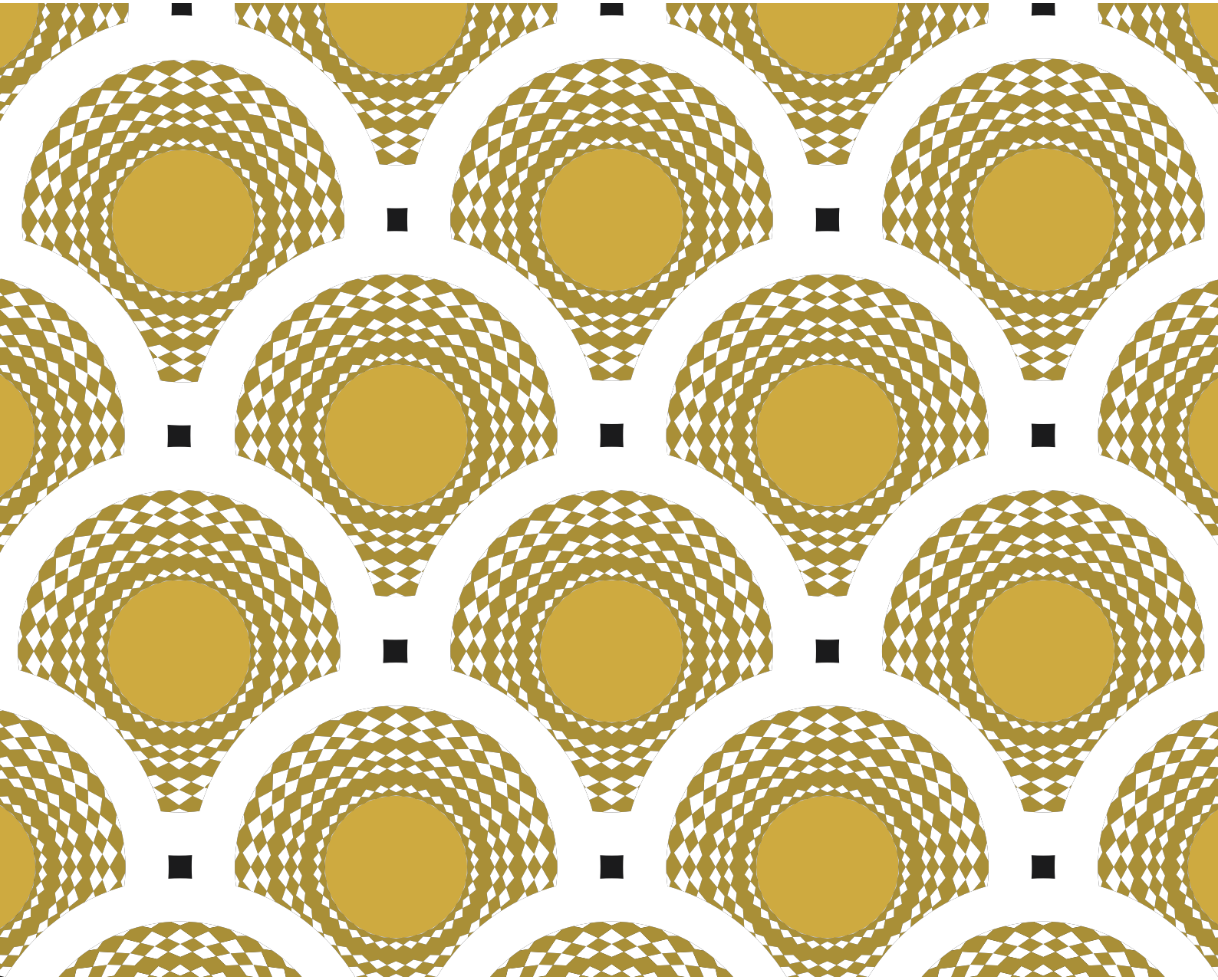
Integrating Southeast Asian SMEs in Global Value Chains

Enabling Linkages with Foreign Investors



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Integrating Southeast Asian SMEs in Global Value Chains

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Foreword

This joint OECD-UNIDO report identifies investment and related policies to enhance linkages between small and medium-sized enterprises (SMEs) in Southeast Asia and multinational enterprises (MNEs) and their impacts on SME outcomes in Southeast Asia. It is part of a joint OECD-UNIDO project comprising new policy research, quantitative and qualitative data collection and capacity building activities to support the development of linkages between SMEs and MNEs in Southeast Asia.

This report is a contribution to the Canada-OECD Project on ASEAN SMEs (COPAS). Under COPAS, the OECD is conducting policy research to develop new policy insights to support implementation of the ASEAN Strategic Action Plan on SME Development 2016-2025. The report is coordinated with the ASEAN Secretariat and its Members.

The report draws on evidence collected through an enterprise survey in Thailand, fact-finding missions in Lao PDR, Malaysia, Thailand, and Viet Nam, and desk research. It also draws on five background papers prepared for the purpose of the project: (1) a review of the literature on the determinants of FDI spillovers; (2) an empirical analysis of the extent and intensity of linkages in Viet Nam; (3) an empirical analysis of the impacts of partnerships on firm performance in ASEAN; (4) a case study of Samsung's mobile phone production in Viet Nam; (5) and an analysis of Thailand's outward FDI.

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Acronyms and abbreviations

ADB	Asian Development Bank
AEC	ASEAN Economic Community
AMS	ASEAN Member State
ASEAN	Association of Southeast Asian Nations
BOI	Board of Investment
BRI	Belt and Road Initiative
CLMV	Cambodia, Lao PDR, Myanmar and Viet Nam
CSR	Corporate Social Responsibility
EEC	Eastern Economic Corridor
EPZ	Export Processing Zone
ERIA	Economic Research Institute for ASEAN
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FTZ	Free Trade Zone
GDP	Gross Domestic Product
GVC	Global Value Chain
HQ	Headquarters
IPR	Investment Policy Review
Lao PDR	Lao People's Democratic Republic
M&A	Merger and Acquisition
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OLI	Ownership-Location-Internalisation
PEZA	Philippine Economic Zone Authority
R&D	Research and Development
RBC	Responsible Business Conduct
RCEP	Regional Economic and Comprehensive Partnership
SEZ	Special Economic Zone
SME	Small and Medium-sized Enterprise
THB	Thai Baht
CPTPP	Comprehensive and Progressive Trans-Pacific Partnership
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
USD	United States Dollars
WBES	World Bank Enterprise Survey
WTO	World Trade Organization

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Preface

by
Angel Gurría, Secretary-General of the OECD
and Li Yong, Director General of UNIDO

As the global economy becomes increasingly interconnected, governments need to address the challenge of bringing about socio-economic progress in an open environment. Foreign direct investment (FDI) offers a useful host of technology and financial resources that may 'spill over' to domestic firms and industries, thereby increasing their productivity and capability. Yet, FDI-reliant countries have experienced diverse outcomes, with some benefiting more than others. One of the many reasons for these diverse outcomes is the extent and quality of linkages between multinational enterprises (MNEs) and domestic firms, in particular small and medium enterprises (SMEs). Economies reaping the most benefits from FDI are also the ones that have been more successful in integrating their domestic firms into the global value chains (GVCs) of MNEs. Integration into GVCs serves as a powerful means to facilitate the transfer of technology, knowledge and skills, and widen access to finance and markets.

This publication, *Integrating Southeast Asian SMEs in global value chains: Enabling linkages with foreign investors,* documents the findings from a joint study by the OECD and UNIDO on leveraging foreign investment in GVCs to create opportunities for Southeast Asian SMEs. The publication's insights and recommendations support the implementation of the 2016-2025 ASEAN Strategic Action Plan on SME Development. As the region pursues its goal of becoming a highly integrated and cohesive economic zone by 2025, in line with the vision of the ASEAN Economic Community, countries need to consider their respective FDI and GVC strategies as well as how their national strategies will work as a whole. The challenges confronting individual Southeast Asian economies are not always the same, given that they are at different stages of development. As the more advanced economies come under the increasing pressure of declining cost advantages, they will need more investment and human capital in the skills- and technology-intensive segments of the value chains. On the other hand, the less developed economies will have to address more fundamental issues, such as basic infrastructure, as a first step towards supporting linkages and integrating into GVCs.

This study shows that it is never too early to consider linkage development in policymaking. While it is unlikely that all SMEs can integrate into global value chains, substantial scope exists in many Southeast Asian countries for their SMEs to forge linkages with MNEs. As local sourcing becomes an increasingly important feature of MNEs' global procurement practices, linkages in which SMEs serve as suppliers to MNEs are a singularly promising area. In forging such linkages, the constraints confronting Southeast Asian SMEs are not unique; relating primarily to the low absorptive capacity common among smaller firms. This presents an opportunity for policy intervention, ranging from the use of targeted fiscal incentives to supplier development and linkage promotion initiatives that benefit both SMEs and MNEs.

It is our hope that this joint study will contribute to the ongoing dialogue and engagement among Southeast Asian economies, paving the way for policy formulation and coordination which promotes equitable economic development in the region.

LI Yong
Director General, UNIDO

Angel Gurría
Secretary-General, OECD

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Executive Summary

Technical progress made possible the fragmentation and geographic dispersion of production into global value chains (GVCs). Firms participate in GVCs by combining trade, investment, movement of staff, and transfer of knowledge and technology, in an effort to optimise their international business strategies.

Leveraging FDI to enhance MNE-SME linkages is a policy opportunity

In ASEAN, small and medium-sized enterprises (SMEs) account for over 60% of employment and 98% of established enterprises, but less than 30% of value added and exports. This low productivity and output relative to high employment is generally attributed to SME-specific barriers to scaling up and accessing strategic assets. Research suggests that GVC participation can help alleviate these barriers and enhance the economic contribution of SMEs. While GVCs are typically a large-firm narrative, SMEs can plug into these value chains by supplying, sourcing from, or partnering with multinationals, or by becoming themselves multinationals. Leveraging foreign direct investment (FDI) to enhance SME participation in GVCs is an opportunity to guide ASEAN on an inclusive and sustainable development trajectory. SME development and integration into GVCs is a strategic objective of the ASEAN Secretariat, outlined in the ASEAN Strategic Action Plan on SME Development 2016-2025.

ASEAN is a leading destination for multinational enterprises

ASEAN has been one of the most successful emerging regions in terms of export-led growth, and a leading destination for multinational enterprises (MNEs) from all parts of the world for over three decades. Inflows have been dominated by Singapore's exceptional FDI attractiveness, but the combined expansion experienced by other ASEAN economies was similarly impressive, with a 25-fold increase over 1990-2016. Some ASEAN economies continue to attract low-skilled labour-intensive FDI (in garment manufacturing, for example), others increasingly attract investment in high-tech sectors, such as automotive production and electronics. Services have attracted the bulk of FDI inflows to ASEAN in recent years, though this partly reflects the services content of manufacturing value chains. The region also benefits from highly diversified investment in terms of source. Historically ASEAN received similar levels of investment from the developed economies in East Asia, Europe and North America, and more recently also from China.

Foreign MNEs source a significant share of inputs locally

Firm-level data suggest that foreign manufacturers in ASEAN member states (AMS) source a significant share of inputs from local suppliers (domestic and foreign) in all AMS, and constitute an important source of revenue for these suppliers, particularly in Indonesia and the Philippines. While ASEAN SMEs source most inputs locally (possibly due to high barriers to trade) there is some evidence that they also source from foreign MNEs established locally.

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Partnerships are prevalent in ASEAN manufacturing

Partnerships, broadly defined as repeated transactions between firms with joint business objectives that involve some degree of knowledge flow (irrespective of equity or contracts), are widespread in ASEAN, particularly Indonesia, Thailand, Viet Nam and Malaysia. Partnerships often take the form of joint ventures or contract manufacturing agreements; within manufacturing, they prevail in food processing, chemicals, plastic, metals, machinery and transport equipment.

Outward FDI from Southeast Asian countries is growing steadily

Although most ASEAN countries have been and continue to be major FDI destinations, they are also emerging as important sources of FDI in their own right, both in the region and overseas. Singapore is responsible for 70% of ASEAN's outward FDI (much of which is re-routed FDI of major international investors), though Malaysia and Thailand have become dynamic investors abroad, and their contribution is growing steadily. ASEAN outward investments are dominated by services (particularly financial services for Singapore and Malaysia), but Thai manufacturing investments in Cambodia, Lao PDR, Viet Nam and Myanmar (CLMV) are on the rise. Investors from other advanced manufacturing hubs in ASEAN, such as Malaysia, are also likely to increase their presence in CLMV, as they focus on higher-tech activities domestically, in an effort to remain competitive.

Linkages with foreign investors benefit domestic firms

FDI can benefit the host economy, by creating value and jobs, or by transferring knowledge, through supply chain linkages, market interactions and employee turnover. The empirical evidence on spillovers of FDI and partnerships to domestic firm performance is inconclusive, likely due to the inability to identify supply chain linkages. Original survey evidence from Thailand where linkages are reported shows that GVC linkages through trade, investment and partnerships are indeed associated with above average firm performance, both in terms of objective measures of productivity and of perceived improvements related to product quality, skills development and access to markets. Similarly, survey evidence from Viet Nam suggests that linkages with foreign buyers are positively related to the productivity of domestic suppliers. In both cases the direction of causality is likely to go both ways.

The materialisation of linkages depends on investor motives and SME capacities

Investor business strategies and domestic firm capabilities affect the materialisation of linkages and linkage-induced benefits. In Thailand, access to the regional markets and linkages with local suppliers are important motives for investors; and surveyed investors report efficiency gains as a result of sourcing from Thai firms. However, they report that foreign suppliers in Thailand offer higher quality products and have greater technological capacity. In fact, World Bank Enterprise Surveys suggest that the gap between foreign firms and local SMEs with respect to quality certifications, use of foreign technologies, and training of employees, is very high in some AMS. Moreover, survey evidence from Thailand supports the claim that international certification, often very costly for SMEs, but a pre-requisite for MNEs, increases the likelihood of participating in GVCs. Thus policies targeting skills and that facilitate certification can significantly improve domestic firms' capacity to absorb foreign knowledge, and successfully support linkages.

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Outward investment can also benefit the home country

Outward investment can positively impact employment, technology adoption and trade balance of home countries, when it allows the outward investors to scale up and raise efficiency, and when acquired knowledge is transferred back to the home country. The enterprise survey of Thailand suggests that manufacturers that invest overseas are 40% more productive than peers that export and import only, and 11 times more productive than firms that are not internationalised at all.

Outward FDI in ASEAN supports regional integration and SME participation in GVCs

Intra-ASEAN FDI enhances regional integration, and can create opportunities for ASEAN SMEs to plug into regional value chains, grow, and become themselves multinationals. Outward FDI is influenced by a variety of factors ranging from investor business models and local firm capabilities, to home and host country policies and economic conditions. Drivers of ASEAN manufacturing investments in CLMV countries, specifically, include saturated markets in more advanced ASEAN economies, relatively cheap and abundant labour in CLMV, geographic and cultural proximity, investment incentives, and land availability.

An enabling policy environment is crucial for MNE-SME linkages

The policy environment is a crucial ingredient for attracting foreign investment, enabling growth and competitiveness of local SMEs, and anchoring investors through deep linkages with the local economy. This report provides a framework for examining policies to improve the investment environment and support the development of local linkages with foreign investors. It then applies a similar approach to understanding policies that support outward investment of ASEAN firms, with a focus on intra-regional investments in less developed CLMV countries.

FDI liberalisation remains an unfinished agenda

Over the past five years, FDI inflows have been at record levels for many ASEAN countries, thanks to their increased attractiveness as both production bases and consumer markets, but also partly due to assertive policy interventions to reform FDI restrictions. However, while other emerging regions have further opened to FDI, some AMS are still lagging behind. According to the OECD FDI Regulatory Restrictiveness Index, six AMS are still among the top ten most restrictive economies to FDI based on a sample of more than 60 countries. In particular, significant progress remains to be made in liberalising services sectors, which could translate into greater productivity in downstream manufacturing, and deeper linkages between foreign investors and local SMEs.

Good contract enforcement procedures support local sourcing

The quality of contract enforcement procedures varies widely in ASEAN countries, with Singapore well above the OECD average, and Cambodia and Myanmar, well below average non-OECD levels. Good enforcement procedures are found to be associated with higher levels of local sourcing. This suggests that linkages with SMEs may be enabled by reforming the judicial system or providing alternative dispute settlement mechanisms in countries where contract enforcement is relatively poor (e.g. Cambodia and Myanmar).

Tax incentive schemes should be targeted to linkages and skills development

Tax incentives (particularly tax holidays) can impose significant fiscal costs on countries using them. In Cambodia, for example, the estimated revenue loss corresponds to up to 6% of GDP. International organisations and other institutions generally agree that targeted

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incentive schemes are to be preferred. Targeted incentives for SME and supplier engagement, have been demonstrated to be effective in Malaysia and Singapore, but must be accompanied by a credible effort to develop SME skills and capabilities.

Responsible business practices can be a signalling tool for ASEAN SMEs

Expectations about responsible business conduct (RBC) are growing and are increasingly being reflected in international agreements and in home country legislation. AMS have made efforts to address responsible investment, both through the implementation of the AEC Blueprint which contains provisions on RBC but also at national level, such as through national action plans. These initiatives not only bring about improved outcomes in terms of sustainable development but can also help to position the region as a reliable location for production and safe sourcing by helping to reduce the reputational risks faced by investors and thereby support MNE engagement with ASEAN SMEs.

Big data solutions can serve to level the playing field

Big data solutions, including blockchain technology and other fintech applications, can provide opportunities to facilitate SME compliance with RBC standards as well as alternative sources of finance. These solutions are quickly gaining ground in both advanced and developing countries and have the potential to accelerate SME development and create a more level playing field for SMEs. Policies that support digital infrastructure can facilitate adoption of big data solutions in ASEAN, which in turn have the potential to support SME linkages with foreign investors and participation in GVCs.

Successful SME linkage programmes require adequate financial commitment

ASEAN member states have, to varying degrees and with varying levels of success, put in place policies and programmes designed to deepen linkages between local SMEs and foreign MNEs. The majority of countries provide funding for vendor training and development programmes and have an agency that directly offers business matching services, while only two have put in place designated SME centres. Singapore and Thailand lead the way in terms of devising and implementing comprehensive policies for embedding their SMEs in global value chains. In other ASEAN countries, linkage programmes are not really operational or well-funded and there has been no report on their achievement levels, despite being articulated as a key policy priority. Effectiveness of these programmes in achieving the desired SME linkage impacts requires a strong political and financial commitment that is not observed in many ASEAN countries.

Special economic zones should be embedded in cluster development strategies

Special economic zones (SEZs) have been at the heart of successful export-led development strategies of ASEAN countries over many decades. The ASEAN region has more than 1,600 economic zones of various types. But the spread of backward linkages has varied greatly across countries and is by no means assured. Some ASEAN countries are converting their SEZ approach into a more elaborate and comprehensive strategy of cluster development, while reducing distortionary incentives for the support of strategic sectors. For example, in Malaysia and Thailand, stronger emphasis is given to SME development, in an active and successful effort to link foreign firms with local suppliers. Thus, while SEZ strategies have been successful in attracting FDI, they need to be complemented by policies that support skills and cluster development in order to have the desired spillovers on SMEs.

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Home country policies are important in fostering outward investments into CLMV

Policy plays an important role in promoting and facilitating internationalisation of firms through outward investment. For ASEAN, this is true both at the regional and national levels. Development of regional infrastructure, and harmonisation of procedures and standards can advance regional integration and greatly reduce barriers to outward FDI. At the national level, direct measures to support firms financially, technically, and through risk mitigation are useful tools to promote further investment in regional value chains. Singapore, Malaysia and Thailand have put in place policies, instruments and institutions to support outward FDI, including direct technical assistance, financial support, investment insurance and international investment agreements to protect investments. As information is reported as a significant barrier to outward investments, technical and financial supported aimed at reducing informational barriers are particularly important. At the same time, outward FDI support policies should be simple to understand and access for potential beneficiaries.

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1. Why study SME linkages with foreign investors?

This introductory chapter presents a simple conceptual framework to describe the channels through which SMEs can participate in GVCs, arguing that integration in GVCs has predominately been viewed through the lens of trade and highlighting the important role FDI can play through supply chain linkages between local SMEs and foreign MNEs. It further discusses how inward and outward direct investment and a wide range of partnerships may support greater knowledge transfer and stronger participation in GVCs. The framework serves as a reference for the discussions in subsequent chapters.

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GVCs offer an opportunity for SME development in ASEAN

Reductions in transport and communication costs have made it possible for firms to establish production chains that are geographically dispersed across the world. Global value chains (GVCs) have enabled firms to combine multiple channels – imports, exports, foreign direct investment (FDI), movement of personnel, and knowledge – to optimise international business strategies and enhance productivity.

Through their activities in home and foreign markets, MNEs are estimated to account for roughly one-third of global output and between 50-60% of global exports (De Backer and Miroudot, 2017). MNEs also source inputs and services from their networks of suppliers. Taking these supply-chain linkages into account, MNEs may be responsible for up to 80% of global trade (OECD-WTO-UNCTAD, 2013).

Recent estimates suggest that SMEs represent over 98% of all established enterprises, and are responsible for over 60% of employment in all AMS (see Box 1.1 for the definition of SMEs in ASEAN used in this report). Due to relatively low productivity, however, SMEs are responsible for less than 30% of value added and exports in most ASEAN countries (Lopez-Gonzalez, 2017). This mismatch between high aggregate employment versus low productivity and output has traditionally been attributed to SME-specific constraints, related to size and inexperience, preventing economies of scale and access to strategic resources (OECD-World Bank, 2017).[1]

While these constraints lower opportunities for SMEs to be competitive global market players (Bernard et al., 2007), research suggests that GVC participation can provide a channel through which these constraints can be relaxed, by allowing firms to access new markets, technologies, services, capital and high-quality intermediates at competitive prices (OECD-World Bank, 2017). Enabling SMEs to integrate into GVCs can enhance their economic importance and support more inclusive growth in the region (OECD, 2016a).

GVC benefits for SMEs are enhanced if businesses – be it investing MNEs or SMEs themselves – engage in responsible business conduct (RBC). RBC means that businesses avoid and address negative consequences of their operations, while contributing to sustainable development of the countries where they operate. This includes integrating and considering environmental and social issues within core business activities, including throughout the supply chain and business relationships.[2]

The ASEAN region has received considerable foreign investment over recent decades. Local firms have also started to invest abroad, both within and outside the region. Drawing on these investments to enhance participation of SMEs in GVCs and increase their economic importance is an opportunity for supporting inclusive and sustainable growth. SME development and integration in GVCs is a strategic objective of ASEAN member states, as outlined in the ASEAN Strategic Action Plan on SME Development 2016-2025 (ASEAN, 2015).

[1] See also ADB (2015) and (2016); UNIDO (2015); and Harvie, (2015)

[2] The main international instruments on RBC were aligned in 2011 – including notably the OECD Guidelines for Multinational Enterprises (OECD Guidelines) and the UN Guiding Principles for Business and Human Rights (UN Guiding Principles). Increasingly, international trade and investment agreements and national development strategies, laws, and regulations (also in ASEAN) include RBC expectations.

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Box 1.1. Some definitions

What are SMEs?

There is no universally-accepted definition of SME, and no unique definition among ASEAN countries. The definition is typically a function of number of employees, annual turnover, value of fixed assets, value of invested capital, or a combination of the above. In some countries (including Indonesia, Malaysia, Singapore and Thailand) the definition varies by industry. For example, in Thailand, SMEs in manufacturing are defined as firms with no more than 200 employees and 2 million Baht in fixed assets; these thresholds are lower for SMEs in retail and whole services. In Singapore, an SME is a firm that employs fewer than 200 workers or with a turnover of less than S$100 million. This report assigns a common definition of SMEs for all ASEAN countries that is consistent with OECD work in the region: ***SMEs are firms with fewer than 200 employees.*** Where data limitations require using a different definition, the applied definition is specified.

Source: OECD-ERIA (2014); ADB (2015); OECD (2016b); Lopez-Gonzalez (2017)

What are foreign firms?

Firms are defined as foreign when ***foreign investors own at least 10% of their equity stocks***. This is in line with the *OECD Benchmark Definition of Foreign Direct Investment,* according to which "lasting interest" in an affiliate that is resident in an economy other than that of the direct investor is evidenced when the direct investor owns at least 10% of the voting power of the direct investment enterprise. Transactions between direct investors and such direct investment enterprises are thus included in OECD FDI statistics.

Source: https://www.oecd.org/daf/inv/FDI-statistics-explanatory-notes.pdf

What are partnerships?

In a broad sense, a partnership is a cooperative endeavour between firms driven by joint business objectives. While equity stake may be present in partnerships, it is neither a prerequisite nor a defining characteristic. This distinguishes partnerships from FDI, in which equity stake in affiliates is considered fundamental for the purpose of control. Equity-based partnerships (i.e. joint ventures) involve the creation of a new entity to undertake a specific project. Profits and risks are shared for the duration of the project, but the parties involved remain separate legal entities. On the other side of the spectrum, partnerships also include (domestic and cross-border) trade transactions underpinned by contractual terms and conditions that seek to minimise costs of externalisation and protect assets, technology and IP of all parties. Such contractual partnerships are often vertical (e.g. contract manufacturing) and repeated and will be interchangeably referred to in this report as deep trade linkages. Partnerships that are distinct from both equity investments and trade transaction are often horizontal and referred to as strategic alliances. They can involve sharing products, distribution channels, manufacturing capability, capital equipment, expertise, or intellectual property.

For the purpose of this report, the defining characteristic of a partnership is that it involves ***repeated interactions*** and some degree of ***knowledge transfer***, (irrespective of whether it is vertical, horizontal, equity-based or contractual).

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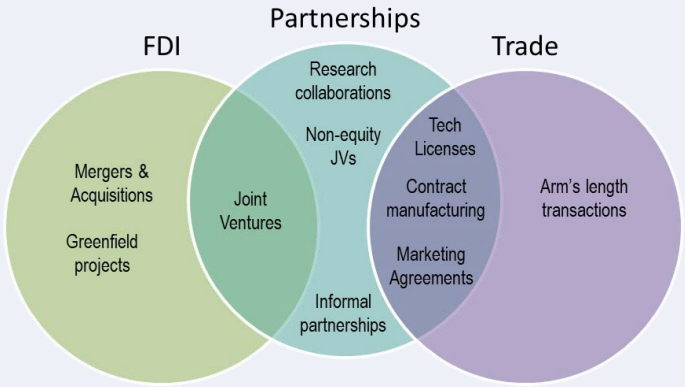
Stylised illustration of cooperative business relationships



Note: The figure is not intended to be exhaustive of all types of cooperative business relationships.
Source: OECD (2008); UNCTAD (2011); Thomson & Reuters (2018)

Not all SMEs have the potential to integrate in GVCs

It is important to bear in mind that not all SMEs have the potential to become highly productive firms that contribute to long-term growth and competitiveness or that are able to integrate into GVCs (e.g. corner-shops, hair dressers or small restaurants). Simply put, the mass of SMEs may never access GVCs (which is not necessarily an issue but should be acknowledged). Moreover, a focus on smaller firms overlooks the experience of firms that have been small in the past but have overcome barriers to growth and internationalisation. The manner in which they overcame these barriers can provide instructive lessons for AMS.

In order to account for these concerns, this report includes statistics and analysis on both large firms and SMEs to compare these two groups, and identify policies and programmes that can enable GVC integration for SMEs with adequate capabilities. In this context, it is important to reflect on whether and how SME policies can be developed to support SME development. This requires a delicate balance, as SME-specific policies and support programmes can have distortionary effects in that they may create disincentives for firms to grow (Cusmano, 2016).

GVC participation involves multiple channels

This study follows a simple conceptual framework that illustrates a potential trajectory of SME participation in GVCs through supply chain linkages, and how inward and outward direct investment and contractual partnerships may help strengthen SME participation in GVCs (Figure 1.1).[3] This framework was used as a reference in guiding the data collection methodology for this study (Box 1.2).

[3] This stylised illustration reflects one possible evolution of SME participation in GVCs, but avenues for upgrading that do not involve inward or outward FDI are also possible, and will be the focus of other components of this project. Moreover, the framework only considers collaborative linkages between foreign MNEs and domestic SMEs, but FDI can also crowd SME activity through increased competitive pressures.

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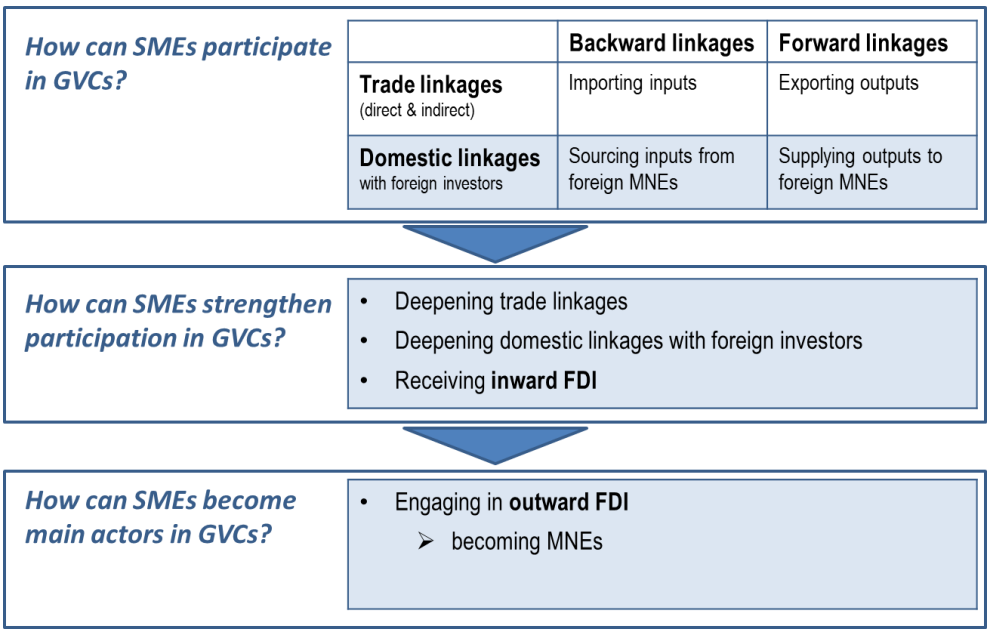
Figure 1.1. A conceptual framework for SME participation in GVCs



SMEs access GVCs through supply chain linkages

SMEs often access GVCs via arm's length supply chain transactions, involving the purchase and sale of goods and services (Figure 1.1, top). These transactions constitute trade linkages when SMEs directly or indirectly import and export (Lopez-Gonzalez and Munro, 2017). Alternatively, SMEs participate in GVCs by supplying to or sourcing from local affiliates of foreign MNEs (FDI linkages), or by supplying larger, more established domestic firms which in turn supply inputs to foreign MNEs. SME participation in GVCs has predominately been studied through the lens of trade, namely direct imports of inputs and exports of outputs. New OECD work focuses on indirect trade as a channel of SME participation – in other words, SME sales of inputs to larger firms that are further processed and then exported (Lopez-Gonzalez and Munro, 2017). Evidence on the role of FDI for SME participation in international production networks is emerging but remains more limited (OECD-World Bank, 2017; UNCTAD, 2011). This report focuses on FDI channels, though it is important to keep in mind that SME integration in GVCs through investment is often additive and complementary to integration through trade.[4]

SMEs strengthen participation in GVCs through deeper linkages and FDI

Greater involvement in GVCs is expected when SMEs forge deeper linkages beyond arm's length transactions with foreign firms, both domestically and abroad (Figure 1.1, middle). These deep linkages – described at length in the next chapters – essentially involve repeated interactions and greater knowledge flows. In practice, they can take many forms, including partnerships, contractual arrangements, technology licenses, franchises, research

[4] The trade channels are studied under a different component of the COPAS project. The interrelations of trade and investment channels for SME integration in GVCs will be examined in a COPAS synthesis report.

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collaborations, as well as informal arrangements. For the purpose of this study, we will refer to them broadly as partnerships (see Box 1.1 above). Alternatively, deep linkages can arise when SMEs receive direct equity investments from foreign firms (inward FDI). Strengthened GVC participation through deep trade or FDI linkages can in some cases result in upgrading, including getting better at producing goods, moving to different tasks within the value chain, or changing the activity altogether.[5]

SMEs can become main actors in GVCs through outward investment

As SMEs grow and develop, and as domestic markets grow, what SMEs produce at home may also evolve. Relative cost differentials, access to technology and skills, or access to new markets may push SMEs that are at a more advanced stage of development to invest abroad, become multinational and grow into larger corporations (Figure 1.1, bottom). It is important to have the full potential growth trajectory of an SME in mind and to design policies that support firm growth and long-term competitiveness.

Chapter 2 provides an overview of the extent of participation in GVCs of ASEAN SMEs through the various channels described in the conceptual framework.

SMEs benefit from foreign investment

FDI can have beneficial impacts on SMEs in both host and home countries. Beyond immediate and direct impacts such as inflows of financial capital and creation of new business opportunities, FDI linkages can enable firms in host countries to develop managerial skills, improve products, innovate, reduce costs, improve working conditions, or shift to more sustainable production practices.[6] Similarly, outward investors can acquire new knowledge and technologies by investing abroad and transfer it back to parent companies and potentially other firms in the home country

Most studies on FDI impacts have focused on the extent to which FDI creates economic spillovers in host economies.[7] Often these studies do not directly observe linkages or knowledge transfer, but look at how the presence of FDI is correlated with SME outcomes (particularly productivity and export performance), or at the more aggregate level how FDI is related to economic growth in host economies. Findings from this literature are mixed (Alfaro, 2017), but suggest that FDI-driven productivity spillovers to SMEs do not always materialise. Where spillovers are present, they are typically associated with supply chain linkages between foreign investors and local firms, which in turn are influenced by investor motives and local firm capacities.

Chapter 3 explores FDI-driven benefits to the host economy through supply chain linkages, and examines firm-level factors that determine linkages, including original empirical evidence in relation to partnerships, and survey evidence of linkages. The chapter then examines the benefits and determinants of outward investment from the perspective of the home country.

[5] Note that FDI can at the same time lead to greater market consolidation.

[6] It is important to note that MNE-SME linkages do not always result in benefits for SMEs. For example, it is often argued that MNEs dominating GVCs exert unfair price pressure on SMEs.

[7] See Tusha, Jordaan and Seric (2017) and Tong (2018) for a literature review. Both studies serve as background papers for this report.

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An enabling policy framework matters

Existing evidence shows that host country policies (e.g. on trade, investment, labour, taxation, education, etc.) affect the extent to which MNE-SME linkages materialise, and whether they enhance SME outcomes (Farole and Winkler, 2014).[8] While many governments have put in place policies and programmes targeting MNE-SME linkages and their associated benefits, evidence on whether and under what conditions these policies are effective is limited.[9] Similarly, limited evidence exists on how home country policies can support firm internationalisation through outward investment that produce benefits for the investing country.

Chapter 4 provides a framework for understanding how host country policies can enable FDI that produces opportunities for SMEs through business linkages, presenting and discussing evidence from ASEAN. The second part of the chapter puts forward a framework for understanding how home country policies can support outward investment of domestic firms with a focus on intra-regional investments directed at CLMV countries.

Box 1.2. Brief methodological note

OECD-UNIDO Thai Enterprise Survey 2018

An original survey of enterprises in Thailand was undertaken to provide insights on the determinants and benefits of participation in GVCs through the various channels depicted in the conceptual framework (Figure 1.1). The Thai survey was launched in April 2018 after a pilot phase of one month. The survey was administered face-to-face by a survey management company based in Bangkok, over a period of four months. Of the 300 enterprises that participated, 250 responses from manufacturing sectors are considered for this study. See Annex 1.A for a full description of the sample.

It is important to note that the survey sample is *not* intended to be representative of the general population of firms; sectors of strategic importance were deliberately over-sampled, while many sectors were left out. As discussed in in this chapter, not all SMEs have the potential to integrate in GVCs. Given limited resources, government efforts to support linkages should focus on areas of greatest potential and SMEs with adequate capabilities. For this reason, relatively more weight is given to larger enterprises.

Business interviews

Beyond surveys, the data collection approach involved semi-structured qualitative interviews focusing on the outward FDI from Thailand to CLMV countries. In Thailand, meetings were held with firms that have production operations in Thailand and CLMV countries. In Lao PDR, interviews were held with MNEs and SMEs that initially established production operations in Thailand and recently relocated some of these operations to Savan-Seno Special Economic Zone in Savannakhet. Specifically, 12 semi-structured face-to-face interviews were held with 7 Thai firms and 5 foreign investors in Thailand. Annex 1.B provides an overview of the business interviews.

[8] See also Perez-Villar and Seric (2015) for a discussion on the role of institutional quality in driving interfirm linkages.

[9] See Görg and Seric (2015) for a study of the African context.

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Case study

The case study on Samsung mobile phone production in Vietnam was based on an analysis of secondary materials as well as semi-structured interviews with 35 firm and non-firm actors. Those interviewed were: Samsung's Vietnam subsidiary; 4 foreign firms (all 100% owned by South Korean interests); 12 domestic firms (all 100% owned by Vietnamese interests); 11 central and local government agencies; 6 quasi-government bodies and industry trade groups; and one university.

Secondary data sources

This study also uses a variety of secondary data sources at different levels of aggregation; namely, country-level FDI statistics (UNCTAD, ASEAN) and regulatory climate indicators (World Bank Doing Business); firm-level information (World Bank Enterprise Surveys, FactSet, UNIDO Viet Nam Investor Survey); and, project-level information on partnerships (Thomson & Reuters).

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Annex 1.A. The OECD-UNIDO Thai Enterprise Survey 2018

Sampling

Annex Table 1.A.1. Target and realised sample

Strata	Description	Target	Realised
Sector	Food products, beverages and tobacco (ISIC 15-16)	50	82
	Textiles, textile products, leather and footwear (ISIC 17-19)	50	55
	Basic and fabricated metals; machinery (ISIC 27-33)	50	75
	Motor vehicles and other transport equipment (ISIC 34-35)	50	38
	Business services (ISIC 72-74)	50	50
Size	<100 employees	120	170
	100-199 employees	90	24
	200+ employees	90	88
Ownership	Domestic	210	253
	Foreign	90	47
Export	Yes	120	164
	No	180	136
Location	Bangkok	150	114
	Outside Bangkok	150	186
Total		300	300

Note: This report only focuses on manufacturing sectors, while the sampling table includes also services.
Source: OECD-UNIDO Thai Enterprise Survey 2018

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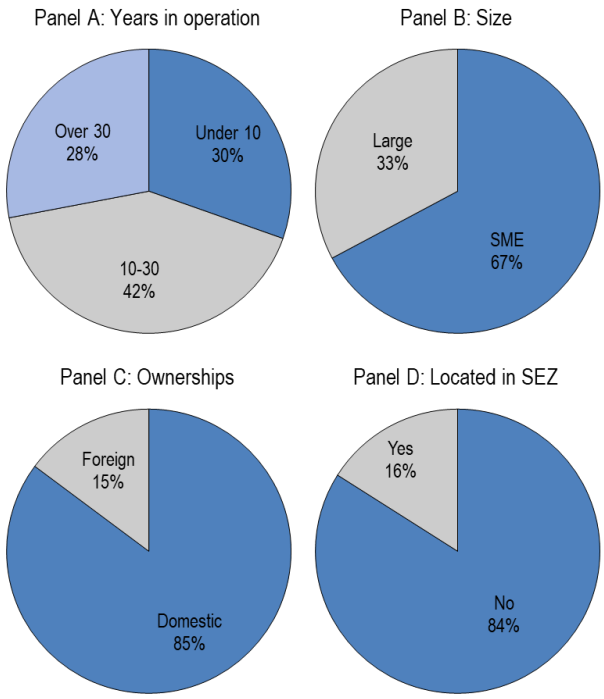
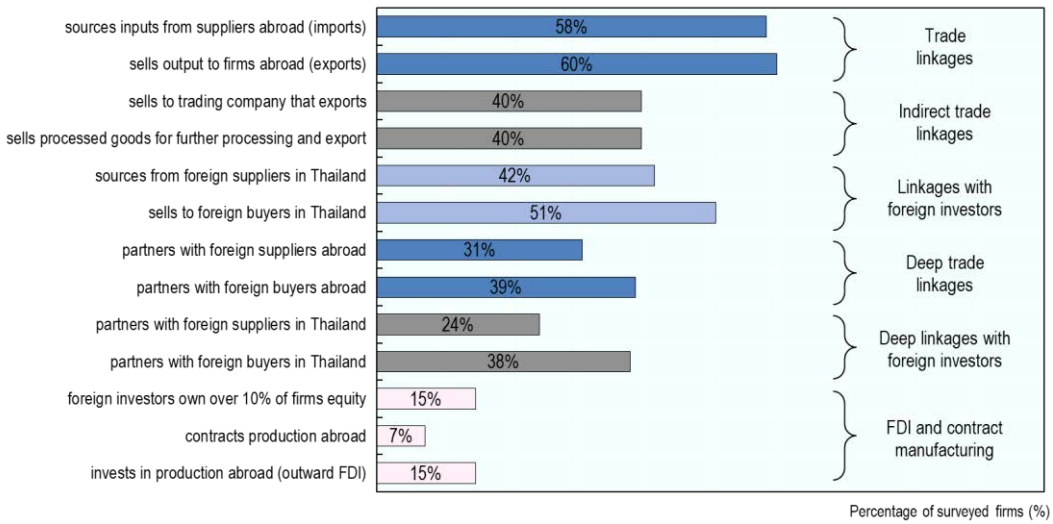
Summary statistics

Annex Figure 1.A.1. Age, size, ownership, location



Note: The figure is based on 250 responses of enterprises with manufacturing operations in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey 2018

Annex Figure 1.A.2. Extent and type of GVC linkages



Note: The figure is based on 250 responses of enterprises with manufacturing operations in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey 2018

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Annex 1.B. Semi-structured interviews

This annex provides an overview of interviews conducted in Bangkok, Thailand, and Savan-Seno SEZ, Lao PDR, for the purpose of this study. All interviews were conducted between March and April 2018.

Annex Table 1.B.1. Overview of business interviews

Firm/ interview number	Sector/ value chain	Supply chain role	Origin	Subsidiary in Thailand	Subsidiary in CLMV
1	Agro-food processing	Lead company	Thailand	Yes	LAO
2	Electronics	Lead company	Thailand	Yes	No
3	Electronics	Lead company	Canada	Yes	LAO
4	Electronics	Lead company	Japan	Yes	LAO
5	Electronics	Lead company	Japan	No	LAO
6	Electronics	Local supplier	Japan	No	LAO
7	Garments/ textiles	Global supplier	Thailand	Yes	LAO, KHM, VNM
8	Automotive	Lead company	Japan	Yes	LAO
9	Renewable energy	Lead company	Thailand	Yes	LAO
10	Logistics	Lead company	Thailand	Yes	LAO
11	Logistics	Lead company	Thailand	Yes	MYM
12	Logistics	Lead company	Thailand	Yes	No

Note: LAO = Lao PDR; KHM = Cambodia; VNM = Viet Nam

Annex Table 1.B.2. Overview of interviews with government and private stakeholders

Sector	Agency	Country
Business Association	Thai Chamber of Commerce	Thailand
Business Association	Thailand Board of Trade	Thailand
Business Association	American Chamber of Commerce	Thailand
Business Association	Joint Foreign Chamber of Commerce	Thailand
Business Association	Thailand-Laos Business Council	Thailand
Business Association	Office of Small Medium Enterprise Promotion	Thailand
Government	Investment Promotion Department, Ministry of Planning and Investment	Lao PDR
Government	National Institute for Economic Research	Lao PDR
Government	Central Institute for Economic Management (Ministry of Planning and Investment)	Viet Nam
Government	Savannakhet Special Economic Zone Authority	Lao PDR

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2. What is the state of FDI and SME linkages in ASEAN?

This chapter examines the important role of FDI in ASEAN's development trajectory and integration in global value chains (GVCs). It begins with an overview of inward investment trends, in relation to ASEAN's industrialisation, export and growth dynamics. Following the conceptual framework presented in Chapter 1, the remainder of the chapter maps the extent to which ASEAN firms participate in GVCs through supply chain linkages with foreign MNEs, partnerships and outward investment. The mapping makes use of firm-level data to construct novel indicators of supply chain linkages, giving particular attention to SMEs.

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Summary

The ASEAN region has been one of the most successful emerging regions in terms of export-led development in part through foreign direct investment (FDI), and a leading destination for multinational enterprises from all parts of the world for at least three decades. Inflows have historically been dominated by Singapore's exceptional FDI attractiveness, but the combined expansion experienced by other ASEAN economies was similarly impressive, with a 25-fold increase over 1990-2016, against a backdrop of rising global FDI flows.

ASEAN receives investment not only in labour-intensive industries but increasingly in high-tech sectors such as automotive production and electronics. Services have received the bulk of ASEAN FDI inflows in recent years; although some of this shift also represents the services content of GVCs in manufacturing. The region also benefits from highly diversified investment by country of origin. Historically ASEAN has received similar levels of investment from the developed economies in East Asia, Europe and North America, and more recently also from China.

FDI can serve as a conduit for SMEs to access global value chains through supply chain linkages with foreign multinationals. Using novel indicators based on firm-level data, this chapter explores the extent of linkages between foreign MNEs and ASEAN firms. The analysis suggests that foreign manufacturers in AMS establish substantial upstream linkages with local producers, and constitute an important destination for the intermediate goods they produce, particularly in Indonesia and the Philippines where foreign firms purchase over 45% of locally-produced intermediates. Local firms (large and small, foreign or domestic) account for the bulk of all intermediates supplied to foreign firms, in all developing AMS. While SMEs source most inputs locally (possibly due to higher barriers to trade) there is some evidence that they also source from foreign MNEs established locally.

Partnerships are widespread in ASEAN, particularly Indonesia, Thailand, Viet Nam and Malaysia where the number of partnerships in the manufacturing sector exceeded 200 over 2010-16. Within manufacturing, partnerships are mostly observed in the form of joint ventures and contract manufacturing agreements, in processed foods, chemicals and plastic, basic and fabricated metals, and machinery and transport equipment.

Although most ASEAN countries have been and continue to be major FDI destinations, they are also emerging as important sources of outward FDI in their own right, both in the region and further afield. Singapore alone is responsible for around 70% of ASEAN's outward FDI, though Malaysia (13%) and Thailand (8%) have become dynamic investors abroad, and their contribution is growing steadily. ASEAN outward investments are dominated by services (particularly Singaporean and Malaysian investments in financial services), but Thai manufacturing investments in CLMV countries are on the rise.

ASEAN is a rising hub for GVC investments

The establishment of the Association of Southeast Asian Nations (ASEAN) in 1967 set in motion new and lasting developments in FDI flows into the region. Thanks also to its strategic geographic position, and its historical role as a trade hub, FDI flows into ASEAN shifted from mining and extraction activities, to increasing investments in trade, communication and manufacturing. Early investments in manufacturing sought primarily

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to serve the national and regional markets, and to overcome the high tariffs associated with the newly-independent countries' import-substitution policies (ASEAN, 2017).

In the 1970s and early 1980s, multinational enterprises (MNEs) of OECD countries were confronted with rising input prices, stagnating markets and declining profits, partly due to economic turmoil. As these MNEs sought new business and production strategies to cut costs, they were drawn to developing countries with lower labour costs as new production locations. Reductions in transport and communication costs triggered the international fragmentation of their production processes into global value chains. Together with currency realignments after the Plaza Accord and macroeconomic stabilisation policies of the mid-1980s, this boosted FDI flows from developed to developing countries (OECD, 2018). In this new paradigm, capital- and skills-intensive activities were retained in the investing developed economies, while low-value added labour-intensive activities were offshored to developing countries, such as AMS.

Strong FDI inflows in ASEAN were not only the result of external factors. Closer regional integration efforts pursued by the ASEAN countries (e.g. the signing of agreements in 1992 to create the AFTA and lowering tariff rates to 0-5% for goods originating from within ASEAN by 2010) were an important factor which led to recalibration of regional value chains and attracted FDI from outside and inside ASEAN. Concurrently, AMS replaced import substitution policies with export promotion policies, further attracting export-oriented MNEs (ASEAN, 2017).

As production chains fragmented and spread across borders, ASEAN attracted disproportionately more FDI relative to other developing regions. The share of ASEAN in total developing country FDI stocks increased from just above 5% in 1980 to 20% in 1996 (Figure 2.1).[10] The Asian Financial Crisis of 1997-98 and its aftermath negatively affected investor perceptions of economic and political stability in some AMS. At the same time, foreign investors were increasingly attracted to China's huge domestic market and low costs of production. The combined effect was a reduction in ASEAN's share in developing country FDI stocks, down to approximately 15% in 2001, which was restored by 2016 with a new boost to FDI inflows. Investment attractiveness relative to OECD countries remained stable at about 5% until the early 2000s but then also experienced a boost. By 2016, ASEAN FDI stocks relative to those of the OECD were at 10%.

Inflows of FDI into ASEAN over the past three decades have been dominated by Singapore's exceptional FDI attractiveness. Singapore alone experienced a 36-fold increase of FDI stocks since 1990, from USD 30 billion to almost USD 1100 billion in 2016 (Figure 2.2, Panel A). The combined increase of other ASEAN economies was similarly impressive with a 25-fold increase of FDI stocks over 1990-2016, from USD 30 billion to USD 775 billion. By 2016, Singapore hosted almost 60% of total FDI stocks in ASEAN, followed by Indonesia, Thailand and Malaysia (13%, 10% and 6%, respectively). CLMV countries[11] jointly accounted for 9% of total ASEAN FDI stocks, of which 70% are located in Viet Nam (Figure 2.2, Panel B).

[10] Total developing country stocks are based on UNCTAD's development status classification: http://unctadstat.unctad.org/EN/Classifications/DimCountries_DevelopmentStatus_Hierarchy.pdf

[11] Cambodia, Laos, Myanmar and Viet Nam

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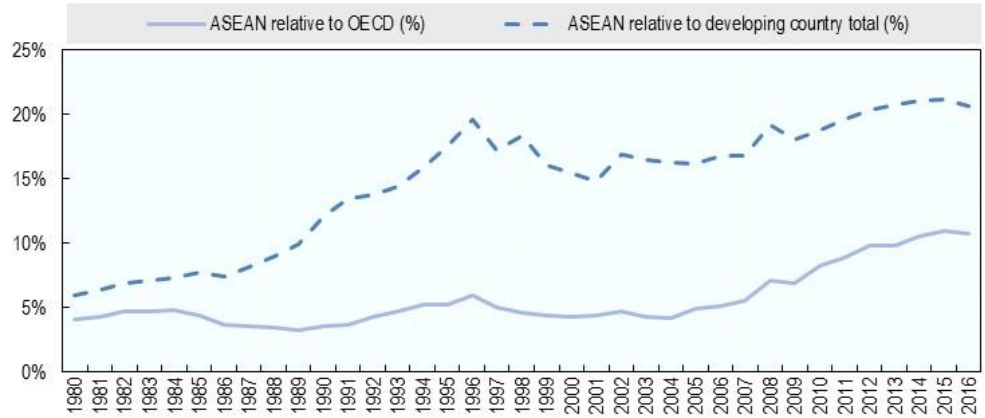
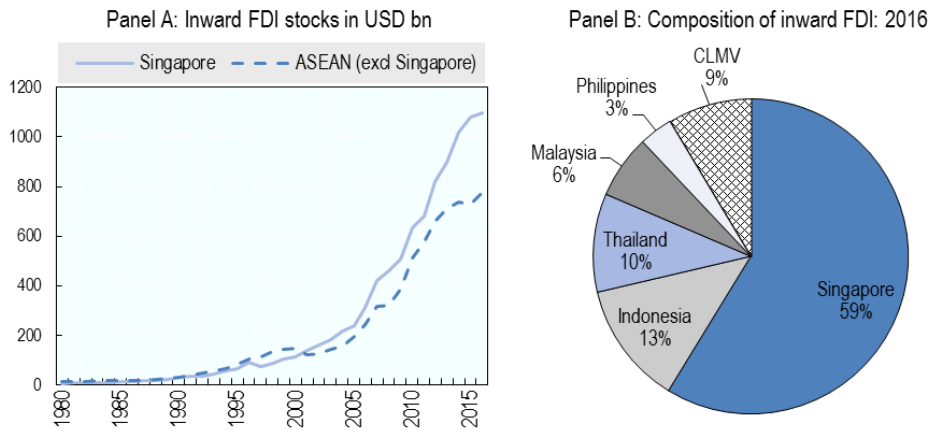
Figure 2.1. ASEAN became an increasingly attractive investment destination

ASEAN inward FDI stocks relative to OECD and developing country total, 1980-2016



Note: Developing countries is based on UNCTAD development status grouping, available at: http://unctadstat.unctad.org/EN/Classifications/DimCountries_DevelopmentStatus_Hierarchy.pdf
Source: UNCTAD FDI statistics

Figure 2.2. Inward FDI stocks increased in ASEAN but growth was driven by Singapore



Source: UNCTAD FDI statistics

A closer look at FDI in ASEAN

Rapid expansion of FDI stocks was a key driver of industrialisation and export growth for ASEAN. Six out of ten AMS are among the 20 countries in the world that have increased their shares of non-resource based manufacturing exports the most over the past three decades (ASEAN, 2017). Relative to GDP, FDI stocks expanded in all AMS over 1996-2016 (Figure 2.3). In 2016, FDI stocks amounted to 76% of ASEAN GDP, up from 25% a decade ago. Excluding Singapore, the ASEAN FDI stock represented less than 45% of GDP in 2016; still higher than the same ratio for the OECD, at just above 35% in 2016.

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Services received the bulk of ASEAN FDI inflows during recent years; although some of the shift also represents the services content of GVCs in manufacturing (OECD, 2018).[12] Singapore accounts for most services FDI inflows and much of those investments are made in the financial sector. In 2016, the services sector accounted for 73% of ASEAN inward FDI stocks, a ratio that is similar to the OECD aggregate (70% in 2015) and to the global trends (UNCTAD, 2017). In the early 2000s, the sector accounted for around 50% of total FDI flows received by ASEAN. A decade later, the accumulated FDI flows received between 2012 and 2016 by the services sector represented more than two-thirds of total inward FDI flows (Figure 2.4, Panel A). In contrast, the share of ASEAN manufacturing FDI fell, as the sector attracted less than 20% of total inward FDI received by ASEAN in the past five years. Within the manufacturing sector, AMS receives not only labour-intensive FDI (in garment production, for example), but also, and increasingly, investment in high-tech sectors such as automotive and electronics production.

Beyond the strong performance of Southeast Asia in attracting FDI, the region also benefits from one of the most diversified sources of investment. It has historically received investment in roughly equal proportions from the developed economies in East Asia, Europe and North America. Over 2012-16, the shares of FDI inflows from Japan, the EU, the US accounted for 13%, 18% and 14%, respectively (Figure 2.4, Panel B). It has also received investments from Chinese Taipei, Hong Kong (China) and more recently from China. Different investors have a preference for locating in different AMS and the sectors involved vary widely. This ability to attract investment from a diverse and increasing number of countries has been one of the traditional strengths of the region and contributes to potentially more resilient ASEAN economies (OECD, 2018). A considerable share of sales of Japanese and US MNE in ASEAN serves the local and regional markets, suggesting that many MNEs invest to benefit from proximity to those markets and may be less likely to relocate outside the region (OECD, 2018).

Finally, rising intra-regional FDI further supports the development of an integrated regional market. Historically around one fifth of total FDI inflows, intra-ASEAN FDI increased to one fourth over 2012-16. Investments from Singapore account for almost two thirds of intra-ASEAN FDI (Figure 2.4, Panel B). Intra-regional FDI is particularly important for CLMV countries, as MNEs from Malaysia, Singapore and Thailand (including foreign MNEs with production facilities in these more advanced ASEAN manufacturing hubs) establish production operations abroad. CLMV countries are a natural choice for these MNEs as they seek to exploit complementary resources, differences in comparative advantage, and regional trade integration to increase the efficiency of their supply chains. The end of this Chapter will examine in more detail intra-regional outward FDI in CLMV countries.

[12] Recent estimates indicate that FDI in the services sector may be overestimated by more than a third because of the current industry classifications: a large part of FDI allocated to services in FDI statistics reflects regional headquarters functions or operations carried out by holding companies, even when parent companies operate in the manufacturing or primary sectors (UNCTAD, 2017).

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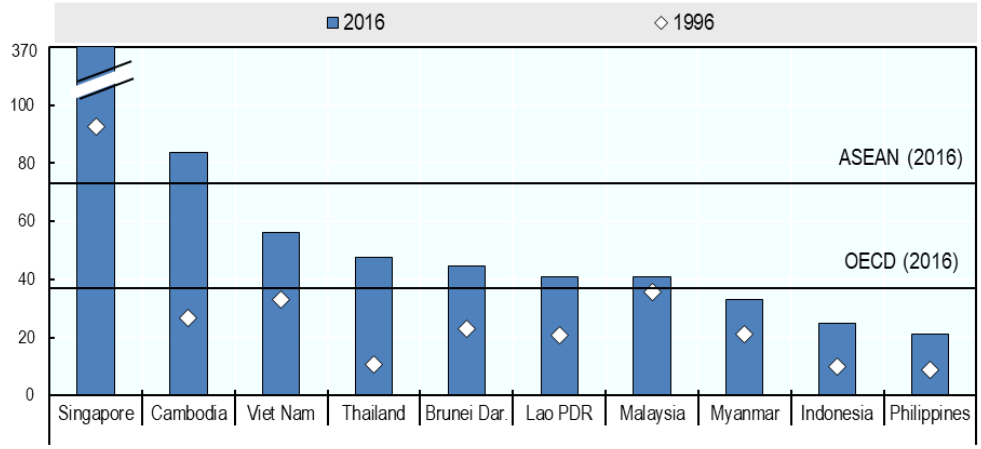
Figure 2.3. FDI stocks in ASEAN have expanded faster than GDP over the last two decades

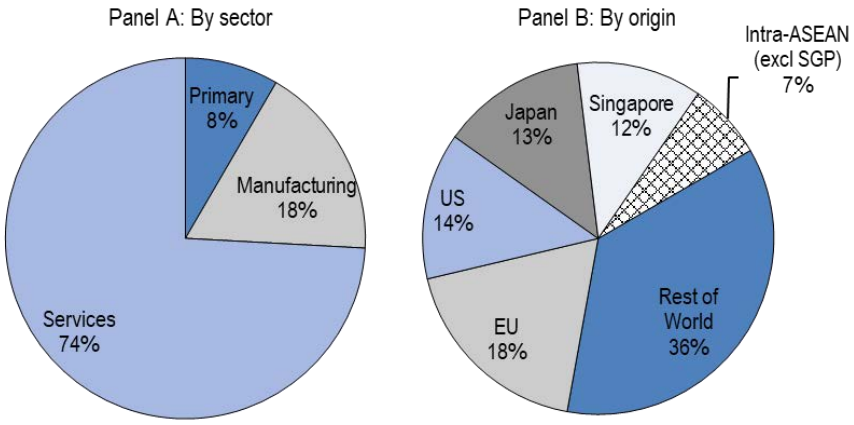
Inward FDI stocks relative to GDP (in %)



Source: UNCTAD FDI statistics

Figure 2.4. The bulk of FDI inflows goes to services, and comes from EU, US, Japan and Singapore

Cumulated FDI flows into ASEAN, 2012-16



Source: ASEAN FDI statistics

Supply chain linkages with foreign MNEs are widespread in ASEAN

As mentioned before, leveraging the considerable foreign investments in ASEAN offers an important opportunity for SME development and integration in GVCs and is a strategic objective of ASEAN countries (ASEAN, 2015). The remainder of this chapter focuses on measuring the extent of supply chain linkages between foreign MNEs and SMEs in ASEAN. The indicators focus exclusively on the manufacturing sector and are based on the most recent World Bank Enterprise Surveys of AMS. See Box 2.1 and Annex 2.A. for more details on the data, methodology and limitations associated with the indicators.

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Box 2.1. Four novel indicators of supply chain linkages in ASEAN

Four novel indicators of the extent of supply chain linkages between foreign and domestic firms were developed for the purpose of this report, using manufacturing firm-level data from the most recent World Bank Enterprise Surveys (2015-16) of eight ASEAN member states. These indicators can be produced for more than 100 countries. Broadly speaking, the indicators answer the following questions:

- *Indicator 1*: To what extent do foreign MNEs in ASEAN source locally?
- *Indicator 2*: How much do foreign MNEs contribute to purchases of locally produced intermediates?
- *Indicator 3*: How much of the local intermediates purchased by foreign MNEs are produced by local SMEs?
- *Indicator 4*: To what extent do SMEs source from foreign MNEs?

It is important to note that sample sizes of foreign firms used to construct these indicators are low for Myanmar (27), Cambodia (36) and Lao PDR (46). Moreover, strong assumptions are made in constructing indicators 3 and 4: the indicators assume that sales of intermediates follow the same split across firm type (SME, large, foreign) as sales of final goods. As such the indicators should be taken as preliminary and interpreted with caution. Further research with the OECD Trade and Agriculture Directorate will focus on developing more precise and robust indicators, using detailed survey data from four AMS. For a more detailed description of the data, methodology and limitations associated with the above indicators, please refer to Annex 2.A.

Foreign manufacturers source a significant share of intermediates locally

A policy question of critical interest to FDI host economies is the extent to which the foreign affiliates of MNEs source from domestic firms, and specifically SMEs. Local sourcing of MNEs, when not the result of restrictive trade policies such as high tariffs or local content requirements, can generate demand for host economy firms and lead to productivity-enhancing knowledge spillovers.

Foreign manufacturers in ASEAN source considerably from local producers (Figure 2.5). In Thailand, Lao PDR, Indonesia, Malaysia and Philippines, foreign MNEs (defined as firms with over 10% foreign ownership) source over 60% of intermediate inputs from (domestic and foreign) firms that produce locally. The average share of local sourcing by foreign MNEs in Viet Nam, though somewhat lower, is still significant (45%). Foreign affiliates in Myanmar and Cambodia source approximately 10% locally.[13]

The observed differences may reflect differences in the sectoral structure of the economy, positioning within specific value chains, and policy factors. In other words, differences in local sourcing of foreign MNEs do not necessarily indicate greater or lesser integration of the local firms in the supply chains of foreign MNEs in ASEAN. Additionally, within countries, sourcing practices of foreign firms can vary considerably and are not necessarily captured by these aggregate shares. Thus, while Indicator 1 suggests that supply chain linkages are indeed present in ASEAN, more information is necessary to understand the extent of these linkages.

[13] Data limitations do not allow producing this indicator for Brunei Darussalam and Singapore.

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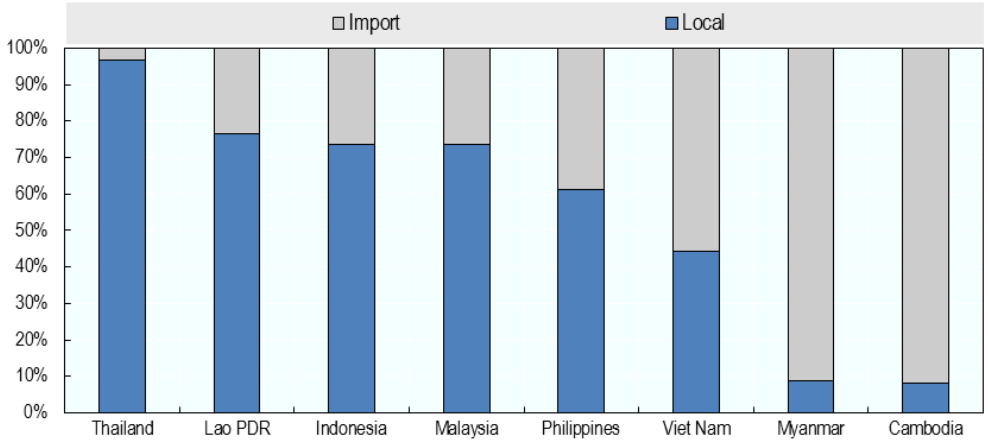
Figure 2.5. Foreign manufacturers source a significant share of intermediates locally

Output-weighted share of local sourcing by foreign manufacturers



Note: The figures are based on self-reported estimates of interviewed foreign manufacturing firms. Local sourcing tends to be over-reported, which may result in bias. The figures can be considered an upper bound for local sourcing of foreign manufacturers. The relative importance of local sourcing across countries is consistent with findings from business interviews conducted in selected ASEAN countries. Reference years are 2015 (Indonesia, Malaysia, Philippines, Viet Nam) and 2016 (Cambodia, Lao PDR, Myanmar, Thailand). See Box 2.1 and Annex 2.A for details.
Source: OECD-UNIDO based on World Bank Enterprise Surveys

In Lao PDR, foreign investors in manufacturing (including joint ventures with local firms) are concentrated in food and garments. Accordingly, the indicator represents a weighted average of foreign firms' reported local sourcing practices predominantly in these two sectors. The garment sector in Lao PDR has traditionally relied on imports of inputs (cotton, yarn and fabrics) from abroad (Nolintha and Jajri, 2015). Considerable local sourcing reported by foreign firms may reflect a recent increase in the local availability of cotton and fabrics. More likely, however, it indicates significant sub-contracting activities (i.e. cut, make and trim factories) of foreign firms to local garment producers specialised in assembly (Nolintha, 2016).

In contrast, in the Philippines foreign investors in manufacturing have a more diversified portfolio, from low-tech industries such as food processing, to high-tech industries such as machinery production. This is thanks to a combination of low wages and relative availability of skills (Oxford Business Group, 2017). More than 30% of inputs used by foreign MNEs for the production of machinery are sourced locally. Traditionally, high levels of local sourcing may have been related to local content requirements for local production of MNEs (Battat et al., 1996). With accession to the WTO and ASEAN, these restrictions have been lowered over time, but left some industries struggling to keep up with rising import competition and relatively low supplier bases, for instance in the automotive industry (Aldaba, 2014).

Significant local sourcing in Viet Nam (45%) may reflect strong domestic capacity for producing specific inputs, notably, textiles. In fact, cotton and other fabrics are increasingly produced domestically rather than imported. Foreign MNEs in the basic metals, fabricated metals and electronics sectors also report relatively high levels of local souring of inputs, at approximately 50%.

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High levels of domestic sourcing observed in Malaysia and Thailand may reflect advanced local supplier capabilities, or 'supporting industries', in these countries (though they are likely also related to differences in sectoral specialisation). In some key sectors, such as motor vehicles and machinery and equipment, foreign lead firms that established a few decades ago attracted foreign multinational suppliers to follow suit and also produce in Malaysia and Thailand. As the industries grew, local producers also developed.

Foreign MNEs buy a significant share of locally-produced intermediates

Local sourcing of foreign manufacturers matters for domestic producers of intermediates, particularly in the Philippines and Indonesia, (Figure 2.6, Panel A). In these countries, foreign firms buy 45% of locally-produced intermediates. The share is lower though still significant (above 15%) in Malaysia, Viet Nam, Cambodia and Thailand, while it is less significant in Lao PDR and Myanmar. These shares should be considered in comparison to how important sales of intermediate inputs are relative to total manufacturing sales. The share of intermediates in total sales of manufactured goods is particularly high in Indonesia and Viet Nam (15%), while somewhat lower in Thailand and the Philippines (4-8%). Lao PDR and Myanmar report similar share of intermediates in total sales, but given that foreign MNEs account for a negligible share of the demand of intermediates (Figure 2.6, Panel A), these figures are less meaningful for discussions on local sourcing.

The ensuing question for policymakers is what types of firms supply foreign manufacturers in AMS. Exploiting information on the distribution of SMEs, large domestic firms and foreign firms in overall production, allows estimating the extent to which these three categories of firms account for foreign manufacturers' purchases of intermediates.[14]

Preliminary estimates suggest that SMEs[15] and large domestic firms may jointly account for over 50% of all intermediates supplied to foreign MNEs in ASEAN (Figure 2.6, Panel B). The contribution of SMEs, specifically, may vary substantially across AMS: In Cambodia, Lao PDR and Myanmar, SMEs may account for more than 40% of all inputs supplied to foreign MNEs, while in other AMS these figures are considerably lower. It is important to acknowledge that Cambodia, Lao PDR and Myanmar have relatively higher trade barriers (which may explain higher observed linkages with locally established foreign MNEs), and that such barriers distort incentives from optimal sourcing decisions. Indonesia stands out with relatively high estimated shares for foreign firms that supply intermediates to other foreign firms (approximately 30%). This is often observed in GVCs when lead firms establish in host economies and large international first-tier suppliers locate affiliates in their proximity.[16]

[14] It is important to note that the distribution of SMEs, large domestic firms and foreign firms in production of intermediates is not observed and may not coincide with that of overall sales. Thus, the resulting indicators should be taken as preliminary and interpreted with some caution. See Box 2.1 and Annex 2.A for more details.

[15] Here defined as firms with fewer than 100 employees

[16] See Tong and Seric (2018), for the case of Samsung's mobile phone assembly in Viet Nam.

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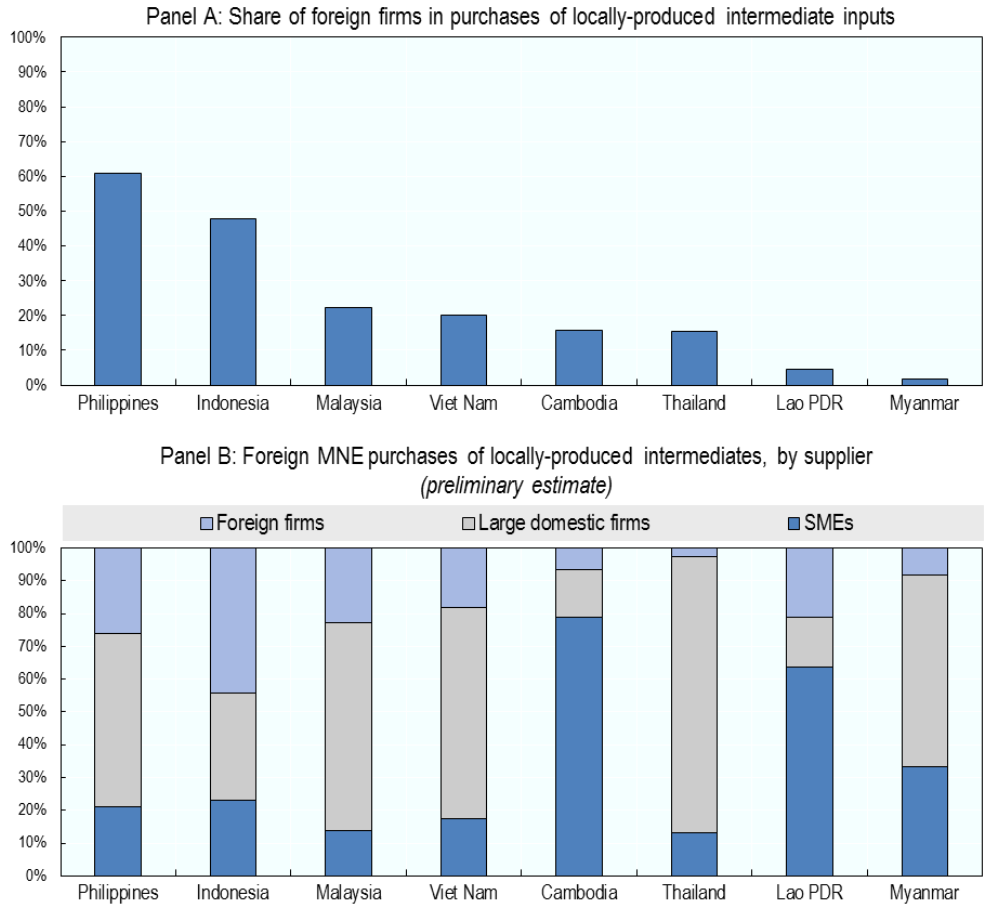
Figure 2.6. Foreign MNEs are an important destination for local producers of intermediates



Note: The indicators cover manufacturing only. Reference years are 2015 (Indonesia, Malaysia, Philippines, Viet Nam) and 2016 (Cambodia, Lao PDR, Myanmar, Thailand). See Box 2.1 and Annex 2.A for details.
Source: OECD-UNIDO based on World Bank Enterprise Surveys

In some AMS, SMEs may source extensively from foreign MNEs

Sourcing of ASEAN SMEs is also a potentially important channel for participating in GVCs (see Chapter 1). In ASEAN, SMEs source intermediates predominately from local suppliers (Figure 2.7),[17] though in some member states (Cambodia, Malaysia, Philippines, and Viet Nam), SMEs source up to a quarter of inputs from abroad. Among local producers of intermediates, SMEs depend considerably on inputs from foreign-owned suppliers according to preliminary estimates. In Indonesia, for example, around 40% of the inputs used by manufacturing SMEs are produced locally by foreign suppliers. This share is about 20% in Lao PDR, Malaysia, the Philippines and Viet Nam. It is negligible in other developing AMS.[18]

[17] This could also point to significant trade barriers.

[18] This indicator hinges on the assumption that the distribution of SMEs, large domestic firms and foreign firms in production of intermediates is similar to their distribution in production of final goods, which may not be case. As such the observed shares should be interpreted with caution.

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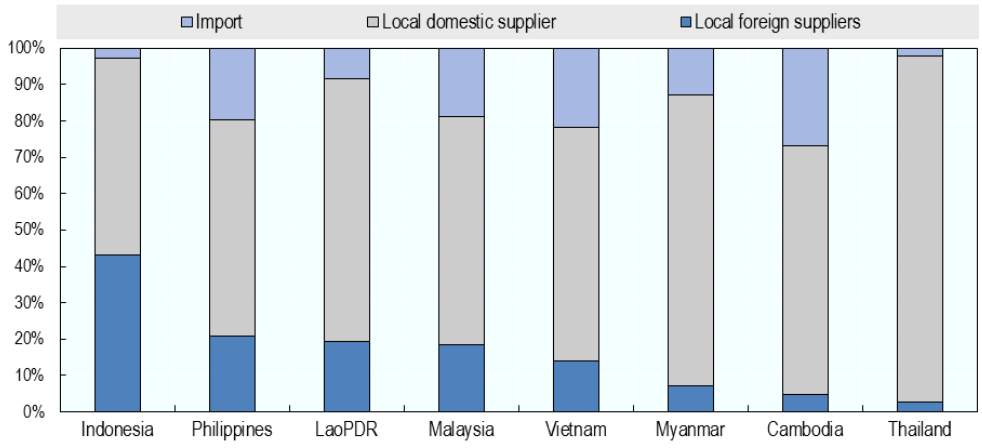
Figure 2.7. In some AMS, SMEs source extensively from foreign MNEs

Intermediate inputs used by domestic manufacturing SMEs, by supplier *(preliminary estimate)*



Note: The indicators cover manufacturing only. Reference years are 2015 (Indonesia, Malaysia, Philippines, Viet Nam) and 2016 (Cambodia, Lao PDR, Myanmar, Thailand). See Box 2.1 and Annex 2.A for details.
Source: OECD-UNIDO based on World Bank Enterprise Surveys

Partnerships are common in ASEAN manufacturing

As discussed in Chapter 1, linkages can take various forms and intensities. MNEs establish linkages with domestic firms through arm's-length transactions, direct investment, and an array of relationships in between, summarised as partnerships (see Box 1.1). Different business models entail different levels of control over the supply-chain activities of domestic firms, with deeper linkages involving greater control. New OECD evidence shows that partnerships are largely used by MNEs both in high-tech and low-tech sectors (OECD, 2016).

Partnerships are widespread in ASEAN. Indonesia, Thailand, Viet Nam and Malaysia are the AMS with the largest number of partnerships in the manufacturing sector (200+) in 2010-16 (Figure 2.8, Panel A). Within manufacturing, partnerships are mostly observed in processed foods, chemicals and plastic, basic and fabricated metals, and machinery and transport equipment. Joint ventures (equity-based partnerships) and manufacturing agreements (contractual partnership) are the main forms of partnerships observed in the data. Jointly, they account for over 90% of partnerships in the manufacturing sector in the region (Figure 3.3, Panel B). The remaining 10% includes marketing agreements, R&D agreements, and licensing. In terms of ownership, the majority of partnerships in the manufacturing sector involve both a foreign and a domestic partner (Figure 3.3, Panel C): with the exception of Brunei Darussalam, in all AMS over 60% of partnerships in the manufacturing sector are domestic-foreign; 11%-35% of partnerships are foreign-foreign; and 2%-17% are domestic-domestic.

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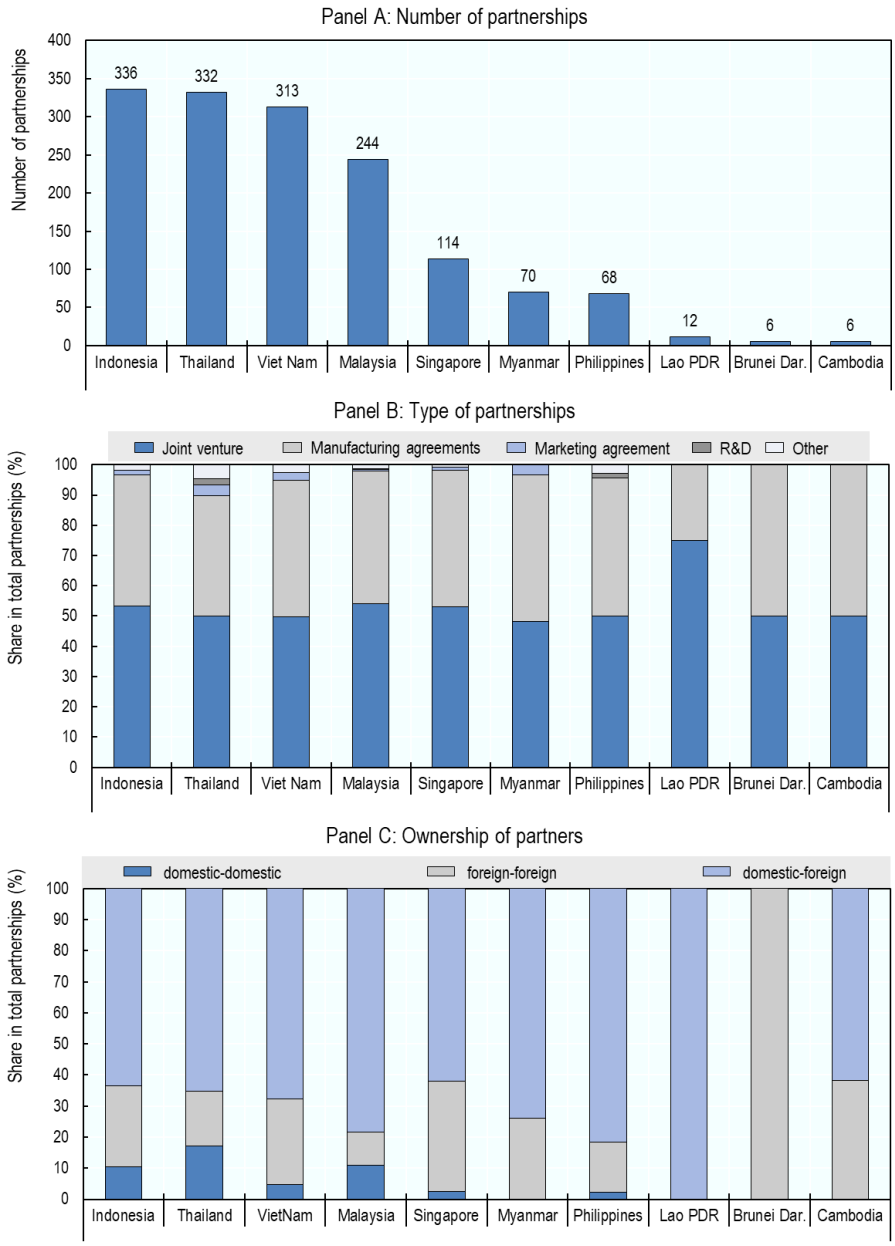
Figure 2.8. Partnerships are common in ASEAN manufacturing



Note: Data covers partnerships in manufacturing over 2010-16.
Source: OECD-UNIDO based on Thomson & Reuters

Outward FDI from Southeast Asian countries is gaining importance

Following the framework in Chapter 1, what SMEs produce at home is expected to evolve over the life-cycle of the SME and the development trajectory of the economy. Rising incomes, changing skills, and saturating markets may drive more successful SMEs to invest abroad and become protagonists in the GVC narrative (see Figure 1.1). This theme is becoming increasingly relevant to firms in ASEAN.

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Although most ASEAN countries have been and continue to be major FDI destinations, they are emerging as important sources of outward FDI in their own right, both in the region and elsewhere. Outward flows grew rapidly between the 1990s and the mid-2000s, outpacing growth of inward flows by a large margin. The share of ASEAN outward FDI relative to inward FDI stock increased from less than 20% in 1990 to almost 60% by 2007 and has since levelled off at around 55% (Figure 2.9, Panel A).

The dominance of Singapore as a source of outward FDI is even stronger than for inward investment. Singapore is responsible for almost 70% of ASEAN direct investment positions abroad (Figure 2.9, Panel B). While much lower in scale, Malaysia and Thailand have also become dynamic investors abroad. In 2016, they were responsible for 13% and 8% of total outward FDI stocks, respectively. Since ASEAN countries do not participate evenly in outward investment, it is useful to categorise them according to their level of engagement in outward FDI; namely, the traditional largest investors abroad; emerging investors; and recipients only of FDI (Box 2.2).

Recent data show significant variation in intra-ASEAN outward FDI from the perspective of member states (Figure 2.10, Panel A). Indonesia and Brunei Darussalam invested almost entirely within ASEAN, over 2012-16 (though the scale of these investments is low compared to Singapore, Thailand and Malaysia). Other member states invested between 10% (Philippines) and 40% of their overall outward FDI within the region.

Beside intra-regional investment, ASEAN has become a more important source of investment in the rest of the world. Outward FDI in agri-business from Southeast Asia has spread to African countries. Moreover, ASEAN investment in developed countries aimed at obtaining previously out-of-reach competitive advantages is rising, particularly technology-seeking investments in Germany and the UK (Lee and Sermcheep, 2017).

The structure of ASEAN outward FDI is dominated by services, which account for 54% of ASEAN's outward FDI stocks. Singaporean and Malaysian firms have prevailed in overseas investment in services, particularly in finance and real estate. However, manufacturing also constitutes a sizeable share of outward investments (Figure 2.10, Panel B), and grew by 63% from 2015, to USD 8.3 billion in 2016. This growth can largely be attributed to Thai manufacturing investments in the region (particularly in CLMV countries), which experienced a 35-fold increase to USD 4.2 billion, almost to the same level as Singapore (ASEAN, 2017).

Finally, outward FDI activities from the region were spearheaded by state-owned enterprises and government-linked companies, and remain largely in their control, particularly for Singapore and Malaysia. However, publically-listed private firms are steadily increasing their contribution to outward FDI. Aside from large companies, SMEs from ASEAN have also increased their presence in the region, in an effort to reduce costs and become more competitive. According to evidence from the northern region of Peninsular Malaysia, 54% of 77 surveyed SMEs reported that they had at least three overseas subsidiaries and joint ventures, and 36% had been involved in international business for 6-10 years (Chelliah et al., 2010).

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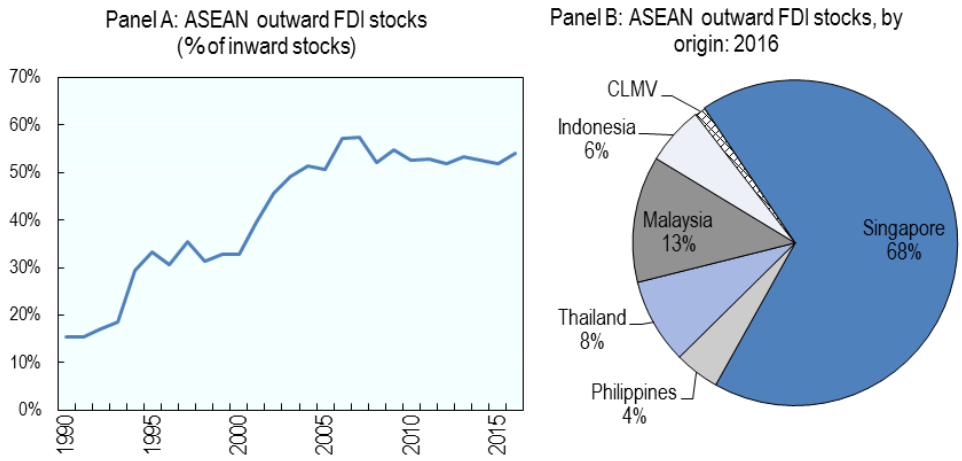
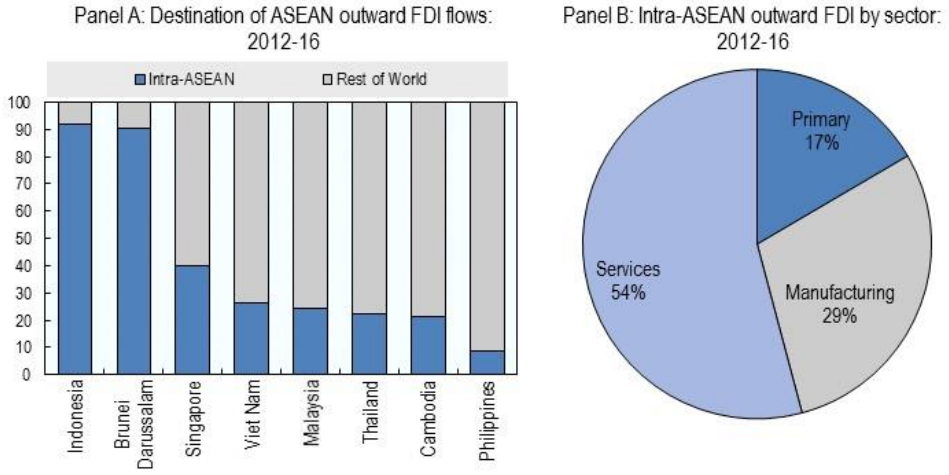
Figure 2.9. ASEAN outward FDI grew rapidly in the 1990s and is dominated by Singapore



Note: CLMV stands for Cambodia, Lao PDR, Myanmar and Viet Nam.
Source: UNCTAD FDI statistics

Figure 2.10. AMS invest extensively within the region, and predominantly in services



Source: UNCTAD and ASEAN FDI statistics

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Box 2.2. Development of FDI outflows from ASEAN

Traditional largest investors abroad

Singapore and Malaysia started investing abroad in the 1980s, primarily through state-owned enterprises and government-linked companies. **Singapore** is the largest source of FDI in ASEAN (reaching USD 23 billion in 2016), and has leveraged outward FDI as a means to enhance its international competitiveness. Singapore's financial companies, in pursuit of economies of scale and scope in larger markets abroad, have profoundly affected the financial services industry, which accounts for 50% of the country's outward FDI. Singapore holds significant shares in FDI stocks of other ASEAN members, particularly Myanmar (33%), Indonesia (25%), Malaysia (21%), and Thailand (14%).

Like most developing countries, **Malaysia** started as a net capital recipient but experienced a significant upsurge in outward investment starting in 2006, after lifting capital controls in the aftermath of the Asian Financial Crisis. As a result Malaysia transformed itself into a net international investor, and remains the only net capital exporter in ASEAN. Even after the global financial crisis, Malaysia has continued to play a major role as a global investor. A significant portion of outflows takes place in oil and gas, mining, banking, and agriculture. There are signs that private companies have become increasingly active overseas investors alongside government-linked companies.

Emerging investors abroad

FDI outflows from **Thailand** grew at a modest rate in the past, reaching USD 500 million in 2005. Since outward FDI restrictions were lifted, outward investment increased rapidly (reaching USD 6.2 billion in 2011) and Thailand became a net international investor. The rise in Thai outward FDI was market-driven rather than policy-driven (as in Singapore and Malaysia), with private companies accounting for the majority of overseas investors. While traditionally market-seeking and agro-focused, in recent years Thai firms (particularly in garments, jewellery and auto manufacturing) have started investing abroad to reduce costs, in response to currency appreciation, labour shortages, and rising wages. CLMV countries have received around 40% of all Thai greenfield investments since 2003, though their value of these investments has more than doubled over 2003-16 (from USD 22 billion to USD 56 billion). Myanmar and Viet Nam received 70% of these Thai-CLMV investments.

Another emerging investor is **Indonesia**, where outward investment jumped to USD 3.4 billion in 2004, due to the decline in the domestic investment climate and high investment risk in the country. FDI outflows reached their peak in 2011, at USD 7.7 billion. In the **Philippines**, inward and outward FDI flows have been small. As a result of effective reforms, both inflows and outflows grew in the 1990s. Outward FDI reached a peak in 2007, when the country became a net investor despite low levels of overall FDI. For **Viet Nam**, FDI inflows have skyrocketed, reaching a record high of USD 9.6 billion in 2008. Though outflows began to materialise since the mid-2000s, the amount remained insignificant until 2013, when it surged to almost USD 2 billion.

FDI recipients only

Cambodia, Lao PDR and **Myanmar** have mainly played a role as recipients of FDI. Outward FDI is limited or negligible, presumably due to the lack of a strong private sector and the fact that these countries are still at an early stage of internationalisation and do not possess the competitive advantage to invest abroad.

Source: Lee and Sermcheep (2017), Hers et al. (2018), Financial Times (2017)

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Annex 2.A. Linkages indicators: data, methodology and limitations

The data

The indicators are constructed using manufacturing firm-level data from World Bank Enterprise Surveys covering eight ASEAN member states over 2015-16: Cambodia (2016), Indonesia (2015), Lao PDR (2016), Malaysia (2015), Myanmar (2016), Philippines (2015), Thailand (2016), Viet Nam (2015). The indicators can be produced for over 100 countries. Contingent on data availability, the indicators can further be disaggregated to approximately 10 manufacturing sub-sectors, though only indicators for the manufacturing sector as a whole are presented in this report.

The figures presented in the text are based on the following number of foreign firm observations (in parentheses): Cambodia (25), Indonesia (88), Lao PDR (21), Malaysia (125), Myanmar (23), Philippines (224), Thailand (75), Viet Nam (69).

Methodology and limitations

Indicator 1: Output weighted share of local sourcing by foreign MNEs

This indicator quantifies the share of local sourcing of foreign MNEs weighted by their contribution to the manufacturing sector. The formula is as follows:

$$INDICATOR_1 = \sum_{i}^{I} w_i * shareLocalSourcing_i$$

where $shareLocalSourcing_i$ is the share of local sourcing in total sourcing of intermediates of foreign firm i; w_i is the sampling weight attributed to foreign firm i relative to other firms in the sample*; I is* the total number of surveyed foreign firms in the manufacturing sector.

Indicator 2: Share of foreign MNEs in locally-produced intermediates

This indicator quantifies the extent to which domestic demand for locally produced intermediates is driven by foreign MNE affiliates. The formula is as follows:

$$INDICATOR_2 = \frac{\sum_i^I w_i * MNELocalSourcing_i}{\sum_h^H w_h * TotalLocalSourcing_h}$$

where $MNELocalSourcing_i$ is the monetary value of locally sourced intermediates of foreign firm i; w_i is the sampling weight attributed to foreign firm i relative to other firms in the sample; I is the total number of surveyed foreign firms that source in the manufacturing sector; $TotalLocalSourcing_h$ is the monetary value of locally sourced intermediates of firm h; w_h is the sampling weight attributed to firm h relative to other firms in the sample, including foreign and domestic firms; H_j is the total number of surveyed firms that source in the manufacturing sector; c.

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Indicator 3: SME contribution to locally-produced intermediates sourced by foreign MNEs

This indicator builds on Indicator 2 to estimate the extent to which domestic manufacturing SMEs account for the locally-produced inputs purchased by foreign MNEs (i.e. relative to large domestic firms and foreign firms). The formula is as follows:

$$INDICATOR_3 = \frac{\sum_k^K w_k * SMEDomesticSales_k}{\sum_h^H w_h * TotalDomesticSales_h}$$

where $SMEDomesticSales_k$ is the monetary value of sales of intermediates from domestic SME k to foreign MNE affiliates in the manufacturing sector; w_k is the sampling weight attributed to SME k relative to other firms in the sample; K is the total number of surveyed domestic SMEs in the manufacturing sector; $TotalDomesticSales_h$ is the monetary value of domestic sales of intermediates from firm h to foreign MNE affiliates in the manufacturing sector; w_h is the sampling weight attributed to firm h relative to other firms in the sample; H is the total number of surveyed firms in the manufacturing sector; $I \in H$. SMEs are defined as firms with fewer than 100 employees (taken from the classification of SMEs in World Bank Enterprise Surveys).

A serious limitation of this indicator is that sales of intermediates are not directly observed, and the indicator hinges on the very strong assumption that sales of intermediates follow the same split across firm type (SME, large, foreign) as sales of final goods. Given this strong assumption, the resulting indicator should be taken as a first approximation, and interpreted with caution. More robust indicators of this type will be developed using more detailed survey data from four AMS in a future component of this project, in collaboration with the OECD Trade and Agriculture Directorate.

Indicator 4: Domestic SMEs' composition of intermediates sourcing by origin

While Indicators 1-3 provide insights on backward linkages from the perspective of foreign MNEs, Indicator 4 examines backward linkages of SMEs with respect to foreign and domestic suppliers (including imports). The indicator is composed of three sub-indicators that add up to 100%:

$$INDICATOR_4 = Imports + ForeignMNEs + DomesticSuppliers = 100\%$$

The formula for the first sub-indicator is as follows:

$$Imports = \sum_k^K w_K * shareImports_k$$

where $shareImports_k$ is the share of imported intermediates in total intermediates of SME k; w_k is the sampling weight attributed to SME k relative to other firms in the sample; K is the total number of surveyed SMEs in the manufacturing sector.

The formula for the second sub-indicator is as follows:

$$ForeginMNEs = \sum_k^K w_K * shareForeignMNE_k$$

where $shareForeignMNE_k$ is the share of intermediates sourced from foreign MNE affiliates in total intermediates of SME k. Weights and indexes remain the same as in sub-indicator 1.

The formula for the third sub-indicator is as follows:

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$$DomesticSuppliers = \sum_{k}^{K} w_K * shareDomesticSuppliers_k$$

where $shareDomesticSuppliers_k$ is the share of intermediates sourced from domestic suppliers in total intermediates of SME k. Weights and indexes remain the same as in sub-indicator 1.

As in the case of Indicator 3, $shareForeignMNE_k$ and $shareDomesticSuppliers_k$ are not directly observed. The split is derived from the split in overall sales in the sector across foreign and domestic firms. In other words, the indicator hinges on the strong assumption that sales of intermediates to SMEs follow the same distribution across firm type as overall sales in the sector. Given this strong assumption, the resulting indicator should be taken as a first approximation, and interpreted with caution.

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3. How do SMEs benefit from FDI?

The evidence on FDI spillovers with respect to domestic firm outcomes has produced contradictory and incomplete findings. This chapter corroborates these findings in relation to partnerships with foreign firms, and their spillovers to host economy firms. It then examines the relationship between observed linkages and firm-level performance in Thailand and Viet Nam and finds evidence of significant performance improvements. The chapter explores the firm-level determinants of linkages, including investor motives and business models and domestic firm capabilities in ASEAN. It finds that foreign investors come to ASEAN to access the regional market and establish linkages with local suppliers, but prefer to entrust higher value added activities to other foreign firms, as the gap between foreign and domestic firms is still high in many respects. Intra-ASEAN investment can also support greater regional integration and create opportunities for ASEAN SMEs to plug into regional value chains, grow, and potentially evolve into multinationals themselves. The chapter concludes with an assessment of the benefits and determinants of ASEAN firms' outward investment in CLMV countries.

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Summary

FDI can benefit the host economy by creating value and jobs, transferring knowledge to suppliers, buyers and partners, and interacting with other economic actors. The empirical evidence on the impact of FDI on domestic firm performance has produced contradictory and incomplete findings, in part as a result of too aggregated data. Analysis of partnership data in ASEAN produces similarly inconclusive evidence, most likely because industry averages mask heterogeneous effects across domestic firms with different capacity to participate in the supply chains of foreign investors.

Evidence from the OECD-UNIDO Thai Survey where supply chain linkages are reported shows that trade, investment and partnership linkages are indeed associated with above average firm performance, both in terms of objective measures of productivity and of perceived improvements in product quality, skills and access to markets. Similarly, survey evidence from Viet Nam suggests that linkages with foreign buyers positively affect the productivity of domestic suppliers. In both cases, the direction of causality is ambiguous: linkages may induce productivity gains, or more productive firms may be more attractive to investors, or both.

Investor motives and domestic firm capabilities affect the materialisation of linkages and linkage-induced benefits. In Thailand, access to the regional market and linkages with local suppliers are important motives for investors; and surveyed investors report efficiency gains as a result of sourcing from Thai firms. However, they report that foreign suppliers in Thailand offer higher quality products and have greater technological capacity. World Bank Enterprise Surveys suggest that the gap between foreign firms and local SMEs is indeed high in some AMS, for instance with respect to quality certifications, use of foreign technologies and training of staff. The analysis of partnership spillovers with respect to firm outcomes that accounts for firm characteristics provides additional corroboration that productivity benefits of partnerships depend on absorptive capacity.

Outward investment can also have significant beneficial effects on employment, technology adoption and the trade balance of investing countries, when it allows outward investors to scale up and raise efficiency, and when acquired knowledge and technology is transferred back to the parent company and diffused to the wider economy. The Thai survey suggests that manufacturers in Thailand that invest overseas are 40% more productive than peers that export and import, and 11 times more productive than firms that are not internationalised at all. The causal relationships between outward investment and productivity work in both directions, although it is likely that the success of domestic firms at home what leads them to invest abroad rather than the other way round.

Intra-regional outward FDI enhances economic integration and can create opportunities for ASEAN SMEs to plug into regional and global value chains, grow, and become themselves multinationals. Outward FDI is influenced by a variety of factors ranging from investor business models and local firm capabilities, to home and host country policies and economic conditions. Drivers of ASEAN manufacturing investments in Cambodia, Lao PDR, Myanmar and Viet Nam, specifically, include saturated markets in more advanced ASEAN economies, relatively cheap and abundant labour in CLMV, geographic and cultural proximity, investment incentives, and land availability.

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3.1. Benefits and determinants of MNE-SME linkages

ASEAN has attracted considerable foreign investment, and locally established MNEs have, to varying degrees, forged trackable supply chain linkages with ASEAN firms, including SMEs. ASEAN firms also partner extensively with foreign MNEs through contract manufacturing, marketing agreements, and joint ventures, and engage in outward investment activities (Chapter 2). The question addressed here is how these forms of GVC participation affect domestic firm performance in ASEAN.

Linkages with foreign investors benefit domestic firms

FDI can benefit the host economy through its direct economic contribution (e.g. jobs, value added); through spillovers that arise from vertical and horizontal linkages (e.g. technology transfer); and through spillovers that arise from market interactions (e.g. imitation effects) and employee turnover, also referred to as externalities. This chapter examines the channels through which FDI induces positive outcomes for the host economy, as summarised in Figure 3.1, focusing specifically on GVC linkages and outcomes for domestic firms.

GVC linkages can benefit domestic firms in a variety of ways: they can enable firms to develop managerial skills, develop new products, improve quality of existing products, acquire new technologies, reduce costs, improve working conditions, or reduce the environmental footprint. As suggested by the conceptual framework in Chapter 1 (Figure 1.1), these linkages are likely to generate different impacts depending on their depth: the benefits for SMEs depend to some extent on the degree to which MNEs transfer knowledge to them through cooperative business relationships that involve greater control (e.g. partnerships or direct investment). Benefits are also likely to differ depending on sector and on whether linkages are upstream (with suppliers) or downstream (with buyers).

The empirical evidence on the existence and direction of FDI-generated impacts on domestic firm outcomes (e.g. productivity, exports, and innovation) is vast. Existing studies tend to focus on FDI spillovers in general rather than disentangling spillovers through supply chain linkages, as the linkages are typically not observed in the data. Moreover, studies on MNE-SME linkages focus primarily on FDI as the entry mode and do not systematically study how alternative entry modes (e.g. partnerships) affect local firm performance.[19] This chapter contributes to this literature by applying the same lens to examine partnership-induced outcomes for domestic firms, and then making use of survey evidence to examine benefits associated with GVC linkages, where these linkages are observed.

[19] Some exceptions exist where for example technology licencing is found to increase productivity of local SMEs (Farole and Winkler, 2014), or corporate venture capital investments are more likely to lead to patent filing of SMEs compared to standard venture capital funds (Dushnitsky, 2012).

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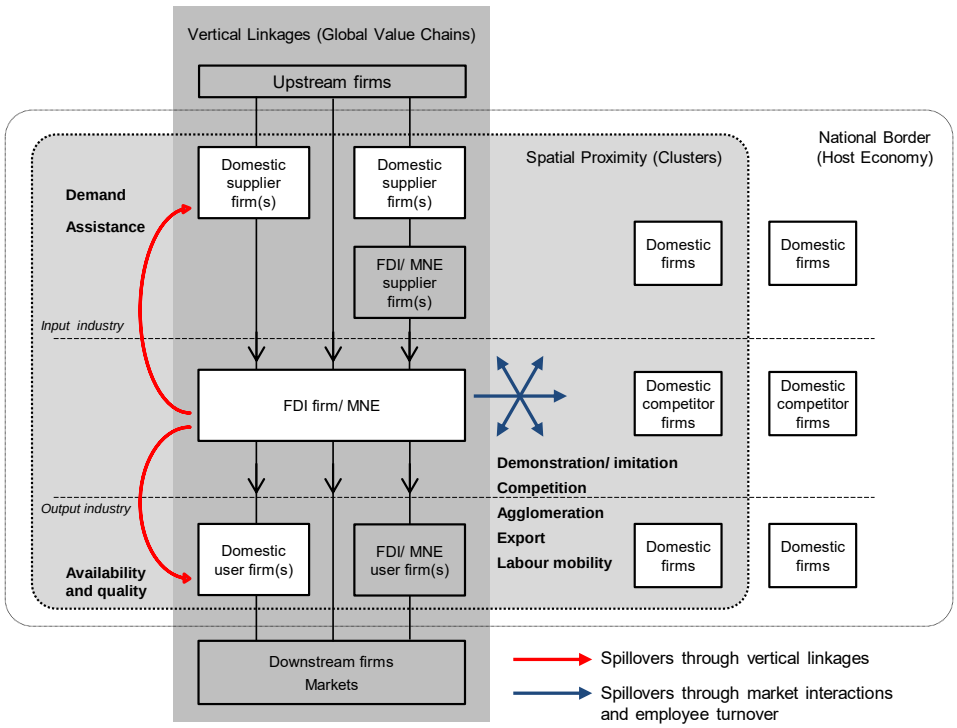
Figure 3.1. Stylised channels of FDI spillovers



Note: For simplicity, the figure omits horizontal linkages (e.g. joint ventures) as a channel for FDI spillovers, although the associated spillovers can be similar to what is shown.
Source: Tong (2018)

Evidence on FDI spillovers tends to be inconclusive

The approaches used to estimate the effects of linkages on firm outcomes diverge along different literature strands, and they tend to produce inconclusive and contradictory findings. The mainstream approach is the estimation of FDI spillovers using an industry-level measure of FDI presence and estimating its effect on a given performance indicator at the firm level.[20] Although findings from empirical research adopting this approach have been inconclusive, several patterns arise. Evidence for intra-industry spillovers is broadly absent, which is often attributed to the fact that foreign firms are protective of their technology advantage and try to limit knowledge spillovers to domestic competitors. Using this approach, no horizontal spillovers across the manufacturing sector are found in Indonesia (Blalock and Gertler, 2008), while there is evidence that domestic firms may even experience productivity decreases, as fierce competition with more superior foreign firms drives them out of the market (Aitken and Harrison, 1999). The picture is more positive when considering vertical spillovers, especially to upstream domestic suppliers, which are attributed to an effort of foreign firms to raise the productivity of their suppliers

[20] For intra-industry spillovers, FDI presence is measured as the share of output (employees) in the industry that is produced (employed) by foreign firms. For inter-industry spillovers, backward (forward) FDI presence in an industry is measured as the sum of weighted shares of foreign output or employment in downstream (upstream) sectors. To construct the weights, most studies use supply and buy relationships between pairs of industries, retrieved from national Input-Output tables.

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and improve the quality of their inputs through knowledge transfers (Javorcik, 2004; Blalock and Gertler, 2008).

Subsequent research has refined these findings further by allowing for firm heterogeneity to play a role in the realisation of benefits from FDI spillovers. A study on FDI spillovers in 10 transition countries finds that size, productivity, technology gap and absorptive capacity of firms play a role (Damijan et al., 2013). Using World Bank Enterprise Survey data, another recent study estimates FDI spillover effects on host country firm productivity, accounting for three types of conditioning factors: (a) characteristics of foreign firms, including FDI motives and sourcing strategies in GVCs; (b) characteristics of domestic firms and their capacity to absorb and internalise spillovers; and (c) host country policies and structural factors, including income, demographics, and geography (Farole and Winkler, 2014). The study finds a negative effect of foreign presence on domestic firms, which according to the authors is related to short-term competitive pressures, and the skills differential between employees in foreign and domestic firms. It also finds that, if foreign firms have relatively high shares of local sales (a proxy for market-seeking FDI), foreign presence positively affects productivity of local firms.[21]

Empirical analysis undertaken for the purpose of this study corroborates the general findings on FDI spillovers for the case of partnerships: the presence of partnerships involving foreign firms is unrelated to improvements in domestic firm productivity or export intensity, on average (Box 3.1).

Box 3.1. Partnerships have limited spillovers on average firm outcomes

The literature does not provide much evidence on how partnerships affect firm outcomes, particularly for the case of developing regions like ASEAN, and for the case of SMEs. However, partnerships are widespread, including in ASEAN manufacturing sectors. In an effort to understand the role of different forms of entry (i.e. partnerships) and different forms of linkages (i.e. upstream, downstream and horizontal) in relation to productivity and internationalisation benefits for ASEAN firms, an empirical analysis was undertaken for the purpose of this study, where industry-level information on FDI is replaced with industry-level information on different forms of partnerships.

The analysis uses firm characteristics and performance measures from the most recent World Bank Enterprise Surveys and project-level information on partnerships (aggregated to the industry-level) from Thomson Reuters. The estimation covers four AMS; namely, Indonesia, Lao PDR, Philippines and Viet Nam.

The main finding from the baseline estimation is that the presence of partnerships in an industry is unrelated to domestic firm performance, irrespective of the nature of the partnership (upstream, downstream, horizontal), and of whether foreign investors are involved in partnerships. As the estimation does not explicitly model the relationship between supply chain linkages and firm performance (because the data does not allow partnership information to be linked to firm-level outcomes), insignificant industry averages may mask heterogeneous effects at the firm-level. See Annex 3.A for details of the data and methodology.

[21] It should be noted that estimates of FDI spillovers that follow this approach may not reflect causal relationships, as the transmission mechanism for these spillovers is not observed or modelled. Results should therefore be interpreted with caution and treated as correlations rather than cause and effect.

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GVC linkages are associated with improved firm performance

As discussed above, approaches that examine spillovers of FDI or partnerships to local firms without explicitly accounting for linkages fail to disentangle the relationships between supply chain linkages and domestic firm performance (from other potential channels of FDI spillovers) and assume that all domestic firms are affected by FDI to the same degree. However, firms differ in their ability to develop linkages with foreign firms, and the impact of foreign presence or of partnerships in the economy on their performance should also vary accordingly.

Another strand of research is emerging that tries to account for this by controlling for vertical linkages using data from surveys of foreign affiliates and domestic suppliers, although currently with limited evidence on ASEAN economies. A study that employs survey data on 809 foreign affiliates in five transition economies finds that linkages are indeed important for knowledge transfer (Gentile-Lüdecke and Giroud, 2012). The same finding emerges using survey data from the UK (Potter et al., 2003). Both studies use self-reported measures of benefits (e.g. product development, production organisation or skills development) rather than an objective measure of supplier productivity. Studies that make use of data from an UNIDO Investor Survey in sub-Saharan African countries find a positive association between linkages and labour productivity (Sanfilippo and Seric, 2016b), as well as suppliers' product and process innovation (Görg and Seric, 2016).

Using new data from an original OECD-UNIDO survey of enterprises in Thailand, it is possible to examine the direct relationship between linkages and firm outcomes. Linkages are associated with above average firm productivity[22] in Thailand (Figure 3.2). Firms that enjoy some form of trade, partnership or FDI linkage experience an average productivity premium of a factor of at least eight relative to firms that do not. The highest productivity premium (16) is observed for firms that receive direct equity investment (i.e. foreign affiliates), which is consistent with the prevailing literature. Partnerships are also associated with a relatively high productivity premium (8.6-9.4), suggesting that they are indeed associated with greater knowledge transfer and productivity benefits. In all cases, however, the direction of causality is unclear, and further empirical analysis is needed to shed more light on this question.

Beyond objective measures of above-average productivity, over 95% of firms that report linkages also report some kind of perceived performance improvement as a result of supplying or sourcing from foreign companies (Figure 3.3). The most commonly reported benefits on the buying side are improved product quality and reduced costs; while the top perceived benefits on the selling side are related to upgrading and skills development (Figure 3.4). The most common reported benefits from receiving inward FDI product diversification and new export channels.

A background paper for this study contributes an additional empirical analysis using a comprehensive UNIDO Investor Survey in Viet Nam (Box 3.2).

[22] Productivity is measured as turnover per employee. Though we acknowledge that this does not take into account costs of production, it serves as a rough approximation.

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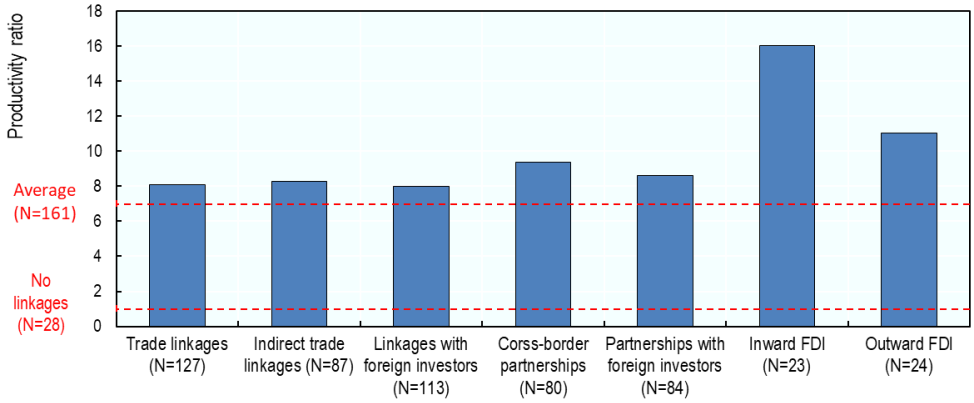
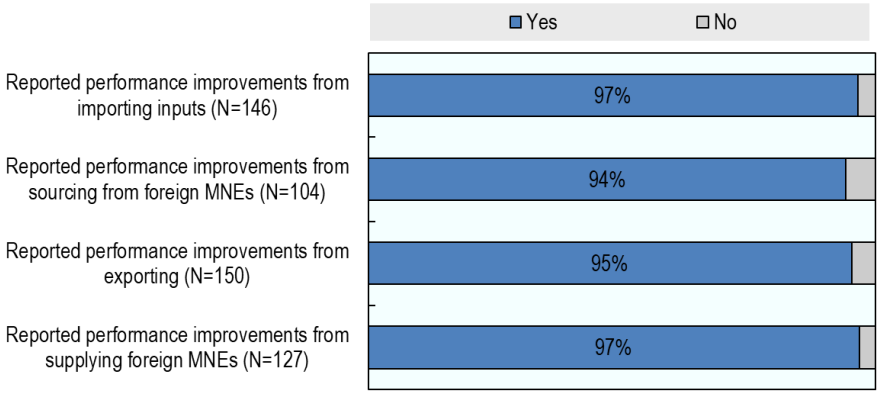
Figure 3.2. GVC linkages are associated with above average productivity



Note: Productivity is measured as sales per employee, and normalised by productivity of firms with no linkages. Sample sizes in parentheses. Of the 28 firms with no linkages, 25 are small (<50 employees). See Box 1.1 in Chapter 1 for a definition of partnerships.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Figure 3.3. Firms perceive improvements in performance as a result of linkages



Note: Number of observations for each category is reported in parentheses.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

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Figure 3.4. Top perceived benefits of linkages

Note: Number of observations for each category is reported in parentheses.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Box 3.2. Productivity impacts of vertical linkages in Viet Nam

A background study for this report estimates the effect of the extent and intensity of linkages with foreign firms that operate in Viet Nam and abroad, on domestic supplier productivity, controlling for participation in GVCs. The study finds that having a higher share of linkages with foreign buyers in Viet Nam positively affects the productivity of domestic suppliers. Greater presence of foreign buyers in Viet Nam is also positively associated with the productivity of local suppliers. However, linkages with foreign firms outside Viet Nam do not translate into productivity increases, and neither does GVC participation.

This finding could be an indication of the importance of geographical proximity for the materialisation of benefits from linkages: not only does geographical proximity lead to more linkages, but linkages with foreign firms in the country have a greater potential to translate into higher productivity benefits for local suppliers than linkages with firms abroad. The same argument can be extended to GVC participation: while being part of a GVC helps local firms to receive support, especially from their foreign buyers abroad, the correlation to productivity is not significant. These findings emphasise the importance of creating the right conditions to develop linkages with FDI in the country: there is potential for a productivity increase for domestic firms, as long as they are able to increase the extent of linkages with foreign firms in downstream sectors in Viet Nam.

Source: Tusha et al. (2017)

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Investor business models affect linkages

The Ownership-Location-Internalisation (OLI) framework proposed by Dunning (1977, 1993) provides a useful way of thinking about MNEs and what determines their internationalisation decisions. *Ownership advantages* are assets that enable firms to overcome the costs associated with setting up affiliates abroad. *Location advantages* originate from the characteristics of a specific country or region – for instance, natural resources, manpower and skills on the supply side, or a large consumer base on the demand side. *Internationalisation advantages* exist in the presence of high transaction costs, which induce the firm to internalise activities through affiliates, rather than purchasing goods or services through trade. According to this framework, trade and investment are either complementary (vertical FDI) or substitutes (horizontal FDI), and why companies invest abroad is tied to the hold-up problem: the impossibility of writing complete contracts imposes high transaction costs (Grossman and Hart, 1986).

Global production networks have undergone a profound transformation in terms of firms' internationalisation strategies. The OLI paradigm formulated 40 years ago remains an extremely useful tool but shows several limitations when confronted to today's business reality. Horizontal and vertical FDI are not the only strategies behind investment, and trade and investment are not simply substitutes or complements (Alfaro and Charlton, 2009; Atalay et al., 2014; Ramondo et al., 2016; and Herger and McCorriston, 2016). MNEs combine horizontal strategies of FDI in some countries and vertical strategies in others. In some cases, MNEs might decide to concentrate their value chain abroad (vertical investment) while at the same time serving proximate foreign markets through horizontal investment as in the case of "export-platform FDI" (Ekholm et al., 2003).

Another limitation is that a significant share of investment is neither purely vertical nor horizontal (Herger and McCorriston, 2016; Ray 2016), which raises the question as to why MNEs establish affiliates that do not provide inputs to the parent company and do not serve foreign markets. A fourth category of 'strategic asset-seeking' FDI was later acknowledged by Dunning (1993) himself, as somehow neglected by the traditional OLI framework. This is because MNEs are understood to have ownership advantages *ex ante* which allow them to overcome the costs associated with setting up an affiliate abroad. The strategic asset seeking motive describes rather the opposite phenomenon: MNEs try to access assets and capabilities which are not inside the firm. This acknowledgment of MNEs seeking new and complementary assets is an important extension of the OLI framework.

Finally, entry strategies vary considerably both across and within sectors, suggesting that the business model is investor-specific rather than sector or region-specific (OECD, forthcoming). Companies that are in the same product market and view each other as competitors may organise their global supply chain very differently. Moreover, MNEs increasingly engage in partnerships, especially in high-tech and knowledge-intensive industries (e.g. pharmaceuticals), where intangible assets and R&D activities are critical to maintaining a competitive product line. Anecdotal evidence on the entry strategies of two lead automobile companies in ASEAN suggests that the choice of business model may indeed be subject to the investor rather than driven by sectoral or regional specificities (Figure 3.5): While General Motors relies almost exclusively on trade and investment, Toyota engages extensively in partnerships in the region.

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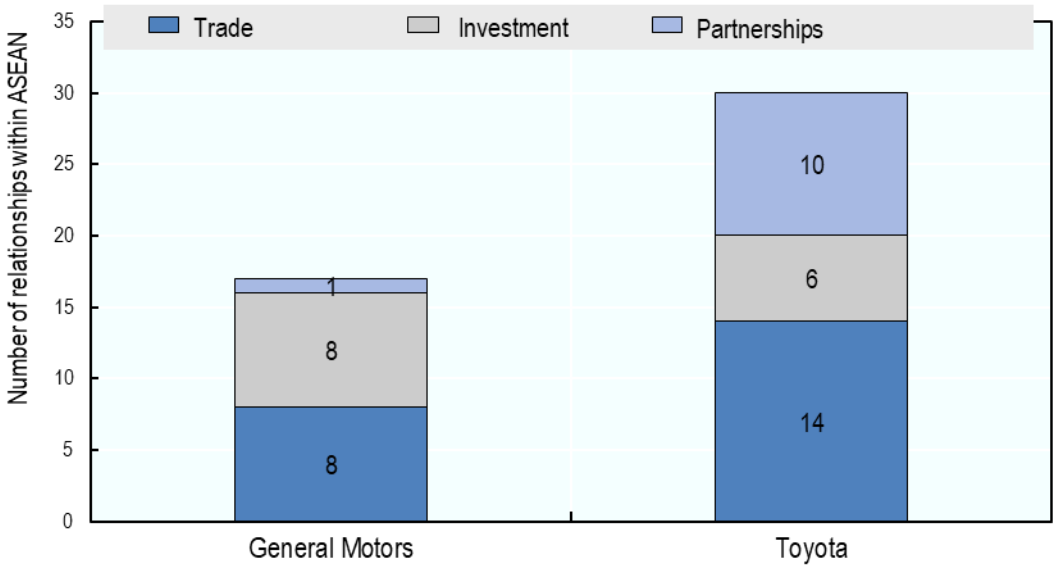
Figure 3.5. Toyota and General Motors display very different entry strategies in ASEAN



Note: See Box 1.1 in Chapter 1 for a definition of partnerships.
Source: FactSet Supply Chain Relationships (2018)

Investors in ASEAN are motivated by market access and local production

In order to uncover more precise evidence of investor motives in the context of ASEAN, the OECD-UNIDO survey covered a range of questions related to investing in Thailand and sourcing locally, addressed to 37 foreign firms (defined as firms with over 10% foreign ownership) with manufacturing operations in Thailand. According to the survey, a majority of investors are motivated by market access and efficiency gains (i.e. cost reductions), while over a third invest in Thailand in order to access other markets (in ASEAN) and 30% to establish linkages with local suppliers. In other words, foreign firms invest in Thailand to produce locally and to source from local suppliers to some extent, but also to use Thailand as a springboard to export to other neighbouring markets (Figure 3.7).

The survey further suggests that foreign investors are able to experience significant efficiency gains as a result of sourcing from local firms (Figure 3.8). However, when asked why they prefer to source from other foreign affiliates with operations in Thailand, over 50% of foreign investors that participated in the survey respond that they choose foreign suppliers because they offer higher product quality (Figure 3.9). Over a third of respondents prefer sourcing from foreign MNEs in Thailand because of their higher technological capacity. While this may create opportunities for lower-tier suppliers, it also suggests that linkages between foreign investors and domestic suppliers in Thailand are to some extent limited by the capacity differential between foreign suppliers of intermediates and domestic suppliers of intermediates.

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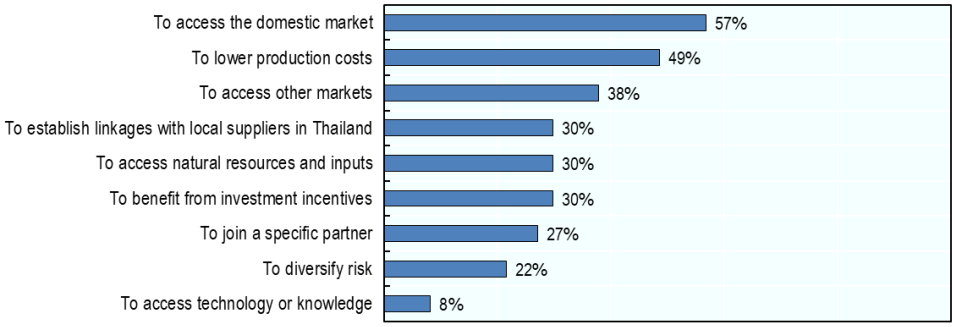
Figure 3.6. Investors come to Thailand to access the market and raise efficiency

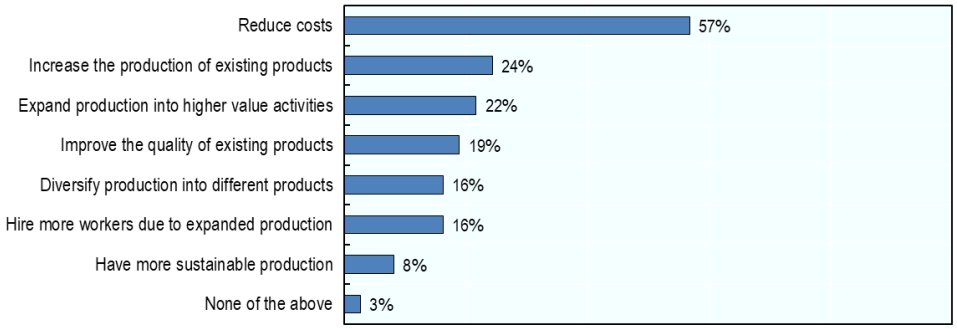
What were the most important factors for your firm to invest in Thailand? (Select all that apply)



Note: The figure is based on 37 responses of foreign enterprises with manufacturing operations in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Figure 3.7. Foreign investors enjoy efficiency gains as a result of sourcing from Thai firms

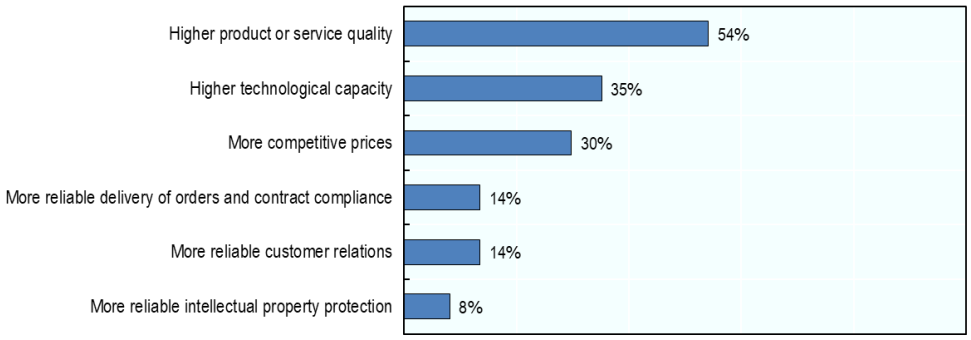
Sourcing inputs from locally-owned firms based in Thailand has enabled your firm to: (Select all that apply)



Note: The figure is based on 37 responses of foreign enterprises with manufacturing operations in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Figure 3.8. Foreign investors prefer to source from foreign firms for higher quality products

Why do you source inputs from foreign-invested rather than Thai-owned firms? (Select all that apply)



Note: The figure is based on 37 responses of foreign enterprises with manufacturing operations in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

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Absorptive capacity of domestic firms affects linkages

Global production networks and the presence of MNEs in particular provide local SMEs in emerging regions like ASEAN with an important opportunity to increase productivity and acquire knowledge. Technology transfers are more effective when firms possess previously accumulated knowledge and innovative capabilities. This set of knowledge and capabilities is generally identified by the literature as absorptive capacity.

More specifically, absorptive capacity is defined as the ability of the firm to utilise available information or knowledge that comes through the interaction with other firms (Cohen and Levinthal, 1990). It involves the ability to acquire, assimilate and exploit the value of the information and knowledge (Todorova and Durisin, 2007). Absorptive capacity is a function of domestic firms' characteristics and of the technology gap between domestic and foreign firms. Empirical evidence shows that absorptive capacity of domestic firms is an important determinant of knowledge transfer between foreign affiliates and domestic firms. In particular, domestic suppliers with better technical capabilities tend to develop more knowledge-intensive types of linkages with foreign firms (Saliola and Zanfei, 2009).

Case study evidence on the agribusiness sector shows that supply chain linkages between foreign MNEs and domestic firms are more widespread in Viet Nam than in Sub-Saharan Africa as a result of the greater absorptive capacities of local firms. Specifically, their greater capacity to comply with international standards functions as a catalyst for supporting knowledge transfers from locally established foreign firms (Farole and Winkler, 2014). A case study of the South African automobile supply chain illustrates that global car manufacturers with establishments in South Africa consider technical capabilities a major hurdle to increase sourcing from local firms, including SMEs. Even if local firms possessed those capabilities, it is seen as too costly to support them in obtaining the required certifications (OECD, 2017).

Survey evidence of MNE-SME linkages in Thailand and Viet Nam provides further evidence that differential capabilities between foreign and domestic suppliers matter for the materialisation of linkages with domestic suppliers. As discussed in the previous section, foreign investors in Thailand prefer to source from other foreign manufacturers present in the country rather than domestic firms because they offer higher product quality. An empirical study that serves as a background paper for this report makes use of a recent UNIDO investor survey of Viet Nam to investigate the extent and intensity of vertical linkages in relation to firm characteristics (Box 3.3). The study finds that foreign firms in Viet Nam tend to develop more linkages with other foreign suppliers than with domestic suppliers, and that, domestic firm characteristics, such as size, geographic proximity, and participation in GVCs, affect the intensity of their linkages with foreign firms.

This section considers measures of absorptive capacity that have been studied in the literature and have been found to have an impact on the realisation of vertical linkages and FDI spillovers. It then provides an assessment of the performance of ASEAN SMEs with respect to these measures based on data from the World Bank Enterprise Surveys, and further evidence on the relevance of absorptive capacity for linkages based on primary evidence collected in Thailand.

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Box 3.3. Determinants of linkages: Survey evidence from Viet Nam

A background paper for this report (Tusha et al., 2017) provides further empirical evidence for the case of Viet Nam: the study investigates the extent and intensity of vertical linkages between local suppliers in Viet Nam and domestic and foreign firms (both inside and outside Viet Nam), using a unique database of Vietnamese foreign and domestic manufacturing firms, collected by UNIDO in 2011. The extent of linkages is measured as the number of foreign buyers, while intensity of linkages is captured by different types of knowledge transfer offered by the foreign buyer (technology transfer, product quality upgrading, or financial and training support).

One of the key findings is that foreign firms in Viet Nam tend to develop more linkages with other foreign suppliers than with domestic suppliers. Moreover, domestic buyers are found to provide more support in terms of access to finance and employee training, while foreign buyers (in Viet Nam and abroad) offer more support in terms of technology transfer and joint product designs. In terms of domestic firms' characteristics, the study finds that medium-to-large suppliers that are in closer proximity or located in an industrial zone are more likely to receive knowledge transfers. Greater knowledge transfer is also associated with a higher likelihood of GVC participation, and vice versa.

The gap between foreign firms and local SMEs is very high in some AMS

The role of firm characteristics and absorptive capacity has been mostly studied in the context of FDI productivity spillovers to domestic firms. In general, FDI is found to have a positive effect on domestic productivity growth when the technology gap between domestic and foreign firms is not too large and domestic firms have enough absorptive capacity (Nicolini and Resmini, 2010).[23] The productivity gap between domestic and foreign firms has also served as a proxy for absorptive capacity. Several studies show that relatively high productivity is needed for domestic firms to reap FDI related spillovers (Nicolini and Resmini, 2006). However, other studies argue that less productive firms have the potential to benefit more from FDI spillovers (Castellani and Zanfei, 2003).

Absorptive capacity is also found to be determined by the level of human capital and skills in domestic firms (Meyer and Sinani, 2005). Several studies highlight positive FDI spillovers in companies that invest in human capital as opposed to companies that do not (Ben Hamida and Gugler, 2009). An additional determinant of absorptive capacity identified by the literature is company size (Knell and Rojec, 2007). Bigger firms tend to have higher levels of absorptive capacity (Tusha et al., 2017) and are also more innovative (Veugelers and Cassiman, 2004).

Aggregate productivity measures for foreign MNEs and domestic SMEs constructed from micro data are susceptible to bias if there is a mismatch between the coverage of sectors for foreign versus domestic firms (e.g. if the surveyed foreign firms operate in industries that are relatively more labour-intensive than domestic ones). Given the unreliability of economy-wide productivity measures using available micro data, other performance gaps are considered that relate to the firm's ability to participate in GVCs. Specifically, the measures consider different aspects of the absorptive capacity of firms such as : (1) the share of firms that have internationally-recognised quality certifications; (2) the share of

[23] See also Halpern and Murakozy (2007); Ben Hamida and Gugler (2009); Abraham et al. (2010); and Girma et al. (2008)

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firms that use technologies licensed by a foreign firm; and, (3) the share of firms that offer formal training to their employees (Figure 3.10).

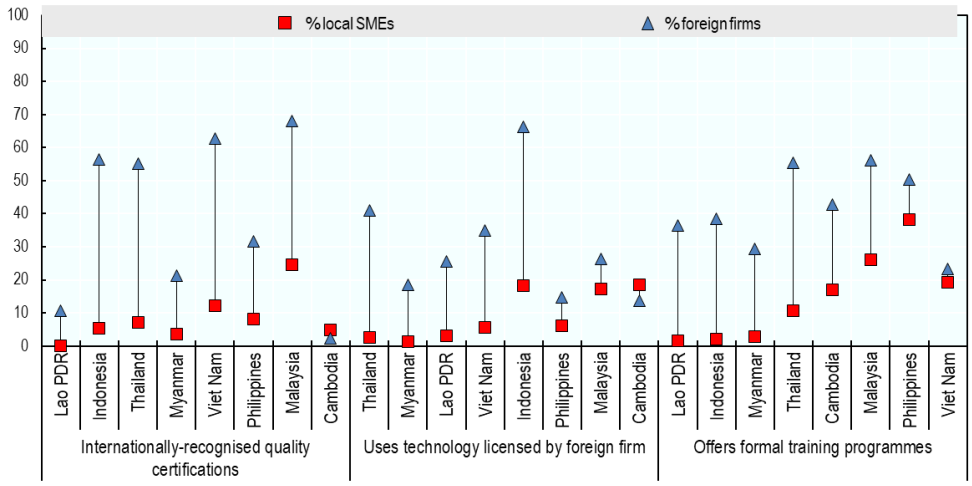
Foreign firms outperform local SMEs across all measures in all AMS (with the exception of adherence to standards and use of technology in Cambodia, where the gap is however very small). Notably, the gap is largest for internationally-recognised quality certifications, which may seriously limit SMEs' absorptive capacity in the region. In Lao PDR, Myanmar and Cambodia, even foreign firms perform relatively poorly in this respect, with fewer than 20% reporting adherence to some form of internationally-recognised quality certifications. Use of technologies licensed by foreign firms is severely limited for SMEs in most AMS, with the exception of Indonesia, Malaysia and Cambodia (approximately 20% of local SMEs). As far as training is concerned, there is wide variation across AMS in their absorptive capacities, with as many as 40% of SMEs offering formal training in the Philippines, and as low as 1% in Lao PDR. Foreign firms tend to perform significantly better in this respect, with the gap being highest for Thailand, Indonesia and Lao PDR.

Survey evidence from Thailand corroborates the notion that international certification increases the likelihood of integration in GVCs (Figure 3.11). In fact, for all types of GVC linkages considered, the incidence of linkages is significantly higher for firms that adhere to internationally-recognised quality standards. Given the low levels of certification observed among ASEAN SMEs, this evidence suggests that difficulty in obtaining internationally-recognised certifications does indeed significantly constrain participation in GVCs.

Finally, an empirical analysis of the relationship between the presence of partnerships in an industry and firm outcomes in the same industry that accounts for firm characteristics provides additional corroboration that productivity benefits of partnerships depend on absorptive capacity (Box 3.4).

Figure 3.9. Performance gaps between foreign firms and ASEAN SMEs are substantial

% of local SMEs (red rectangles) and % of foreign firms (blue triangles)



Note: Shares are constructed using the survey weights. The figure considers SMEs in manufacturing only.
Source: OECD based on World Bank Enterprise Surveys.

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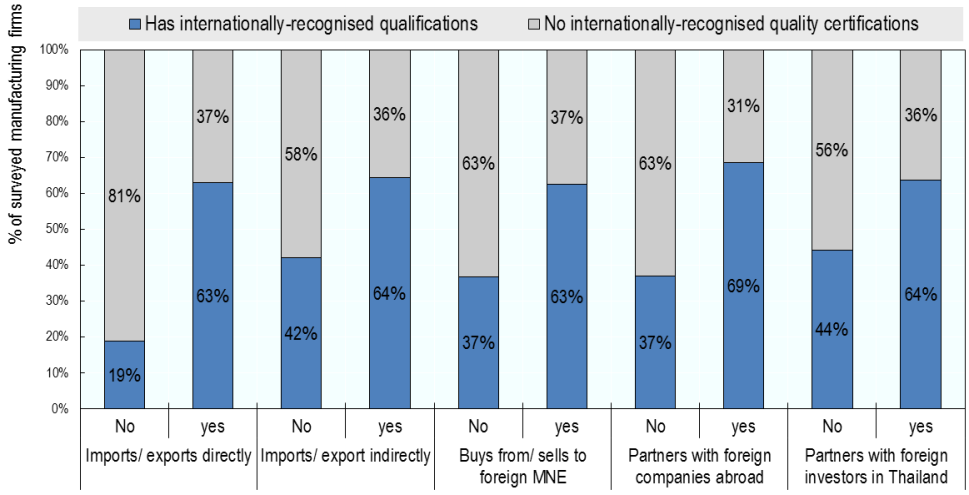
Figure 3.10. International certification increases the likelihood of integration in GVCs



Note: Figures are based on 250 responses from manufacturing firms in Thailand.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Box 3.4. Productivity benefits of partnerships depend on absorptive capacity

The empirical model relating presence of partnerships to firm outcomes in an industry (Box 3.1) fails to find evidence of significant partnership spillovers, potentially because industry averages mask heterogeneous effects across firms with different capabilities. In order to account for this, the model is extended so as to allow the relationship to vary with difference firm characteristics and measures of absorptive capacity (see Annex 3.A).

In general, the extended model provides evidence that firm capabilities do matter for the relationship between productivity and presence of partnerships to be significant. This is likely because the firms that gain from the presence of partnerships are those either directly involved in the partnership or somehow in the supply chains of the partners, and therefore firms with greater capabilities. Of course, the direction of causality could go both ways: firms that are more productive at the offset are more likely to be selected as partners, or as suppliers by firms that engage in partnerships. Nevertheless, the empirical analysis provides evidence of the following associations:

- SMEs are less productive when partnerships are more prevalent.
- Foreign firms are more productive when foreign partnerships are more prevalent, and export less when local partnerships are more prevalent.
- The productivity premium associated with partnerships is higher for firms with greater absorptive capacities (e.g. with internationally-recognised quality certifications, or that offer formal training to employees)

Once again, these findings suggest that certain firms that are more likely to be directly or indirectly involved in partnerships experience efficiency gains (e.g. foreign firms, firms with greater absorptive capacities) while the others lose out as a result of their exclusion (e.g. SMEs). On internationalisation, abundant domestic partnerships may be an indication of thriving industries with large customer bases, where the need for exporting is relatively low.

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Geographic proximity increases the chances of linkages

Another key factor that affects the ability of domestic firms to reap the benefits of FDI spillovers is their geographic distance from foreign affiliates. Domestic firms that are located in close proximity to foreign firms are more likely to benefit from knowledge spillovers than other firms (Sanfilippo and Seric, 2016). Geographic proximity is necessary to facilitate knowledge spillovers, especially as far as tacit knowledge is concerned (Jacobs, 1967).

This is reflected in a case study analysis of Samsung's mobile phone production in Viet Nam, which serves as a background study for this report (Box 3.5). The case study finds that no domestically-owned firm in Viet Nam directly supplies key parts and components of Samsung mobile phones. However, the physical establishment of large multinationals that do manufacture these parts and components as first-tier suppliers to Samsung offers some scope for domestic firms to participate in Samsung's value chain. The number of domestic firms supplying lower-value added components and services as lower-tier suppliers in the chain has increased in recent years.

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Box 3.5. Lessons from Samsung's mobile phone production in Viet Nam

Based on qualitative information collected through business interviews, a study that serves as a background paper for this report (Tong and Seric, 2018) considers the case of Samsung's mobile phone production in Viet Nam to understand the factors that affect the development of linkages for spillovers from FDI. The study finds that FDI productivity spillovers are limited by weak linkages, despite massive FDI inflows into Viet Nam. Spillovers occur mainly through direct employment. Local firms are constrained by their capabilities and production capacity, and fall short of the product and process standards required of Samsung suppliers. As a result, local firms serve as lower-tier suppliers of low value-added products and services, while none directly supplies specialised parts and components of Samsung mobile phones. Instead, these parts and components are often produced by large, mostly Korean multinational first-tier suppliers that have close ties with Samsung.

While direct supply linkages to Samsung are not present, local firms in Viet Nam find opportunities for serving Samsung's supply chain by forging linkages with Samsung's global suppliers. This is an important first step to reap the benefits of spillovers from linkages.

Indirect access to GVCs of local firms can be facilitated by attracting FDI from first-tier suppliers of lead multinationals like Samsung. FDI attraction policies need to be complemented, however, with policies designed to raise the capabilities of local firms with the potential to provide the relevant products and services to these first-tier suppliers. Policies to strengthen linkages must form part of a wider integrated strategy to improve the overall business and regulatory environment. This will benefit not only firms with potential to establish linkages with FDI but the wider domestic industrial base. Improvements in the business climate will remove horizontal constraints that hinder performance and competitiveness of firms – linked or non-linked – most notably in relation to access to finance and markets, backbone services and infrastructure, skills, and entrepreneurship.

Source: Tong and Seric (2018)

3.2. Benefits and determinants of outward FDI

Outward FDI benefits the home country

Outward FDI was once the preserve of a small number of wealthy and highly developed countries (Bano and Tabbada, 2015). Today almost every country is both home and host to MNEs, including in ASEAN. The public debate has traditionally focused on the consequences of inward FDI for economic development and on linkages with host country SMEs. More recent literature suggests that FDI has economic effects not only in recipient economies, as research shows, but also in source economies ("home effects") including on the home country's capital stock, balance of payments, employment, wages, exports, imports, and technology development (Sauvant et al., 2014).

Empirical evidence suggests that outward FDI can have significant beneficial macroeconomic effects on employment, technology adoption and the trade balance of investing countries (Thomsen, 2006). A recent study finds that outward FDI increases rather than substitutes for home country exports for selected ASEAN countries: a 1% increase in outward FDI is associated with an increase in exports of USD 750 million for

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the Philippines, USD 72 million for Singapore, USD 41 million for Thailand, and USD 31 million for Malaysia (Ahmad et al., 2016). The effects of outward FDI on the home economy arise through three channels (World Bank, 2018):

- *Scale effects*: outward investors grow larger by expanding overseas and enjoy traditional gains based on economies of scale and scope, lowering costs of production and operation.
- *Competition effects*: competition with firms in foreign markets forces outward investors to become more efficient and upgrade production processes.
- *Knowledge effects*: outward investors can acquire knowledge directly, through M&A, joint ventures, or other forms of partnerships, and transfer this knowledge back to the parent firm and potentially other firms in the home country.

Outward FDI helps firms plug into GVCs through backward and forward supply chain linkages, stimulating exports of intermediate inputs. The evidence suggests that outward FDI is typically reserved for larger firms with scale-related advantages in terms of access to knowledge and finance. But regional integration creates opportunities for ASEAN SMEs to plug into regional value chains, grow and potentially evolve into multinationals themselves.[24] As illustrated in Chapter 1, outward FDI is the last stage in the trajectory that brings the firm from an SME that is included in GVCs to a multinational lead actor in GVCs. It is important to have this full growth trajectory in mind in devising policies that support firm growth and long-term competitiveness.

Outward investments help diversify and raise efficiency

Information collected in the OECD-UNIDO Thai enterprise survey provides some evidence of association between productivity and outward investment, reflecting partly the scale effects of outward investment with respect to investing firms. Companies that engage in outward investment activities are 40% more productive, on average than those that import and export, and eleven times more productive than firms that are not internationalised at all (Figure 3.12). In terms of other benefits, the majority of outward investors report access to new markets and over a third report improvements in terms of diversified products and reduced costs.

[24] This mode of internationalisation is different from the born-global firms, which are characterised by their rapid internationalisation, typically within three years of their establishment. They typically serve niche markets and their operations are further facilitated by digitalisation and related policy developments (ASEAN-UNCTAD, 2016).

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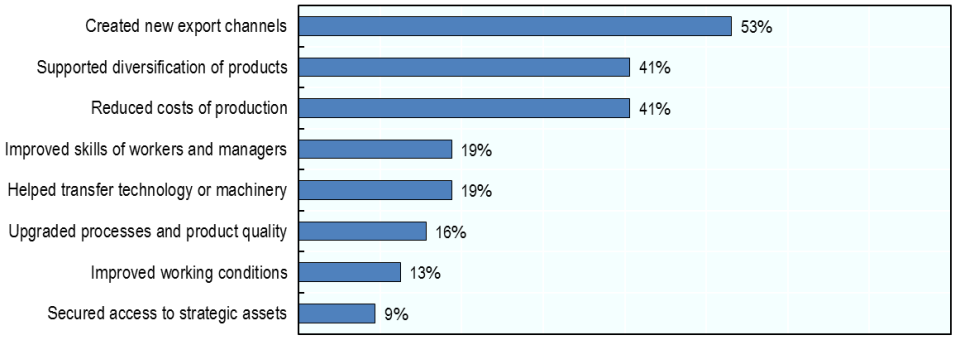
Figure 3.11. Outward FDI supports product and market diversification

How has your firm benefited from its investment abroad (outside Thailand)? (Select all that apply)



Note: Figures are based on 32 responses from Thai manufacturing firms with outward investments.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Efficiency motives drive intra-ASEAN investments in CLMV

In ASEAN, the current outward investment landscape was shaped by a combination of domestic policies and regional and global economic conditions of recent decades. The liberalisation and deregulation reforms of the 1980s–90s raised competitive pressures in many developing countries, eventually "pushing" firms out of their home markets. From their side, firms in high-growth countries like Singapore started to embrace outward FDI in the late 1990s as a development strategy to achieve efficiency in resource allocation and diversify risks from economic shocks in any one region. Supported by government incentives, firms in other ASEAN countries soon followed, as outward FDI was increasingly seen as a means to access markets, capital, technology, and knowledge in international markets, which could boost national competitiveness (World Bank, 2018). The recent rise in intra-ASEAN outward FDI (Chapter 2) reflects the fact that the less developed CLMV countries of the region, have been relatively resilient to recent global economic shocks, and have attracted investment from neighbouring AMS facing rising production costs (Chongvilaivan and Menon, 2015).

The following discussion examines drivers of recent intra-regional manufacturing investments into CLMV countries, based on evidence collected through semi-structured interviews with (foreign or domestic) manufacturing firms that initially established operations in Thailand and later relocated some of these operations to CLMV countries.[25] Though the evidence focuses on the experience of Thailand, similar conclusions can be drawn with respect to the other main outward investors in the region (i.e. Malaysia and Singapore). The top drivers common across most interviewed firms that are discussed in this chapter are related to cost, proximity, national and regional policies, and land.

While the discussion focuses on factors that have enabled rapid outward FDI expansion in ASEAN, significant challenges also constrain intra-regional investments. Inadequate infrastructure, overly cumbersome laws and regulations, lack of transparency in business procedures, and the multiplicity of quality standards and certifications across AMS are

[25] See Box 1.2 in Chapter 1 for more details on the methodology, and Annex 1.B for a summary of the interviews.

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cited among the constraints that outward investors face in the region. Specific challenges faced by firms with operations in Lao PDR's Savan-Seno SEZ are discussed in Box 3.6.

Cost differentials and saturated markets are the main drivers of regional FDI

Low costs of production in CLMV countries coupled with rising wages and saturated markets in advanced AMS have been the main impetus for rising intra-ASEAN FDI, particularly for manufacturing firms from relatively high-cost countries. Singapore is a relatively small and saturated market, with high wages and limited resources. Indonesia, Thailand and Malaysia have much larger domestic markets but are also facing rising costs and increased competition from companies in China and other ASEAN economies as a result of liberalisation. Firms from these countries started investing in neighbouring countries in the region to remain competitive: over a third of surveyed Thai firms with overseas activities report that they invest abroad to reduce production costs (Figure 3.13). The contrast in labour costs across ASEAN is reflected in the wide discrepancy in daily and monthly minimum wages, ranging from USD 2.7 per day in Myanmar to USD 10 per day in Thailand (Table 3.1).

The availability of abundant and young workforces in CLMV countries is expected to keep labour costs relatively low in the coming decades (ADB, 2015). Conversely, an aging population and shrinking labour force in more advanced ASEAN economies will likely put additional upward pressures on production costs (Banzon, 2018).

Thailand-Plus-One, a strategy first spearheaded by Japanese companies with production operations in Thailand, involves relocating labour-intensive production activities to neighbouring CLMV countries while the main production base remains in Thailand. Thai firms increasingly adopt this model, tapping into the locational comparative advantages and linking SEZs between Thailand and neighbouring AMS. European companies have also adopted this business model, particularly for garment manufacturing. Given persisting labour cost differentials, the momentum of Thailand-Plus-One regional investments in CLMV is likely to continue.

In addition to labour costs, the low cost of electricity in some CLMV countries is also a major driver of intra-regional FDI, particularly for electricity-intensive manufacturing. Electricity is considerably cheaper in Lao PDR than in Thailand or Viet Nam, though power outages often disrupt production. Electricity is often provided in SEZs by the zone developers, with conditions that are more favourable than in other areas (ASEAN-UNCTAD, 2017). In Lao PDR's Savan-Seno SEZ, cheap electricity was reported as a motive for investing by almost all interviewed firms. Given the high demand for electricity, major investments in this sector across CLMV countries are likely to improve the reliability of supply. In Lao PDR, the electricity sector accounts for over 50% of FDI inflows (ASEAN-UNCTAD, 2016). A Thai based-company is in the process of developing the first wind power project in Lao PDR and largest wind farm in ASEAN, which is expected to significantly improve Lao's electricity capacity, and increase its potential for electricity exports to neighbouring Cambodia, Thailand and Viet Nam (IES, 2018).

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Figure 3.12. Thai firms invest abroad to enjoy efficiency gains

What were the most important factors for your firm to invest abroad (outside Thailand)? (Select all that apply)

Note: Figures are based on 32 responses from Thai manufacturing firms with outward investments.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Table 3.1. Minimum wages are significantly lower in CLMV countries

Country	Daily Minimum Wage (in USD)	Monthly Minimum Wage (in USD)
Myanmar	2.4	71
Lao PDR	3.6	108
Cambodia	5.7	170
Viet Nam	4.7 – 5.3	146 -- 165
Philippines	5.7 – 7.5	170 – 224
Indonesia	3.0 – 7.6	91 – 228
Malaysia	7.5 – 8.1	224 -- 243
Thailand	9.4 – 10.1	283 – 303
Brunei Darussalam	No minimum wage	--
Singapore	No minimum wage	--

Note: Minimum wage as of 31 August 2018.
Source: Department of Labor and Employment of Philippines (2018), accessed 8/10/2018, available at: http://www.nwpc.dole.gov.ph/pages/statistics/stat_comparative.html

Proximity and policy factors facilitate ASEAN investments in CLMV

Aside from efficiency and market concerns, a number of other factors influence the decisions of ASEAN firms to invest in the region, and particularly in CLMV, namely:

- *Geographic and cultural proximity*. Geographical proximity and close cultural affinity are one of the motivations often reported by Thai manufacturing firms that are setting up production plants in CLMV countries (instead of further away). For example, several interviewed Thai-based MNEs opened new factories in the Savan-Seno SEZ in Lao PDR to produce intermediate inputs, which are then transported to the main plants in Thailand for further processing. Linguistic and cultural affinity (e.g. between Thailand and Lao PDR) facilitates communication between staff, which is important for the transfer of skills and know-how. Geo-cultural proximity is particularly important to SMEs as they experience greater barriers to competing in large and distant markets where they lack the necessary networks and experience (World Bank, 2018).

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- *Preferential market access*. The search for trade privileges is a major driver of outward FDI. Both foreign and domestic manufacturers in ASEAN increasingly relocated to locations such as Cambodia and Lao PDR in order to qualify for preferential trade access to European and US markets, particularly in the garment and electronics industries. After Thailand lost its trade privileges with the EU on all product items in 2015, companies located in Thailand started to look to neighbouring countries such as Lao PDR where tariff exemptions in the EU are still in place (Export-Import Bank of Thailand, 2017). Most interviewed companies with a manufacturing hub in Thailand relocated some of their production operations to a secondary factory in Lao PDR's Savan-Seno SEZ, primarily to enjoy tariff-free access to the EU and US markets.
- *Incentives.* Outward FDI in the region is also driven by fiscal and non-fiscal incentives in home countries. In 2015, Singapore introduced three incentive schemes to raise grant levels for SMEs, share risks and initial costs, and support outward activities of larger companies. Since 1995, all income remitted by Malaysian companies investing overseas (except from banking, insurance and sea and air transport businesses) was fully exempted from income tax (Zin, 1999). Thailand also offers incentives to outward investors, in addition to providing information assistance on investment opportunities (Pananond and Cuervo-Cazzura, 2015). Interviews with Thai firms suggest that incentives are a more important factor for smaller companies with less capital and access to finance.
- *Regional policies.* Since its launch in 2015, the ASEAN Economic Community (AEC) has encouraged businesses in ASEAN to expand their regional footprint, prompting the expansion of logistics companies to serve the operations of outward investors in the markets where they set up new production facilities. For example, Thai logistics providers are increasingly investing in CLMV countries to offer logistics services for Thai firms that expanded their operations in the region.
- *Land availability.* The rise of industrial and agricultural land prices in more advanced ASEAN countries has also been an important driver of outward FDI into CLMV countries according to interviews with agro-food processing firms in Thailand. In the coming years, CLMV countries are expected to continue attracting agricultural investments from neighbouring countries given the availability of large tracts of land in favourable climatic locations and at a relatively low cost.

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Box 3.6. Drivers and constraints of investments in Savan-Seno SEZ

Drivers

- *Strategic geographic location.* The SEZ is in a strategic position, connecting production hubs from north to south and west to east. It includes the only dry port in Lao PDR, which is crucial for cargo unloading and reloading, as the size of trucks permitted in Thailand is different than in China and other countries.
- *Rising labour costs in Thailand*. Many foreign investors with operations in Thailand moved to Savan-Seno as a result of considerably lower labour costs in Lao PDR.
- *Common language*. Similar language is reported as a key factor for choosing Savan-Seno over zones in neighbouring countries.
- *Low electricity costs*. Low cost of electricity with relatively few disruptions is often mentioned as a decisive factor for investing in Savan-Seno, particularly for labour-intensive production that requires a lot of electricity (e.g. garment manufacturing).
- *Access to water*. Savan-Seno has very good access to water and a good system of wastewater treatment (in one of the four sub-zones), which are not a given in large part of the CLMV region.
- *Preferential trade schemes*. Preferential access to the EU, Japanese and US markets is an important motive for relocating to Lao PDR.
- *Investment incentives*. Tax and other incentives provided in the Zone were reported as key for investment decisions.
- *Political stability*. A stable political environment was also a determining factor for relocating investments to Lao's Savan-Seno.

Challenges

- *Lack of coordination.* While the governance of the Zone is good, policies are not coordinated with the provincial and central government of Lao PDR. For example, clearance of airfreight in Vientiane is highly inefficient and is not coordinated with the governance of the Savan-Seno SEZ, resulting in long delays.
- *Connectivity.* The only airport, Savannakhet, is very small, serves only a few flights per week, and cannot serve large planes due to its short runway.
- *Waste and water treatment.* Though significantly better than in other CLMV countries, waste and waste water treatment systems exist only in one of four sub-zones.
- *Skills and reliability of workers.* Some investors report that workers may abandon the workplace to help their families during harvesting season, with the expectation to return after the season is over. For technology intensive firms, it is very difficult to find skilled labour and engineers. Local universities could coordinate more with industry to provide relevant engineering programmes and develop required skills.

Source: Business interviews, see Annex 1.B.

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Annex 3.A. Empirical analysis of partnership spillovers

The empirical analysis investigates four key research questions:

1. Do partnerships matter for firm productivity or export intensity?
2. Does ownership of partners matter? i.e. does it matter for productivity and export intensity whether firms are exposed to partnerships that are purely domestic, purely foreign or that are between domestic and foreign firms?
3. Does the type of partnership matter? i.e. does it matter whether partnerships are horizontal (joint ventures), upstream (manufacturing) or downstream (marketing)?
4. Do firm characteristics matter for the realisation of productivity or export-related benefits?

The data

Partnership data are retrieved from SDC Platinum Thomson Reuters. The dataset provides information on the firms involved in an agreement (e.g. name, country, industry), the type of partnership (e.g. including equity and/or technology transfer), and the objective of the partnership (e.g. marketing, manufacturing, R&D).

The sample considers agreements between a maximum of two entities, for a total of 6 434 partnerships established over 2004-16 in Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand and Viet Nam. For each country, partnerships are classified according to firm ownership in the following three categories: (1) *Domestic-Domestic*, if both firms are from the focal country; (2) *Domestic-Foreign*, if one firm is from the focal country and the other is from a different country; and, (3) *Foreign-Foreign*, if both firms are from a different country than the focal one. Partnerships are further classified according to type into three categories: (1) manufacturing agreements, (2) marketing agreements, and (3) joint ventures (defined as partnerships in which new autonomous and independent firms are created by the two or more parties involved in the agreement).

Partnership data are aggregated to the country-, industry- and year-levels, for each category of ownership and type. Industry aggregates were combined with manufacturing firm-level data from ASEAN countries with at least two years of World Bank Enterprise Surveys; namely, Indonesia (2009, 2015), Lao PDR (2009, 2012, 2016), Philippines (2009, 2015), and Viet Nam (2009, 2015).

Descriptive statistics

Annex Table 3.A.1. Distribution of partnerships by country and ownership

Country	Domestic-Domestic	Domestic-Foreign	Foreign-Foreign	Total
Indonesia	202	957	293	1452
Lao PDR	14	90	18	122
Philippines	358	590	92	1040
Viet Nam	258	1105	469	1832
Total	832	2742	872	4446

Source: SDC Platinum Thomson Reuters

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Annex Table 3.A.2. Distribution of partnerships by country and type

Country	Joint ventures	Manufacturing agreements	Marketing agreements
Indonesia	1249	489	54
Lao PDR	116	14	2
Philippines	790	114	43
Viet Nam	1654	609	34
Total	5705	1718	189

Note: Each partnership can be assigned to more than one type (e.g. a partnership can be classified both as marketing and licensing). Joint ventures are defined as partnerships in which new autonomous and independent firm created by the two or more parties involved in the agreement.
Source: SDC Platinum Thomson Reuters

Annex Table 3.A.3. Summary of firm-level variables

Variable	Units	Observations	Mean
productivity (sales/labour cost)	USD	5371	402
productivity (sales/total FTE)	USD	5584	125,847
share of sales exported	%	6065	20.4
share of internal working capital	%	6089	3.9
experience of top manager	years	6089	2.8
female top manager (1=yes)	binary	6089	0.2
share of locally sourced inputs	%	5900	3.8
capacity utilisation	%	5352	4.3
working hours operation per week	hours	5642	4.0
line of credit (1=yes)	binary	6089	0.4
labour force cost	USD	5500	18.7
main owner share dummy (1=100%)	binary	6089	0.5
private domestic owner share dummy (1=100%)	binary	6089	0.8
SME dummy (1=yes)	binary	6089	0.8
training program dummy (1=yes)	binary	6089	0.3
quality certifications dummy (1=yes)	binary	6089	0.2
private foreign owner dummy (1=100%)	binary	6089	0.1
female is owner (1=yes)	binary	6089	0.5
imported inputs share dummy (1=100%)	binary	6089	0.1

Source: World Bank Enterprise Surveys

Estimation and limitations

The empirical framework resembles that of many existing studies on FDI spillovers, but replaces industry-level information on FDI presence with industry-level information on the presence of different forms of partnerships (including joint ventures) between ASEAN firms and foreign MNEs, both in upstream and downstream sectors. The estimation employs ordinary least squares and standard errors that are robust to heteroscedasticity. The baseline model is as follows:

$$y_{i,cy,s} = \beta * p_{cy,s} + \delta_{cy} + \gamma_s + \theta * X_{i,cy,s} + \varepsilon_{i,cy,s}$$

where $y_{i,cy,s}$ is productivity or export intensity of firm i, operating in sector s, which was surveyed in country c in year y. Productivity is defined as sales per employee and alternatively as sales per unit of labour costs. Export intensity is defined as share of exports in total sales. These three dependent variables are used in logs. $p_{cy,s}$ is the industry-level partnership variable. It corresponds to the total number of reported partnerships over five

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years prior to and including the year over which productivity and exports are observed. Partnership data are used in logs and alternatively industry-level dummy variables on presence of partnerships are constructed. δ_{cy} and γ_s are survey (country-year) and sector fixed effects. $X_{i,cy,s}$ is a vector of firm-level variables used in various robustness checks. $\varepsilon_{i,cy,s}$ is the error term.

The baseline model is extended to include interactions between firm-level variables and the partnership variable. These interactions are intended to capture differential effects of the presence of partnerships on firms with different characteristics or absorptive capacities. The augmented model is as follows:

$$y_{i,cy,s} = \beta_1 * p_{cy,s} + \beta_2 * x_{i,cy,s} + \beta_3 * (p_{cy,s} * x_{i,cy,s}) + \delta_{cy} + \gamma_s + \varepsilon_{i,cy,s}$$

where $x_{i,cy,s}$ corresponds to specific firm-level characteristics such as size and ownership; and $(p_{cy,s} * x_{i,cy,s})$ corresponds to the interaction term between firm-level variables and the partnership variable.

Given that the estimations do not explicitly model the relationship between supply chain linkages and firm performance, and cannot control for reverse causality (e.g., more productive firms attract more partnerships), in both cases, interpretations of relationships should not be taken as causal, but rather as correlations.

Main findings

The main finding from the baseline estimation is that the presence of partnerships in an industry is unrelated to domestic firm performance, irrespective of the nature of the partnership (upstream, downstream, horizontal), and of whether foreign investors are involved in partnerships. As the estimation does not control for firm involvement in the partnership, insignificant industry averages may mask heterogeneous firm-level effects.

The extended model provides evidence that firm characteristics affect the relationship between productivity and presence of partnerships to be significant (notably firm size, foreign ownership, internationally-recognised certifications and staff training). This is likely because the firms that gain from the presence of partnerships are those directly involved in the partnership (or in the supply chains or partners), and therefore firms with greater capabilities. Alternatively, firms that are more productive at the offset are more likely to be selected as partners. For more details of the regression results and their interpretation, please refer to Di Lorenzo and Wermerlinger (forthcoming).

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4. How can policy enable SMEs to benefit from FDI?

The policy environment is a crucial ingredient for attracting foreign investment, building local capacity, and anchoring investors through deep linkages with the local economy. Regional and national policies also play an important role in promoting and facilitating outward internationalisation of firms through investment. This chapter examines policies to improve the investment environment and support the development of local linkages with foreign investors. It then explores policies that support outward investment of ASEAN firms, with a focus on intra-regional investments in less developed CLMV countries.

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Summary

Over the past five years, FDI inflows have been at record levels for many ASEAN countries, in part thanks to assertive policy interventions to reform FDI restrictions. But many other emerging regions have moved beyond ASEAN in terms of openness. Indeed, six ASEAN members are among the top ten most restrictive economies to FDI covered by the OECD *FDI Regulatory Restrictiveness Index*. Significant progress remains to be made in liberalising services sectors, which could translate into greater productivity in manufacturing, and deeper linkages between foreign investors and local SMEs.

Efficient and fair resolution of commercial disputes is essential for the establishment of linkages between foreign investors and local suppliers. Based on evidence from World Bank Enterprise Surveys, good contract enforcement procedures are found to be associated with higher levels of local sourcing, suggesting that where contract enforcement is relatively less efficient (e.g. Cambodia and Myanmar), significant gains may be made in terms of promoting linkages with local suppliers by strengthening the judiciary or providing alternative dispute settlement mechanisms.

Tax incentives (particularly tax holidays) can impose significant fiscal costs on the countries using them. International organisations and other institutions generally agree that targeted incentive schemes are to be preferred. While under-researched, evidence supporting targeted approaches is emerging. Targeted incentives for SME and supplier engagement, for example, have been demonstrated to be effective in Malaysia and Singapore. Governments may consider targeting incentives on technology acquisition and delivery of technology-related capacity building, so as to foster greater SME access to supply chains of multinationals.

Expectations about responsible business conduct are growing and are increasingly reflected in international agreements and in home country legislation. ASEAN member states have made efforts to address responsible investment, both through the implementation of the ASEAN Economic Community Blueprint and through national action plans. These initiatives can help position the region as a reliable location for production and local sourcing and reduce any reputational and financial risks perceived by international investors. Big data solutions can facilitate SME compliance with responsible business conduct standards and create a more level playing field that supports SME linkages with foreign investors.

ASEAN member states have to varying degrees put in place policies and programmes specifically designed to deepen linkages between local SMEs and foreign multinationals. The majority of countries offer support for vendor development programmes and have an agency that provides business matching services, though only two have designated SME centres. According to the OECD SME Policy Index, Singapore, Malaysia and Thailand lead the way in terms of devising and implementing comprehensive policies for integrating SMEs in global value chains, including business linkage programmes. In other ASEAN countries, linkage programmes are not operational or well-funded and there has been no report on their achievement levels. Achieving the desired SME linkage impacts through these programmes requires strong political and financial commitment.

Special economic zones (SEZs) have been at the heart of successful export-led development strategies of ASEAN countries, over many decades. The ASEAN region has more than 1 600 economic zones of various types. But the spread of backward linkages has varied greatly across countries. Some ASEAN countries are adapting their SEZ strategy to a more elaborate and comprehensive strategy for cluster development. A stronger emphasis

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is given to SME development in Malaysia and Thailand, in an active and successful effort to link foreign firms with local suppliers.

Policies that support outward FDI are complementary to measures aimed at attracting inward FDI. Regional integration efforts have been a key driver of outward FDI within the ASEAN region. The growing number of SEZs along national borders, the Belt and Road Initiative and the Regional Economic and Comprehensive Partnership are expected to further stimulate regional FDI flows. National policies in support of outward FDI are also in place, to varying degrees, including capital control liberalisation measures, technical and financial assistance, fiscal incentives and insurance against political risk. Businesses in Thailand report that complicated bureaucratic procedures pose the greatest obstacle to outward investment. Many interviewed firms are unaware of existing support for outward investment.

Based on the evidence gathered and assessed in this chapter, the main policy implications that emerge are the following:

- There remains scope for significant progress in granting foreign investors access to the services sector across ASEAN members. Advancing FDI liberalisation of services sectors can raise productivity of manufacturing firms and create new opportunities for ASEAN SMEs to plug into global value chains.
- Gains may be achieved in the effort to promote local linkages by improving the quality and efficiency of judicial processes and by providing alternative mechanisms for resolving commercial disputes.
- Targeted incentives for SME and supplier engagement have been effective in Malaysia and Singapore, but must be accompanied by a credible effort to develop SME skills and capabilities.
- Governments may consider targeting incentives on technology acquisition by medium- and large-sized domestic firms.
- Raising awareness among business about the benefits associated with adhering to responsible business conduct principles and making an explicit link between RBC and business matchmaking efforts can help fill the information gap for foreign investors and signal safe sourcing opportunities.
- Policies in support of data protection and digital infrastructure can facilitate adoption of big data solutions in ASEAN, which in turn have the potential to accelerate SME development and support SME linkages with foreign investors.
- Advancing the implementation of existing SME linkage programmes by providing adequate funding and resources is necessary to maximise their impact.
- SEZ strategies should be complemented by policies that support skills and cluster development in order to have the desired spillovers on SMEs.
- Liberalising capital controls is an important first step to enable domestic firms to become multinational. Governments should consider transitioning toward policies that allow firms to undertake outward investments, without influencing the types of investments or the destination
- Technical and financial support aimed at overcoming informational barriers can significantly alleviate constraints faced by potential outward investors. Outward FDI support policies should be advertised, easily accessible and understandable.

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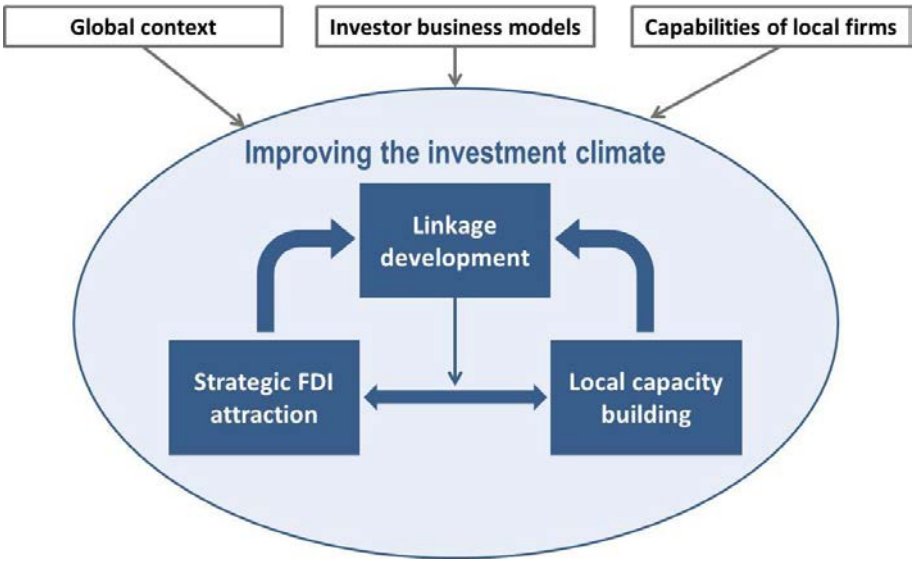
4.1. Policies for enabling MNE-SME linkages

The development of business linkages between foreign investors and local firms is affected by a variety of policy and non-policy factors (Figure 4.1). On the non-policy side, the global context, including macroeconomic factors related to the business cycle and long-term growth as well as geographic and cultural factors, among others, affects FDI trends and sourcing decisions of multinationals. Additionally, business models on the side of investors and capacities on the side of local firms (discussed at length in the previous chapters) determine the extent to which foreign MNEs are likely to forge linkages with local SMEs.

Policy can play a pivotal role in attracting and anchoring investors through deep linkages with the local economy. The first step to supporting linkages is implementing measures to improve the overall investment climate.[26] A healthy investment climate can by itself help to create an environment which is propitious for foreign firms to invest and link with local firms. Governments may nevertheless decide to implement additional targeted measures to enhance linkages, but without an underlying policy environment that fosters and facilitates private investment, these proactive policies are likely to prove ineffective.

Figure 4.1. A policy framework for investment and linkages



Source: Adapted from UNCTAD (2010)

Targeted policies to support linkages integrate complementary elements directed to foreign investors and domestic SMEs. On the investor side, it is necessary to invite a critical mass of targeted FDI to form an industrial cluster that can create real opportunities for business. On the domestic side, putting in place a supporting mechanism to help local firms overcome supply-side constraints and achieve the standards required to become suppliers to FDI (quality, delivery, performance, compliance, etc), is necessary to create a pool of qualified local firms capable of supplying goods and services that meet FDI requirements. Having

[26] The OECD *Policy Framework for Investment* (PFI) addresses questions pertaining to 12 policy fields that are critically important for improving the quality of a country's enabling environment for investment, ranging from investment promotion to human resources development (Box 4.1).

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attracted foreign investors and developed local capabilities, policy can serve to build an effective selection and matching mechanism to link potential FDI and local firms.

This chapter first examines selected areas of the investment climate in ASEAN that may have particular influence on the development of linkages, drawing on the PFI. It then zooms in on specific policies for linkage promotion and local capacity building, and the extent of their success in ASEAN, drawing on specific national experiences.

Box 4.1. The OECD Policy Framework for Investment

The *Policy Framework for Investment* (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate. The PFI was first developed in 2006 by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. Designed by governments to support international investment policy dialogue, co-operation, and reform, it has been extensively used by almost 30 countries as well as regional bodies to assess and reform the investment climate. The PFI was updated in 2015 to take this experience and changes in the global economic landscape into account.

The PFI is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in 12 policy areas: investment policy; investment promotion and facilitation; trade; competition; tax; corporate governance; promoting responsible business conduct; human resource development; infrastructure; financing investment; public governance; and investment in support of green growth. Three principles apply throughout the PFI: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

The value added of the PFI is in bringing together the different policy strands and stressing the overarching issue of governance. The aim is not to break new ground in individual policy areas but to tie them together to ensure policy coherence. It does not provide ready-made reform agendas but rather helps to improve the effectiveness of any reforms that are ultimately undertaken. By encouraging a structured process for formulating and implementing policies at all levels of government, the PFI can be used in various ways and for various purposes by different constituencies, including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions.

The PFI looks at the investment climate from a broad perspective. It is not just about increasing investment but about maximising the economic and social returns. Quality matters as much as the quantity as far as investment in concerned. It also recognises that a good investment climate should be good for all firms – foreign and domestic, large and small. The objective of a good investment climate is also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

For more information on the PFI, see: http://www.oecd.org/investment/pfi.htm.

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Improving the investment climate

FDI liberalisation can boost SME productivity

Regulatory restrictions on FDI limit market access and thereby limit the potential for linkages between foreign investors and local SMEs. As such, reforming FDI restrictions can serve to promote MNE-SME linkages. The fast pace of regulatory reform in ASEAN in this regard has no doubt contributed to the region's success in attracting FDI. The following discussion considers discrimination against foreign investors in ASEAN and comparator countries, based on the OECD *FDI Regulatory Restrictiveness Index* (Box 4.2), and how this relates to FDI performance.[27]

Box 4.2. The OECD FDI Regulatory Restrictiveness Index

The OECD *FDI Regulatory Restrictiveness Index* seeks to gauge the restrictiveness of a country's FDI rules. The measures taken into account by the index are limited to statutory regulatory restrictions on FDI (typically listed in countries' lists of reservations under FTAs). The *Index* does not score actual implementation of formal restrictions. Neither state ownership nor preferential treatment for export-oriented investors are scored, to the extent they are not discriminatory towards foreigners.

The *Index* covers 22 sectors, including agriculture, mining, electricity, manufacturing and main services (transport, construction, distribution, communications, real estate, financial services and professional services). Restrictions are evaluated on a 0 (open) to 1 (closed) scale. The overall restrictiveness index is a simple average of individual sectoral scores.

For each sector, the scoring is based on the following elements:

1. the level of foreign equity ownership permitted,
2. the screening/approval procedures applied to inward FDI;
3. restrictions on key foreign personnel; and,
4. other restrictions, e.g. on land ownership, corporate organisation (branching).

Source: For more information on the methodology, see Kalinova, Palerm and Thomsen (2010). For the latest scores, see: www.oecd.org/investment/index.

Countries in the Asia-Pacific region, including many ASEAN economies, tend to be relatively more restrictive than in other regions (Figure 4.2). All governments discriminate among investors in one way or another. This is the case even in OECD countries where restrictions on foreign investment tend, on average, to be lower than in other parts of the world. Foreign investors might, for example, face restrictions on their ownership in a local company, particularly in strategic sectors. Larger countries also tend to be more restrictive, partly because larger domestic markets give them greater scope to impose discriminatory conditions on investors.

Based on the experience of early and late industrialisers up to the 1970s, developing countries imposed FDI restrictions as a means to limit foreign competition while providing room for domestic firms to grow. The results were mixed. Subsequent changes in the global trade and production environment, coupled with the success of East Asian newly-industrialised economies, persuaded governments to relax FDI restrictions in a more

[27] For a more detailed discussion on FDI liberalisation in ASEAN refer to OECD (2018a)

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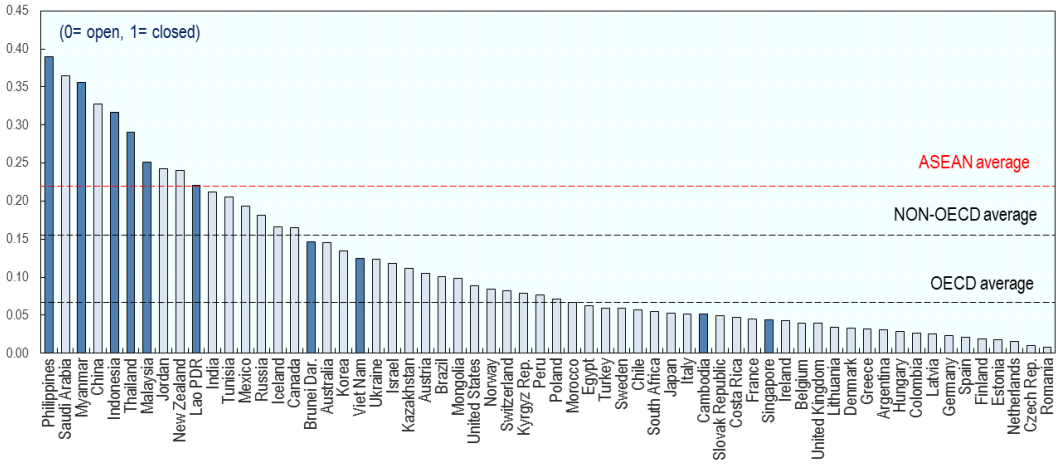
strategic manner. The extent of restrictiveness of FDI regulations in ASEAN economies is considerably higher than observed elsewhere. Indeed, six AMS are among the top 10 most restrictive economies to FDI based on a sample of more than 60 countries covered by the *Index*. This finding may seem at odds with the fact that many AMS have largely relied on FDI as part of their export-led development, but the *Index* does not capture the often more liberal regime enjoyed by export processing zones or exporters more generally.

Figure 4.2. Many ASEAN economies are among the most restrictive toward FDI



Notes: See Box 5.1 for a description of the Index. Data reflect restrictions as of end-December 2016. Scores for Brunei Darussalam, Thailand and Singapore are preliminary.
Source: OECD FDI Regulatory Restrictiveness Index database, http://www.oecd.org/investment/fdiindex.htm

Seen from a broad perspective, ASEAN economies have been among the most active FDI reformers in the past two decades in absolute terms, consistently moving towards levels of FDI restrictions observed in more advanced economies (OECD, 2018a). Over time, greater efforts have been made to dismantle barriers to FDI in manufacturing industries as governments have come to accept the potential benefits of industrial FDI for development.

Outside of manufacturing, FDI restrictions remain high in the services and primary sectors. Further liberalisation could help raise efficiency in sectors still dominated by large state monopolies and improve services efficiency and availability. Opening services for FDI could have catalytic effects by creating opportunities for developing services that have not been available before and enable important knowledge and technological spillovers, not only in services but also in manufacturing and other sectors. It would also increase the use of high quality services in production and thus raise manufacturing productivity in ASEAN.

Services liberalisation may be particularly important for the competitiveness and productivity of smaller ASEAN manufacturers. SMEs rely proportionately more on high quality backbone and other services that are provided by upstream, external providers. Restrictions are likely to lower competitiveness and quality of service provision and may increase costs. With scale, firms are more likely to internalise certain services or source them from other markets and thus restrictions in upstream services could affect them less.

The regional IPR of Southeast Asia includes an empirical assessment of the role of FDI liberalisation in services on firm productivity in downstream manufacturing sectors (OECD, 2018a). A key finding from that analysis is that while services liberalisation may

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boost productivity of any type of manufacturer in ASEAN, this productivity premium may be particularly pronounced for SMEs.

Good enforcement procedures support local sourcing

The ability to make and enforce contracts and resolve disputes is fundamental for markets to function properly. Good enforcement procedures enhance predictability in commercial relationships by assuring investors that their contractual rights will be upheld promptly by local courts. When procedures for enforcing contracts are overly bureaucratic and cumbersome or when contract disputes cannot be resolved in a timely and cost-effective manner, foreign investors may restrict their activities or refrain from engaging with local companies. As a result, guaranteeing good enforcement procedures or alternative dispute resolution mechanisms can serve not only to promote linkages between foreign investors and local SMEs but also to make technology transfers more likely.

As the court system plays a fundamental role in enforcing contracts, a number of judicial reforms can be considered good practices in responding to the need of modern societies for efficient and high-quality judicial systems. They include such measures as producing and monitoring statistics on the efficiency and independence of the judicial system; adopting e-justice systems to facilitate the management of cases by both judges and lawyers; and organising the judicial system along key areas of specialisation. Alternative dispute resolution mechanisms, including arbitration, mediation and conciliation, are also available and increasingly used for resolving commercial and investment disputes. International investment agreements, although with variations in scope and content, also provide for standards of treatment of investors and their investments. As such, they may provide an additional layer of security to covered investors, including sometimes by offering recourse to international investment arbitration to resolve investor-state disputes (OECD, 2015).

Country performance in terms of contract enforcement can be assessed using indicators covered in the World Bank's *Doing Business* indicators. Figure 4.3 illustrates the ease of enforcing contracts in ASEAN countries based on the distance of each country from the frontier, or best performance in enforcing contracts since 2005. Performance is measured across three dimensions: (1) days to resolve a commercial dispute through the courts; (2) attorney, court and enforcement costs as a share of claim value; and (3) use of good practices promoting quality and efficiency.[28] As shown in the figure, there is wide variation in contract enforcement among ASEAN countries, with Singapore well above the OECD average, Thailand and Malaysia performing at average OECD levels, and Cambodia and Myanmar, well below average non-OECD levels.

Combining contract enforcement scores with data on local sourcing by foreign-invested companies from the World Bank *Enterprise Survey* provides some evidence that, in ASEAN, good enforcement procedures are indeed associated with higher levels of linkages (Figure 4.4). In other words, foreign companies appear to source a larger share of intermediate inputs locally in countries where contracts are enforced more efficiently. This suggests that strengthening the judiciary, increasing the efficiency of contract enforcement procedures, and providing alternative dispute settlement mechanisms can serve to encourage greater local sourcing and linkages with SMEs.

[28] For more details on the methodology, visit the World Bank Doing Business website: http://www.doingbusiness.org/Methodology/enforcing-contracts

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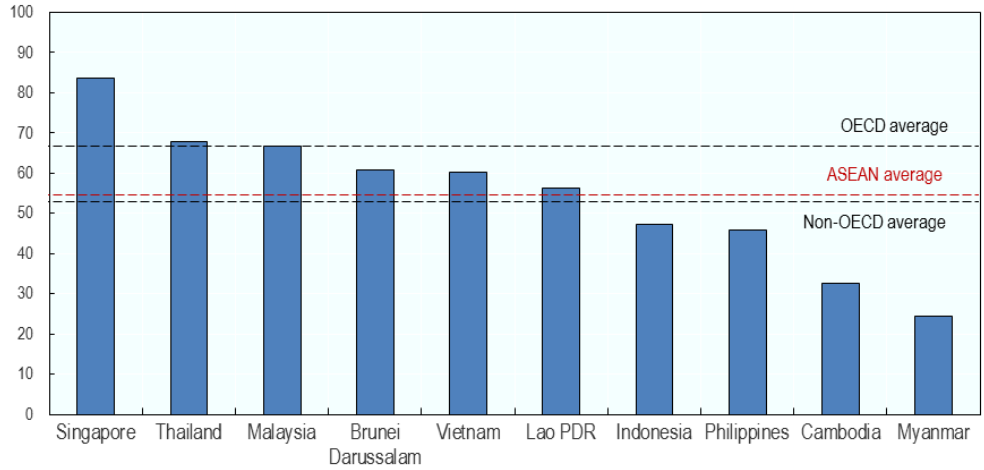
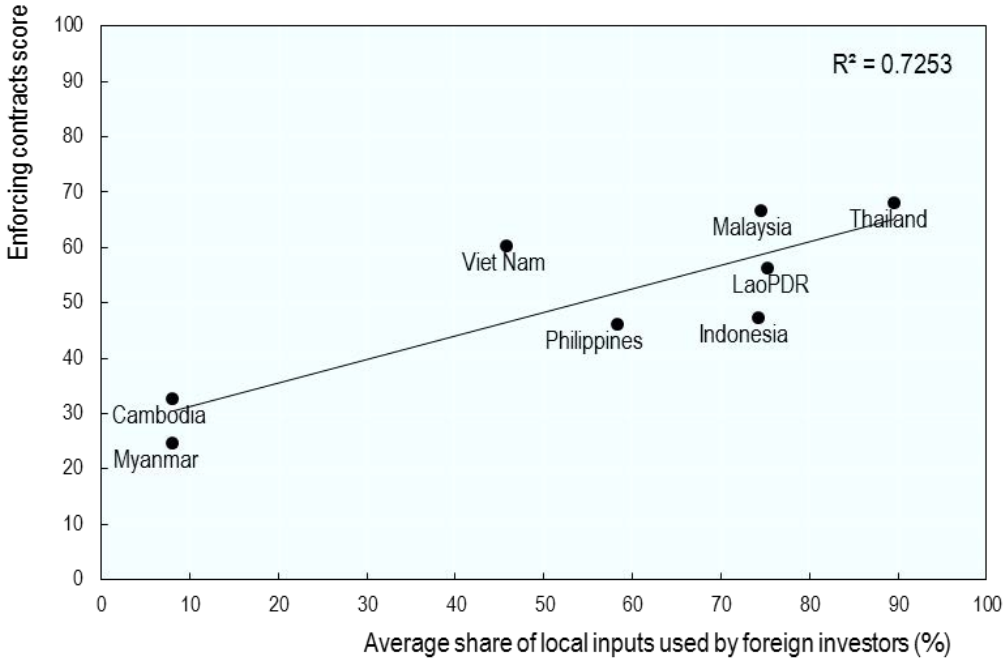
Figure 4.3. Ease of enforcing contracts varies considerably across AMS



Note: In *Doing Business,* "Distance to frontier" (DTF) measures the distance of an economy from the best performance observed in all years and all economies since 2005. The distance is measured on a scale from 0 (lowest performance) to 100 (frontier). The overall score for enforcing contracts is a simple average of the DTF scores for (1) days to resolve a commercial dispute through the courts; (2) attorney, court and enforcement costs as a share of claim value; and (3) use of good practices promoting quality and efficiency.
Source: World Bank (2018), http://www.doingbusiness.org/data/exploretopics/enforcing-contracts.

Figure 4.4. Better enforcement procedures are associated with greater local sourcing



Note: The figure considers manufacturing firms only. The threshold for foreign ownership is 10% of equity. The national average is constructed using survey weights. Over 20 foreign firms are observed for all AMS.
Source: OECD based on World Bank *Doing Business* (2018); World Bank *Enterprise Survey* (2017).

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Targeted incentives may be useful to promote SME linkages

ASEAN member states use targeted incentive schemes (such as tax deductions and tax credits) to promote and encourage investment activities that enable economic and social spillovers (Table 4.1). Tax deductions allow firms to subtract certain expenses (e.g. on training programmes, R&D activities, capacity building of SMEs, and environmental protection) or revenues (e.g. export revenues) from taxable income. Tax credits are similar but enable investors to use such expenses directly to reduce the amount of taxes owed. Most AMS have some targeting of specific regions, either via special incentive provisions for less developed regions or additional incentives in special economic zones. More advanced countries within ASEAN, such as Singapore, Malaysia and Thailand, have a more nuanced approach to targeting, with specific tax incentives to promote SME linkages, skills, environmental protection, R&D, automation and high-tech activities.

Tax incentives (particularly tax holidays) can impose significant fiscal costs on the countries using them. In Cambodia, for example, the estimated revenue loss corresponds to up to 6% of GDP. International organisations and other institutions generally agree that targeted approaches in terms of activities should be preferred. Targeted tax incentives and their effectiveness are under-researched, but some evidence supporting targeted approaches is emerging. Targeted incentives for SME and supplier engagement, for example, have been demonstrated to be effective in Malaysia and Singapore (Box 4.3).

Since many SMEs do not directly supply foreign MNEs, but rather access their value chains as lower-tier suppliers of larger domestic firms, emphasis could be given to domestic firms that have the capacity to serve as a conduit between MNEs and SMEs. In other words, governments may consider providing incentives to key domestic firms that are able to absorb knowledge from foreign MNEs and transfer it to their SME suppliers. Such incentives could target technology acquisition (e.g. royalties on license agreements, consultancies by tech experts, overseas training, in-house R&D facilities) and be conditional on the delivery of technology-related capacity building to their supplier base.

Table 4.1. Targeted tax incentive schemes are widespread in ASEAN

AMS	Local sourcing, SMEs	Training & skills	R&D, strategic sectors	Green growth	High-tech	Export	Import	HQ	Territorial, SEZs	Infra-structure
BRU		X	X	X	X		X			
KHM						X	X		X	
IDN					X		X		X	X
LAO						X	X		X	X
MYS	X	X	X	X	X	X	X	X	X	X
MMR		X	X			X	X		X	
PHP					X	X	X	X	X	X
SGP		X	X		X		X	X	X	
THA	X	X	X				X	X	X	X
VNM		X	X		X		X		X	X

Source: OECD (2018a)

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Box 4.3. Effective use of tax incentives: Malaysia, Singapore and Thailand

Tax and other incentives to foster linkages with SMEs and improve their skills have proven effective in various countries around the world (Perera, 2012; UNCTAD, 2011; Christiansen and Thomsen, 2005). **Malaysia**, for instance, offers various incentives to encourage linkages between foreign investors and local SMEs. Under the Industrial Linkage Programme, 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. A Global Supplier Programme offers financial and organisational support to MNEs, if specialists from their foreign affiliates are seconded to local firms (for up to two years) for the purposes of local upgrading.

Singapore has the Pioneer Certificate Incentive and Development and Expansion Incentive. They encourage foreign MNEs to set up local upstream and downstream activities that are more typically conducted at companies' headquarters. The incentive provided is a corporate tax exemption or a reduced concessionary tax rate on eligible income. Companies that apply for this incentive must commit to upgrading their employment and business investments. The programme intends to foster technology transfers and the scale-up of the local economy. Similarly, **Thailand** moved from a system of location-based incentives (economic zones) to an activity- and merit-based one. These new incentives also include the promotion of SME linkages and skills.

These targeted tax incentive programmes reduce the perceived risk for foreign investors when engaging in capacity building of local suppliers. Studies have shown that these programmes have been effective in establishing linkages and boosting productivity in the SME sector in Malaysia and Singapore (UNCTAD, 2011). The programmes in Malaysia have influenced Intel in its decision to develop local SMEs as suppliers. Intel is reported to have developed a model for supporting supplier development and upgrading: 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, the global Intel network. Intel estimates benefits amounting to USD 50 million per year from participating in these programmes (Christiansen and Thomsen, 2005).

Source: OECD (2018a)

Responsible business conduct signals safe local sourcing opportunities

Responsible business conduct (RBC)[29] principles and standards set out an expectation that all businesses – regardless of their legal status, size, ownership structure or sector – should avoid and address negative impacts of their operations, while contributing to the sustainable development of the countries where they operate. These expectations are prevalent throughout GVCs and are affirmed in the main international instruments on RBC – notably the OECD *Guidelines for Multinational Enterprises* (OECD *Guidelines*), the UN *Guiding*

[29] RBC is often referred to as corporate social responsibility or CSR, though the two are not exactly equivalent. Responsible business conduct means that businesses should make a positive contribution to economic, environmental and social progress with a view to achieving sustainable development and that they have a responsibility to avoid and address the adverse impacts of their operations. While the concept of CSR is often associated with philanthropic corporate conduct external to business operations, RBC goes beyond this to emphasise integration of responsible practices within internal operations and throughout business relationships and supply chains.

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Principles for Business and Human Rights (UN *Guiding Principles*), and the *Fundamental International Labour Organization* (ILO) *Conventions* – and increasingly in international trade and investment agreements and national development strategies, laws, and regulations all over the world.

Many businesses also find that responsible business is good business, beyond ensuring that they respect human rights and comply with relevant laws and regulations. Understanding, addressing, and avoiding risks material to business operations in a more comprehensive way – that is, beyond financial risks – often leads to a competitive advantage. A market in which internationally accepted environmental and social principles and standards are not respected faces an increased risk of being excluded from value chain activity.

As a response to increasing demands by businesses, civil society and other stakeholders to take more strategic measures and emphasise company responsibility for economic, social and environmental impacts, references to corporate social responsibility (CSR) and key RBC concepts have been included in the ASEAN Economic, Socio-Cultural, and Political-Security Community Blueprints 2025. Beyond this strategic guidance, specific action has also been taken on urgent social issues in the global supply chain, notably on preventing human trafficking, protecting migrant workers and transitioning from informal to formal employment. ASEAN members are also implementing concrete and innovative measures to promote and enable RBC domestically (OECD, 2018a).

ASEAN governments may want to assess whether a stronger focus on non-fiscal incentives is warranted in light of the findings that it remains unclear whether tax incentives are an effective tool to attract investment or encourage business linkages. RBC expectations could be included in FDI attraction efforts and may help attract MNEs that are more inclined to source locally. The current Invest in ASEAN website does not mention environmental and social issues or corporate social responsibility. This is a missed opportunity to connect with investors that are keen on doing business responsibly and to brand ASEAN as a responsible business destination.

For example, companies from the European Union are important investors in ASEAN. RBC is a pillar of the new EU trade strategy (EC, 2015). Additionally, for some EU members, RBC expectations can also be a legal requirement. Making an explicit link between RBC and investment promotion efforts can help fill the information gap for foreign investors, who may otherwise perceive the risk of operating in ASEAN to be higher than it otherwise is.

One element of supplier databases and matchmaking events could be RBC. Governments could include RBC principles and standards in industry-specific training programmes as a way to build absorptive capacity of domestic companies and encourage business linkages with foreign investors. This could encompass everything from promotion to capacity building exercises to supporting cross-sectoral learning efforts (for example, supporting cost-sharing efforts within and among industries for specific due diligence tasks, participation in initiatives on responsible supply chain management and cooperation between industry members who share suppliers).

Additionally, training and awareness-raising with business leaders could also be useful in promoting a wider understanding and recognition of the importance of RBC. Educational institutions such as business schools can be important platforms. The authorities could make educational and training programmes more market driven by increasingly involving the private sector in human resource development policies and encouraging internal and external training by employers.

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Lastly, big data solutions can serve as opportunities to facilitate SME compliance with RBC standards (Box 4.4). These solutions are quickly gaining ground in both advanced and developing countries and have the potential to accelerate SME development and create a more level playing field that supports SME linkages with foreign investors.

Box 4.4. Big data solutions for SME linkages

Blockchain technology is expected to revolutionise the way companies do business and holds immense potential for SME participation in global supply chains and SME productivity, more broadly.

Blockchain is a digitally distributed ledger of records, transactions, or executed events that are shared across participating parties. Each transaction is time stamped and verified by a consensus of a majority of participants in the system. Blockchain solutions can allow authenticated data communication between each player in a supply chain without the intermediation of a trusted central organisation. Blockchain can improve supply chain transparency by allowing participants to record and verify price, date, location, quality, certification, and other relevant supply chain information in real time. Resulting benefits include:

- increased traceability of material supply chains to meet RBC standards;
- lowered risk of fraud and counterfeit sourcing;
- improved visibility and compliance over outsourced contract manufacturing;
- reduced paperwork and administrative costs; and
- enhanced position as a leader in responsible manufacturing.

Administrative costs associated with quality control and compliance with RBC standards can be prohibitively high for SMEs. By reducing such associated costs, both for the contracting and the contracted parties, blockchain solutions have the potential to create a more level playing field and support greater linkages between responsible MNEs and local SMEs that meet their standards.

Similarly, **fintech** solutions based on big data analytics can empower local SMEs to compete against large MNEs to secure supplier contracts by reducing the credit gap. In other words, blockchain can be used to provide alternative financing solutions that grant SMEs greater access to global supply chains. In China, for instance, Ant Financial's MYBank (Alibaba) offers a "310" loan service (3-minute application, 1-second approval, and 0-human intervention) for small businesses. The model is based on big data analytics, using client data and predictive modelling to conduct credit analysis. In five years Ant Financial has given out more than 4 million loans to small businesses, with a total loan amount of 700 billion RMB (103 billion USD).

Source: Deloitte (2017); Alibaba Research Institute (2017)

Building capacity and facilitating linkages

The discussion in the previous sections has emphasised that the broader policy environment affecting the business climate is crucial for attracting foreign investment, enabling growth and competitiveness of SMEs, and anchoring investors through deep linkages with the local economy. Having put in place policies that ensure a competitive market structure and predictable and smooth-functioning commercial relationships, without too many barriers to foreign investors, governments can play a vital role in increasing SMEs' attractiveness as business partners for foreign investors, through specific policies and programmes.

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The evidence suggests that SMEs are less likely than larger firms to participate in global value chains because their limited size, resources, managerial structure and geographic location can result in informational, technical and administrative barriers that make it difficult to access finance, comply with quality standards, bridge connectivity and infrastructure constraints, innovate or find and develop suitable human capital.

Policy interventions designed to increase the SME presence in global value chains thus often focus on export financing facilities, training programmes and portals on international marketing, business matchmaking activities between SMEs and MNEs, support to acquire internationally recognised product quality certification, support for attending international trade fairs, and the creation of e-commerce platforms on which SMEs can list. These programmes are often part of a country's overall economic development strategy.

The OECD SME Policy Index for ASEAN summarises some of the policies enabling SME internationalisation in GVCs, although it does not specifically focus on policies on MNE-SME linkages. One particular dimension of the SME Policy Index for ASEAN deals with SME access to markets and internationalisation, measured along five policy areas: export promotion, integration in GVCs, use of e-commerce, quality standards, and trade facilitation. Overall, ASEAN scores relatively highly in terms of policies that support SME access to markets and internationalisation (4.5 out of 6), suggesting that the region as a whole is already quite advanced in this domain. However, country-to-country variation is very high both overall and in the five sub-dimensions, suggesting (as one might expect) wide differences in the policies implemented by AMS (OECD, 2018c).

Successful SME linkage programmes require adequate resourcing

ASEAN member states have, to varying degrees and with varying levels of success, put in place a range of policies and programmes designed to raise the capabilities of domestic firms and deepen linkages between local SMEs and foreign MNEs (UNIDO 2018). These initiatives can be grouped into seven broad categories:

- *SME centres* offer a wide array of services designed for SMEs including business matching activities (see also Box 4.5).
- *Matching services* provide direct assistance in identifying business partners or buyers, and in setting up meetings or on-site factory tours.
- *Networking events* include SME showcase events and exhibitions and business matching sessions that bring together SME suppliers and prospective MNE buyers.
- *SME portals* provide SMEs with listings of commercial and government opportunities, networking events, or directly connect businesses through online channels
- *Supplier databases* provide lists of local suppliers by product or sector of activity.
- *Training and supplier development* initiatives offer funding to MNEs that support local SMEs in acquiring skills or technology, or in meeting specific vendor requirements.
- *SME solutions* initiatives offer funding for collaboration to develop solutions to help SMEs improve operational efficiency, adopt new technologies, upgrade capabilities, or develop new offerings.
- *MNE specialist secondments* provide financial and organisational support to MNEs whose specialists are seconded to SMEs to assist them in meeting vendor requirements.

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Box 4.5. Matchmaking portal with support services

Over the last 25 years, UNIDO has established a network of over 30 Subcontracting and Partnership Exchange (SPX) Centres, with the objective of helping local enterprises to take advantage of opportunities in relation to industrial subcontracting, outsourcing and international supply chains. The original network served as an information portal for matchmaking suppliers and buyers, and was effective in dealing with short-term buying contracts on the basis of 'requests for quotations'. The SPX programme has since been revised to incorporate active engagement with the procurement and local sourcing departments of large companies, identifying and mapping requirements and generating needs analysis emanating from these procurement strategies and plans. Potential local suppliers, many of which are SMEs, benefit from rigorous profiling and benchmarking assessment tools.

Depending on the institutional set up of each country, an SPX Centre is hosted either by a private sector association (Chamber of Commerce, Manufacturer's Association, etc.) or a public sector institution (Investment Promotion Agency, SME Development Agency, etc.). The SPX Centre acts as a clearing house between buyers and suppliers and therefore saves buyers cost and time to maintain supplier data and in undertaking supplier audits. Buyers benefit from potential reductions in long-term procurement cost through collaborative supplier development partnership programmes, and can use the SPX Centre as one single point of contact for subcontracting and FDI opportunities on local and global level.

Table 4.2. SME linkage programmes vary in intensity across ASEAN

	Incubator/ SME centre	Matching services/ assistance	Matching/ networking events	Portal/ platform	Supplier database	Training/ supplier development	Solutions for SMEs	MNE specialist secondment
Brunei Dar.	iCentre		MA; FSLS			KHUB		
Cambodia								
Indonesia		GBM, ABM						
Lao PDR		Plaosme				Plaosme		
Malaysia						ILP		GSDP
Myanmar								
Philippines		Go Lokal!; BM	DTEx	FAME Connect	DTEx, EPBMP			Kapatid
Singapore	SME centres	PACT		SME Portal		LEAD; PC; DEI	TAP	
Thailand		VMC	BLing		ASID	A.S.I.A.		
Viet Nam		SMEDF		ICTCOMM		VS		

Note: This table is not comprehensive. Refer to Annex 4.A for a description of these programmes.

Overall, there is significant variation in the types of SME linkage programmes offered in ASEAN countries (Table 4.2). The majority of countries provide funding for vendor training and development programmes and have an agency that directly offers business matching assistance and related services, while only two have put in place designated SME

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centres. Nominally, Singapore and the Philippines offer the richest variety of programmes, while no evidence of linkage programmes was found for Cambodia or Myanmar.

A more in-depth assessment, undertaken in the context of the OECD SME Policy Index, suggests that Singapore and Viet Nam have developed coherent policies designed to promote SME inclusion in GVCs. Various initiatives by Enterprise Singapore are not only exposing SMEs to GVCs but also upgrading their capability to move up the value chain. These initiatives include the PACT programme, the Local Enterprise and Association Development (LEAD) programme, and the Technology Adoption Programme (TAP). Viet Nam has also shown strong political commitment to deepening economic integration and participation in the regional production network, particularly after the country's accession to the WTO in 2007. The Vietnamese government has mandated measures to support MNE-SME linkages for SMEs engaged in ancillary industries. These measures include business matching through specialised industrial parks and FDI incentives.

Among the other AMS, Thailand, Malaysia and Indonesia are at a relatively advanced stage of developing SME linkage programmes, while Myanmar and Lao PDR are still in an early stage. Nevertheless, scattered initiatives can be identified. The government of Lao PDR, in collaboration with a third party, provides paid assistance for SMEs to connect with foreign investors (Plaosme). Myanmar still relies heavily on foreign donor support (for example from UNIDO and USAID), to develop the necessary framework for integrating SMEs into GVCs, and efforts are confined to special economic zones.

Regarding implementation, Singapore, Thailand, and Malaysia are the top performers. Their programmes are operational and well-funded. In Singapore, for example, around SGD 300 million (USD 227 million) were allocated for PACT, with another SGD 80 million to enhance the programme. Singapore reported that 1 024 SMEs were involved in 147 PACT projects between 2013 and 2016. Meanwhile, Thailand's Board of Investment Unit for Industrial Linkage Development (BUILD) allocated THB 23.9 million (USD 758 000) in 2017 to establish linkages between SMEs with larger companies and MNEs and to expand market opportunities. Moreover, the example of Thailand's illustrates that successful linkage promotion needs to be part of a longer-term development plan that is coordinated across multiple government bodies (Box 4.6).

Viet Nam has established a relatively strong framework for enhancing SME participation in GVCs, but the programmes are not really operational and there has been no report on their achievement levels (OECD, 2018c). A similar situation is found in Cambodia, even though SME integration into GVCs was one of the main priorities articulated in the country's Industrial Development Policy 2015-2025. The AMS with less developed policies for integrating SMEs into GVCs also have weak implementation levels. Lao PDR mostly relies on the Plaosme initiative and occasional business matchings, and in Myanmar there are no clear measures for establishing linkages between SMEs and larger companies in SEZs.

Overall, Singapore, Malaysia and Thailand lead the way in terms of devising and implementing comprehensive policies for actively embedding their SMEs in global value chains. Singapore, as a hub for many types of modern economic activities, realised that SMEs need to keep upgrading their capacities in order to stay competitive and remain integrated in GVCs. To promote technology transfer and other linkages between large firms and SMEs, the Economic Development Board of Singapore has provided subsidies since the 1980s to allow local SMEs to employ engineers and technicians from MNEs for a period of two years. As a result, Singapore's SMEs have a flexible skilled production base that continues to attract MNEs.

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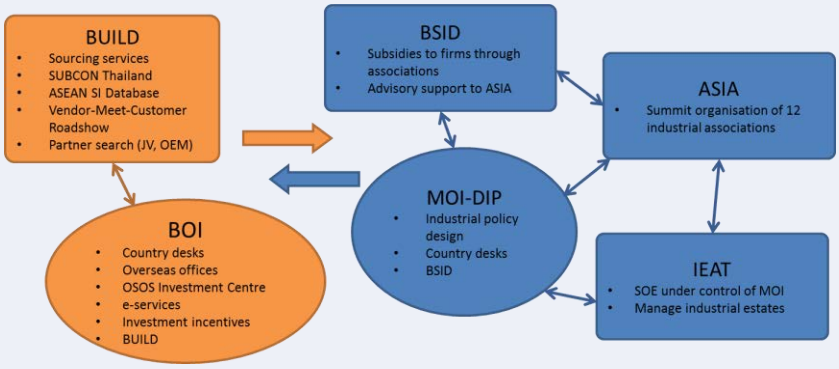
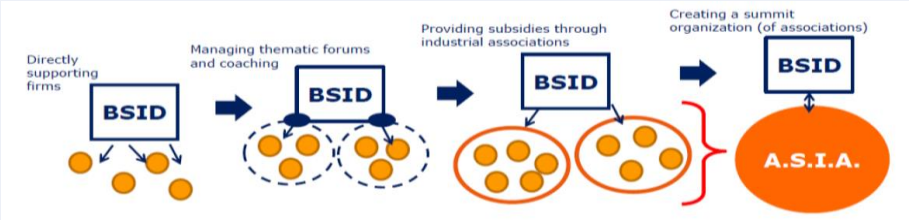
Box 4.6. Thailand's strategic network approach to linkage promotion

In Thailand, the Board of Investment (BOI) and the Ministry of Industry (MOI) are the key official actors responsible for the three core elements of linkage policies. They flexibly and informally coordinate activities of related agencies and units affiliated with BOI or MOI, as well as private sector bodies such as the Alliance for Supporting Industries Association (ASIA). In addition, there are academic institutions and non-profit organisations that provide technical support and business consulting, among which the Technology Promotion Association is the most prominent. The resulting network is neither dominated by a single organisation nor governed by explicit rules. Each member organisation performs its functions separately, and refers customers to other organisations wherever they can fill required functions better.



As an investment promotion agency, the BOI is the first point of contact for foreign investors and is charged with attracting FDI strategically (based on the published list of priority activities and products) and linking it with local companies, through its BOI Unit for Industrial Linkage (BUILD). BUILD receives inquiries from foreign investors through various channels (including the One Start One Stop Investment Centre and BOI's overseas offices), announces the specification and volume requirements of foreign buyers in its website, and solicits expressions of interest from Thai suppliers. It also subsidises Thai firm participation in overseas trade shows (Vendor-Meet-Customer Roadshows).

The Department of Industrial Promotion of MOI is responsible for local capacity building directly and indirectly through various bodies such as the Bureau of Supporting Industry Development (BSID), sector-specific institutions, industry associations, and the Industrial Estate Authority of Thailand. BSID is the unit that was originally charged with delivering local capacity building through the provision of technical and managerial support to companies in "supporting industries", but as the number of these companies grew to over a thousand, thematic forums were established and BSID's role shifted from technical support to advisory and financial support. Gradually, the forums gained experience and developed into 12 privately-run industrial associations, under the summit organisation ASIA.



Source: Punyasavatsut (2008)

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Corporate investors play a role in promoting business linkages

Beyond public policies and programmes to support SME linkages with large firms, foreign investors also have incentives to develop and engage with local business communities. Potential benefits for foreign investors include enhanced reputation and local license to operate, improved integration in new markets, reduced foreign exchange needs and increased flexibility due to proximity of local suppliers, among others. Accordingly, corporate actors have also played a role in promoting business linkages, including in ASEAN.

For instance, in Viet Nam, a number of prominent footwear brands (including Nike and Adidas) came together with a range of suppliers to explore ways of improving compliance with supplier codes of conduct. As a result, the Viet Nam Business Links Initiative (VBLI) was created to help SME suppliers in footwear meet international standards for chemicals use and disposal, and occupation health and safety through statement of good practice, management support system and a train the trainers program. Over 60% of footwear factories in the country participated and the success of the VBLI initiative motivated the government to develop national training courses for supplier health and safety professionals. VBLI was identified as a model that could be applied to other industries.

Enhanced SEZ strategies can support linkages

Many governments opt for special economic zones (SEZs) to attract investors, create jobs and increase export earnings. SEZs (or free zones) represent designated geographical areas within an economy where business activity is subject to different rules from those prevailing in the rest of the economy. Zones can be established with different policy goals. The most common objective is to attract FDI as a means of boosting exports, links to global value chains, and structural transformation of the economy.

The critical feature distinguishing SEZs from the rest of the economy is the distinct incentives they offer to companies operating in the zone territory. These incentives are generally grouped into two broad categories: tax and non-tax incentives. Tax incentives (including duty-free imports of intermediates) reduce investors' tax liabilities, typically for a predetermined period of time. Non-tax incentives range from streamlined administrative procedures (e.g. one-stop shops for government services, fast-track customs procedures), to the provision of infrastructure, or simplified legal and regulatory requirements.

Under the right conditions, economic zones can serve to create vertical linkages with local suppliers, and specifically SMEs. Foreign investors in developing country SEZs have an interest in finding low-cost reliable suppliers in the host economy: there is evidence of foreign investors providing local suppliers with help in setting up production lines, training in quality control, coaching in management strategy and financial planning, advance payment and others kinds of financing, and introduction to export markets (Javorcik and Spatareanu, 2005).

But the spread of backward linkages has varied greatly across countries that have opted for special economic zones and is by no means assured. The extent of local procurement by foreign investors depends, in the first instance, upon a host country's business-friendly climate that allows local firms to grow and prosper. Local companies need contract enforcement, reliable infrastructure, lack of red tape, and access to duty-free inputs no less than the foreigners if they are to become certified as suppliers to foreign exporters in the SEZs. The nature and extent of local sourcing also depends on how wide the gap is between the capabilities of the local business elite and the sophistication of what is demanded by

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the foreign purchaser, so that a more robust local private sector translates to a greater probability of successful supplier development.

In other words, a zone-based strategy may be effective in attracting investors in the short-run, by offering adequate infrastructure services and duty-free access for capital goods and other inputs. Yet, economic activities within free trade zones tend to have weak linkages with the rest of the economy if not firmly embedded in a wider development agenda.

In Southeast Asia, SEZs have been at the heart of successful export-led development strategies over many decades. The ASEAN region has more than 1 600 economic zones of various types (see Table 4.A.2 in Annex 4.A). SEZs in Viet Nam, the Philippines, Indonesia, and Thailand are well developed and long established, though they serve primarily to attract foreign investors, with little emphasis on local linkages. The SEZ experience of Cambodia, Lao PDR, and Myanmar is relatively more recent. In Lao PDR, of the 10 existing zones only two are in operation, and one is successfully contributing to economic diversification, providing evidence that successful SEZs take time to evolve (Box 4.7).

Some countries is Southeast Asia are actively adapting their SEZ strategy to a more elaborate and comprehensive strategy of cluster development. A stronger emphasis is given to SME development in an attempt to link industrial and enterprise policies. Malaysia and Thailand establish secondary industrial zones alongside the major Export Processing Zones (EPZs), with data banks and "marriage counsellors" to link foreign firms with local suppliers. In Malaysia, the Penang SME Centre was established to act as an incubator for SMEs, providing them with rental subsidies to help them take advantage of the facility. Johor and Klang Valley follow a similar approach to industrial cluster development.

Box 4.7. SEZs in ASEAN

In **Viet Nam**, SEZs play a key role in the government's FDI attraction strategy. There are currently 295 industrial parks, 3 technology parks and 15 economic zones, which concentrate over 50% of total FDI and 80% of manufacturing FDI. A master plan approved in 2015 provides for the creation of a total of 400 industrial parks and 18 economic zones by 2020. SEZs currently contribute to 40% of GDP and 45% of export value, and employ approximately 2.5% of the workforce. SEZs are under the responsibility of provinces, with the central government only having a coordinating role. All 58 provinces have at least one zone.

In **Lao PDR**, SEZs have been developed since the early 2000s but remain a relatively new concept. Ten zones have been created, although only two are fully operational. Due to its location on the economic corridor that links Viet Nam, Lao PDR and Thailand, Savan-Seno, the first SEZ established in 2002, attracts investors from a broad range of economic sectors, thereby contributing to the diversification of the economy, currently driven by natural resource extraction. The government is preparing a new SEZ law to ensure that zones have their own regulatory framework, reflecting good practice.

SEZs are well developed in **Indonesia** and employ about 2.5% of the workforce. Batam Free Trade Zone attracted over 150 major international maritime companies, contributing to a booming shipbuilding and shipyard industry, also facilitated by the advantageous position of the Riau Islands Province. Batam is also becoming an electronics manufacturing hub and benefits from the presence of global leaders such Panasonic, Sanyo and Siemens, partly thanks to the relatively high quality of its infrastructure.

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The **Philippines** hosts well over 300 economic zones administered by the 18 different investment promotion agencies which have contributed significantly both to FDI inflows and to exports. The Philippines Economic Zone Authority (PEZA) alone owns three eco-zones and administers the incentives for over 300 privately-managed zones. These include 21 agro-industrial economic zones, 216 IT parks and centres, 64 manufacturing economic zones, 19 tourism economic zones, and two medical tourism zones (as of May 2015). PEZA has a good reputation among investors for its one-stop, non-stop service.

In **Cambodia**, the legal framework for SEZs was established in 2005. There are currently 34 approved SEZs, of which 14 were operational as of September 2015. Most are located along the borders with Thailand and Viet Nam and at Sihanoukville and Phnom Penh. As in the Philippines, these SEZs are often privately owned. These zones have helped to start diversifying the industrial base away from garments towards electronics, electrical products, household furnishings and car parts. The zones remain relatively small and account for a low share of total investment and employment (68 000 workers in 2014, or less than 1% of total employment and 3.7% of total manufacturing employment).

Myanmar opted early on in its reform process to develop SEZs to attract FDI. The first SEZ in Myanmar, the Thilawa Special Economic Zone began operation in late 2015. The majority of the roughly 60 businesses that set up in Thilawa are Japanese, although Chinese, US and Thai investors are also present. Sectors include manufacturing of garments and toys, steel products, radiators, aluminium cans, packaging and waste management. As in other AMS, the SEZs in Myanmar could be used as effective pilot schemes for testing new approaches to improve the investment climate, through streamlining registration and licensing procedures, managing incentives, promoting linkages, and building capacity for monitoring investment impacts.

Source: OECD Investment Policy Reviews of Cambodia (forthcoming), Indonesia (2010), Lao PDR (2017), Malaysia (2013), Myanmar (2014), the Philippines (2016), and Viet Nam (forthcoming).

Enhancing SEZs with vocational training partnerships and cluster policies

SEZs in ASEAN have helped improve the general investment environment, generated employment (including for women), increased foreign exchange earnings, generated government revenues, caused spillover effects in the local economy, developed domestic contract manufacturers and linked the host country in global value chains controlled by MNEs (UNCTAD, 2017).

At the same time, those zones have often failed to sustain innovation and competitiveness over time, with little technological upgrading or new firm creation. Most of the jobs created are low-skilled and concentrated in low-technology manufacturing operations. With few exceptions, zones tend to work in enclaves and generate few backward linkages with domestic companies. In some countries, decentralised policymaking for developing zones tends to lead to excessive competition between provinces and a misuse of resources and land when zones are only partially occupied. SEZ development needs to be firmly embedded in a wider development agenda, including appropriate connectivity to the rest of the economy and reduced barriers to investment, to be able to generate stronger ties with domestic firms.

Evidence from countries that have been most successful in using an SEZ strategy to advance development suggests that partnerships between foreign investors and local universities and vocational training institutes constitute an important magnet in attracting anchor investors, stimulating follow-the-leader behaviour on the part of other investors,

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and ultimately expanding backward linkages into the host economy (Moran, 2011). For instance, the site selection for the "TI industrial complex" at Baguio in the Philippines was stimulated in large part by the strength of educational facilities in the region. In Malaysia, the Penang state government created a Skills Development Centre that organises its curriculum around specific needs and gaps identified by foreign multinationals in the booming regional electronics complex. The Penang success story in Malaysia illustrates how important is the involvement of university and vocational training in carrying out an effective FDI-SEZ-export strategy (Box 4.8).

Box 4.8. Penang's success in promoting SME linkages (Malaysia)

Amidst fierce national debates on the relative virtues of export-led versus import-substitution growth strategies, the Penang SEZ became known in the 1980s as the site in Malaysia where multinational investors engaged in basic consumer electronic assembly and export. In combination with vigorous investment promotion policies, the Penang state government established the Penang Skills Development Centre (PSDC), which was later recognised as a world-class model for partnerships between government, academia, and industry. PSDC initially concentrated on vocational training in electrical engineering and electronics, as part of Malaysia's advance into standardised component production (such as printed circuit boards), and subsequently to higher value-added components and products in the semiconductor, information technology, audio visual, and digital camera sectors.

Beginning in 2000, Penang added life sciences, biotechnology, pharmaceuticals and medical devices to its repertoire for FDI-SEZ-export expansion. Penang's particular niche combines advanced electronics with life sciences, including, for example, precision and tooling-based medical devices, electrical and electronic-based medical devices, automation-based medical devices, and diagnostic tools. In an effort to ensure that its vocational training programmes kept pace with FDI promotion efforts, PSDC created a Micro-Electronics Centre of Excellence at Universiti Sains Malaysia, which relies on support from international corporations for specialization in mechanical engineering (e.g. robotics, micro- and nano-assembly), chemical engineering (e.g. gasses and chemical delivery techniques), materials sciences (e.g. packing R&D), and supply chain management. More recently, Universiti Sains Malaysia has begun to cultivate similar government-industry-academic partnerships in the pharmaceutical and nutraceutical sectors.

Penang's FDI-SEZ-export strategy has created a virtuous cycle for Malaysia by integrating attraction of foreign investors, skill-building initiatives, and infrastructure upgrades. In 2005, the Malaysian central government chose Penang to roll-out the Multimedia Super Corridor IT platform for industries and businesses. At the onset of the international financial crisis in 2008 there were more than 700 companies operating in Penang's eight SEZs (4 Free Trade Zones and 4 Industrial Estates) with a total of 775 factories employing more than 170 000 workers. At the same time Penang – and Malaysia overall – have generated one of the world's more successful records in generating backward linkages and supply chains within the host economy, from complex packaging to a broad array of contract engineering services.

Source: OECD (2013)

Development of SEZs can also be facilitated by a cluster-based approach. It is well-documented that co-location of large numbers of firms engaged in similar or related activities helps firms lower their transaction costs and expand. The potential for cluster development is often not realised because governments focus on attracting initial investors

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but pay less attention to after-investment care. Encouraging large foreign investors to reinvest their earnings and expand their operations is a useful strategy to induce entry of their first-tier suppliers to the host economy, which in turn may create more opportunities for forming backward linkages with domestic firms (Moran et al, 2018; Monga, 2011).

4.2. Policies for enabling outward investment

Policy plays an important role in promoting and facilitating outward internationalisation of firms through investment. For ASEAN, this is true both at the regional and national levels. Development of regional infrastructure and connectivity and harmonisation of procedures and standards can advance regional integration and greatly reduce barriers to outward FDI. At the national level, direct measures to support firms financially, technically, and through risk mitigation are useful tools to promote further investment in regional value chains. The next sections discuss policy practices to support intra-ASEAN investment, focusing on FDI from Thailand, Singapore and Malaysia to CLMV countries.

Deeper regional integration can stimulate outward investment

Regional integration policies have played an important role in promoting and facilitating outward investment in ASEAN (Chapter 3). The ASEAN Economic Community (AEC) has been a catalyst for, and will continue to support, intra-regional investment. Other region-wide initiatives that are emerging could also facilitate and stimulate intra-regional FDI, including the growing number of special economic zones along national borders; the Belt and Road Initiative (BRI); and, the Regional Economic and Comprehensive Partnership (RCEP).

Developing border SEZs to lower risks

Thailand and neighbouring CLMV countries have been developing numerous SEZs along national borders, in recent years, and plan to develop many more (ASEAN-UNCTAD, 2017). Proximity is an important consideration for investment decisions, and is associated with lower perceived risk. The existence of SEZs near border towns allows firms to internationalise and take advantage of cost differentials at even lower levels of risk, while remaining close to Thailand's main production base. As a result, CLMV countries serve not only as production bases for labour-intensive segments of the value chain, but also compete for end-to-end supply chain operations between Thailand and the CLMV region.

Thailand plans to create many new border SEZs as part of its recently announced Eastern Economic Corridor (EEC), which aims to upgrade the country's manufacturing capabilities towards high-tech industries (Box 4.9). These zones are expected to facilitate the expansion of production operations to neighbouring CLMV.

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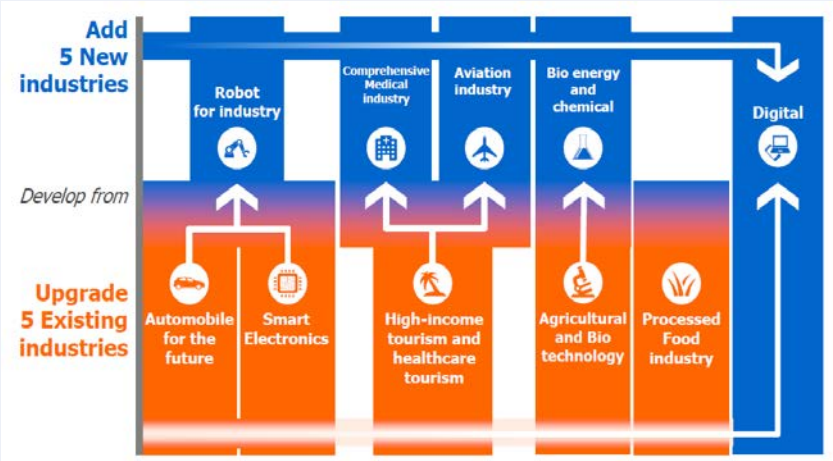
Box 4.9. Thailand's Eastern Economic Corridor

Thailand's Eastern Economic Corridor (EEC) is an initiative approved by the Thai parliament in February 2018 that aims to develop Thailand's eastern provinces with a focus on improving existing connectivity and fostering manufacturing innovation. The initiative will include the development of several special economic zones in these three provinces and is estimated to cost USD 43 billion over the next five years.

The EEC is part of the government's New Cluster Development Policy that aims to bring Thailand to a new development frontier. In particular, the strategy envisages upgrading five existing industries (next-generation automotive, smart electronics, luxury and healthcare tourism, agriculture and biotechnology, and processed food), and developing as an offshoot five new high-tech industries – namely, robotics, medical devices, aviation, bio-chemicals and digital.



Moreover, the EEC is part of Thailand's effort to promote trade and investment opportunities with bordering countries and is expected to allow investors to take advantage of the existing local and regional supply chains and new transport infrastructure to gain easy access to large markets such as Southern China and other ASEAN countries. The EEC adds a significant transport route linking to China's Belt and Road Initiative, connecting outward investors with global markets. Thailand recently announced the integration of the EEC with the BRI through a high-speed train connecting Bangkok to Vientiane (Lao PDR) and Kunming (China). The route through China's Maritime Silk Road will connect export zones in the EEC to markets in Asia, Africa, the Middle East and Europe. As a result CLMV countries are also expected to become part of BRI and EEC's economic chain.

Source: ASEAN-UNCTAD (2017), Financial Times (2018), Le Fevre (2018)

Improving connectivity through the BRI

China's Belt and Road Initiative aims to build new roads, railways and ports across ASEAN (Table 4.3). This infrastructure plan is expected to close some of Southeast Asia's infrastructure investment needs, which are estimated at USD 2.8 trillion or 5.2% of its GDP through 2030 (ADB, 2017). For investors, the BRI is expected to contribute infrastructure and logistics improvements that will result in lower transport costs and make it easier to ship products to new markets across ASEAN as well as overseas. This initiative will also

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contribute to the implementation of the Master Plan on ASEAN Connectivity 2025, which is ASEAN's priority for connectivity (ASEAN, 2016). The prospects of improved trade connectivity due to the BRI are expected to encourage ASEAN firms to invest in the region.

For countries with large infrastructure deficits such as Lao PDR, which aims to position itself from landlocked to land-linked, the BRI is an opportunity to attract more investments from neighbouring countries. The BRI would allow some of Lao's SEZs such as the Savan-Seno SEZ to be more integrated with the outside world through economic corridors across Viet Nam, Cambodia, Myanmar and Singapore, thereby triggering faster trade and investment growth.

Table 4.3. Belt and Road Initiative is expected to increase ASEAN's connectivity

	Name	Location	Length (km)	Status	Estimated cost (USD million)
Railway	Phnom Penh – Ho Chi Minh City	VNM / KHM	384	Proposed	600
	Boten – Vientiane	LAO	421	Under construction	7,000
	Savannakhet – Lao Bao	LAO	220	Under construction	4,000
	Bangkok – Nong Khai	THA	873	Under construction	11,360
	Bangkok – Chiang Mai	THA	715	Proposed	14,000
	Jakarta – Bandung	IDN	150	Under construction	5,135
	East Coast Rail Line	MYS	620	Under construction	13,000
	Gemas – Johor Bahru	MYS	197	Under construction	2,000
Port	Kuantan Port	MYS		Under expansion	700
	Dawei Port	MMR		Initial phase	1,700

Source: DBS Group Research (2017)

Harmonising standards through the RCEP

The Regional Economic and Comprehensive Partnership is a proposed free trade agreement between the ten ASEAN member states and the six Asia-Pacific states with which ASEAN has existing free trade agreements (Australia, China, India, Japan, South Korea and New Zealand), currently under negotiation.[30] One of the most important provisions likely to be included in the agreement is the harmonisation and mutual recognition of standards across ASEAN. Currently, outward investors are overburdened by different national regulations and international quality standards, which constrain regional value chains. Mutual recognition and regularisation of standards would, for instance allow a product produced in Thailand, Myanmar, and Viet Nam to be sold in China and Japan.[31]

Advancing implementation of the AEC to create a single market

The ASEAN Economic Community, established in 2015, is a major milestone in the regional economic integration agenda in ASEAN that resulted in considerable expansion in cross-border activities of both local and foreign firms in the region (ASEAN-UNCTAD,

[30] Originally scheduled to be signed in November 2018, but expected in 2019.

[31] ASEAN's participation in other free trade agreements such as the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), signed by four AMS in March 2018, could also strengthen ASEAN's outward investment.

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2016). As stated in the AEC Blueprint 2025, the goal of the AEC is to create a single market and production base by 2025 (Invest ASEAN, 2018).

The challenge is to expand the plan of a single production base to all businesses in ASEAN, including SMEs (Inama and Sim, 2015). The AEC has also not made much progress on issues such as facilitating the movement of business people across ASEAN, which would also further facilitate outward FDI in the region. Overall, policies at the national level designed to facilitate and promote outward FDI should be coordinated with the implementation of the AEC so as to move closer to a single market and enable more ASEAN firms to integrate into regional value chains.

Direct measures in support of outward FDI

Direct measures to support outward FDI include liberalisation of capital controls, technical and financial support, fiscal incentives, and investment insurance and protection (Pananond and Cuervo-Cazzura, 2015; Sauvant et al., 2014).

The responsibility for carrying out outward investment promotion and facilitation policy may lie in different institutions, depending on the policy area and national context. In some countries institutions charged with trade or inward investment promotion are also responsible for promoting outward FDI. In Thailand, the responsibility for promoting outward investment is split between the Board of Investment and the Department for International Trade Promotion (DITP) of the Ministry of Commerce. The BOI focuses on outward investment in larger economies, and the DITP covers smaller countries. Business associations also play a role in promoting outward investment in specific destination countries, for instance, through bilateral chambers of commerce. This is the case in Thailand, where the Thai-Lao Business Council provides support for the private sector to invest in Lao PDR.

Outward FDI support policies may also include SME-specific support to overcome disadvantages related to firm size and financial capabilities. Empirical evidence suggests that public measures to support outward investments of SMEs are associated with increased domestic turnover and productivity growth, especially for smaller and younger firms (Bannò et al., 2014). In general, OFDI support policies should be simple to access and understand for potential beneficiaries. Many firms interviewed in Thailand were either unaware of existing support measures, or found them difficult to access.

Capital control liberalisation is the first step

Liberalising capital controls is an important first step to enable domestic firms to become multinational. By doing so, the government allows firms to undertake outward investments, without influencing the types of investments or the destination (Pananond and Cuervo-Cazzura, 2015). Since the 1980s, most developed countries have eliminated capital control restrictions in line with the OECD Code of Liberalisation of Capital Movements. More advanced emerging economies in East and Southeast Asia such as Korea, Chinese Taipei, and Singapore followed in the 1990s and adopted a more liberal policy toward capital controls.

In Thailand, deregulation and liberalisation of capital controls also started in the 1990s and proceeded even after the 1997 Asian Financial Crisis (Edison and Reinhart, 2000). The Bank of Thailand gradually expanded the amount investors are entitled to invest in foreign countries (Pananond and Cuervo-Cazzura, 2015). By 2012, the Capital Account Liberalisation Master Plan allowed Thai residents and companies to invest unlimited

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amounts of capital in foreign countries (Bank of Thailand, 2012). Liberalisation of capital controls was Thailand's main outward FDI policy until 2012 when the BOI assumed a new mandate to promote and facilitate outward FDI in addition to attracting inward FDI.

Technical assistance reduces information barriers

Information and technical support is an important component of government policy to promote and facilitate outward FDI. More advanced AMS offer information on the economic climate and regulatory environment of host countries, such as industry data, investment legislation and investment opportunities. Services with more targeted information are offered on a fee basis while more general services are available for free.

One example of information and support service is the Malaysia-Singapore Third Country Business Development Fund, which supports Malaysian and Singaporean companies to undertake joint feasibility studies, research or business missions for investment and business opportunities in 'third countries' outside of Malaysia and Singapore (MIDA, 2014). In Thailand, the Federation of Thai Industries and the Board of Trade (which are both private sector organisations) also provide such information services by organising overseas business visits, business seminars and dialogue with business associations of other countries. Thailand's BOI established the Outward Investment Support Centre to conduct in-depth studies on investment prospects in ASEAN, arrange seminars on laws and regulations for doing business overseas and identify opportunities in growth industries (Thailand Board of Investment, 2015). In Thailand, such services are seen to be highly relevant, based on the findings of the enterprise survey conducted for this project: Complicated bureaucratic procedures are the most commonly reported barrier to investing abroad for firms operating in Thailand (Figure 4.5). Information on these procedures can significantly alleviate this barrier.

Figure 4.5. Complicated procedures are the biggest barrier to outward FDI for Thai firms

Note: Figures are based on 32 responses from Thai manufacturing firms with outward investments. The listed barriers relate to host countries for outward investment only.
Source: OECD-UNIDO Thai Enterprise Survey (2018)

Financial assistance reduces credit constraints

In addition to delivering direct technical assistance, governments can also provide grants targeted at overcoming informational barriers, or loans to overcome credit constraints. Funding can cover the entire investment project or specific stages of the investment process, such as feasibility studies and seed funding for smaller domestic firms. Malaysia

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and Singapore provide such grants for pre-investment activities in various amounts. For example, the Malaysia-Singapore Third Country Business Development Fund offers grants up to USD 33 000 for market research to identify business opportunities and to analyse the business environment of a specific destination country and sector (MIDA, 2014). Loans to finance outward FDI are provided either as direct loans to businesses or through a co-sharing scheme where the risks of default are shared with commercial lenders. In Thailand, the Export-Import Bank of Thailand, provides loans to outward investors. In 2017, the aggregate amount of credit lines was more than USD 1.7 billion, with 60% going to CLMV countries (Export-Import Bank of Thailand, 2018).

Tax policy can stimulate outward investment

Tax policy can be used to incentivise outward investment. Singapore and Malaysia offer tax exemptions on incomes of foreign affiliates that are remitted back to the home country. This type of incentive has stimulated the relocation of labour-intensive production that is no longer competitive at home, and at the same time encouraged Singaporean firms to remit their profits back home rather than directing them elsewhere (Rasiah, et al., 2010). In Malaysia, a domestic company in the manufacturing or services sector that acquires a company abroad is eligible for tax deductions for a period of five years after acquisition. Many countries also establish agreements to avoid double taxation of their firms and residents. In ASEAN, Thailand and Malaysia have signed the most double taxation agreements (61 and 74, respectively, as of 2018), while Cambodia, Lao PDR, and Myanmar have concluded the fewest.

Investment insurance mitigates political risk

Investment insurance, also referred to as political risk insurance, is an instrument offered to outward investors to mitigate political risks associated with the unlawful interference by host governments in the operations of foreign affiliates (Sauvant et al., 2014). The provision of such insurance may induce firms to undertake larger investments than they would otherwise do. Such measures were traditionally offered by developed countries, but as some AMS have become significant outward investors, they too have begun establishing political risk insurance for their firms. The EXIM Bank of Malaysia started offering insurance in 1977, and Singapore in 2012. Thailand's EXIM Bank also offers investment insurance coverage for up to 90% of loss actually incurred. Most of its insurance projects are in CLMV countries where the investment risk is considered as relatively high (Pananond and Cuervo-Cazzura, 2015).

In addition, governments may engage in bilateral investment treaties to protect domestic investors abroad from loss and expropriation resulting from government actions in host economies (see OECD, 2018, for a more detailed discussion on ASEAN practices).

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Annex 4.A. Linkage programmes and SEZs

Annex Table 4.A.1. SME linkage programmes in ASEAN

	Agency	Policy/ programme	Description
BRN	DARe	Market Access platform	Business matching and networking sessions
	DARe	FDI-SME Linkage Sessions	Business matching and networking sessions (seafood products)
	DARe	Knowledge Hub (KHUB)	Training in software development (Microsoft)
	BEDB	iCentre	Incubator that offers business matching services to tech start-ups
IDN	KADIN	General Business Matching	Assistance finding potential partner based on the sector
	KADIN	Advanced Business Matching	One-to-one meeting with businesses identified in general matching
LAO	DIMEX	Plaosme	Infrastructure and training for Lao SMEs, business matching services
MYS	MIDA	Industrial Linkage Programme	Tax deductions for providing support to local suppliers
	MIDA	Global Supplier Development Programme	Financial and organisational support to MNE specialist secondment
PHP	DTI	Domestic Trade Exchange (DTEx)	Marketing events, trade fairs, showcases; database of products, suppliers and buyers
	DTI	Go Lokal!	Free marketing platform, product specialists to assist with packaging and quality assurance
	CITEM, DTI	Manila FAME Connect	Online business matching system that connects buyers to exhibitors at Manila FAME trade show
	DTI, PCE	Kapatid Mentor Me Project	Coaching and mentoring by large corporations; SMEs linked into large company value chains
	EMB	Business Matching	Business matching services, through overseas posts
	EPBN	EU-PH Business Matching Program	Business partnerships database for Filipino and EU firms
SGP	Enterprise SG	SME Centres	10 centres that provide business matching services
	Enterprise SG	SME Portal	Government and commercial opportunities, networking events
	Enterprise SG	Partnership for Capability Transformation (PACT)	Work with large firms to identify and implement collaborative projects between the large firm and SMEs
	Enterprise SG	Local Enterprise and Association Development (LEAD)	Funding for supplier development programmes, joint procurement, shared services
	Enterprise SG	Technology Adoption Programme (TAP)	Funding for collaborations to translate new technologies into Ready-to-Go solutions for SME adoption
	EDB	Pioneer Certificate (PC)	Tax deductions for developing capabilities of local business partners
	EDB	Development and Expansion Incentive (DEI)	Tax deductions for developing capabilities of local business partners
THA	OSMEP	Business Linkage (BLing)	Business matching sessions conducted at annual flagship events
	BUILD	Vendors Meet Customers (VMC)	Meetings and factory tours for BUILD-registered suppliers
	BUILD	ASEAN Supporting Industry (ASID)	Database of ASEAN suppliers in five main industries
VNM	MPI	ICTCOMM Viet Nam	Platform through which businesses in telecommunication industry are connected
	EDA	Volunteer scheme	Support from Korean and Japanese experts for help in fulfilling required quality standards
	EDA	SME Fund	Two pilot programmes for matchmaking activities with between Korean and Japanese investors and Vietnamese SMEs

Source: Authors based on desk research

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Annex Table 4.A.2 Economic Zones in ASEAN

Economic zone	Description	Example countries
Free zones	A designated and secured area in which commercial and industrial activities are carried out. Investment projects often benefit from incentives and are usually for export purposes. Customs checkpoints control the movement of goods at the entry and exit points of the zone.	Indonesia, Malaysia, Philippines, Singapore
Free industrial zones (FIZs) or free trade zones (FTZs)	A type of free zone focused on industrial activities, where most manufacturing activities are carried out for export purposes.	Indonesia, Malaysia, Singapore
Free commercial zones (FCZs)	A type of free zone focused on commercial activities, which facilitates trading, relabelling, repacking and other value added activities. Most are located near a port.	Malaysia
Export processing zones (EPZs)	A specialized industrial estate located outside the customs territory and predominantly oriented to export production. Enterprises located in EPZs are allowed to import capital equipment and raw materials free from duties, taxes and other import restrictions.	Indonesia, Philippines, Thailand, Viet Nam
Industrial zones or industrial estates	There are two types: general and specialized. The latter can have free zone status (e.g. industrial estates in EPZs or FTZs). They are also referred to interchangeably as industrial parks or industrial estates.	All ASEAN member states
Special economic zones (SEZs)	An SEZ may consist of one or more industrial estates, EPZs, FTZs, tourism centres, economic zones and other industrial structures (e.g. a port) in a defined or demarcated area.	Indonesia, Cambodia, Lao PDR, Myanmar, Philippines, Thailand
Border special economic zones	SEZs located in contiguous areas bordering another AMS, to facilitate investment, trade, services and production linkages.	Cambodia, Lao PDR, Myanmar, Thailand, Viet Nam
Licensed manufacturing warehouse	These are also bonded warehouses for manufacturing, with customs control. These can be a manufacturing unit (factory) granted to an investor for manufacturing and warehousing of approved products in the same premises. It caters to export-oriented industries.	Malaysia
Technology park	Facilities or areas that support and promote technological development including through research and attracting technology-based companies. It aims to facilitate innovation and knowledge-based economy. Such parks provide an environment and ecosystem (e.g. proximity to research institutes, universities) conducive for technological activities.	Malaysia, Singapore, Philippines, Thailand, Viet Nam
Science park	Facilities or areas that support and promote science and research activities. Such parks provide an environment and ecosystem (e.g. proximity to research institutes, universities) conducive for innovation, knowledge-based work, and research and development.	Malaysia, Singapore, Philippines, Thailand, Viet Nam
Regional economic corridors	Large economic areas involving a number of contiguous States or provinces. Their development draws on the sectoral and geographical strengths of the constituent areas to support economic clusters and bene t from economies of scale.	Malaysia, Lao PDR

Source: UNCTAD (2017), ASEAN (2017)

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