross-border partnerships, particularly sub-contracting relationships. The SPX programme facilitates contact between SMEs in the emerging markets and those operating in the main markets where sub-contracted components are a routine feature. SMEs in emerging markets are introduced to potentially

suitable partnership enterprises in the OECD countries, through participation in the main annual international sub-contracting fairs and through the creation of appropriate databases. The programme is also concerned with the dissemination of technical and other standards, as well as providing assistance in developing the necessary quality standards and specifications required for higher value-added markets.

73. UNIDO has also developed a sector specific programme – the “FIAT/UNIDO Partnership Programme” – which focuses on promoting growth and competitiveness in the auto parts industry in western India. It links INSEAD, the French Business School, the Prince of Wales Business Leaders Forum, the Automotive Component Manufacturers Association of India, the Automotive Research Association of India and the Government of India. This initiative associates Indian SME’s with international expertise and network support into Fiat motor vehicle value chain. This multi-sector, cross-border partnership has allowed Indian SME auto parts manufacturers to expand their production capability to meet both local and international demand.

74. The European Union Europartnariat Initiative programme is another long-standing example of promoting direct contacts between potential SME partners. In 1999, the European Commission held the twentieth Europartnariat SME forum in Vienna. The event allows SME’s to explore opportunities for future cross-border business co-operation, helping firms to begin to adapt to the single European market. The Commission also provides support to SME’s through direct business aid, business-related infrastructure as well as through advisory and training services.

75. The EU also has an “EU-Mexico-Central-America Partnariat”. Within the framework of the EC’s AL-Invest programme and following the Europartnariat formula, the EU-Mexico-Central-America Partnariat is an event that brings together SME’s from EU states, from Mexico and from Central America to establish cross-border communication and discuss future business co-operation. The forum will include over 500 enterprises from Mexico and Central America and over 250 companies from EU Member States. The European Commission also sponsored a similar ASEAN-EU Partenariat through its Asia-Invest Programme.

76. Individual governments are also able to support SME partnerships. The National Small Industries Corporation in India has successfully worked with partner organisations in other countries to match up the strengths and needs of small enterprises abroad with those of Indian enterprises and develop long-term business partnerships.

77. Both technology transfers and other types of information exchange are goals of these partnerships. The NSIC works with organisations such as the Small & Medium Industry Promotion Corporation in Korea, the World Trade Centre in Chinese Taipei, the North West Regional Technology Centre in the U.K., the Small Business Authority of Israel, Bundesverband Mittelständische Wirtschaft in Germany and Confederazione Italiana della Piccola e Media Industria in Italy.

78. Another useful way of facilitating SME partnerships has been through supporting the participation of SMEs from emerging countries in a number of the more high-profile international subcontracting events. Several OECD governments have also experimented quite successfully with “marriage broking” programmes, which bring together enterprises into partnership relations, which have the capacity to be mutually beneficial.

79. Korea has pursued a vigorous policy of mandating and encouraging subcontracting of SMEs by larger corporations and this contributed to a change in industrial structure. A number of subcontracting exchanges can be developed to promote contacts and information exchange, facilitating and lowering the costs and risks associated with subcontracting.

Policy Recommendation: “Within the context of a targeting strategy, take steps to facilitate the development of co-operation links by promoting direct SME-SME contacts”

4.3 Assessment of Legal Frameworks

80. Protecting intellectual property rights can expand SME partnerships in knowledge-based industries and franchising can be encouraged through protection of brand names. If higher value-added types of partnership arrangement between SMEs in OECD and non-OECD countries are to be encouraged, governments in non-OECD member countries particularly will need to evaluate the adequacy of existing legal frameworks and contract enforcement procedures, particularly with respect to the protection of IPR.

Policy Recommendation: “Assess the adequacy of existing legal frameworks with respect to partnership arrangements together with the adequacy and effectiveness of the methods and procedures for contract enforcement and the protection of intellectual property rights.”

4.4 Development of International Networking Capacity

81. Most governments have some kind of programme of support for business associations which want to make links with associations and clusters abroad, with a view to encouraging market development, technology upgrading and technical assistance. The success of the Indian software export industry is, in part, a story of linkages between the SME clusters in Bangalore and Bombay on the one hand and the business clusters in Silicon Valley, Route 128 (Massachusetts) and the emerging Dulles Internet Corridor in Northern Virginia. Business incubators are increasingly being used to promote innovative clusters of SMEs. This increasingly includes support for those most likely to become involved in cross-border partnerships and sub-contracting arrangements. Programmes to support spin-offs include measures to develop sub-contracting arrangements with the “parent” firm, but also prioritise links with international firms in order to reduce the dependency upon a single local customer.

82. The EU has a programme “Global Marketplace for SMEs” which aims to facilitate increased competitiveness and participation in global electronic commerce for SMEs. To do this, they have established a large network of business information on the Web, the Global Information Network for SMEs, with contributions from 15 economies and five international organisations. International and national working groups have also been studying the policy issues in e-commerce for SMEs and working to formulate a “best practices” compilation. A main objective of the project is to strengthen international collaboration between emerging, developing and industrialised economies in E-Commerce for SMEs.

83. Another example for the promotion of Networks through the EU is the COOPME programme. This programme aims to improve the ability of SME associations from Central and Eastern Europe to serve their members; expand relations and twinning arrangements between the EU, SMEs and trade associations as well as their counterparts in Central and Eastern Europe. It also aims to expand co-operation and partnership between SMEs in these two regions.

Policy Recommendation: “Provide help to develop the international networking capacity of national business associations and agencies to include OECD-non OECD country linkages”

4.5 Cross-Border Partnership Search Facilities

84. The Internet offers considerable potential as a tool for partner searching between SMEs and their advisers in OECD and non-OECD countries. The concept could include a chat-room facility for initial

exchanges of information between potential partners and might be best facilitated by a respected international organisation, such as OECD. However, it is important that the implementation of such a proposal is linked to the provision of specialist advisory and training support in order to prepare SMEs to be effective partners (see 4.6).

Policy Recommendation: “Establish a partnership search facility for SMEs in OECD and non-OECD member countries”

4.6 Cross-Border Partnership Support Programmes

85. Although mainly addressing the needs of potential SME partners in industrialised countries, Donkels and Lambrecht (1995), among others, have set out some of the conditions for setting up successful joint ventures in developing countries. They emphasise the need to gain experience of looser form of co-operation with a partner first in order to learn about each partner’s culture and improve communication; plan and prepare carefully; develop a blueprint; and provide information training for management and key staff on both sides that includes cultural awareness training.

86. If policy makers are to promote cross border partnerships between SMEs, it is important that appropriate specialist support is made available to potential partners, based on existing partnership experiences (positive and negative). Whilst the principles set out by Donkels and Lambrecht (1995) seem generally sound, there is a priority need to sponsor more extensive research on cross-border partnerships (of various types) involving SMEs in OECD and non-OECD countries, that can be used as a basis for developing specialist partnership support programmes.

87. The EU has been actively following such an integrated strategy to partnership promotion through the Joint Venture Programme (JOP) in Central and Eastern European Countries, the New Independent States and Mongolia. Set up already in 1991 JOP aims to assist the creation of joint ventures between SMEs in countries in transition and Community SMEs. JOP is based on a network of financial intermediaries to support feasibility studies, participation in the equity of the joint venture, the training of its staff and the information necessary for setting it up. The measures implemented have mostly enabled Community SMEs to carry out the preparatory phases of their joint venture projects, thus reducing the administrative, financial and legal constraints. The programme mainly assists SMES: 69 % of the approved applications were submitted by enterprises with fewer than 100 employees (European Commission, 1998).

Policy Recommendation: “Actively investigate the possibility of establishing cross-border partnership programmes that offer specialist assistance to SMEs with respect to partner search, partner selection guidelines and management and key staff training.”

4.7 Linkages between Support Organisations and Diaspora Communities

88. Many of the SMEs currently enjoying success in export markets in Germany and other EU countries are based on diaspora-inspired linkages with SMEs in the countries targeted for EU Accession, such as the Czech Republic. Programmes can be established involving both OECD and non-OECD countries working together to identify key areas where partnerships based on such linkages are most appropriate, and facilitating their establishment. Often the OECD country is willing to provide financial and other forms of support for the relationship as part of its international assistance programme. The German government has supported sub-contracting links between German SMEs, which are owned and operated by those of Croatian origin, and those operating in the under-developed southern regions of Croatia. In addition, many of the refugees returning to Croatia after several years spent in Germany are

also encouraged to establish an SME in order to take advantage of their employment and family links with German SMEs developed during their enforced absence.

Policy Recommendation: “Promote links between mainstream SME support organisations and business associations with diaspora communities. “

Questions for Discussion

What policies to encourage SME partnerships have proven to be the most efficient? Which policy tools are likely to be appropriate for a specific country or group of countries? What priority should be given to these partnership policies compared to other strategies to improve SME competitiveness?

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