INTEGRATING SOUTHEAST ASIAN SMEs IN GVCs: Enabling linkages with foreign investors
Bangkok, 15 March 2019
Outline

- Why study SME linkages with FDI?
- What is the state of FDI and SME linkages in ASEAN?
- How do SMEs benefit from FDI?
- How can policy enable SMEs to benefit from FDI?
- Key messages
1. WHY STUDY SME LINKAGES WITH FDI?
GVCs offer an opportunity for SME development in ASEAN

- **Mismatch**: (ASEAN)
  - Most prevalent form of enterprise (98%)
  - High contribution to employment (>60%)
  - Low productivity and contribution to value added (<30%)

- **SME-specific constraints**: small size, limited knowledge and lack of experience prevent economies of scale and access to strategic assets

- GVCs, via FDI, can provide a channel to relax SME constraints:
  - new markets, technologies and know-how, capital, and high-quality inputs and services

- **SMEs become more productive** and generate more value added
GVC participation involves multiple channels

1. How can SMEs participate in GVCs?

<table>
<thead>
<tr>
<th>Backward linkages</th>
<th>Forward linkages</th>
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<tbody>
<tr>
<td>Trade linkages (direct &amp; indirect)</td>
<td>Import inputs</td>
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<tr>
<td>Domestic linkages with foreign investors</td>
<td>Source inputs from foreign MNEs</td>
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2. How can SMEs upgrade to higher value added activities?

- Strengthen GVC integration through:
  - Deepening linkages (partnerships) with foreign MNEs established domestically

3. How can SMEs grow and remain competitive?

- Ensure long-term competitiveness via:
  - Engaging in **outward FDI and partnering** with foreign MNEs abroad

Source: OECD-UNIDO (2019)
2. WHAT IS THE STATE OF FDI AND SME LINKAGES IN ASEAN?
FDI has expanded faster than GDP over the last two decades

Inward FDI stocks relative to GDP (in %)

Source: UNCTAD FDI statistics
Foreign manufacturers are embedded within host countries

Output-weighted share of local sourcing by foreign manufacturers

Source: OECD-UNIDO based on World Bank Enterprise Surveys
SME contribution to local linkages is low

Share of total domestically-produced inputs (manufacturing)

Philippines: 61%
Indonesia: 48%
Malaysia: 22%
Viet Nam: 20%
Cambodia: 16%
Thailand: 15%
Lao PDR: 5%
Myanmar: 2%

Share of locally-produced inputs purchased by foreign multinationals

Inputs produced by Thai SMEs
3. HOW DO SMES BENEFIT FROM FDI?
GVC linkages are associated with above average productivity

Source: OECD-UNIDO Thai Enterprise Survey (2018)
Firms perceive improvements in performance as a result of linkages

- Over 95% of firms also report some kind of performance improvement as a result of linkages
- Top perceived improvements:

<table>
<thead>
<tr>
<th>Sourcing from foreign investors</th>
<th>Selling to foreign investors</th>
<th>Inward/outward FDI</th>
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<tbody>
<tr>
<td>Reduced costs</td>
<td>Product upgrading</td>
<td>Product diversification</td>
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<td>Improved product quality</td>
<td>Skills development</td>
<td>New export channels</td>
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Source: OECD-UNIDO Thai Enterprise Survey (2018)
Investor motives affect the realisation of linkages

- Investors in ASEAN are motivated by access to market, local production and sourcing from local suppliers
- They report efficiency gains as a result of local sourcing
- However they report that they source from foreign firms for higher quality products
Linkages are constrained by capabilities of domestic SMEs

- Gaps in absorptive capacity capacity between foreign firms and ASEAN SMEs are substantial

Source: World Bank Enterprise Surveys
International certification increases the likelihood of SME integration in GVCs

Source: OECD-UNIDO Thai Enterprise Survey (2018)
4. HOW CAN POLICY ENABLE SMES TO BENEFIT FROM FDI?
Policies for enabling MNE-SME linkages

- Global context
- Investor business models
- Capabilities of local firms

Improving the investment climate

Specific linkage policies

Strategic FDI attraction

Strengthening local firms
Linkage programmes are widespread in ASEAN

- Successful linkage programmes require adequate resourcing
- First step is knowing your economy: detailed database of enterprises

<table>
<thead>
<tr>
<th>Country</th>
<th>Incubator/SME centre</th>
<th>Matching services/networking events</th>
<th>Portal/platform</th>
<th>Supplier database</th>
<th>Training/supplier development</th>
<th>Solutions for SMEs</th>
<th>MNE specialist secondment</th>
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Tax incentives can be used to support local sourcing and strengthen SMEs

- But incentives can erode the tax base
- Incentives are not always a priority for investors

**Average effective tax rates (%)**

**Source:** OECD Investment Policy Review of Southeast Asia (2018)
Responsible business conduct signals safe local sourcing opportunities

- Unclear whether tax incentives are an effective tool to attract investment or encourage business linkages. A stronger focus on non-fiscal incentives may be warranted.
- Invest in ASEAN website does not mention environmental and social issues or corporate social responsibility.
- Missed opportunity to brand ASEAN as a responsible business destination and attract MNEs that are more inclined to source locally.
- Include RBC principles and standards in industry-specific training programmes to build local absorptive capacity.
- Include adherence to RBC principles in supplier databases and matchmaking events to encourage business linkages with foreign investors.
Enhanced SEZ strategies can support linkages

- Malaysia’s Penang SEZ (1980s)
- Penang SEZ strategy integrates investment promotion, skill-building, and infrastructure upgrades
- Penang Skills Development Centre organises its curriculum around specific needs and gaps identified by foreign multinationals in electronics
- Among the world’s more successful records in generating backward linkages with local suppliers, from complex packaging to contract engineering services.
KEY MESSAGES
Possible actions for IPAs and SME agencies

**Main findings**

- Quality certification increases the likelihood of linkages
- Linkage promotion varies in funding and effectiveness
- Incentives can erode the tax base and are not always important to investors
- RBC can signal safe local sourcing opportunities
- Integrating SEZs with skills building has proven successful for backward linkages
- Technical assistance is useful for SMEs to overcome barriers to outward investment

**Possible policy actions**

- Provide support for obtaining quality certifications
- With limited resources, compiling information on local enterprises should be prioritised
- Consider targeted incentives but also administrative cost of verifying compliance
- Raise awareness on RBC with local business, link RBC explicitly to investment promotion
- Enhance existing SEZs with relevant skills building programmes
- Foster learning through multilateral collaboration and exchange of best practices
THANK YOU

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Local firms invest increasingly within the region

**Panel A: ASEAN outward FDI stocks**
(% of inward stocks)

**Panel B: Destination of ASEAN outward FDI flows:**
2012-16

*Source: UNCTAD FDI statistics*
### Efficiency motives drive intra-ASEAN investments in CLMV

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<thead>
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<th>Drivers</th>
<th>Main barriers</th>
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<tr>
<td>• Low costs of production in CLMV</td>
<td>• Complicated bureaucratic procedures</td>
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<td>• Saturated markets in advanced AMS</td>
<td>• Lack of coordination across SEZ, provincial and central government policies</td>
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<td>• Geographic and cultural proximity</td>
<td>• Poor local connectivity and infrastructure</td>
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<td>• Preferential access to US market (CLM)</td>
<td>• Limited local availability of technical skills</td>
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<tr>
<td>• Fiscal and non-fiscal incentives</td>
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<td>• Regional integration policies</td>
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<td>• Land availability</td>
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*Source: OECD-UNIDO business interviews in Lao PDR, Thailand and Viet Nam*
## Policies for enabling outward investment

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<th><strong>Regional policies</strong></th>
<th><strong>National policies</strong></th>
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<td>• Border SEZs to lower risks and transport costs</td>
<td>• Capital control liberalisation</td>
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<td>• Improved connectivity through the Belt and Road Initiative</td>
<td>• Technical and information assistance</td>
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<td>• Harmonisation and mutual recognition of standards (RCEP)</td>
<td>• Financial support</td>
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<tr>
<td>• Implementation of AEC</td>
<td>• Tax policy</td>
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<td>• Investment insurance to mitigate political risk</td>
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<td>• Treaties (BITs, DTTs, IIAs)</td>
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