

Executive Summary

The globalisation of production has reached an unprecedented extent, with the production of goods and services increasingly fragmented across enterprises and countries. If large and multinational companies (MNEs) of OECD countries clearly lead this process, small and medium-sized enterprises (SMEs) – their traditional partners, suppliers or distributors – are confronted by the diverse opportunities and challenges that arise from the new production context.

Although several aspects of globalisation are now largely understood, notably its main drivers, sparse information is available on the transformation undergoing the relation between large and smaller firms and the evolution of the role of SMEs in global value chains. This study, conducted by the OECD Working Party on SMEs and Entrepreneurship in co-operation with UNCTAD and Swiss academic partners, aims to enlighten this question.

The study collected data through more than 20 country/industry and country/enterprise case studies in five representative industrial sectors, which were selected to illustrate emerging patterns in manufacturing and service sectors where the value chains show a significant presence of independent or affiliate SMEs acting as subcontractors or suppliers. These included the automotive, scientific and precision instruments, software, tourism and cinema industries. The sectoral approach was adopted to take into account that globalisation affects different sectors in different ways and that the role of SMEs varies across sectors.

Globalisation of value chains brings opportunities to SMEs

Overall, the case studies support the argument that the participation in global value chains benefits SMEs. The reorganisation of production at the international level, through increased outsourcing and the development of global value chains, is having significant effects on small and medium-sized suppliers. New niches for the supply of products and services continuously emerge from the fragmentation of production, where small firms can quickly position themselves, exploiting their flexibility and their ability to move fast. Some key benefits include the following:

Participation in global value chains enhances SME internationalisation and growth.

It provides SME suppliers access to global markets at lower costs than those faced by individual small-scale producers, due to the intermediation function assured by the contractor. Firms that have successfully integrated into one or more value chains have been able to expand their business, and gain stability.

Small firms that focus on multipurpose technologies have secured their position in the market by becoming specialised suppliers serving different global value chains, especially in manufacturing sectors such as automotive and precision and scientific instruments. Specialised and niche market SMEs are become conscious

of their competitive strengths, which they associate in particular to the flexibility and quality of their offer (as in the precision and scientific instrument and software industries) or the personalised service (as in the tourism sector). Some of these firms have also succeeded in leveraging key assets from their lead partner, namely reputation.

SMEs increasingly choose to outsource, even offshore, non-core activities when this allows them to gain competitiveness from rationalisation of production and optimisation of resources allocation. In many cases, it is the decision to follow the contractor abroad that determines the offshoring strategy of SMEs.

Co-operation with partners upstream and downstream improves the small firm's efficiency. This is due to the substantial benefits in terms of information flow, technology transfer and learning opportunities. SMEs confirmed that the exposure to learning processes among partners in global value chains generates knowledge spillovers and stimulates human and technological capital upgrading.

Innovating and keeping up with new technologies are seen by SMEs as a requirement for their successful participation in global value chains.

Globalisation of value chains represents important challenges for SMEs

The increased opportunities for SMEs come along with serious challenges. Field work has revealed that:

Awareness and understanding of the structure and dynamics of global value chains by SMEs are generally insufficient, although unequal across firms and sectors. This seems to be a function of the sector and/or the position of the firm in the chain. Small firms in the automotive sector seem more apt to understand the structure of the value chain to which they contribute than the average SME in other sectors, for which the concept itself of value chain is not always easy to grasp. This is likely related to the complexity of the configuration of the value chain (as in the tourism or cinema industries). The fact that the SME serves very different industries (as is the case of suppliers in the scientific and precision instrument industries) or that it occupies a low position in the chain therefore there is limited knowledge beyond the surrounding environment (as is the case of some SME suppliers in the automotive sector).

A majority of SMEs across different industries are not able to identify their competitive strengths within the value chain, nor do they fully understand that this identification is important to optimise their participation in global value chains. Some of the firms interviewed explicitly pointed to the lack of time and resources to understand the evolving global context and devise a market strategy. This, in turn, translates into an insufficient ability to define the adequate business model to gain or reinforce a firm's competitiveness.

SMEs are mainly concerned with both the inadequate availability of managerial and financial resources, and the inability to upgrade, protect in-house technology, and to innovate. SMEs stressed that they do not have the critical dimension necessary to support R&D costs and the training of personnel. Lack of working capital is also an obstacle, in particular when faced with delayed payments from international partners.

Compliance with strict product quality standards required for participation in global value chains is difficult and costly. SMEs are often dissatisfied with the proliferation of private standards set by contractors and the fact that they differ one from another, alleging that this makes the costs of compliance even more burdensome.

SMEs want frameworks that assist them to better manage their intellectual assets, including through protection of intellectual property rights when appropriate. Several SMEs in the automotive and precision instruments industries reported that the current practice requesting complete transparency from sub-contractors on virtually every relevant aspect of their business has facilitated unfair business behaviour, consisting in the contractor passing to lower-cost competitors original designs and plans submitted by SME partners. However, the issue of intellectual property is not to be reduced to one of protection. For some SMEs, in fact, the realisation of value from their innovations comes from selling them to the market instead of keeping them in-house. For this reason, it is the overall management of intellectual assets that SMEs should target.

To move up the value chain, SMEs need to take up larger and more complex sets of tasks, which may range from contributing to product development and organising and monitoring the network of sub-suppliers (as in the automotive industry) to introducing organisational or marketing innovations (especially in the tourism and cinema industries). The lack of managerial capacity to deal with the complexity of these tasks, revealed by many SMEs interviewed, plays against their possibility of responding in a timely and effective manner to the challenges of globalisation.

Policy conclusions

As the globalisation of value chains presents both opportunities and challenges for SMEs, the case studies have tried to understand what SMEs expect from governments in the way of support in the evolving environment. The following points emerged:

- Across countries, many enterprises interviewed indicated that governments at the local or national level have provided them with little or no support for facilitating their participation in global value chains. This answer reflects the fact that many SMEs have a limited understanding of the global environment and therefore cannot easily identify policy initiatives facilitating their effective participation in global value chains. For instance, although the area of skill upgrading is certainly one of the most relevant for the successful integration of SMEs in global value chains, SMEs interviewed did not mention programmes in the field of SME training,
- In most of the case studies, two themes dominate SMEs' concerns: the need to improve technology and innovation capacity and the lack of adequate finance and human capital for this process.
- Other important areas include: the capacity to respond to standards and certification requirements; the ability to better manage intellectual assets, including the protection of IPRs when appropriate; the uneven bargaining power SMEs face with large contractors; and the support of diversification in activities to reduce dependence on one or a few customers.

In light of this, Governments could facilitate SMEs' gainful participation in global value chains through policy initiatives in specific areas:

Raising awareness of the potential of participation in global value chains. Many SMEs that are used to serving local markets may find it difficult to gain a good understanding of the advantages and potential of subcontracting. This also applies to the potential for SMEs to subcontract abroad part of their production, in order to improve their competitiveness through rationalisation of resources. Although the diffusion of ICT has made market intelligence easier for SMEs, their limited resources and lack of managerial capacities still hamper accurate information and analysis on the opportunities in foreign markets.

Increasing participation in global value chains through initiatives such as the facilitation of SME consortia for joint marketing or for entering joint bids, particularly in government procurement, or promotion schemes for potential suppliers.

Supplier financing. Gainful participation in value chains often requires substantial investments to acquire or develop superior production technologies and logistics systems, invest in human capital, or certify newly required standards. Moreover, suppliers normally receive incoming payments from their customers several weeks or even months after the delivery of orders, and contract enforcement and collection of payments may be a significant challenge for an SME. Policies aimed at improving SMEs' accounts receivables and facilitating SME financing can help small subcontractors to overcome liquidity problems, e.g. by contributing to the development of financial schemes such as factoring.

Promotion of technological upgrading is critical in order for SMEs to capture more value added from participation in global value chains. Policies in this area should aim to support training and capacity building via skill development programmes; to promote partnerships between SMEs and organisations overseas that can develop or transfer technology, products, processes or management practices; and to facilitate the technological upgrading through various financial schemes, such as credit lines for upgrading.

The lack of protection of intellectual property rights of SMEs in international markets has harmful effects on those small subcontractors that experience unfair behaviour by their customers. The negative impact is twofold. In addition to the direct damage created by deceptive business practices, small firms' incentives to innovate may be reduced if appropriation of economic benefits is threatened. Governments should consider including provisions for technology transfer from small subcontractors to MNEs within the context of the OECD Guidelines for Multinational Enterprises. At present, these guidelines only cover the transfer of technology and the need for protection of intellectual property rights of multinational enterprises as it is considered that MNEs are the main conduits of technology transfer across borders (*Section VIII. Science and Technology*, OECD Guidelines for MNEs, Revision 2000).

Facilitation of compliance procedures. The adoption of product and process standards has several well-known benefits for firms. It enables them to introduce new technology and integrate business practices that ameliorate their overall performance. However, different and concurrent standards can become barriers to transmission of information and to trade. Also, the costs of compliance to required standards are proportionally too high for small firms. The problem is aggravated when these firms have to cope with an increasing number of private standards set by customers in addition to mandatory ones. Governments should ensure that

national certification systems do not impose an excessive burden on small firms and encourage SME participation in the standard-setting process. Initiatives such as group certification for small firms in local regions might also prove effective, if trust could be gained in the control mechanisms.

Promotion of skills development. The effectiveness of the aforementioned policy measures, to a certain degree, is contingent on having skilled human resources in SMEs. Participation in global value chains can accelerate SMEs' upgrading of human and technological resources, through technology and knowledge transfer and the implementation of new business practices. Conversely, participation may be demanding, to the extent that a threshold of capabilities could be necessary to successfully enter value chains. Policies that aim at raising technical and managerial skills in SMEs can booster integration of these firms into global chains.

Attracting foreign direct investment. FDI promotion policies may facilitate the integration of firms in global supply chains. Some policies can explicitly be designed to attract MNEs that would promote technology and knowledge transfer to local suppliers and subcontractors, whereas others may aim at helping established foreign affiliates to enter and/or upgrade into higher-value activities. After-care services offered to foreign investors influence the investors' decisions on linkage development.

Promoting the development of industrial clusters. Cluster initiatives allow for economies of scale and agglomeration, and also help develop an experienced local pool of skilled labour and a network of firms cooperating in complementary areas of specialisation. By doing so, they strengthen their competitive advantages in a sustainable manner and become attractive sites for quality FDI. In many cases, the presence of MNEs becomes crucial to integrate clusters into global value chains, and to strengthen their export capacity from the point of view of production and distribution.

Promoting the development of domestic industries and service networks in developing countries that are able to link effectively with international production networks, by promoting entrepreneurship and enhancing competitiveness at firm level through technology and business linkages. This calls for using official development assistance (ODA) more effectively to support developing countries efforts to undertake a wide range of proactive measures to promote trade and investment in an integrated way. To address these challenges at the multilateral level, besides the building of appropriate support for trade policy formulation for WTO accession and the negotiation of bilateral and regional agreements, there is need to enlarge the scope of the Aid for Trade to include support for the development of productive capacity.

Table of Contents

Foreword	3
Executive Summary.....	9
Chapter 1.	
Introduction.....	15
The notion of the value chain	15
Methodology of the study	17
Chapter 2.	
Production in Global Value Chains	21
The phenomenon and its drivers	21
Opportunities for SMEs	23
Challenges for SMEs.....	29
Chapter 3.	
Patterns of Globalisation in Five Industrial Sectors.....	35
Globalisation issues in five industries	35
Different configurations of value chains	47
Chapter 4.	
SMEs and Global Value Chains: Case Studies Findings	53
Awareness and understanding of global value chains.....	53
Co-operation in global value chains.....	57
Technology, innovation, standards and IPRs	59
Perceived benefits of SMEs’ participation in global value chains	66
The role of government	68
Chapter 5.	
Conclusions and Policy Recommendations	73
Bibliography.....	76
Annex A. Examples of Specific Country/Economy, Company and International Organisations (IOs) Support Programmes	80
Annex B. Case Studies: Coverage, Main Findings and Research Teams.....	88
Annex C. Assessing the Productivity of Large Listed Enterprises	94

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Tables

Table 1.1.	Distribution of case studies by industry and country	18
Table 3.1.	Key attributes of the five industries analysed	50
Table 4.1.	SMEs' awareness and understanding of the value chain	55
Table 4.2.	Co-operation within the value chain	60
Table 4.3.	Technology, standards and IPRs within the value chain	65
Table 4.4.	Perceived benefits of SMEs' participation in global value chains.....	67
Table 4.5.	Policy issues from the field work.....	70

Figures

Figure 2.1.	Obstacles to Internationalisation as perceived by SMEs	23
Figure 2.2.	Changes in subcontracting structure, Japan	26
Figure 2.3.	SMEs in formal and non-formal co-operation.....	28
Figure 2.4.	National or foreign SMEs as important partners in cooperation	28
Figure 2.5.	Proportion of Japanese companies with overseas subsidiaries	29
Figure 3.1.	Software value chain (personal computer)	40
Figure 3.2.	An example of value network for the tourism industry	43
Figure 3.3.	Value chain for motion pictures	45
Figure C.1.	Share of employment and value added of the LE in labour force and GDP, Triad, 1995 and 2005	95
Figure C.2.	Value added and profits per employee in the Triad and selected emerging economies	97
Figure C.3.	Components of gross value added	97

Boxes

Box 1.1.	Value chain analysis: A tool for understanding competitiveness	16
Box 2.1.	Outsourcing and subcontracting	22
Box 2.2.	Subcontractors	25
Box 2.3.	Electronic marketplaces: the case of Covisint	27
Box 2.4.	Providing financing to small suppliers	31
Box 2.5.	Facing the challenge of global value chains: SMEs in developing countries	32
Box 4.1.	Analysing an enterprise's key attributes	54
Box 4.2.	How Egyptian suppliers are serving Microsoft globally	54
Box 4.3.	Co-operation between first and second tier suppliers of Volkswagen in Mexico.....	58
Box 4.4.	Boosting the competitiveness of the automotive parts industry in Chinese Taipei	58
Box 4.5.	SME alliances in the Austrian tourism sector.....	59
Box 4.6.	Funding innovative SMEs in the Polish tourism sector.....	63
Box 4.7.	Internet usage in the Australian tourism sector.....	64
Box 4.8.	Hovering on the edge of the value chain of Toyota South-Africa	67
Box 4.9.	Protecting IPRs in the cinema industry: the case of Nigeria.....	69



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