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# World Investment Report

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## *Chapter VI*



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## CHAPTER VI.

# KEY ELEMENTS OF A LINKAGE PROMOTION PROGRAMME

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In conclusion, the extent and nature of backward linkages between foreign affiliates and domestic supplier firms depend on many factors. Trends in the global environment encourage firms to concentrate on their core activities and rely more on other firms for non-core functions and inputs. Where the mutual self-interest of foreign affiliates and domestic firms with supplier capabilities leads to the creation and deepening of linkages, no further encouragement by governments is needed. Indeed, evidence shows that linkages evolve over time, as foreign affiliates become more integrated in the local economy.

However, this does not always happen. In fact, it is a reasonable assumption that, whatever the given level of linkages, this can be increased in many cases. Hence there is a role for judicious policy intervention to promote the creation and deepening of linkages, as a strategic tool to promote the development of domestic enterprises. Governments can promote the creation and deepening of linkages in many ways.

In formulating linkage promotion policies, governments need to understand the main determinants involved (chapter IV). Not all of them are amenable to policy influence. For example, it is difficult for governments to influence corporate strategies or the technical characteristics of the activities of foreign affiliates. They can, however, influence other factors affecting the costs and benefits of linkage development.

To do so, they must be aware of TNC procurement strategies and the competitive setting of each industry in which firms operate. The increased concentration of TNCs on core activities creates new opportunities for independent suppliers, but it also raises greater challenges for domestic firms. Uncompetitive domestic suppliers

may find themselves excluded in the increasingly demanding environment of rationalized supply chains. This is particularly true when it comes to foreign affiliates that are part of integrated international production systems, for which scale, standards requirements and technological demands are particularly high. Some activities and TNCs are more amenable to the outsourcing of inputs than are others, and governments that understand the competitive needs and strategies of TNCs can attract new investments more effectively and root them more deeply in their economies.

The role of policy is most significant where there is an “information gap” on the part of both buyers and suppliers about linkage opportunities, a “capability gap” between the requirements of buyers and the supply capacity of suppliers and where the costs and risks of setting up linkages or deepening them can be reduced. While the international regulatory framework is still evolving, the challenge for policy makers is to make use of the options available within the current framework and use other policy measures which are not subject to multilateral rules to encourage and accelerate the linkage formation process. Governments are refocusing their policy intervention towards addressing market failures and reducing the costs involved for linkage partners to create and deepen linkages, with the ultimate aim of strengthening the productive capabilities and competitiveness of domestic suppliers. Such intervention needs to be undertaken in close partnership with the private sector.

Whereas there is no universally accepted best practice in linkage promotion policy, important lessons can be drawn from past experience. Linkage promotion policies, like other development policies, are often highly context-specific and need to be adapted to the particular circumstances prevailing in each host country. They need

to be an integral part of broader development strategies, and their success often depends on factors that may not appear in a narrow assessment of linkage policies. Much also depends on how policies are designed, coordinated and implemented in practice.

There are two basic (mutually not exclusive) approaches through which linkages can be promoted. One involves encouraging linkages through various measures to bring domestic suppliers and foreign affiliates together and to strengthen their linkages in the key areas of information, technology, training and finance. This is a broad approach – it basically improves the enabling framework for linkage formation. A range of measures can be utilized here among which governments can pick and choose in light of their objectives and circumstances. (Table VI.1 contains a number of measures that are relevant here.)

The other approach goes further in that it involves the establishment of a

specific linkage promotion programme combining a number of the measures just mentioned. This is a proactive approach which is typically focused on a selected number of industries and firms dedicated to increasing and deepening linkages between foreign affiliates and domestic firms. As with other policies that span a range of productive factors, activities and enterprises, it is advisable for policy makers that choose this approach to “start small” (perhaps with a pilot scheme) and to build policy monitoring, flexibility and learning into any programme. The need for starting small is all the greater when resources are scarce. Moreover, it is essential for any programme to seek close collaboration with the private sector, both foreign affiliates and local suppliers, in design and implementation.

The general features of a specific Linkage Promotion Programme are set out below. This programme should be seen more as a set of building blocks that countries might “mix and match” according to their specific circumstances, rather than a ready-

**Table VI.1. Specific government measures to create and deepen linkages**

Information and Matchmaking	Technology upgrading	Training	Finance
<p><i>Provision of information:</i></p> <ul style="list-style-type: none"> <li>• Handouts and brochures.</li> <li>• Constantly updated electronic databases.</li> <li>• Linkage information seminars, exhibitions and missions.</li> </ul> <p><i>Matchmaking:</i></p> <ul style="list-style-type: none"> <li>• Acting as honest broker in negotiations.</li> <li>• Supporting supplier audits.</li> <li>• Providing advice on subcontracting deals</li> <li>• Sponsoring fairs, exhibitions, missions and conferences.</li> <li>• Organizing meetings, visits to plants.</li> </ul>	<ul style="list-style-type: none"> <li>• Technology transfer as a performance requirement.</li> <li>• Partnership with foreign affiliates.</li> <li>• Incentives for R&amp;D cooperation.</li> <li>• Home-country incentives.</li> </ul>	<ul style="list-style-type: none"> <li>• Promoting supplier associations.</li> <li>• Collaboration with the private sector for one-stop service, including training.</li> <li>• Support for private sector training programmes.</li> <li>• Collaboration with international agencies.</li> </ul>	<ul style="list-style-type: none"> <li>• Legal protection against unfair contractual arrangements and other unfair business practices.</li> <li>• Encouraging a shortening of payment delays through tax measures.</li> <li>• Limiting payment delays through legislation.</li> <li>• Guaranteeing the recovery of delayed payments.</li> <li>• Indirect financing to suppliers channeled through their buyers.</li> <li>• Tax credits or tax reductions and other fiscal benefits to firms providing long-term funds to suppliers.</li> <li>• Co-financing development programmes with the private sector.</li> <li>• Direct role in providing finance to local firms.</li> <li>• Mandatory transfer of funds from foreign affiliates to local suppliers.</li> </ul> <p>Home country measures</p> <ul style="list-style-type: none"> <li>• Two-step loans.</li> <li>• Using ODA.</li> </ul>

Source: UNCTAD.

made prescription that all countries can apply. Clearly, the choice of measures and the way they are combined must reflect the level of development, policy capabilities, resources and objectives of each country – indeed it must take into account the principal determinants outlined earlier (chapter IV). Even countries at similar levels of development may choose different configurations of policy according to their enterprise and institutional capabilities.

The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of an economy and of the challenges facing it in a globalizing world. A linkage programme should, in particular, address the competitive needs of domestic enterprises and the implications they have for policies, private and public support institutions and support measures (including skills- and technology-upgrading).

A precondition for linkage formation is of course that there is inward FDI and that there are capable suppliers (or suppliers with the potential for upgrading). Where this is the case, the steps that need to be followed in designing a linkage programme include:

1. setting the policy objectives of a linkage programme;
2. identifying the specific measures to be adopted;
3. identifying the targets of the programme;
4. setting up an appropriate institutional and administrative framework to implement and monitor the programme.

Naturally, experience with respect to programmes of this sort in other countries can be helpful when considering the actions to be taken in connection with each of these steps. (The principal characteristics of linkage programmes in a number of countries are summarized in chapter V.D). Moreover, at each step of the implementation of a programme, the government needs to have a clear idea about the costs involved and the resources available.

## A. Setting policy objectives

The starting point is a clear vision of a development strategy, supported by a coherent set of economic policies in the areas of investment, trade, technology and enterprise development. In particular, linkage programmes are at the intersection of two subsets of programmes and policies: those geared towards enterprise development (especially SME development) and those related to FDI promotion. The former are desirable in and by themselves, as a vibrant enterprise sector is the bedrock of economic growth and development; in the context of the promotion of linkages, the capabilities of local firms are the single most important determinant of success. FDI promotion, in turn, increasingly focuses not only on the quantity of FDI, a country attracts but also on its quality, including linkage opportunities.

Linkage programmes can have two broad objectives: to increase domestic sourcing by foreign affiliates (i.e. create new backward linkages) and to deepen and upgrade existing linkages, both with the ultimate aim of upgrading the capacities of local suppliers to produce higher value-added goods in a competitive environment. These objectives are interdependent: deepening may spin off new linkages, and spreading linkages may change their quality and depth.

A government's objectives should be shared with all principal stakeholders, as their active participation is needed for the success of any programme. Active dialogue and consultations are advisable right from the very beginning. This requires first and foremost:

- Initiating a public-private sector dialogue (perhaps in a "Linkage Forum") with stakeholders, including foreign affiliates (and especially their procurement officers), supplier industry associations, chambers of commerce, banks, service providers, trade unions and government agencies (such as investment promotion agencies, development corporations, industrial zone authorities, industry development agencies).

- Disseminating “best practice” experiences based on companies’ programmes and actions and experiences of government programmes and measures in other countries.

## B. Identifying the targets

Governments, in cooperation with private sector institutions, need to define the targets of a programme in terms of the industries and, within them, the foreign affiliates and domestic suppliers to be involved.

- **Industries** can be selected according to:
  - the sectoral development priorities of a country, taking into account the extent of the presence of foreign affiliates and capable domestic firms;
  - the degree of match between local capabilities and the input requirements of foreign affiliates;
  - the nature of international production systems within the industry selected, which partly determines the degree of autonomy of foreign affiliates with respect to local sourcing (foreign affiliates that are part of integrated international production systems are likely to be more dependent on global corporate sourcing policies);
  - the technology content of the activity and the scope for moving up the value-added chain.

Such an analysis is essential for any linkage strategy – without it, a government cannot decide how to allocate scarce resources. It also has to take into account trends in the growth and spread of international production networks and their implications for domestic producers, drawing, among others, on continuous dialogue with key stakeholders.

- **Foreign affiliates** can be selected according to their willingness and potential

to establish beneficial linkages. Beyond that – and as part of their FDI promotion – governments can target TNCs that are particularly interested in developing strong supply links with domestic enterprises. The linkage programme may even support local managers of foreign affiliates in lobbying their head offices to allow greater autonomy in sourcing. In-depth consultations with foreign affiliates can then identify their specific linkage needs.

- **Suppliers** can be selected on the basis of their commitment and capabilities (or potential capabilities) to meet the needs of foreign affiliates. “Commitment” can be tested through certain self-improvement requirements, with some external guidance and minimal support during the initial stage of selection. Other criteria that can be used involve technological benchmarking and skills audits. Specific criteria that have been used include the size of firms, production capabilities, ISO certification and the age of firms. However, one of the most important elements to take into account is the commitment of key managers (and especially the chief executive officer) to the idea of continuous improvement and their willingness to upgrade their operations to meet international standards required for successful linkages. The active cooperation of chambers of commerce, business associations, support centres, service providers and other private sector institutions is very important here, as is the cooperation of SME development programmes, be they local or international. (UNCTAD’s EMPRETEC programme is an example of the latter.) “Linkage Workshops” for representatives of foreign affiliates and local enterprises could provide the mechanism through which eventual programme participants can be narrowed down. Subsequent “Business Clinics” for Linkage Workshop participants could allow for one-to-one consultations for pairs of linkage partners. Firms prepared to go further could thus undertake operational and management audits to determine the strengths and weaknesses of domestic partners.

## C. Areas for specific policy measures

Governments need to be aware of actions already taken by foreign affiliates and domestic firms. Some of these may need to be encouraged and supported. A number of such possible actions were listed earlier in this Part of this report (chapter IV and its annex); for ease of reference, they are listed in table VI.2. Governments can also act as facilitators and catalysts and ensure that private institutions have the incentives and resources needed. They can be particularly proactive in the following key areas of linkage formation:

- information and matchmaking;
- technology upgrading;
- training;
- finance.

The range of measures that can be taken under each heading is wide. Their principal purpose is to encourage and support foreign affiliates and domestic firms to strike up and deepen linkages. They were outlined – individually and as contained in programmes – earlier in this Part of the report (chapter V and its annex); for ease of reference, these measures are listed in table VI.1. They constitute a menu from which governments can mix and match. Specific choices depend on the results of earlier consultations with existing support institutions and relevant programmes in the public and private sectors, as well as with key stakeholders on the specific needs of an industry or set of firms. The results of the Linkage Fora, Linkage Workshops and Business Clinics mentioned earlier and the identification of promising domestic firms are also of help here. Governments could also encourage participating foreign affiliates to agree to a coaching and mentoring arrangement with promising local firms (see box VI.1).

### Box VI.1. Coach an SME!

As part of its efforts to promote backward linkages, a government can encourage foreign affiliates to adopt promising domestic firms (typically SMEs) that are (or have the potential to become) suppliers and assist them in the continuous upgrading of management skills and technology. The specific activities and results of such an effort would be agreed between the foreign affiliates and the domestic firms. It could be, say, a three-year commitment with regular reviews to ensure that specific targets are met. This calls for an investment of time and a commitment by both the foreign and domestic firms.

Possible activities include:

- Participating TNCs give one or a few selected domestic suppliers access to their innovation centres and corporate training programmes.
- Engineers and management consultants from the foreign affiliates visit the firms on a regular basis and provide advice.
- The foreign affiliates assign a few staff members to the firms for a limited period.
- Foreign affiliates give opportunities for the manufacturing of inputs or the provision of services to the firms on a limited basis and increase such opportunities gradually.
- Foreign affiliates assess progress together with the supplier firms; a process of continuous managerial, technological and human-resource improvement is developed.
- Foreign affiliates share market information and strategy with the supplier firms so that the latter can pre-position themselves ready for changes ahead.
- Foreign affiliates provide firms with additional business opportunities through business matching, brokering strategic alliances, trade fairs and exhibitions.
- Foreign affiliates encourage their partners to diversify their customer base.

An approach along these lines has been successfully implemented in Penang, Malaysia (Wong, 2000).

*Source:* UNCTAD.

These measures can be underpinned by efforts to strengthen the negotiating position of local firms vis-à-vis foreign affiliates. For instance, guidelines or making model contracts available. Special informal mechanisms can also help resolve problems and disputes and contribute to more lasting linkage relationships.

The result should be a clear and feasible programme of action.

## D. Organizational and institutional framework

Governments can choose from a number of options in designing the institutional framework for a linkage programme:

- Making the programme a distinct part of an existing body or even to set up a special national-level linkage programme under an independent body to act as the focal point for all relevant activities by different departments and institutions.

Table VI.2. Measures by foreign affiliates to create and deepen linkages

Finding new local suppliers	Transferring technology	Providing training	Sharing information	Giving financial support
<ul style="list-style-type: none"> <li>• Making public announcements about the need for suppliers and the requirements that firms must meet on cost and quality.</li> <li>• Supplier visits and quality audits.</li> </ul>	<p>Product technology:</p> <ul style="list-style-type: none"> <li>• Provision of proprietary product know-how.</li> <li>• Transfer of product designs and technical specifications.</li> <li>• Technical consultations with suppliers to help them master new technologies.</li> <li>• Feedback on product performance to help suppliers improve performance.</li> <li>• Collaboration in R&amp;D.</li> </ul> <p>Process technology:</p> <ul style="list-style-type: none"> <li>• Provision of machinery and equipment to suppliers.</li> <li>• Technical support on production planning, quality management, inspection and testing.</li> <li>• Visits to supplier facilities to advise on lay-out, operations and quality.</li> <li>• Formation of "cooperation clubs" to interact with suppliers on technical issues.</li> <li>• Assistance to employees to set up their own firms.</li> </ul> <p>Organization and managerial know-how assistance:</p> <ul style="list-style-type: none"> <li>• Assistance with inventory management (and the use of just-in-time and other systems).</li> <li>• Assistance in implementing quality assurance systems.</li> <li>• Introduction to new practices such as network management or financial, purchase and marketing techniques.</li> </ul>	<ul style="list-style-type: none"> <li>• Training courses in affiliates for suppliers' personnel.</li> <li>• Offering access to internal training programmes in affiliates or abroad.</li> <li>• Sending teams of experts to suppliers to provide in-plant training.</li> <li>• Promotion of cooperative learning among suppliers.</li> </ul>	<ul style="list-style-type: none"> <li>• Informal exchanges of information on business plans and future requirements.</li> <li>• Provision of annual purchase orders.</li> <li>• Provision of market information.</li> <li>• Encouraging suppliers to join business associations.</li> </ul>	<ul style="list-style-type: none"> <li>• Providing special or favourable pricing for suppliers' products.</li> <li>• Helping suppliers' cash flow through advance purchases and payments, prompt settlements and provision of foreign exchange.</li> <li>• Long-term financial assistance through the provision of capital; guarantees for bank loans; the establishment of funds for working capital or other suppliers needs; infrastructure financing; sharing of the costs of specific projects with suppliers; and leasing.</li> </ul>

- Leave the design and implementation of the linkage programme to local authorities, with central advice, encouragement and support from the central government. This approach might be preferable in large countries or where resources for linkage programmes are limited or where regions have distinct combinations of locational advantages to offer.
- Involve the private sector as the main executing agency for the linkage programme. Suppliers, affiliates or their associations may set up such a body. The role of the government would be to act as catalyst and fulfil regulatory and information functions.

The size of a programme depends on the objectives sought and the resources available. Some programmes benefit from external funding through financial assistance provided by donor countries. In the longer term, the financial sustainability of linkage programmes, directly run by governments, requires adequate government funding. Moreover, cost sharing by participating firms (both buyers and suppliers) is desirable, not only for funding purposes but also for assuring self-commitment of the participants; this is feasible, especially when a programme has demonstrated its usefulness and is recognized for its services. Needless to say, to create trust and credibility among enterprises, a programme must be staffed by professionals with the appropriate private-sector related skills and background.

Linkage programmes can only work if they are networking effectively with efficient intermediate institutions providing support in skill building, technology development, logistics and finance. These include standards and metrology institutes, testing laboratories, R&D centres and other technical extension services, productivity and management training centres and financial institutions. These can be public or private. It is also important that linkage programmes work closely with relevant private associations – chambers of commerce and industry, manufacturers associations, investor associations and so on. Trade unions and various interest groups are other important stakeholders.

Finally, it is important to have a monitoring system in place to evaluate the success of a programme. Often, in a learning-by-doing process, a programme needs to be adjusted and refined as experiences accumulate and situations change. The system could include benchmarks and surveys of users (see box V.11 for an overview of existing approaches on measuring the impact of linkage programmes). Criteria could include the following:

- Outreach: the number of companies included in the programme over time.
- Impact: the impact of the programme can be judged by such indicators as the number of suppliers linked up with foreign affiliates over time, the value of deals and changes in these over time; the share of domestic suppliers in procurement by foreign affiliates, the extent to which R&D activities are being undertaken by domestic suppliers over time (including those resulting in patents); changes in export volumes; the improvements in the productivity or value-added at the firm or industry level; and whether a local supplier establishes itself abroad.
- Cost effectiveness: the cost of the programme in light of the results achieved and the benefits obtained as defined by the objectives laid out at the beginning of the programme.

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It is worth repeating that a linkage programme should be seen as part of a broader set of FDI and SME policies. As networks of viable suppliers often prosper in clusters of firms, attention needs to be given to the development of such clusters, particularly for knowledge-intensive industries and activities. The third generation of FDI promotion policy (see the conclusion of Part One) – targeting foreign investors at the level of industries and firms and using clusters to attract FDI and, in turn, strengthening clusters through it – has a role to play here. In fact, the more linkage promotion policies go hand-in-hand with SME development and targeted FDI promotion policies (and, for that matter, a number of other policies – see figure V.2), the more they are likely to be successful.

