Integrating Southeast Asian SMEs in Global Value Chains

TRADE, INVESTMENT AND REGULATORY POLICY SYNTHESIS NOTE

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This note identifies key findings and policy messages on how small and medium- sized enterprises (SMEs) in Southeast Asia can enhance integration in global value chains (GVCs). The list of policy messages in this note is not intended to be exhaustive but rather to provide a set of concrete and actionable measures. It synthesises insights from three reports that focus on SME integration in GVCs from the regulatory, trade and investment policy perspective.

- *Good Regulatory Practices to Support Small and Medium Enterprises in Southeast Asia*.
- *Participation and Benefits of SMEs in GVCs in Southeast Asia*.
- *Integrating Southeast Asian SMEs in global value chains: Enabling linkages with foreign investors*

Introduction

The fragmentation of production processes across national borders into global value chains (GVCs) has given rise to new opportunities for firms in developed and developing countries. In Southeast Asia, GVCs have played a prominent role in supporting economic development, allowing the region to achieve remarkable export-led growth and become a leading investment destination for multinational enterprises (MNEs). At the same time, Southeast Asian multinationals are emerging as sources of investment in their own right, both within the region and overseas. As participation continues to grow, Southeast Asia is becoming a dynamic regional hub and a pillar of the global production system.

It is unclear whether growing participation in global value chains is confined to larger firms or if small and medium-sized enterprises (SMEs) are also able to take advantage of the new opportunities on offer. While SMEs make up the majority of enterprises in Southeast Asia and employ the bulk of the domestic workforce, their contribution to GDP and exports is modest. Low productivity and lack of international competitiveness are generally attributed to the small size and limited experience of SMEs, which constrain their access to scale, international markets, finance for new investment, information, skills and technology.

Global value chains provide channels through which SME constraints can be relaxed, offering new opportunities to integrate into the global economy. For instance, access to more sophisticated or cheaper inputs from abroad can help SMEs increase their competitiveness. In turn, the fragmentation of production can allow SMEs to specialise in the production of intermediates rather than having to master all the tasks required to produce final goods. Foreign direct investment (FDI) and interaction with multinationals can allow SMEs to acquire new knowledge and technologies, further enhance competitiveness and in some cases become themselves multinationals. Additionally, rising incomes, changing skills, and saturating markets may drive more successful SMEs to invest abroad and become protagonists in the GVC narrative. This theme is becoming increasingly relevant to firms in Southeast Asia.

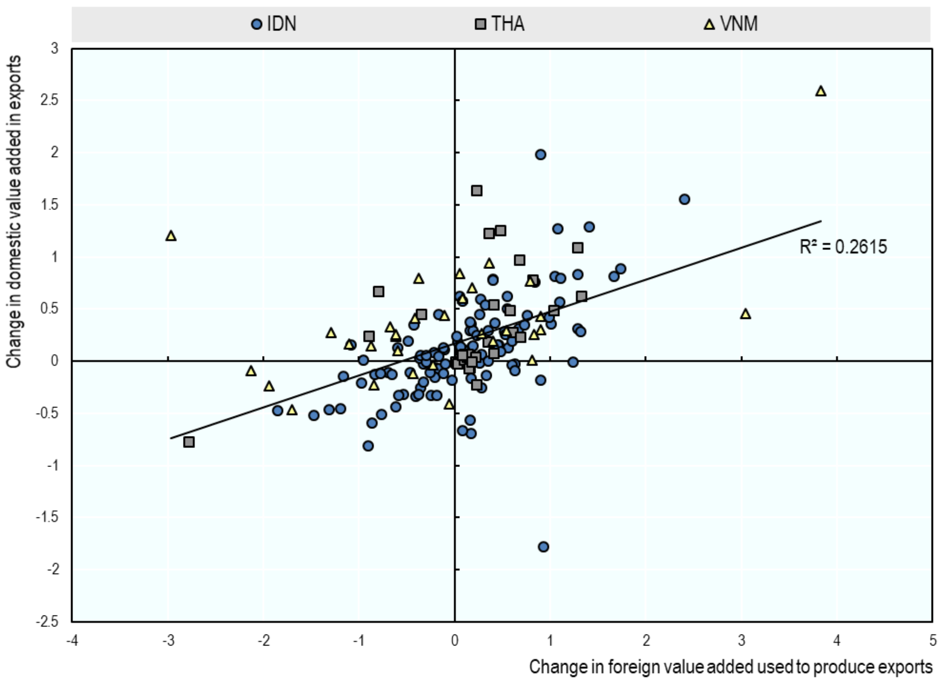
Governments need to consider carefully how to help SMEs integrate into GVCs. Although there are clear benefits from SME participation in GVCs, not all SMEs will be able to participate. SMEs are highly heterogeneous, not just in terms of size and industry, but also in terms of their willingness and ability to grow and engage in GVCs. There is a role for policy to support those SMEs which want to grow by helping them overcome some of the challenges associated with participation. In particular, policy intervention can usefully focus on market failures such as informational asymmetries, which can provide a preferential business environment for large firms relative to SMEs. Measures that are most beneficial for SMEs may not even be targeted specifically to SMEs. For example, in the area of trade facilitation, more efficient customs procedures help large and small firms integrate into GVCs, but they help SMEs more as they may otherwise not even be able to start exporting in the first place. Similarly, transparent and streamlined procedures for firms to obtain quality certifications or comply with responsible business conduct standards may be essential for SMEs to be selected as suppliers by foreign MNEs.

There are some difficult questions about what objectives to pursue given trade-offs between efficiency and inclusiveness. For instance, trade policies such as higher tariffs or local content requirements might be used with the intention of stimulating domestic sourcing in view of integrating SMEs in value chains. However, forcing firms to source more expensive intermediate products than their competitors can entail losses in overall competitiveness, reducing the benefits associated with GVC participation in the first place. This means that governments may need to weigh measures in terms of gains associated with greater competitiveness in terms of net employment and value generation arising from deeper integration, against the gains from redistribution, in terms of more SMEs participating in value chains.

GVC participation is associated with improved SME performance

GVC participation is not an end in itself but a means to achieving greater economic development through, for example, productivity growth, innovation and employment generation. At the same time, GVC participation may expose firms to a number of risks or challenges that threaten firm performance; – increased interconnectedness in the global production system can make firms more vulnerable to competitive pressures, political uncertainty, economic crises and other negative shocks.

Figure 1. ASEAN SME imports are linked with stronger export performance



Note: Figure shows log changes in the use of foreign value added to produce exports (x-axis) and log changes in domestic value added in exports (y-axis). Data is from splitting the OECD TiVA database using firm-level data, it is presented at the sector level.
Source: OECD (2019).

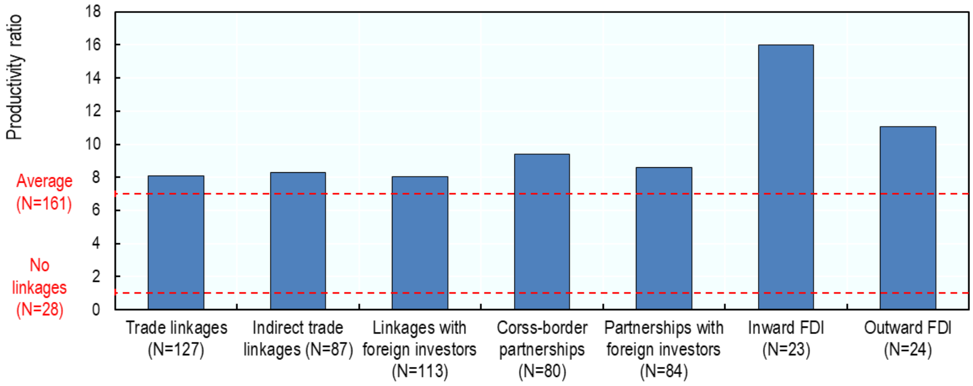
There are many potential benefits for Southeast Asian SMEs that integrate into GVCs. Empirical analysis that combines firm-level data with OECD-WTO Trade in Value Added (TiVA) indicators[1] indicates that imports, for instance, are associated with growth in the domestic content of exports

[1] The OECD–WTO Trade in Value-Added (TiVA) database measures the value added by each country in the production of goods and services that are consumed worldwide. The database (2018 revision) covers 63 economies and 34 unique industrial sectors up to 2013.

(Figure 1), higher total factor productivity and higher rates of upgrading. In turn, GVC participation through direct exports is associated with productivity growth and upgrading, although the direction of causation is hard to establish. Moreover, greater participation is also linked to employment generation.

GVC participation is associated with higher productivity. An original survey of enterprises with manufacturing operations in Thailand also provides evidence that GVC participation through trade, investment and strategic partnerships is associated with a productivity premium of a factor of eight and above with respect to firms that do not participate in global value chains through any channel (Figure 2). While GVC participation could boost productivity of firms, participating firms are likely to be among the most productive more generally. As such, the direction of causality is likely to go both ways. Nonetheless, over 95% of firms that engage in trade and investment linkages in GVCs, report perceived performance improvements related to efficiency, product quality, skills development, product diversification and access to new markets, as a result of these linkages. Similarly, survey evidence from Viet Nam suggests that linkages with foreign buyers are positively related to the productivity of domestic suppliers.

Figure 2. GVC participation is associated with higher 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). Partnerships are defined as cooperative business endeavours between firms that involve repeated interactions and some degree of knowledge transfer, irrespective of equity. See OECD-UNIDO (2019) for details.
Source: OECD-UNIDO (2019).

But evidence shows that SMEs in the region have low participation

SMEs in the region tend to import less than larger firms. For instance, the foreign value added content of exports of SMEs in Viet Nam was 43% while that of larger firms was 51%, suggesting that SMEs might face additional constraints limiting their ability to source foreign inputs, affecting their competitiveness.

Southeast Asian SMEs are more specialised in the production of intermediates for export than larger firms.[2] For example, in Thailand, 18% of direct SME exports are sold to firms abroad for further export processing; for large firms, it is only 8%. This is likely to reflect that SMEs are better suited to producing intermediate rather than final goods. This suggests that the evolving environment of growing trade in intermediates provides new opportunities for internationalisation of SMEs in the region.

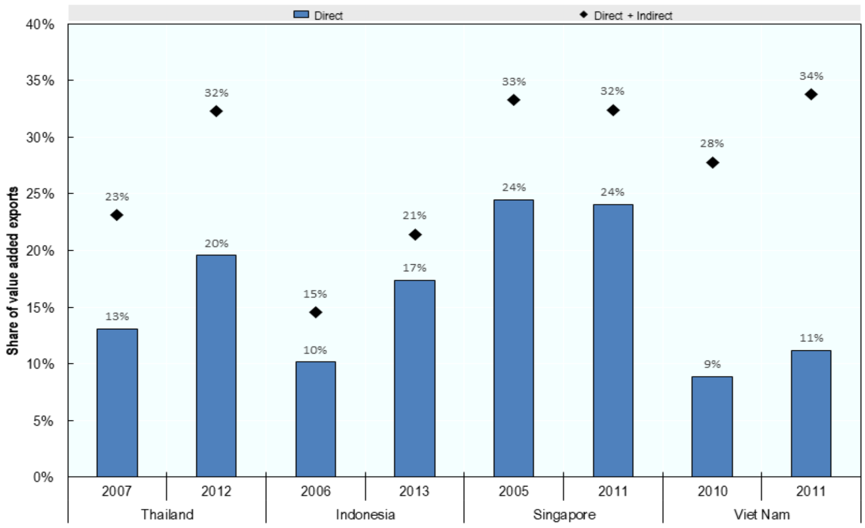
SME participation through exports remains low. Here too the firm evidence suggests that the share of firms that export, whether intermediates or final products, is considerably lower for SMEs (13% in Indonesia, 8% in Viet Nam and 5% in Thailand) than it is for large firms (50%, 69% and 55%,

[2] Exports of intermediates should not be confused with direct exports shown in Figure 3, which include both intermediates and finished goods

respectively). This means that, although SMEs might be more specialised in producing intermediates, they struggle to integrate in GVCs through exports.

Indirect exporting represents an important channel through which Southeast Asian SMEs internationalise. In Viet Nam, SMEs export more than twice as much through larger firms than they do directly (Figure 3). The evidence also shows that indirect exporting is most prevalent in GVC intensive sectors such as electrical equipment and transport equipment.

Figure 3: Indirect exports are important for ASEAN SMEs



Note: All figures are aggregates for manufacturing sectors that are common across the countries covered. SMEs are defined as firms with less than 200 employees.
Source: OECD (2019).

Foreign MNEs source a significant share of inputs locally, but primarily from large domestic or foreign suppliers. Firm-level data suggest that foreign manufacturers in Southeast Asia source a significant share of inputs from local suppliers (domestic and foreign), and constitute an important source of revenue for these suppliers, particularly in Indonesia and the Philippines. Qualitative interviews suggest that the majority of these suppliers are large domestic firms or other foreign firms.

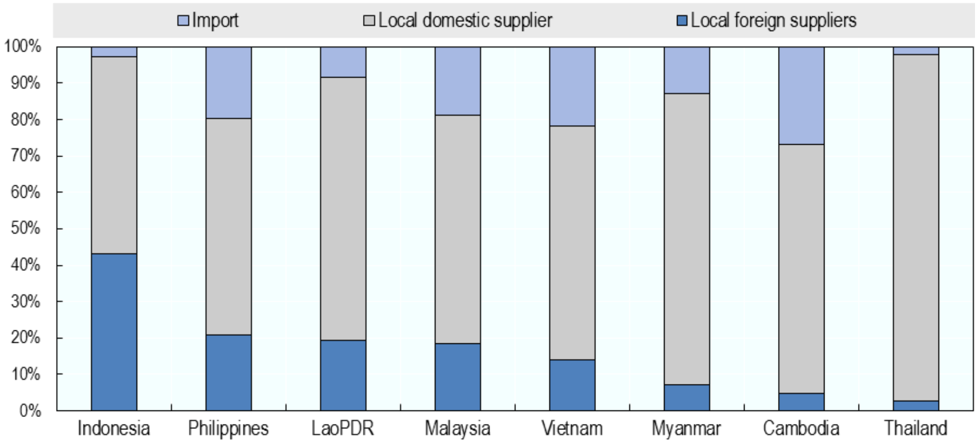
Southeast Asian SMEs are likely to source a big share of inputs from foreign MNEs established locally. In Indonesia, for example, sourcing from foreign affiliates could represent as much as 40% for SMEs. This share is about 20% in Lao PDR, Malaysia, the Philippines and Viet Nam. It is negligible in other developing AMS (Figure 4).[3]

SMEs from Southeast Asia are beginning to invest abroad. While Southeast Asian countries continue to be major FDI destinations, some are emerging as important sources of outward FDI in their own right, both in the region and elsewhere. Singapore is responsible for almost 70% of ASEAN direct investment positions abroad, although Malaysia and Thailand are increasingly dynamic investors abroad (accounting for 13% and 8% of outward stocks, respectively). Aside from the prevailing state-owned enterprises and large companies responsible for outward FDI, Southeast Asian SMEs 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

[3] This indicator hinges on the assumption that SMEs' sourcing of locally produced intermediates has the same distribution in terms of origins of suppliers (domestic versus foreign) as does the sourcing of non-SME producers and final consumers. As such the observed shares should be interpreted with caution.

overseas subsidiaries and joint ventures, and 36% had been involved in international business for 6-10 years. According to original evidence gathered in Thailand, 15% of the 168 surveyed manufacturing SMEs either invest in production abroad or contract production abroad.

Figure 4. In AMS, foreign affiliates are likely to be important source of inputs for SMEs



Note: The indicators cover manufacturing only and are derived from output measures from the World Bank Enterprise Survey. Reference years are 2015 (Indonesia, Malaysia, Philippines, Viet Nam) and 2016 (Cambodia, Lao PDR, Myanmar, Thailand). Foreign ownership is defined at the 10% threshold. See OECD-UNIDO (2019) for details.
Source: OECD-UNIDO (2019).

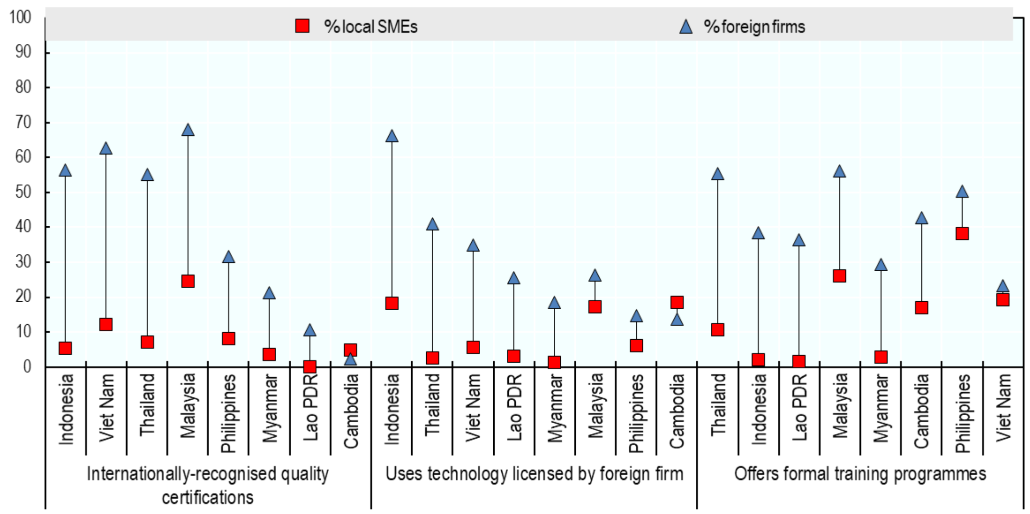
SME participation in GVCs is constrained by their capabilities

The gap in capabilities between foreign firms and local SMEs is substantial. Absorptive capacity is the ability of a firm to utilise available information or knowledge that is transferred through the interaction with other firms, and is a function of domestic firms' characteristics and of the technology gap between domestic and foreign firms. World Bank Enterprise Surveys suggest that the gap between foreign firms and local SMEs with respect to different measures used as proxies for absorptive capacity – namely, quality certifications, use of foreign technologies, and training of employees – is very high in some Southeast Asian countries (Figure 5).

Limited resources make it difficult for SMEs to comply with requirements of international certifications, rules and principles. 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. Given the low levels of certification observed among ASEAN SMEs, this evidence suggests that difficulty in obtaining internationally-recognised certifications could significantly constrain participation in GVCs. Difficulty in obtaining certifications may relate to an increasing number of non-tariff measures (NTMs) and significant regulatory heterogeneity in Southeast Asia. NTMs can be a particular impediment for SMEs, given their limited resources to comply or adapt production to different requirements. Similarly, the complexity of Rules of Origins (RoOs) and their divergence across agreements inflate the costs of compliance and impede SME participation in GVCs. Moreover, resource constraints also make it difficult for SMEs to adhere to responsible business conduct principles, which are increasingly a pre-requisite to access multinationals' supply chains.

Low capabilities and skills constrain SMEs participation in GVCs. Evidence suggests that GVC participation and FDI spillovers are higher for SMEs that invest in human capital as opposed to those that do not. Across ASEAN, governments opt for special economic zones (SEZs) to attract investors, create jobs, and increase export earnings. However, SEZs often exhibit limited linkages to the local economy. Evidence from countries that have been most successful in using SEZs to advance development suggests that encouraging collaboration between foreign investors and vocational and higher education institutes can be an effective means of anchoring foreign investors to the local economy. 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.

Figure 5. Performance gaps between foreign firms and ASEAN SMEs are substantial



Note: Shares are constructed using the survey weights from the World Bank Enterprise Survey. The figure considers SMEs in manufacturing only.
Source: OECD-UNIDO (2019).

An enabling policy environment is essential

The first step to supporting SME participation in global value chains is to level the playing field for SMEs by facilitating business operation and regulatory compliance. Compared to large companies, SMEs tend to face greater hurdles in qualifying for financial assistance, and are often disproportionately affected by the stock and flow of regulations due to their weaker capacity to comply with complex or changing regulations. In order to help SMEs thrive locally and internationally, a fair, sensible and transparent regulatory environment is crucial. Implementing good regulatory practices (GRP) can help boost investment, trade, and entrepreneurship for businesses of all sizes – especially SMEs - by making regulatory planning more inclusive and regulations easier to understand, as well as by reducing the time and costs associated with compliance(Box 1).

Policy plays a pivotal role in attracting investors and creating an enabling environment to promote linkages with domestic SMEs. Indirect exporting is a key channel for SMEs to internationalise, particularly in sectors that tend to be strongly associated with GVC activity. Promoting the creation of domestic supply chain linkages by connecting SMEs with larger firms and multinationals can help increase their integration in global supply chains. The realisation of linkages depends critically on governments creating a favourable investment climate. Governments may decide to implement additional proactive policies to enable supply chain linkages, targeting foreign investors and domestic SMEs. Such targeted policies typically focus on building domestic SME capacity and creating an effective selection and matching mechanism to link potential FDI and local firms, potentially in SEZs.

Policy needs to consider the demands of the GVCs of tomorrow. The pace of GVC expansion is slowing, in part, due to changes in global demand (e.g. increasing social and environmental concerns of consumers) and the transformation of business models as a result of digitalisation (e.g. reshoring production activities as a result of new technologies that facilitate automation). This means that international competition faced by SMEs is intensifying, and underscores the importance of reducing trade costs and facilitating SME participation in GVCs through trade and investment openness. But these policies need to be leveraged in the context of wider regional and domestic reforms aimed at helping SMEs better adopt new technologies and access new skills to enable their participation in the GVCs of tomorrow.

Box 1. Good regulatory practices to enhance SME participation in GVCs

Good regulatory practices (GRP) are internationally recognised processes, systems, tools and methods for improving the quality of regulations. GRP includes the use of impact assessments, stakeholder engagement, *ex ante* and *ex post* evaluations that help to ensure that regulatory compliance is as efficient and meaningful as possible. In the context of supporting SME development and participation in global value chains, the following recommendations could be considered as GRP.

Tailor regulatory interventions to the needs of SMEs. As modes and manners of doing business become more dynamic than ever – increasingly cutting across sectors or jurisdictions – policymakers and regulators must ensure that they continuously update their understanding of SMEs and their needs. Regulatory interventions should be tailored to the sectors in which SMEs operate and the tools that they use, rather than administered according to simple employee count or revenue. In the case of regulations relating to SMEs, it would be helpful to review whether dedicated focus needs to be placed to differentiate treatment of SMEs, or if a general regulation covering businesses of all sizes may suffice. On the flip side, where a general business regulation covers SMEs, it would be important to review whether SMEs are disproportionately affected by the regulation or are at a disadvantage to participate vis-à-vis their larger counterparts.

Subject new and existing regulations to ex ante and ex post reviews. Regulatory reviews should be built in from the design phase and periodically re-assessed over time. Regulations that are relevant and efficient today may no longer be so tomorrow. Given that for most governments, the stock of regulations tends to increase over time, it would be important to undertake periodic reviews and de-regulation programmes using transparent performance measurement methodologies, and with adequate stakeholder consultation. Performance measurements should be considered early in the regulatory design process, and take into account how the impact of the regulation will be measured and who will be responsible for monitoring and evaluating performance. The review process perpetuates regulatory quality, capacity-building, and responsibility by ensuring that policymakers and regulators keep track of the progress and outcomes of the regulations they introduce; it also helps strengthen transparency and communication about the purpose of regulations to stakeholders. The credibility of regulatory performance reviews can be boosted if they are undertaken by bodies other than the regulator responsible for the regulation. Such external review bodies may include: the central regulatory oversight body, the Competition Authority, or another body with expertise to examine the relevant regulatory legislation and programmes.

Create effective public consultation mechanisms and procedures that adequately involve all relevant stakeholders. Regulations should be developed openly and transparently, with appropriate and well-publicised procedures for inviting and incorporating inputs from national and foreign parties who would be impacted. Stakeholders that might be relevant to the consultation process include businesses, trade unions, wider interest groups such as consumer or environmental organisations, other parts of government, sector or technical specialists. Best practice stakeholder consultation engages relevant parties publicly and systematically throughout the regulatory process. Governments may consider publishing or otherwise establishing a register for information collected during consultations in order to identify routine questions or concerns, and to reduce administrative burden or duplication of engagement efforts. Once decisions are taken, policymakers and regulators should be held accountable for the consultation process, including taking time to explain how and why they have reached certain conclusions. This helps to maintain the utility and credibility of the consultation process. In Southeast Asia where SMEs tend to be dispersed and thus have a weaker voice than their larger counterparts, stakeholder consultations with SMEs tend to reach out to SME representative organisations or industry groups. Attention should be paid to what extent the opinions of SME representative groups adequately reflect the true composition and interests of the SMEs they speak for.

Actionable policy measures to support SME integration in GVCs in Southeast Asia

The following list of recommendations condenses selected key policy messages emerging from the three publications synthesised by this report. The list is not intended to be exhaustive but rather to provide a set of concrete and actionable measures spanning the trade, investment, and regulatory policy spaces that can serve as a starting point for ASEAN countries to support greater SME participation in global value chains.

1. ***Reduce non-tariff measures and advance regional regulatory harmonisation.*** While tariffs have fallen considerably in the region, the number of non-tariff measures (NTMs) has grown rapidly – from 1 634 measures in 2000 to 5 975 measures in 2015. Lacking the resources to comply or adapt production to different requirements, NTMs can be particularly onerous for SMEs. While, compliance with regulations and standards can help SMEs signal quality, thereby stimulating demand, other NTMs and regulatory heterogeneity (which has a strong and SME-specific negative impact) reduce the ability of SMEs to integrate into GVCs through export, and constrain their ability to source intermediates from abroad. Moves towards further regulatory harmonisation within ASEAN based on international best practices could ease these constraints. Anticipating regional regulatory requirements in the development and application of national regulations can help transition to harmonised regulatory policies across countries. Regulators could benefit from undertaking earlier analyses on whether or how proposed regulation or regulatory changes may complement regional regulatory harmonisation efforts.
2. ***Engage in trade facilitation reforms.*** Reducing tariffs and non-tariff measures is key. It will help SMEs to better source intermediates and upgrade. Another key priority action area is trade facilitation reform. More efficient customs procedures help large and small firms integrate into GVCs, but they help SMEs more. This means that trade facilitation reforms promote overall efficiency and also level the playing field between small and large firms.
3. ***Simplify Rules of Origin (RoO) and adopt more flexible rules.*** Although RoO are designed to prevent products from non-member countries entering a free trade area, their complexity and divergence across agreements inflate the costs of compliance and impede SME participation in GVCs. The adoption of more flexible rules of origin, allowing for instance for accumulation mechanisms (i.e. mechanisms that enable production sharing within a free trade agreement territory), can help ASEAN SMEs draw benefits from further integration into regional value chains.
4. ***Link investment promotion activities to Responsible Business Conduct (RBC).*** Expectations about RBC 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 on business and human rights. The government plays a pivotal role in raising awareness about how adhering to RBC principles can benefit businesses. Making an explicit link between RBC and investment promotion efforts can also help fill the information gap for foreign investors, and brand Southeast Asia as a responsible business destination. Policies in support of data protection and digital infrastructure can facilitate adoption of big data solutions, which in turn can facilitate SME compliance with RBC standards and create a more level playing field that supports SME linkages with foreign investors. For instance, Blockchain and Distributed Ledger Technologies (DLT) in general can increase traceability of material supply chains, lower the risk of fraud and counterfeiting, and reduce paperwork and administrative costs associated with complying with RBC standards, which can be prohibitively high for SMEs.[4]
5. ***SEZ strategies should be complemented by policies that support skills and cluster development in order to have the desired spillovers on SMEs.*** Special economic zones (SEZs) have been at the heart

[4] The OECD is currently exploring the policy implications of a range of potential use cases of these technologies, including for due diligence in raw material supply chains.

of successful export-led development strategies of Southeast Asian countries, over many decades. The region has more than 1 600 economic zones of various types. But the spread of backward linkages has varied greatly across countries. Some countries in the region are adapting their SEZ strategy to a more elaborate and comprehensive strategy for cluster development. A stronger emphasis is given to SME development in Malaysia and Thailand, in an active and successful effort to link foreign firms with local suppliers, while in others this trend is not apparent.

6. ***Prioritise compiling supplier databases and providing support for obtaining certifications.*** Allocate adequate funding and resources to implement and maximise the effectiveness of existing SME linkage programmes. With limited resources, compiling information on local enterprises should be prioritised. One element of the supplier database could be responsible business conduct so as to signal safe local sourcing options. The low levels of certification observed among Southeast Asian SMEs suggests that the difficulty in obtaining internationally-recognised certifications significantly constrains participation in GVCs. Consider facilitating seminars and workshops on obtaining certifications. All new and existing programmes may be subject to ex post and ex ante reviews.
7. ***Tailor regulatory interventions to the needs of SMEs.*** To date, many ASEAN countries continue to distinguish the support offered to SMEs according to their size (i.e. number of employees or annual turnover), but do not adequately reflect on other characteristics of SME operations, such as whether they operate online or whether they trade in goods or services, which are in fact more relevant factors for targeted regulatory intervention.
8. ***Ensure mandatory and systematic ex post evaluation for existing and new regulations.*** After laws and regulations are introduced, they should be evaluated ex post for continuous effect, relevance and efficiency in achieving its targets and objectives. Present uses of ex post evaluations in Southeast Asia are limited. Only a few countries such as Brunei, Malaysia, the Philippines and Singapore conduct some reviews of regulations after they are implemented, typically on an ad hoc or project-by project basis. This may be linked to the resource-intensive nature of ex post evaluations and the need for more sophisticated tools to review entire sets of regulations more efficiently.
9. ***Ensure sufficient consistency and coordination in regulatory implementation,*** particularly where there are multiple oversight bodies or where there are cross-border regulatory gaps. Oversight bodies are crucial in the implementation of regulatory policy tools and the improvement of the regulatory management system overall. Most ASEAN countries have assigned government ministries or set up dedicated regulatory oversight bodies to monitor and assess the quality of regulatory delivery. Some countries have a centralised oversight body that is responsible for co-ordinating GRP implementation – i.e. Cambodia, Lao, Thailand and Viet Nam - while others have multiple regulatory oversight bodies. A combined option is to assign one overarching co-ordinating body that oversees individual regulatory bodies, as in the case of Malaysia Productivity Corporation (MPC) and the National Economic and Development Authority (NEDA) of the Philippines. There is no singular structure that is considered to be the most appropriate way to oversee a country's regulatory framework.

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