UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Promoting International Investment by Small and Medium-sized Enterprises

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CONTENTS

KEY MESSAGES

Small and medium-size enterprises (SMEs) are important contributors to economic development, representing a substantial portion of businesses globally. Global markets offer SMEs opportunities for growth, diversification and resilience. Access to international markets enables them to tap into new customer bases, gain exposure to diverse business practices and foster innovation through cross-cultural collaboration.

However, SMEs encounter significant challenges that hinder their investment overseas. SME investors, relative to large Multinational Enterprises (MNEs), face distinctive bottlenecks including financial and information constraints, difficulties in dealing with regulatory complexities and, importantly, an international investment environment in which facilitation and investment promotion institutions are often geared towards attracting large-scale investment projects. Foreign direct investment (FDI) by SMEs has been in decline in recent years: the number of outward greenfield investment projects in 2022 was only about a quarter of that in 2015.

There are good reasons for governments and investment promotion institutions to pay more attention to supporting SME investment. SME investment can be most beneficial for development because it is less footloose, relies more on local suppliers and partners, and is less likely to crowd out local firms. SMEs can become real game changers in a global context characterized by greater competition for a shrinking pool of large-scale projects; a general trend towards regionalization and international tax reforms that will reduce the effectiveness of incentives for large MNEs.

Based on original empirical studies in different developing regions and selected developed economies, this report discusses how to reduce the common investment policy bias in home and host countries towards large MNEs, the role of SMEs in South–South and intraregional FDI, and ways and means to maximize the development impact of SME FDI. It introduces a new framework to assess the relevance and effectiveness of existing investment policies for the promotion of SME investment and presents policy options to facilitate overseas investment by SMEs and reduce the existing policy bias, including these six:

- Adjusting investment promotion and facilitation services towards addressing the needs and challenges that SMEs face, so that size does not hinder their access to financial incentives and facilitation mechanisms.
- Establishing comprehensive support networks and designing accessible matchmaking programmes and events to help small businesses connect and to foster sustained and successful partnerships.
- Improving SMEs' competitiveness by supporting their innovation capacity, including through digitalization, technology adoption and capacity-building.
- Facilitating SMEs' access to capital, including by improving digital services and infrastructure development.
- Simplifying the regulatory and administrative framework and improving access to information by using digital platforms.
- Promoting SMEs' participation in trade to increase their international exposure and knowledge of foreign markets.

By implementing a combination of these policies, governments can create an environment that supports SMEs in their efforts to invest and thrive in international markets and to harness the related development benefits.

1

OVERSEAS INVESTMENT BY SMEs

1.1. INTRODUCTION AND BACKGROUND

In an interconnected and rapidly evolving global economy, small and medium-sized enterprises (SMEs) can have a pivotal role in achieving sustainable development. Often regarded as the backbone of economies worldwide, SMEs can significantly contribute to cross-border economic growth, innovation and job creation (the definitions of SMEs, including the designations used in the empirical studies of this report appear in box 1). Yet, their participation in overseas investment has historically been limited by various challenges, including financial constraints, information gaps and regulatory complexities. For this reason, SMEs' potential as investors is typically neglected. The assessment of foreign direct investment (FDI) both inward and outward, usually takes headline numbers without specifying whether the actors are large or small firms. By contrast, this study focuses on SMEs as actors of FDI themselves, thereby complementing the research focus of the established literature. UNCTAD's experience in working with investment authorities, investment promotion agencies (IPAs) and special economic zones (SEZs) has shown that institutions, policies and infrastructure aimed at attracting and promoting investment are mostly geared towards large-scale industrial projects by large Multinational Enterprises (MNEs).

While *inward FDI* by SMEs is important, the promotion of *outward FDI* in developing countries can also bring development benefits, helping them grow, improve productivity and strengthen their resilience to external shocks. For knowledge-intensive enterprises, FDI can bring significant learning benefits, accelerating the technological catch-up of developing countries. This contributes to developing a dynamic and competitive private sector, key to economic growth. Facilitating *inward FDI* by SMEs has positive effects on the recipient economy, including increasing local employment because SMEs are less footloose, rely more on local suppliers and partners, and are less likely to crowd out local firms.

This report examines through original empirical research and policy analysis the internationalization process of SMEs, shedding light on the key factors, challenges and strategies essential for harnessing the potential of smaller enterprises. UNCTAD first published a study on FDI by SMEs three decades ago, focusing on the motives and drivers for SMEs to invest, followed by a study of Asian SMEs (UNCTAD, 1993 and 1998). Since then, the international trade and investment landscape has changed markedly, calling for a fresh look at the issue.

The objective of this report is to assess the common investment policy bias in home and host countries towards large MNEs. It presents a policy framework that policymakers can use to promote and facilitate inward and outward investment by SMEs. It aims to identify ways and means both to attract FDI by foreign SMEs and to support the internationalization of domestic SMEs, to maximize their development benefits.

The report presents new insights and real-world examples of SMEs that have successfully navigated international markets, emphasizing lessons learned and best practices, and illustrating the impact of supportive government policies and initiatives on SMEs' global ventures. The case studies at the basis of this report, which cover major developing regions, provide innovative empirical evidence on the characteristics of multinational SMEs from home countries such as Brazil, Colombia, Ghana, Morocco, Peru, South Africa, the Republic of Korea, Thailand and Türkiye. The studies shed light on the different policies and policy instruments that are most effective in promoting and facilitating FDI by SMEs. Three commissioned background studies on Türkiye, the Republic of Korea, and a research note on the growth performance of SMEs, which contribute to underresearched streams of literature on SME internationalization, were published in various issues of *Transnational Corporations,* UNCTAD's peer-reviewed academic journal. For example, the study on Türkiye (Koyden et al., 2022) investigates the relative innovation performance and international presence of SMEs, looking at government incentives that promote innovation and hence internationalization. The research on the Republic of Korea (Park et al., 2022) analyses how the adoption of Fourth Industrial Revolution (4IR) technologies can affect SMEs' decisions to invest abroad; it addresses the impact of the 4IR on international production across different technologies, and how the probability of investing abroad and the intensity of the investment relates to the adoption of 4IR technologies. Also, an innovative empirical analysis of the growth performance of SMEs when they internationalize through outward investment (Santos-Paulino et al., 2023) is part of the assessment of SMEs' internationalization modes in this report.

The report analyses countries' investment policy toolkits and presents a new policy framework that provides policy recommendations for home and host economies based on the empirical evidence. The framework for assessing investment policy from the perspective of SMEs and the proposed recommendations were discussed with major stakeholders and practitioners in a dedicated session at the 8th World Investment Forum, held by UNCTAD in October 2023. The framework provides guidance for refocusing investment promotion policies and facilitation measures, with particular attention to smaller firms and their needs, and suggests policies to enhance institutions, infrastructure and the general business environment for SMEs. Other policy areas not directly linked to investment promotion and facilitation but found to support SMEs in their growth and internationalization strategies notably include promotion of technological upgrading and Industry 4.0, innovation, and trade participation and regionalization.

The rest of this chapter provides an overview of major FDI trends and explains the importance of supporting SMEs on their internationalization path. Chapter 2 analyses the internationalization of SMEs through the lenses of different theories and SME characteristics and evaluates the challenges and factors that facilitate SMEs' internationalization by FDI. Chapter 3 presents the policy framework to facilitate and support investment by and in SMEs and to leverage their development impact. Chapter 4 presents priority areas for intervention and concludes.

Box 1. Definition of SMEs

The definition of what constitutes an SME varies significantly across national and international sources. Some definitions are exclusively based on the number of employees of a firm or its annual turnover, its capital or fixed assets, or all these characteristics. The number of employees is the most common criterion, yet the thresholds vary across countries and regions, and in some cases also across industries within the same country.

The Organisation for Economic Co-operation and Development (OECD) uses a threshold of 250 employees. The International Finance Corporation and the Multilateral Investment Guarantee Agency (MIGA) use a threshold of 300 employees. The World Bank recognizes that a unique definition does not exist; depending on the context, it either conflates SMEs with microenterprises (fewer than 10 employees) or uses criteria that are consistent with the IFC and MIGA thresholds or adopts country-specific definitions (World Bank, IEG, 2019). In the World Bank Enterprise Surveys, SMEs are defined as enterprises with fewer than 100 employees.

The European Union and the United Kingdom define an SME as an enterprise that employs fewer than 250 people and has an annual turnover not exceeding €50 million, and/or a balance sheet total not exceeding €43 million (European Commission, 2003). In the United States, the threshold is 500 employees and $1 billion in revenues (USITC, 2010). In China, the threshold ranges between 300 and 3,000 employees, depending on the industry (SME Promotion Law of China, 2002) – for example, an SME in the industrial sector can employ a maximum of 2,000 people. In the countries of the Association of Southeast Asian Nations (ASEAN), the turnover threshold varies from lows of less than $5 million in Indonesia and the Lao People's Democratic Republic to highs of more than $70 million in Singapore. Most ASEAN countries define SMEs as firms that employ fewer than 200 people, except Cambodia and the Lao People's Democratic Republic, both with a threshold of fewer than 100 (Asian Development Bank, 2015).

These variations in definition and conceptualization mostly relate to the size of the economy. For example, a United States firm with $900 million in revenue or a Chinese firm with 1,500 employees will be considered midsized in their respective countries but viewed as large in smaller economies. In addition, these variations lead to significant differences in the regulatory environment and the relative support available to firms of different sizes within specific markets.

For the global trend analysis, this report follows the International Finance Corporation's (IFC) definition: SMEs are enterprises with revenues of less than $15 million and fewer than 300 employees. This implies a discrepancy between global statistics reported here and those reported by the national statistical offices of developed economies. In the case studies developed for this report, by contrast, the definition relies on thresholds set in the data used and in the country of analysis. In the various databases considered, microenterprises (fewer than 10 employees) are typically not included.

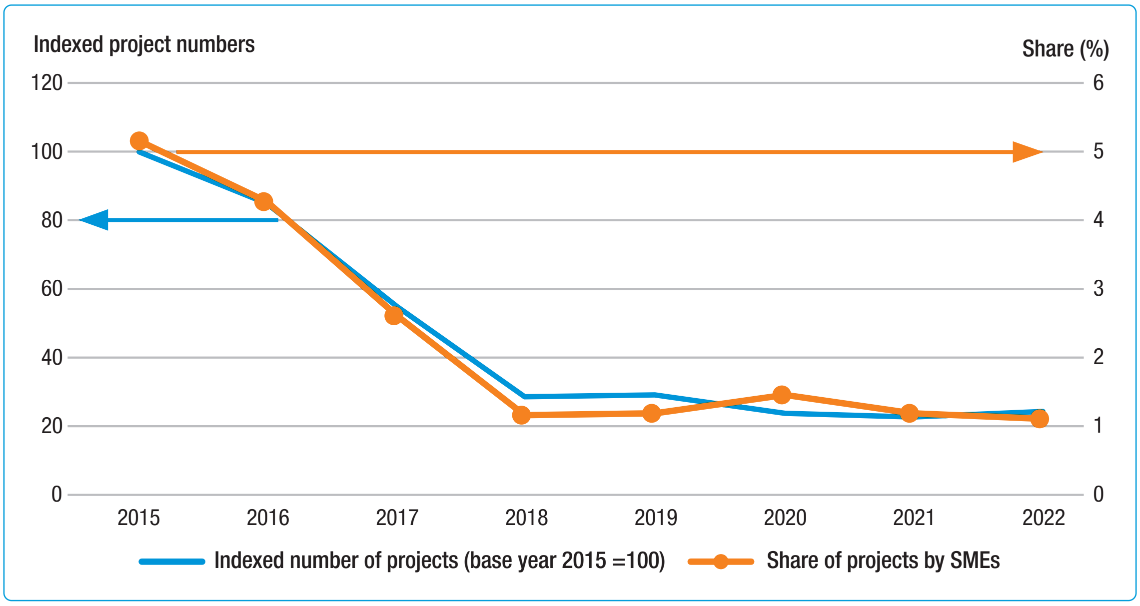
Source: UNCTAD.

1.2. WHY IS SME FDI A RELEVANT TOPIC TODAY?

In developed economies, notably in Japan and the Republic of Korea and in Europe, SMEs have been active international investors, especially in the period ranging from the 1990s until the financial crisis of 2008 (box 2). During that period, the decreasing costs of transportation, trade and communication and the introduction of technological innovations facilitated SMEs' access to international markets through both exports and international investment. For example, over the period 2003–2015, European SMEs accounted for 30 per cent of all FDI projects (greenfield investment as well as mergers and acquisitions (M&As)) by European investors (ESPON, 2018). More than half of these projects (55 per cent) were intra-European. Similarly, according to the Korean Statistical Office, SME investments accounted for 8–9 per cent of Korean outward FDI in 2012–2014, growing to about 25 per cent in 2019–2021 (Park et al., 2022). In the United States during the period 1989–2016, almost all foreign affiliates (94 per cent) had a small-business parent and an additional 2 per cent graduated to larger enterprises either through growth or by M&As (SelectUSA, 2020 and 2021). In contrast, estimates based on the payments of foreign affiliates to parents in Japan indicate a lower level of FDI by SMEs – about 5 per cent (METI, 2022).

More recently this trend has reversed, with SME investment activity down. The number of outward greenfield investment projects by SMEs reported by fDi Markets in 2022 was only about a quarter of that in 2015 (UNCTAD, 2022). Their share in all FDI projects fell from almost 6 per cent to just above 1 per cent (figure 1). The decline in 2020 can be explained by the economic fallout from the COVID-19 pandemic, which hit small businesses disproportionally. The decline before the pandemic indicates that longer-term factors hinder SME internationalization. These factors include unequal access to finance, the growing digital gap between SMEs and larger companies, continued concentration in international business and, from a policy perspective, a lack of investment promotion and facilitation measures targeted to SMEs. The deteriorating international policy environment for trade and investment, especially the trade tensions after 2017, are also likely to have affected SMEs more than large MNEs (UNCTAD 2020, 2022).

Figure 1 Cross-border greenfield projects by SMEs, 2015–2022 (Index and per cent)

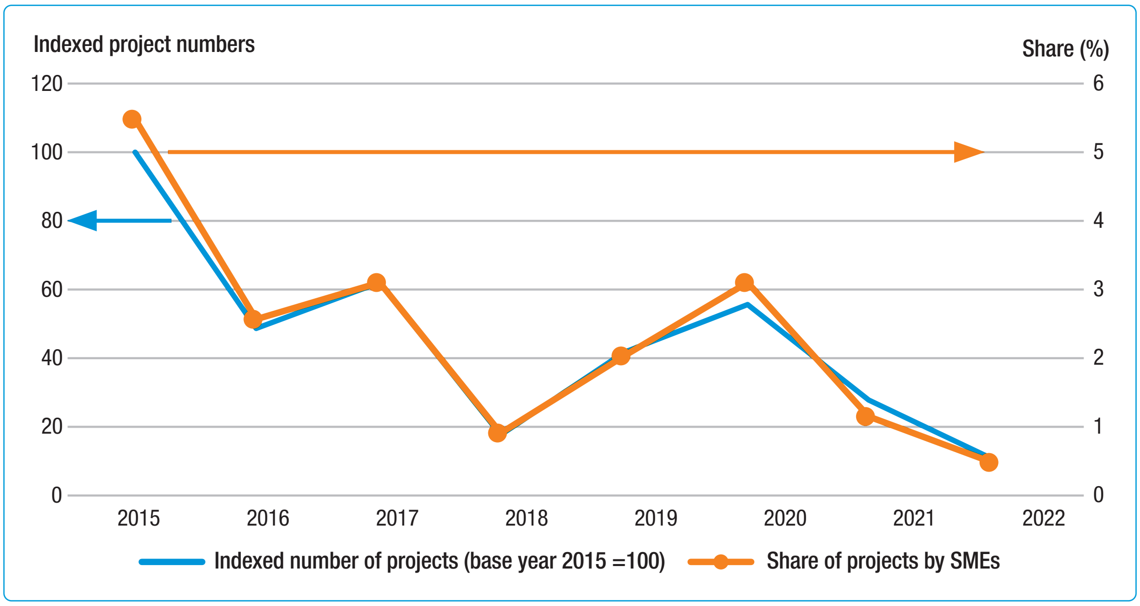


Source: UNCTAD based on information from The Financial Times, fDi Markets (www.fdimarkets.com).

Note: The figure shows only trends, as the turnover threshold defining SMEs in this report is lower than that of most developed economies, resulting in a significantly lower share of projects than reported in national statistics.

A similar downward trend can be observed in international M&As by SMEs, portraying even lower numbers of projects. Such deals fell from about 30 in 2015 to only 3 in 2022 (figure 2). International equity acquisitions by SMEs are rare. In addition to the difficulties in raising the necessary capital and having sufficient insight into foreign host markets and local procedural know-how, M&As require another layer of knowledge and management skills – including finding the right foreign company to acquire and/or merge with and entering equity markets – that deters most SMEs. The few deals that were recorded are concentrated in specific industries of the digital economy – software publishers and developers, and web portals – and knowledge-intensive health companies such as biotechnology or pharmaceutical testing companies. These two industries were behind an increase in SME mergers during the pandemic in 2020.

Figure 2 Cross-border acquisitions by SMEs, 2015–2022 (Index and per cent)



Source: UNCTAD based on information from Refinitiv SA.

The declining trend in SME participation in FDI activity is worrying because FDI is an important growth strategy for SMEs (Lu and Beamish, 2001). Both in home countries and at the global level, FDI by SMEs can contribute to a continuous renewal in the universe of MNEs. Moreover, in UNCTAD's experience working with investment authorities, IPAs and SEZs, it appears that institutions, policies and infrastructure aimed at attracting investment are mostly geared towards large-scale industrial projects by large MNEs. Most incentives used to attract FDI are linked to employment creation and thus often focus on large, labour-intensive projects. The original concept of SEZs was developed for large, industrial, export-oriented projects, again targeting larger investors (UNCTAD, 2021 and 2023b).

Box 2. FDI by SMEs: How is today different from 30 years ago?

UNCTAD first published a study on FDI by SMEs in 1993 (UNCTAD, 1993), followed by a study on Asian SMEs in 1998 (UNCTAD, 1998). The reports address the motives for SMEs to invest abroad globally and in Asia, respectively. Market opportunities and access to technology were identified among the main drivers of FDI. Since 1993, the new industrial revolution (and the associated rise in wages and employment), the continued rise of emerging players, and the growing importance of global and regional value chains have changed that landscape, making it imperative to take a fresh look at FDI and other forms of internationalization of SMEs.

The pandemic-induced crises had a significantly negative effect on SMEs. The major disruption in global supply chains during the pandemic and growing geopolitical tensions brought additional challenges for SMEs seeking to internationalize. These new challenges as well as opportunities for SMEs suggest that there may be room today for SMEs to emerge as important players on the international front, thereby enhancing their development potential in home and host economies.

Table box 2.1: FDI by SMEs: UNCTAD's 1993 and 1998 Reports versus Today

Key issues	Main findings	
	1993 and 1998 UNCTAD Reports	Today
FDI	FDI by SMEs was more concentrated in developed countries.	FDI SMEs from emerging economies is increasing, albeit at a low rate; and since 2015 SME investment activity has shown a downward trend globally.
Challenges	Limited financial and managerial resources, low international exposure, high informational constraints, heavy regulatory burden.	Most of the challenges remain; digitalization has reduced information costs while making skills and technology constraints more stringent. Some of the regulatory burden has been simplified by the adoption of e-procedures and the spread of one-stop shops while transparency requests increased the reporting burden.
Drivers	Efficiency-seeking, need to strengthen the competitive capacity, and use low-cost labour in developing countries. But market seeking investment it is still limited.	Efficiency-seeking drivers are still present especially for manufacturing SMEs from advanced economies, but increasingly SME FDI is market-seeking, in the services sector in particular. Technology acquisition also seems to drive SMEs from emerging economies.

Source: UNCTAD.

New developments in international production make it increasingly important for SMEs to invest abroad, in particular with respect to the following major transformational shifts :

- **Industrial revolution and digitalization** are driving rapid change on an unprecedented global scale. This technology revolution brings great opportunities for SMEs; at little or no cost, the smallest business has access to communications and computing innovations that were not available 15 years ago. Digital technologies lower information costs, facilitate small firms' entry into foreign markets and offer new opportunities for established SMEs to scale up, enhance productivity and become global players. Innovation is key to address the current economic, environmental and geopolitical challenges. SMEs have a prominent role in addressing these challenges; SME flexibility can be an advantage in accelerating innovation and new technology adoption.
- **Growing importance of regional value chains**. Technology trends, together with a decade-long declining trend in FDI, more protectionist international policies and continued geopolitical tensions, have produced a transformation of international production networks to favour shorter and more regional value chains (UNCTAD, 2020). This may make room for SMEs to be more competitive and pivotal in the development process of many developing economies. As their investment is mostly in

neighbouring countries, they can reinforce regional integration processes and regional value chains through forward and backward linkages. FDI by SMEs from a neighbouring economy facing similar challenges, using similar technologies or more adapted to the local context, might bring valuable contributions to the development of the local SME sector.

- **Tax reforms affecting the investment promotion toolbox for large MNEs**. The introduction of a minimum tax of 15 per cent on the foreign profits of the largest MNEs (those with revenues above €750 million), proposed in the context of the G20/OECD Base Erosion and Profit Shifting project, has important implications for international investment and investment policies (UNCTAD, 2022).[1] The implementation of the new tax rules will affect the way in which countries, in particular developing economies, have traditionally promoted – and often competed – for international investment through low tax rates, fiscal incentives and SEZs (UNCTAD, 2023d). Tax is an important determinant of FDI by large MNEs; tax rates enter into their calculations in making investment decisions, and differences between countries affect their locational choices. In a world of smaller tax rate differentials, countries stand to gain more from improvements in other investment determinants – including those related to infrastructure and the regulatory and institutional environment – that are those most of relevance for SMEs wanting to invest abroad.
- **A shrinking pool of manufacturing investment projects**. Trends in FDI since 2010 show a decline in the number of large-scale industrial projects, usually invested by large MNEs (UNCTAD, 2020). This long-term trend will make it harder to attract international investment in productive assets, especially in global value chain-intensive manufacturing sectors. In addition to the promotion of larger investment, the implications for host countries seeking to attract FDI is that they need to increase their focus on smaller investors, developing a more structured portfolio of programmes to attract them and facilitating and simplifying their foreign establishments.

1.3. WHY IS SME FDI IMPORTANT FOR DEVELOPMENT?

1.3.1. BENEFITS OF INWARD FDI BY SMEs

Inward FDI in general – not only by SMEs – can have important implications for development. It is well established that FDI can support the economic development of the host economy by bringing new capital (box 3) and contributing to job creation, knowledge and technology transfer and the integration of domestic firms in global or regional value chains (UNCTAD, 1999). This section will first review the relevant literature on the impact of FDI on the host economy and specifically on local SMEs and then explain the differential impact of investment by foreign SMEs.

MNEs can also facilitate the transfer of technical and business know-how, resulting in productivity gains and competitiveness in local SMEs (Javorcik, 2004). These spillover effects develop through the demonstration and diffusion of best practices, the creation of linkages with foreign and domestic firms becoming either suppliers or customers, and the movement of experienced workers from foreign to local firms. For example, in Ireland most Irish software entrepreneurs had previously worked in foreign firms (O’Malley and O’Gorman, 2001). The entry of foreign firms can generate new entrepreneurial opportunities that were not present before as they introduce new goods to the market and raise customer awareness of these goods. Local entrepreneurs can imitate foreign products (saving on development costs), tailor them to local tastes and offer complementary ones.

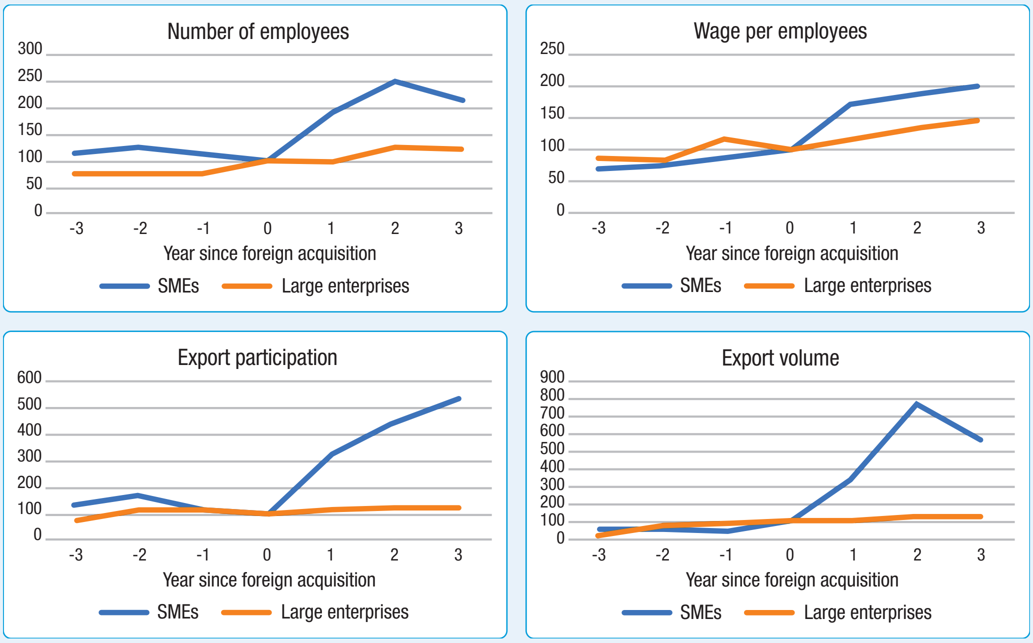
[1] Today, approximately 140 jurisdictions participating in the OECD/G20 Inclusive Framework agree to tax the profits of large multinationals at a minimum effective rate of 15 per cent. To implement this agreement, the Global Anti-Base Erosion (GloBE) Rules (OECD, 2023) have been developed. The GloBE Rules are likely to exert some effect on all countries, even those deciding not to adopt the minimum tax or selected aspects of the agreement.

Box 3. The impact of FDI on acquired SMEs

A firm receiving FDI (in the form of an acquisition or foreign venture capital) can gain access to strategic assets, such as modern management practices and technological know-how, enabling domestic firms to develop competitive competencies (Li et al., 2017). Inward FDI can weaken some of the resource constraints faced by SMEs; it allows domestic firms to gain access to capital, capacity or critical scale, and channels or networks that accelerate their entry into and growth in international markets (Hernández and Nieto, 2016; Scott-Kennel, 2013).[a] A firm's involvement in inward FDI through partnering with foreign investing MNEs also represents a route to the local firm's internationalization. In this case, learning and development of strategic assets facilitate eventual internationalization through exporting and/or investment (Li et al., 2012; Gu and Lu, 2011; Kang et al., 2021).

For instance, in the case of Viet Nam, companies acquired by foreign investors improve their export participation and increase their size immediately after acquisition. This adjustment is more pronounced for SMEs, suggesting that foreign ownership lowers trade participation costs and eases SMEs' resources constraints that hamper their growth (box figure 3.1). Upon acquisition, the export participation and volume per company more than triples, and the average workforce of SMEs doubles – from about 30 to more than 60 employees. The related wage per worker also doubles. Changes for larger companies are less significant. For other indicators of performance, the path is less clear-cut and there is no significant difference across sizes.

Box figure 3.1. Number of employees, wage per employee, export participation, and export volume of Vietnamese companies acquired by foreign MNEs, before and after the acquisition, 2013-2019 (Index)



Source: UNCTAD based on Nguyen et al. (forthcoming).

Note: year 0 =100 denotes the year in which the company was acquired.

By matching the identity of the acquired companies with information on the foreign investors, the case study sheds light on the varying consequences of such acquisitions depending on the investors' size, geography and sector.

[a] In developed countries, companies acquired by foreign MNEs gain access to their network and are shown to increase exports to the countries where the MNEs have a presence, suggesting that foreign ownership also significantly lowers trade participation costs (Conconi et al., 2023).

The entry of an MNE may also increase competition and force domestic firms to imitate and innovate. Yet, competition from foreign affiliates for customers and inputs may "crowd out" or weaken the existing SME sector. For example, foreign firms can offer higher wages and attract skilled workers, driving local SMEs out of the most innovative industries. To limit these potential negative effects of FDI on the local economy while fully leveraging their development impact, the SME sector needs to have adequate absorptive capacity.[2] The stronger the absorptive and innovative capacity of the local SME sector, the higher its chances to benefit from FDI, while the larger the technological gap with the foreign investor, the more difficult the transfer of knowledge and productivity will be (Girma and Wakelin, 2000).

Inward FDI by SMEs has a significantly different impact on the host economy than large MNEs.
Though small businesses tend to invest less capital per FDI project than do large MNEs, their aggregate impact can be considerable. A study by the United States IPA SelectUSA found that foreign-owned small businesses generate significant benefits for the surrounding economy, supporting (directly and indirectly) more than five million jobs (about 4 per cent of all United States jobs), over $1 trillion in output and $350 billion in employee compensation in 2016 (about 5 per cent of total payroll) (SelectUSA, 2020).

Few studies have analysed FDI impacts by investor size. Overall, both empirical research and policy evidence show that foreign investment by SMEs has characteristics that benefit the host economy. The most prominent include the following four:

- **FDI by SMEs has high potential to produce long-term knowledge spillovers** for various reasons: (i) SMEs prefer entering foreign markets by partnering with local firms rather than establishing fully owned subsidiaries, potentially increasing productivity in the local economy – presumably because the partners firms are more likely to share technology and have links with local suppliers (Farole and Winkler, 2012); (ii) given the relative importance of each foreign project with respect to the size of the company, SME investments are less footloose; (iii) the similarity in technologies adopted (i.e. a smaller technological gap) makes such technologies more accessible to local firms (UNCTAD, 1993 and 1998) and the transfer of knowledge and increase in productivity more likely (Girma and Wakelin, 2000); iv) SMEs are less able to source inputs on a global scale, thus relying more on local suppliers.
- **Often FDI by SMEs is in neighbouring countries, facilitating the integration of regional markets** and the establishment of regional value chains (see, for companies in the Association of Southeast Asian Nations (ASEAN), Yeung (2017); in the European Union, ESPON (2020); in Africa, Ng'ombe et al. (2023)). Also, the geographical proximity and agglomeration effects of foreign investment positively influence the transfer of knowledge (Girma and Wakelin, 2000).
- **SMEs are less likely to crowd out local firms**, to significantly raise wages or to skim skilled workers. In contrast, they can embed in and strengthen local clusters (UNCTAD, 2020).
- **SMEs are less likely than large MNEs to have a sophisticated network of offshore locations** in their corporate structures and are thus less likely to engage in tax avoidance schemes.

1.3.2. BENEFITS OF OUTWARD FDI BY SMEs

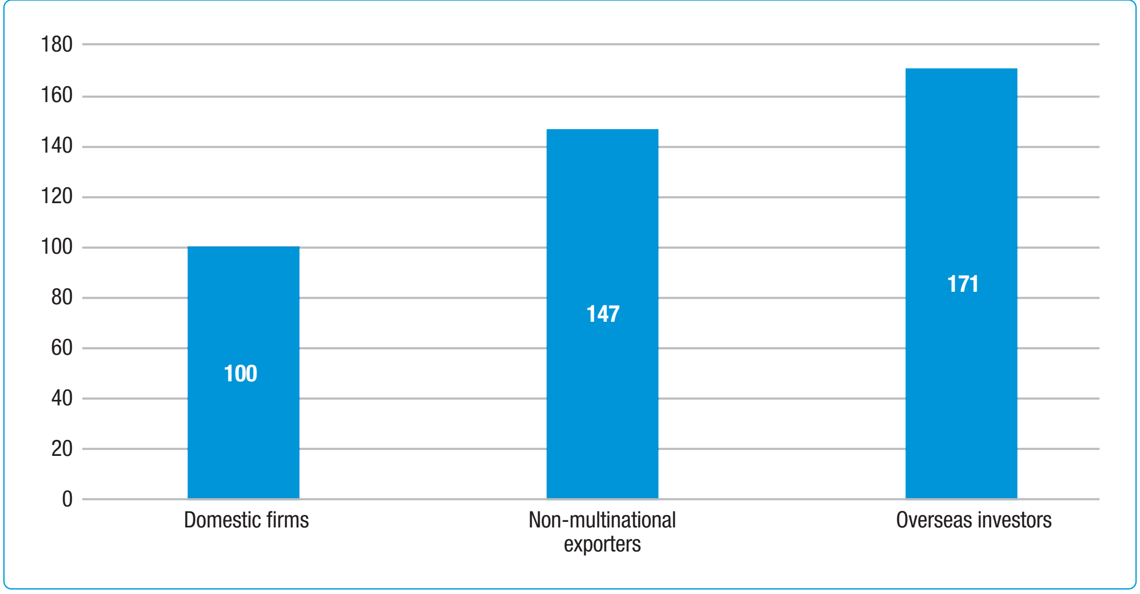
Outward FDI by SMEs can also bring economic benefits to home countries. It helps SMEs, grow improve productivity and strengthen their resilience to external shocks. For knowledge-intensive enterprises, FDI can bring significant learning benefits, accelerating the technological catch-up of developing countries. This contributes to developing a dynamic and competitive private sector, key to economic growth. In addition, outward FDI has positive effects on the home economy, including increasing local employment, especially in high-tech manufacturing and service industries that employ skilled domestic workers (Crescenzi et al., 2021).

The benefits for the economy of promoting outward FDI by SMEs are not automatic. In fact, in the short term, engaging in FDI can temporarily slow a company's sales growth rate. The short-term negative effects

[2] Absorptive capacity refers to a firm's financial, human and knowledge-based capital and its efficiency in creating value from it (OECD, 2021).

on sales show that policy measures supporting firms through the initial stages of internationalization can be important to maximize the benefits for firms and the wider economy. It is well documented that firms that are more involved in international markets will exhibit higher productivity. In particular, exporters have higher productivity than non-exporters and multinational firms have the highest productivity (Helpamn et al., 2004).

Figure 3 Average productivity levels by internationalization type, 2004 (Index)



Source: UNCTAD, adapted from Helpman et al. (2004). The index is defined by setting the value of total factor productivity for domestic companies = 100.

The reasons are twofold: (i) a self-selection mechanism (as explained by Melitz (2003) for exports and Helpman et al. (2004) for FDI), as only the most productive firms can afford the sunk costs related to internationalization, and (ii) learning effects arising from being present in foreign markets. While the self-selection mechanism explains the productivity differentials before companies become multinational (figure 3), the learning effects explain why multinationals are growing faster. In competitive markets, firms find additional stimuli to improve their efficiency, making better use of slack resources, applying the best available technologies and managerial techniques. Similarly, expanding the array of stakeholders (suppliers, customers, partners) can become a source of spillovers through the embodied knowledge and experience that these relations may incorporate. So, firms with productive locations in different countries can benefit not only from cost advantages, but also from those spillovers that the foreign environment may generate. The subsidiary presence of the internationalizing firm in the foreign market, without any trade intermediaries, can minimize transaction-related risks and increase the value of proprietary assets (Roberts and Muralidharan, 2022; Li et al., 2018). In addition, serving foreign markets allows firms to grow in size (Merino, 2012).

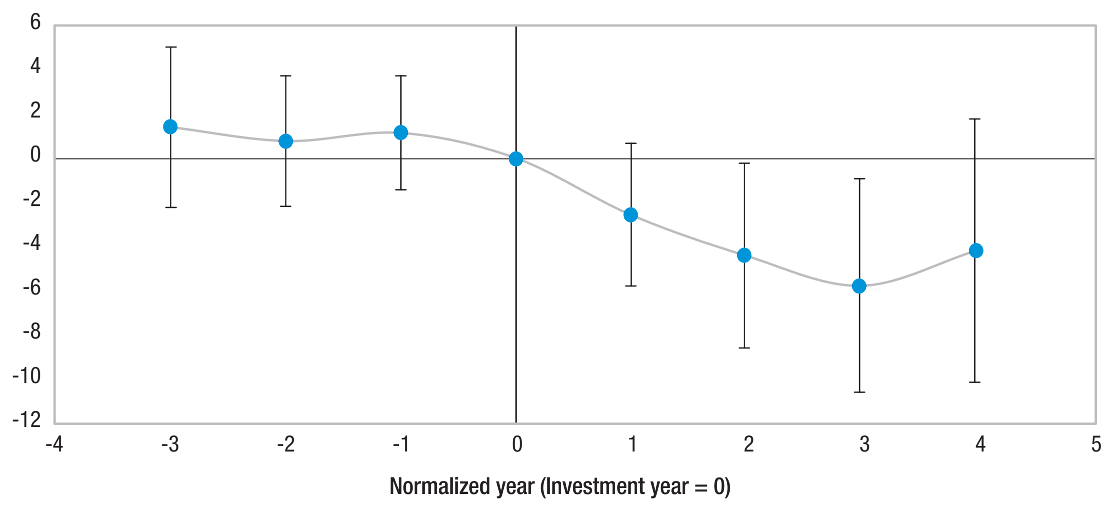
Research on the internationalization of SMEs has mostly focused on exporting, which has been extensively employed by firms as a core growth strategy. Exporting allows a firm to broaden its consumer base and potentially achieve a higher sales volume. In turn, a higher sales volume results in a higher production volume, new investments in technologies and a resulting improvement in productivity. In comparison with exports, FDI implies higher sunk costs and risks, potentially adding to the challenges that SMEs already face. Thus, although there is general agreement in the literature discussed above that internationalization by exports benefits the performance of SMEs, the relationship is less clear-cut for FDI. This is mainly because of the additional strains that FDI can put on the internal resources of SMEs.

When SMEs engage in international investment, they introduce additional complexity to both their internal and their external processes, primarily owing to the unfamiliarity of foreign markets (Cho and Lee, 2018; Lee et al., 2012; Rhee, 2008). Fulfilling the additional demand for resources to invest abroad – for instance logistics, labour or information processing – may hurt SME performance (Schwens et al., 2018). An overseas investment that does not quickly increase returns can disrupt the vulnerable business balance of an SME and potentially lead to failure.

Although the empirical evidence on the impact of FDI by SMEs on their performance is limited, a few studies found a positive relationship between FDI and firm growth (Lu and Beamish, 2006; Li et al., 2018). However, the growth path is not linear; SME performance starts to improve only after an initial deterioration at the beginning of the internationalization effort. The initial decline could be due to the shock of foreignness and resource constraints. Shin et al. (2017) confirmed the same type of U-shaped relationship between FDI and performance for SMEs in capital-intensive services, whereas they find an inverted U-shaped relationship for those in knowledge-intensive services. This is related to the special characteristics of knowledge- and technology-intensive firms that are often global at their inception, i.e. "born global" (Singh, 2017).

A background study for this report (Santos-Paulino et al., 2023) looks at the growth performance of FDI after outward investment. The findings suggest that the declining trend of the post-investment growth rate persists for three years after the investment. In the fourth year post-investment, the annual sales growth rate does not differ significantly from that of the investment year, which could be a sign of bouncing back to the previous growing path (figure 4). The negative shock in the growth rate of SMEs is largely found in small manufacturing enterprises, for which establishing a foreign subsidiary requires a sizeable and long-lasting commitment of resources.

Figure 4 Average annual revenue growth before and after investment (Per cent)

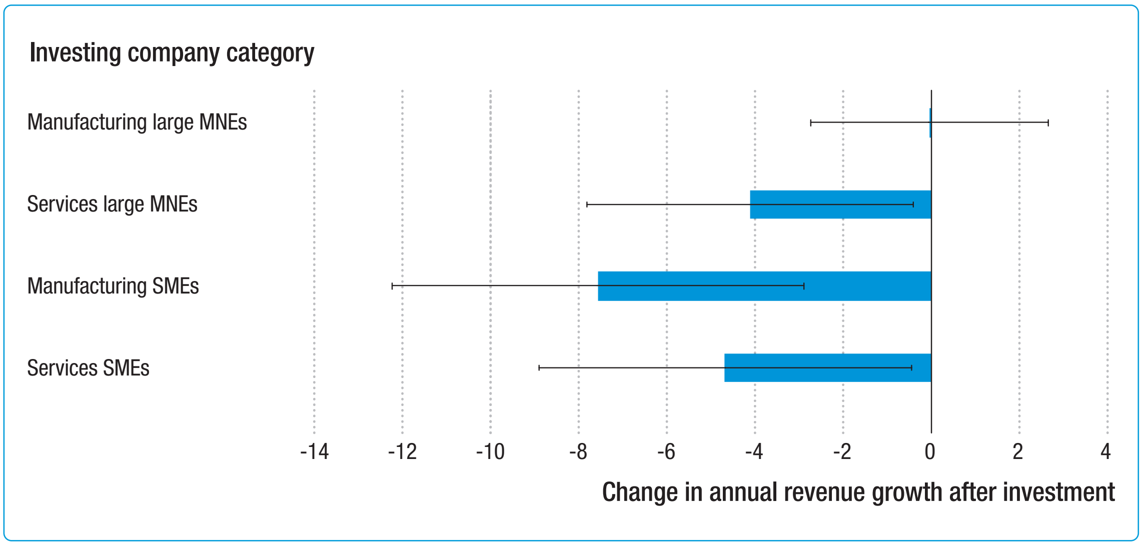


Source: Santos-Paulino et al. (2023).

Note: Error bars represent the 95 percent confidence interval.

This could be explained by two factors: First, manufacturing plants take time to set up and may engage in activities that contribute less to sales growth, such as supply chain activities or adaptation to local legal frameworks and standards. Second, for very small businesses, a foreign investment may divert key resources – in terms of organizational and managerial capacity – from the home market, temporarily slowing their growth rate. In contrast, services affiliates, almost by definition market-seeking, tend to make an immediate contribution to sales and sales growth (figure 5). In addition, as shown in Santos-Paulino et al. (2023), the majority of them operate in knowledge-intensive industries such as software and information technology (IT) services. For this group of companies, learning and knowledge effects from FDI can be especially important, so that not only is the negative shock of foreign investment almost null, but they also gain the most from the investment.

Figure 5 Annual revenue growth after the investment, by firm size and sector (Percentage point change)



Source: Santos-Paulino et al. (2023).
Note: Error bars represent the 90 percent confidence interval.

Based on this evidence, promoting FDI by SMEs can bring benefits to the home country economy. In addition, as shown in the previous section, outward FDI by developed countries SMEs has the double benefit of supporting the host economy and the development in the poorer countries of the world.

2 INTERNATIONALIZATION: DIFFERENCES BETWEEN SMEs AND LARGE MNEs

2.1. SME INTERNATIONALIZATION IN THEORY AND PRACTICE

Internationalization strategies include many modes for entering foreign markets, ranging from exports to establishing and operating (physical) subsidiaries and international offices in multiple markets. SMEs can opt to internationalize through a range of activities before they fully commit to a foreign market, including through non-FDI modes of entry such as exports, research and development (R&D), strategic alliances, partnerships, and joint ventures.

The entry mode choice determines the level of resource commitment, risk and control a firm undertakes in its foreign market activities. Although FDI requires a large commitment of resources to the host country and imposes a high risk, it also offers greater control of the overseas operations. For example, a firm that undertakes a costly greenfield investment in a host country has a greater risk of losing significant resources than does a firm that establishes a licensing agreement with a partner in the same host country. Yet, a high-commitment mode (such as establishing a wholly owned subsidiary) can reduce the risk of unintended knowledge diffusion (for example, of a firm-specific technology). The propensity of such diffusion is much more likely when a partner is involved (e.g. in a franchising agreement or joint venture) and the product is intangible (Laufs and Schwens, 2014).

The existence of resource constraints, which is typical for SMEs, often indicates that there may be specific factors leading to FDI as an entry mode choice and that internationalization theories developed for large MNEs may not fully explain SMEs' internationalization process. In particular, SMEs' level of commitment to a foreign market and how they deal with risks in a host country differ significantly from those of larger MNEs. The "traditional" theories are nevertheless useful starting points for analysis, highlighting the specificities of SMEs.

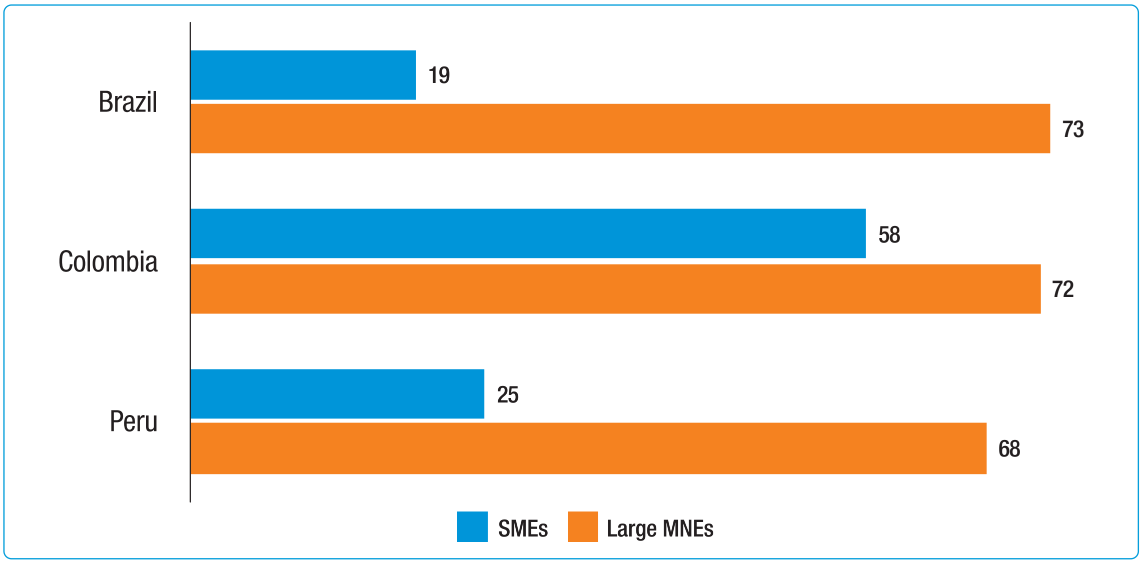
2.1.1. CLASSIC INTERNATIONALIZATION THEORIES

International stage models posit that firms internationalize following a series of hypothetical development stages. The *Uppsala model* (Johanson and Vahlne, 1977) suggests that firm internationalization occurs incrementally and gradually because in the initial stages, firms have to acquire the necessary knowledge and experience, especially experiential knowledge, amid uncertainty. The process of internationalization is divided into four stages: no regular export activities, export through independent representatives, establishment of a sales subsidiary, and overseas production or manufacturing. In each stage the firm learns and acquires knowledge on foreign procedures, business opportunities and networks, enabling it to move to the next stage. The *innovation theory* assumes that firms are active learners and can constructively obtain and use intelligence on foreign markets to innovate. In this theory the internationalization process is a learning sequence that occurs within the innovation adoption process. In other words, firm innovation is two way and related to the different stages of internationalization.

Yet, SME internationalization does not necessarily follow a set pattern of stages. For example, Latin American multinational SMEs tend to engage less in exporting than their larger counterparts (figure 6). The analysis shows that many did not start their internationalization by exporting first and then opening a subsidiary in foreign markets when they attained a certain level of international experience and size, but instead started right away by investing abroad (Graziano et al., forthcoming). In Brazil, among the multinational SMEs, only 19 per cent export goods. In contrast, almost two thirds of all multinationals in Brazil that are considered large firms do sell goods abroad. Similarly in Peru only 25 per cent of multinational SMEs exported goods over the period studied, but more than two thirds of their large counterparts did so. In Colombia the share of exporting multinational SMEs was significantly higher than in Brazil or Peru but still lower than for larger enterprises. This is partly related to the sectoral distribution of SMEs: most small investors are services companies active in high-tech or professional services, industries where companies prefer direct contact with their clients.

Contextual factors such as foreign trade regulations, entrepreneurs' skills and networks, the presence of niche markets and the development of information technologies have been shown to affect SMEs' internationalization mode (Laufs and Schwens, 2014), pushing them to leap-frog into higher-commitment modes from the start of their operations (see for example the discussions of "born global" firms or international ventures).

Figure 6 Exporting multinational enterprises from selected Latin American countries, by firm size (Per cent)



Source: Graziano et al (forthcoming).

The resource-based model is very much related to the stage model in that it is based on the idea that the speed, scope and intensity of internationalization are linked to the firm's endowment. SMEs' lack of resources would imply that their only mode of internationalization would be by exports and that only when they become larger firms could they engage in FDI.

According to *transaction cost economics*, the choice of entry mode relates to the nature of transactions, the risks of foreign operations, and the related controlling and monitoring costs. Companies choose high-control entry modes such as FDI to protect their foreign operations in circumstances in which the uncertainty of opportunities (and thus of losing their assets) and the specificity of their investment (niche technology, intangibles) are higher, whereas they choose to export when such risks are low. This theory would predict that SMEs would prefer foreign markets similar to their home country (Erramilli and Rao, 1993). Importantly, for many SMEs it is difficult to separate production from consumption; thus in general firms other than those in consumer or commercial and professional services (insurance, telecommunication services) are much more likely to choose a high-control entry mode over a low-control entry mode.

Institutional theory posits that a country's institutional environment affects a firm's scope of action because the environment reflects the "rules of the game" (Brouthers and Hennart, 2007, p. 405) according to which firms must behave. The host country institutional environment consists of several dimensions, including regulatory, cognitive and normative rules, that affect the firm's choice of entry. In particular, as SMEs tend to be less able to adapt to very different and/or risky contexts, they tend to choose FDI more often when challenged by the institutional environment in the host country, so as to have better control of overseas operations.

The ownership, location and internalization theory combines insights from the resource-based, institutional and transaction cost theories. Ownership advantages are firm-specific competitive advantages (as in the resource-based view), which must be unique and sustainable (e.g. a firm's international experience, its ability to differentiate a product or service). Location advantages are country-specific advantages (as in the institutional theory) of the international market. Internalization advantages are the benefits (reduced transaction costs) that a firm obtains by choosing a high-commitment entry mode rather than internationalizing through partnership arrangements (Laufs and Schwens, 2014). Even if conceived for larger companies, this framework offers a structured way to explain entry mode decisions (commitment), including smaller investors' choices. For SMEs, internationalization means considering not only ownership advantages, location factors and internalization strategies but also the level of commitment required at each stage of the internationalization process. This includes commitment to building capabilities, understanding local markets, complying with regulations and forming enduring relationships with stakeholders.

2.1.2. INTERNATIONALIZATION THEORIES FOR SMES

The social capability-network theory argues that firms choose their entry mode on the basis of their network relationships (e.g. with customers, suppliers, competitors), rather than solely their firm-specific advantages. The network model of internationalization suggests that interorganizational networks may help alleviate the challenges that SMEs face when operating in foreign markets. This approach underlines two options available to SMEs to foster their networks: firms can either establish strategic alliances through internal resources (such as technical, economic and legal relationships) or they can join an existing network or value chain by, for example, accessing an investment opportunity through overseas suppliers. By integrating into existing networks, firms gradually expand their network linkages and capabilities. Such collaborative linkages help SMEs overcome their resource limitations (Coviello, 2006), establish legitimacy and credibility, and develop capabilities for international entry at lower risks (Zhou et al., 2007). In other words, collaborative internationalization may represent a major source of competitive advantage for internationalizing SMEs.

According to the *international entrepreneurship theory*, SMEs' internationalization mostly depends on the entrepreneur's international vision and international experience. A combination of innovativeness, proactiveness and the risk attitude of the firm in the marketplace is critical to the pursuit and exploitation of opportunities abroad. Often the international entrepreneurship theory is combined with the international new ventures theory to explain the internationalization behaviours of younger and smaller companies such as born globals (Pu and Zheng, 2015). Studies illustrate how internationalization may be rapid and disruptive, and does not necessarily follow a slow, gradual path linked to the firm's accumulation of resources. The skills, international experience and global mindset of a firm's founder play a decisive role in a firm's internationalization.

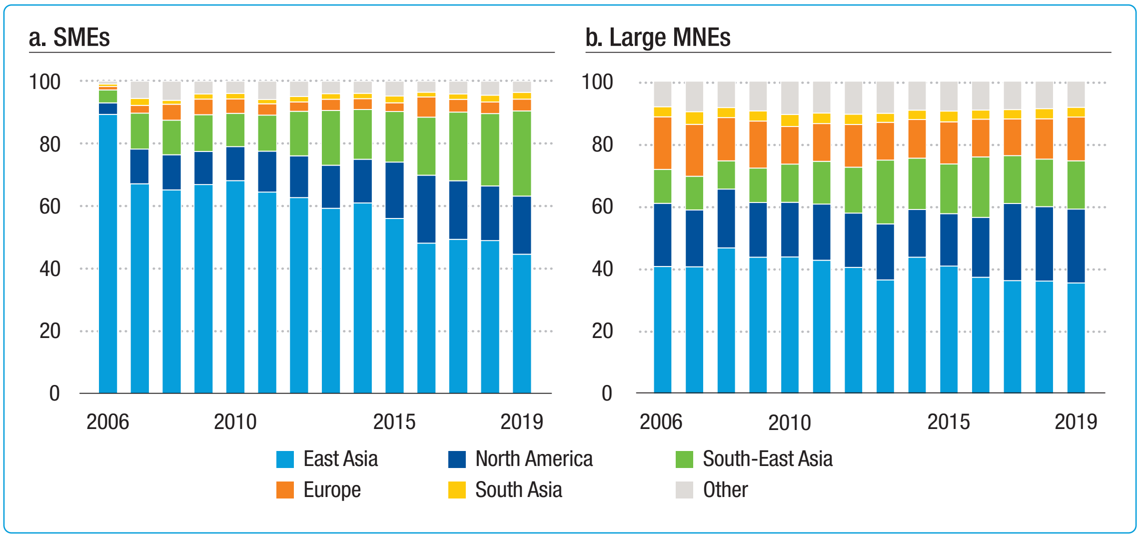
2.1.3. FDI DRIVERS

The traditional drivers of FDI also apply, with some particularities, to SMEs:

- *Resource-seeking investment* is a type of FDI strategy in which firms set up operations in international locations close to natural resources. This type of FDI is particularly prevalent in the energy, mining and agrifood industries. Because of the high costs of extracting oil, gas and minerals, it is mostly pursued by large MNEs that want to secure some priority in exploiting the resource. Yet, small independent miners may decide to buy or open a new mine overseas or integrate vertically, in pursuing their growth path.
- *Strategic-asset seeking investment* is a type of FDI strategy whereby a company looks to set up operations in international locations close to specific strategic resources, such as skilled employees, partners, investors or key customers, that are critical to the firm's growth but not available in their home countries. This type of FDI is particularly relevant for flexible SMEs, often in services, that seek locations that can provide access to the best talent, key customers or cutting-edge technology (Vanninen et al., 2022).
- *Efficiency-seeking investment* aims to achieve efficiency gains thanks to lower costs and better production processes in the host country. This strategy typically underlies large manufacturing projects

in low-cost locations but can also be adopted by manufacturing SMEs from advanced economies to maintain competitiveness. For example, the study in the Republic of Korea commissioned for this report showed that manufacturing SMEs were generally investing in less advanced neighbouring economies to lower their production costs (Park et al., 2022).[3] In contrast, larger MNEs invested more in developed economies, motivated by network and market-seeking purposes (figure 7).

Figure 7 Share of FDI stock held by Korean multinational enterprises by region (Per cent)



Source: Park et al (2022).

- *Market-seeking investment* aims to expand in new markets and gain in distribution channels by investing abroad. For example, in Argentina, approximately 40 per cent of SMEs have an investment in Brazil, in large part operating subsidiaries in services (information and communication, and business services and wholesale). Brazil's large market and geographical proximity represent strong pull factors for SMEs in Argentina. In fact, although the Mercosur agreement eliminates any import-tax incentives to relocate production, SMEs in Argentina can still gain better market access when investing in Brazil by improving their efficiency in logistics. Often for SMEs FDI is a necessity to protect their brand and facilitate international sales while delivering for customers who require physical support and interaction or services in their own languages and time zones. Knowledge content tends to explain the need to be physically close to key clients. Especially for innovative SMEs, direct contact with the customer can be crucial to avoid intellectual property issues. Many born globals "multinationalize" by establishing a presence in so-called strategic markets in order to provide customers with superior service and to work on products or develop new ones in close cooperation with them (Vanninen et al., 2017). Moreover, as geographic distance increases, so do the travel time costs and the adverse effects that frequent long-distance travel has on managers' ability to assimilate knowledge from a new market, pushing SMEs to open a foreign subsidiary.

Other drivers that are particularly relevant for SMEs include hub-searching strategies, short-term opportunities and reactive strategies, and better financing opportunities:

- *Hub-searching strategy.* Firms look to establish an international presence near cluster areas or key industry locations that are dense constellations of potential customers, investors, partners and talented employees. Accessing industry hubs allows multinationalizing firms to reach several important stakeholders in one location and learn from emerging customer needs and industry standards that

[3] This finding is confirmed also for Taiwanese SMEs in Lin and Ho (2019).

would reach peripheral markets much later (Vanninen et al., 2022).[4] For example, almost a third of Ghanian SMEs' investments are in the United Kingdom. Apart from the historical legacy, these SMEs are likely to seek access to the London financial hub as most are active in business and financial services. For example, Zeepay is a mobile financial services company founded in 2016 that also has offices in London. The United Kingdom continues to be an attractive location for fintech companies because of its early adoption of a favourable legislative framework that allowed the development a vibrant ecosystem.[5] Important venture capitalists are based there, as are incubators, start-up accelerators (such as the United States VISA Innovation programme) and other potential partners such as Clear Junction (a United Kingdom fintech firm), with which Zeepay signed an agreement in 2020 to set up a remittance service for Ghanaians living in Europe.

- *Short-term opportunities and reactive strategies*. In general, opportunistic behaviour is more common among SMEs than among large MNEs, because they are often guided by a single entrepreneur or an entrepreneurial family.
- *Financing opportunities*. In emerging economies, where institutional quality and international experience are lower, firms may have specific motivations for investing abroad, most notably the desire to acquire technology, know-how and managerial skills, and to access highly qualified labour (the resource-seeking strategy) and eventually become globally competitive. Moreover, FDI, especially in developed countries, could provide access to *better financing opportunities* than in emerging economies. A study on African SMEs commissioned for this report found that numerous business owners from Malawi mentioned the challenges of getting foreign exchange into or out of the country and subsequent decisions to open an office in Botswana or Ghana. For the same reason, a Zambian SME chose to open a subsidiary in the United States even though almost all its revenues were generated across Africa (Ng'ombe et al., 2023).

2.2. CHARACTERISTICS OF SME INVESTMENT

SMEs' resource constraints shape the decisions on whether and where to invest. Evidence on the characteristics of SME investment is drawn from the case studies prepared for this report on the basis of national firm-level data, analysis of foreign investment projects for selected developing countries and further evidence from data drawn from a microeconomic survey (box 4). The analysis suggests that the main features determining FDI by multinational SMEs are proximity, industry, network and clusters, innovation and digitalization technologies.

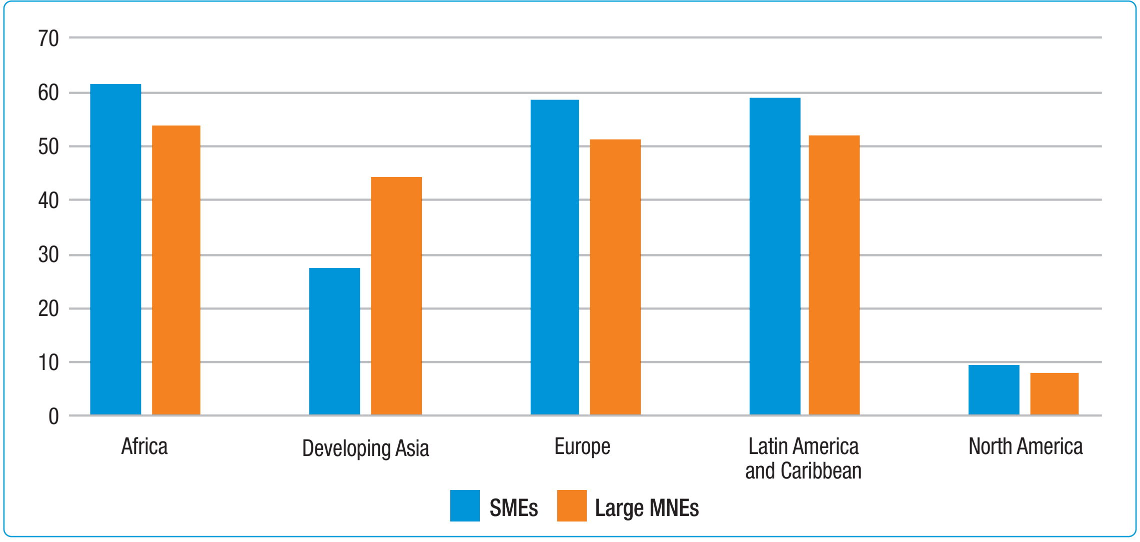
2.2.1. PROXIMITY

SMEs tend to invest in closer (physically, culturally or institutionally) locations where information costs are lower (figure 8). This characteristic suggests that SMEs could benefit more from regional integration efforts. SMEs in Europe target investment projects in neighbouring economies, reflecting the very integrated economic region. Similarly, South African companies invest mostly in African countries. Turkish SMEs – which represent an important share of investors from developing Asia – invest almost exclusively in Europe, a geographically close region. Yet SMEs in the rest of developing Asia constitute an exception, with Chinese SMEs investing mostly in Africa.

4 Multinationalization refers to a process by which a firm becomes a multinational enterprise (MNE) through the establishment of foreign subsidiaries, often during the early years of its organizational existence (Vanninen et al., 2017).

5 The Open Banking initiative was launched in 2018 in the United Kingdom with the intention of increasing competition and innovation in the provision of retail banking services. The United Kingdom then pioneered the adoption of Open Banking globally. Open Banking enables consumers and SMEs to share their bank and credit card transaction data securely with trusted third parties, which are then able to provide them with applications and services that save time and money. It also enables consumers and SMEs to initiate payments directly from their payment accounts to the bank account of their payee, without the use of cards. The Financial Conduct Authority is very supportive of fintech.

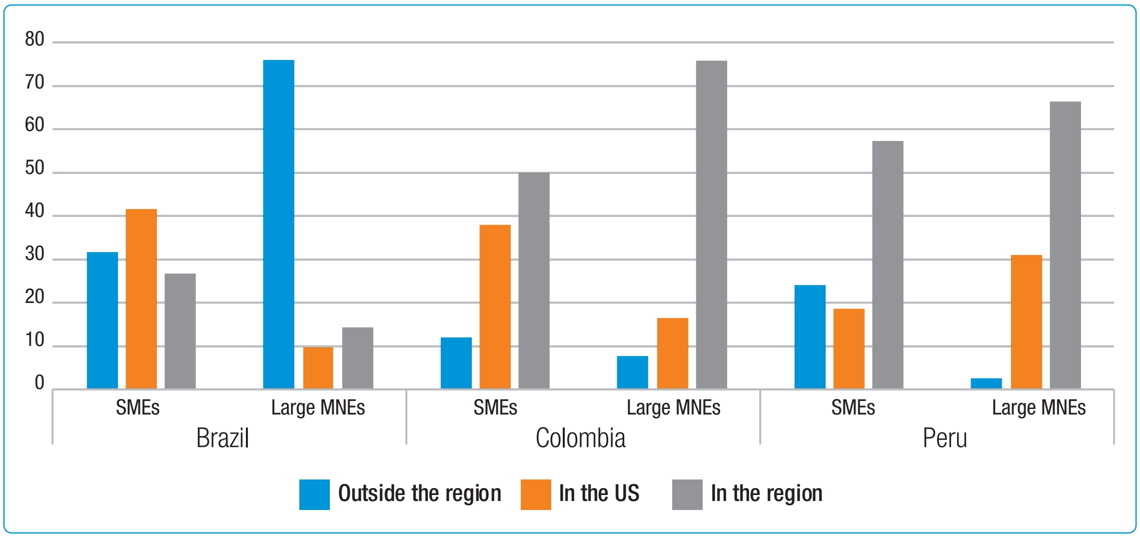
Figure 8 Regional projects by home economy region, share by firm size (Per cent)



Source: UNCTAD based on of fDi Markets (www.fDimarkets.com), Financial Times Ltd.

In Latin America and the Caribbean multinational SMEs tend to have foreign affiliates in host countries that are large or geographically close, or with which home countries have trade agreements or (shared) historical ties (see also Graziano et al., forthcoming). The cases of Brazil, Colombia and Peru show that the location patterns of these affiliates follow the standard trade driving forces – large market size, short distance, common language and lower tariffs (figure 9).

Figure 9 Foreign affiliates location by firm size, selected Latin American countries (Per cent)



Source: Graziano et al. (forthcoming).

Brazilian multinational firms have a significant presence outside of Latin America and the Caribbean through foreign affiliates (excluding offshore locations), particularly in the United States and Portugal. In contrast, almost two thirds of Colombian multinational firms' foreign affiliates in 2018 were located in the region, and one third of these affiliates were SMEs. The share of SME affiliates reached 45 per cent in neighbouring Ecuador. As in Colombia, almost two thirds of Peruvian multinational firms' foreign affiliates active in 2017 were located in the region and slightly more than one third were associated with SMEs. Furthermore, Peruvian multinational SMEs made up more than 70 per cent of all foreign affiliates operating in countries such as Colombia and Ecuador.

Box 4: FDI by SMEs: data providing firm-level evidence

The characteristics of FDI by SMEs presented in this report are derived from firm-level data for 2021 from the Bureau van Dijk business database (Orbis). Information on the number of employees and turnover is used to specify the size of an enterprise. For revenue data, the latest available year is used, which varies by firm; usually the period starts in 2018.

SMEs are defined as enterprises with fewer than 250 employees and a turnover of less than $15 million. If one of these variables was missing (owing to limited availability of employment and financial data in Orbis), only one criterion was considered. For some countries, employment and financial data are still scarce, preventing the identification of SMEs. Of 38 countries in East and Central Asia, Africa and Latin America, in only 3 countries are data on either number of employees or turnover available for more than 70 per cent of the firms. In Argentina, Ghana and Thailand, company size can be defined for 76, 73, and 74 per cent of all enterprises, respectively. Box table 4.1 summarizes key statistics in the countries.

In the case of Morocco, the Orbis database did not contain any financial information, making it impossible to identify SMEs. Instead, Orbis data on 214 enterprises with foreign subsidiaries were matched with information on the number of employees and revenues drawn from the Moroccan Observatory for Small and Medium Enterprises at Bank Al-Maghrib. By the Moroccan definition, SMEs have a turnover of less than 175 million dirhams and fewer than 500 employees.

Box table 4.1. SMEs in developing countries: firm-level evidence

	Number of firms	Percentage of firms with valid size indicators	Percentage of SMEs	Number of SMEs with foreign subsidiaries	Percentage of SMEs with foreign subsidiaries
Thailand	921'892	74	84	339	0.01
Argentina	3'194'972	76	99	204	0.01
Ghana	1'244'904	73	99	57	0.08

Source: UNCTAD based on ORBIS data.

Data on multinationals from Brazil, Colombia and Peru come from a study from the Inter-American Development Bank (IDB), using data from WorldBase matched with data from the the Relação Anual de Informações Sociais, the National Registry of Legal Entities and Brasil Comex for Brazil; from Confecámaras, the Superintendencia de Sociedades, the Directorate of National Taxes and Customs, and the IPA PROCOLOMBIA for Colombia; and from the National Superintendent of Customs and Tax Administration and the IPA PROMPERU for Peru. In the study, SMEs are defined as firms with up to 100 employees. Box table 4.2 shows the resulting samples.

Box table 4.2. Sample structure

Country	Number of MNEs	Percentage of SMEs
Brazil	450	50
Colombia	130	35
Peru	80	50

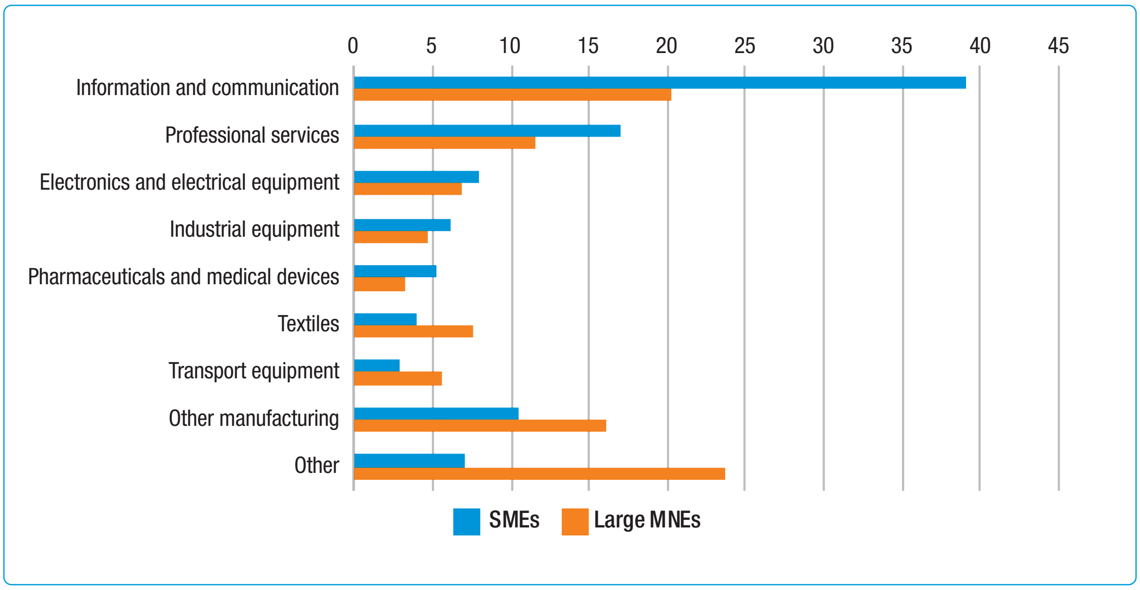
Source: Graziano et al. (forthcoming).

2.2.2. INDUSTRY

Investment by SMEs tends to concentrate in industries that do not require high set-up (or fixed) costs, mainly in software and IT services and in business services, which together account for more than half of all foreign investment projects by SMEs (figure 10). The high share of investment in software and IT services also highlights the importance of the digital economy for developing a dynamic SME sector.

Across manufacturing industries, SMEs concentrate in high-tech industries such as electronics and electrical equipment, industrial machinery, and pharmaceuticals and medical devices, whereas they are underrepresented in most other manufacturing sectors. The disparity is largest in textiles and in transport equipment (including automotives), where economies of scale play a big role in driving profitability.

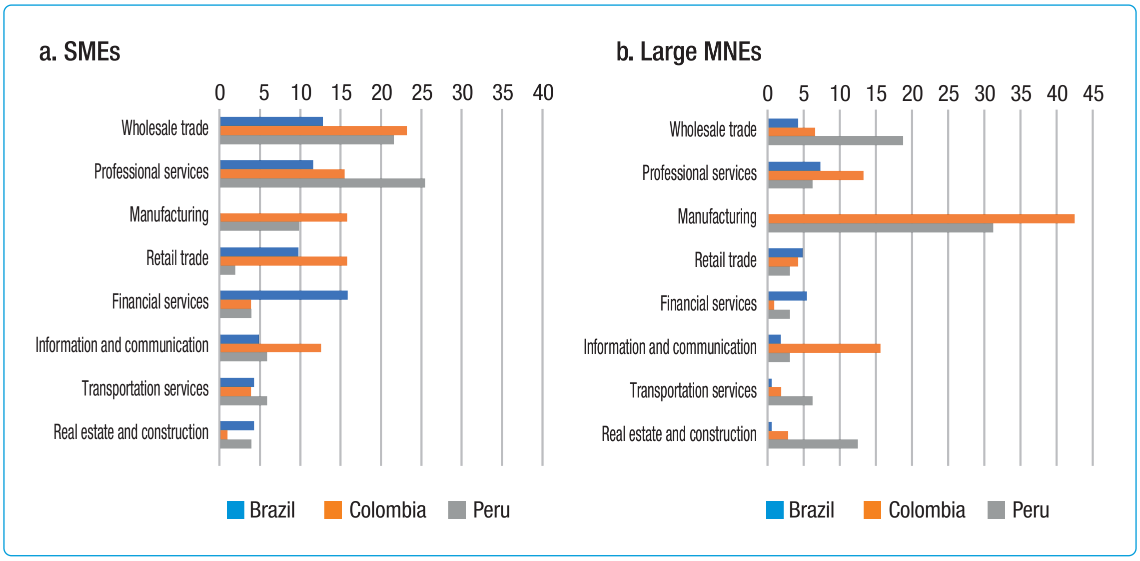
Figure 10 Top industries of multinationals investing abroad, 2015–2022, by firm size (Per cent)



Source: UNCTAD based on fDi Markets (www.fDimarkets.com), Financial Times Ltd.

This is confirmed by sectoral information on multinational SMEs in Latin America. These SMEs are primarily active in the services sector, including especially wholesale trade and professional, scientific, and technical services, and to a lesser extent manufacturing (figure 11). This sectoral distribution could reflect cross-border horizontal integration across the intermediation (and logistic supply) chain to exploit scale economies and solve coordination problems in the case of wholesale trade, and horizontal and market-seeking FDI in the case of professional, scientific, and technical services. An in-depth examination of the mechanisms behind multinational SMEs' location decisions is an important avenue for future research.

Figure 11 Top industries of multinationals investing abroad, selected Latin American countries, by firm size (Per cent)

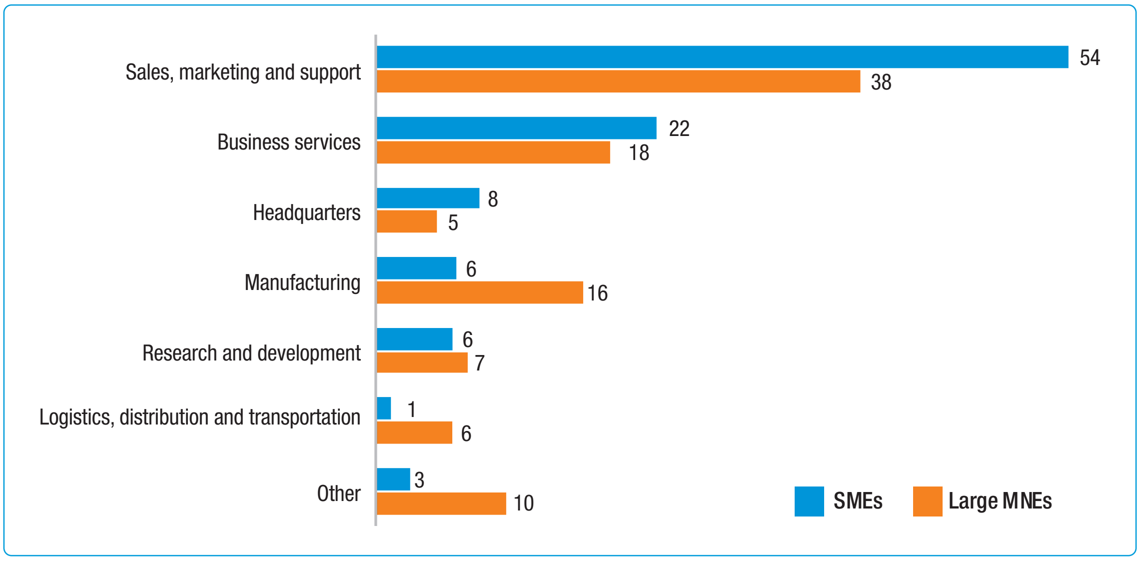


Source: Graziano et al. (forthcoming).

Note: Percentages do not sum to 100 since not all industries are reported.

For SMEs, investing abroad is an important growth strategy, as it provides access to a combination of new resources, knowledge, customers and networks that are not attainable in single domestic markets. Given their resource constraints, SMEs might differ from large MNEs in the FDI strategies they pursue. For example, analysing greenfield investment shows that in comparison with larger investors, SMEs are more likely to open sales, marketing and support offices and significantly less likely to establish manufacturing plants (figure 12). This is partly explained by the sectors in which SMEs are most active, which in many cases is services – in particular IT and communication, and professional services – where direct relationships with the client are very important.

Figure 12 Business function of greenfield subsidiaries, 2015–2022, by size of parent firm (Per cent)



Source: UNCTAD based on fDi Markets (www.fDimarkets.com), Financial Times Ltd.

2.3. SME INTERNATIONALIZATION BY FDI: CHALLENGES AND FACILITATING FACTORS

The internationalization of SMEs through FDI can be a complex process. Success requires a strategic approach that takes into account both the challenges and the facilitating factors (table 1). Governments, industry associations and support organizations play crucial roles in creating an enabling environment for SMEs to invest overseas.

Table 1. SME internationalization: challenges and facilitating factors.

Challenges	Facilitating factors
Access to finance	Networks and cultural ties
Skills and technology constraints	Innovation and capacity building
Information constraints	Digitalization and technology adoption
Regulatory burden and protectionism	Trade participation
International competition	

Source: UNCTAD.

2.3.1. CHALLENGES TO INTERNATIONALIZATION BY SMEs

Owing to SMEs' smaller size, they have limited financial, human and technological resources, and less international experience. Based on the review of policy toolkits and measures, and on the background studies of the report, the most prominent barriers identified for SMEs growth and internationalization – especially through FDI – are limited access to finance, skills and technology constraints, low international exposure, regulatory burden and protectionism, and international competition. While most of these barriers are relevant for all SMEs some particularly hamper those that have overseas activities. In table 1 some corresponding facilitating factors are suggested based on the evidence collected in the case studies.

2.3.1.1. Access to finance

The more limited financial resources of SMEs compared with large MNEs are typically cited as the most important constraint. SMEs are often family owned or privately held, with no or limited access to capital markets, and are typically too small to rely on internal financial sources for their operations and growth. They have more limited collateral than large MNEs and are thus considered higher-risk borrowers. Consequently, finance institutions either are less willing to lend to them or impose high interest rates when they do lend. In addition, some credit institutions may not include SMEs in their client portfolio because of the high cost of screening and administering small loans spread over large areas.

SMEs may face difficulties in preparing applications that meet bank requirements.[6] Consequently, they often rely substantially on informal institutions, internal funds or cash from friends and family to launch and initially run their enterprises. The implications of limited access to finance are multiple: SMEs often lack the working capital that enables longer payments and cash-conversion cycles, and insufficient investment capital hinders their internationalization and, most notably, foreign investment, which has high initial costs. Financial barriers can be particularly binding when SMEs have a shortage of funds for researching

6 For a detailed review of the literature on SME finance, see Kersten et al. (2017).

new markets and adapting marketing strategies to international markets. Financial constraints can also have implications on time frames, influencing SMEs' ability to develop long-term planning. As a result, opportunities that would be available if firms can plan for a more distant time horizon may not be available to small enterprises (De Maeseneire and Claeys, 2012).

2.3.1.2. Skills and technology constraints

Because of their small size, SMEs may have difficulty acquiring management skills and know-how for their enterprises. This constraint is particularly relevant given a lack of managerial skills to plan an internationalization project, insufficiently trained personnel (e.g. language and technical skills), cultural disconnects (e.g. lack of intercultural skills), and insufficient technical know-how for doing business internationally (e.g. taxes, customs, reporting, technical standards, regulations and certification requirements).

Technological constraints also pose a challenge to internationalization that affects SMEs disproportionally. Technological intensity, along with productivity and capital intensity, has long been identified as one of the drivers of internationalization and, specifically, FDI (Bernard and Jensen, 2004). By lacking technological capacity, SMEs often face more severe difficulties in investing abroad than larger MNEs do. For example, a study commissioned for this report on SMEs in the Republic of Korea found a growing gap between SMEs and large firms in terms of adoption of 4IR technology. Not only are large firms more likely to adopt 4IR technologies, but they also are more likely to advance technological innovations at a faster pace. This is often a consequence of a historical gap in R&D spending and contributes to the growing imbalance in productivity between large MNEs and SMEs in recent years. At the same time, SMEs that adopt 4IR are more likely to also invest abroad as shown in the background study of the Republic of Korea (Park et al., 2022).

2.3.1.3. Information constraints

Related to the lack of skills and know-how, information barriers represent a further constraint to internationalization. Informational barriers can be defined as challenges in identifying, selecting, and contacting international markets due to information inefficiencies.[7] When investing abroad, information is generally collected in several iterative rounds, looking for increasingly more detailed and specific information over time. The initial information-gathering seeks to assess the general viability of the project and shortlist possible locations. In this process, informational barriers may also arise from the lack of reliable data about the international market owing to problems associated with the source, quality and comparability of available information. The later rounds of information-gathering are instead intended to collect specific pieces of information to enable project implementation. These include information on market characteristics and potential customers and suppliers, tax levels, trade and investment agreements, regulatory frameworks (e.g. product standards, required certifications), documentation and information on general procedures, and information regarding the company registration process for social security and tax purposes.

Another set of country-specific features that SMEs must consider before investing abroad is the availability and costs of domestic infrastructure (e.g. electricity, access to the grid, power stability), as well as logistical and financial infrastructure (e.g. wiring money into the host country, managing payment processing domestically and internationally). While host country-specific information is key for SMEs and larger firms to export and invest abroad, and to adapt to local customs and resources, SMEs face an additional layer of constraints. Information constraints often derive from little international exposure. For example, a small international network of investors, suppliers and customers can imply marketing barriers that hinder SMEs' product pricing, distribution, logistics and promotion activities abroad. Investors can lack the knowledge on how to organize FDI and foresee potential obstacles, as well as face difficulties

[7] Glossary for Barriers to SME Access to International Markets: https://www.oecd.org/cfe/smes/glossaryforbarrierstosmeaccesstointernationalmarkets.htm#Informational_Barriers.

arising during the establishment of the project or enterprise.[8] For this reason, international exposure – through supply chain linkages with large MNEs, international partnerships and exporting experience – is an important facilitating factor.[9]

2.3.1.4. Regulatory burden and protectionism

A heavy regulatory burden and protectionist measures disproportionally affect SMEs. The regulatory burden on SMEs stems not only from the need to engage with both home and host country regulations but also in comparison with larger enterprises as SMEs have relatively fewer resources and skills available for screening the regulatory environment and dealing with these demands.[10] Protectionist measures related to international operations (e.g. general tariffs, non-tariff barriers, capital transfer restrictions, restrictions on exporting and regulatory requirements for entering an industry) could particularly affect SMEs owing to the additional administrative procedures required and SMEs' fewer resources. Although regulations and trade barriers, in principle, do not primarily target SMEs, these enterprises can be particularly vulnerable given that they generally lack adequate and specialist departments and managers, and tend not to have dedicated internationalization or corporate development departments.

2.3.1.5. International competition

International competition from both domestic players and large MNEs may discourage SMEs' foreign investment. To successfully compete in international markets, SMEs, like large MNEs, need to develop their own competitive strategy, which could involve focusing on specific and well-defined market niches in which they hold a competitive advantage (Onkelinx and Sleuwaegen, 2008). FDI can help SMEs to navigate and thrive in the competitive global landscape, allowing them to access resources, markets and capabilities that contribute to their long-term growth.

2.3.2. FACTORS THAT CAN FACILITATE INTERNATIONALIZATION BY FDI

2.3.2.1. Networks and cultural ties

According to the network theory, close cooperation and social capital are both main drivers and key factors allowing SMEs to establish foreign operations. Some studies show that early and rapid multinationalization is often based on networking and social capital as they provide very important ways for SMEs to abate information costs in foreign markets (Dimitratos et al., 2016; Dimitratos et al., 2014).

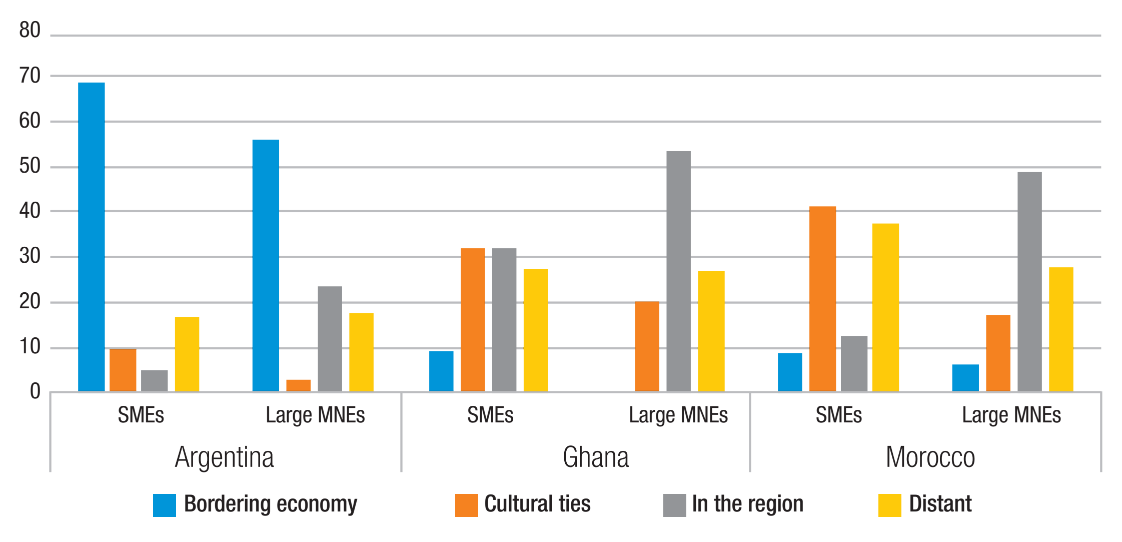
SMEs tend to invest in bordering countries and countries where there is some cultural tie deriving from a common language, a diaspora or a colonial past (figure 13), which is consistent with the empirical regularity that FDI follows gravity forces – i.e. distance and cultural proximity (e.g. Antràs and Yeaple, 2014; Conconi et al., 2023). Almost 70 per cent of Argentine SMEs, for example, choose to open a subsidiary in neighbouring economies (mostly Brazil), and 10 per cent invest in Italy or Spain, historical sources of immigration.

[8] Informational constraints are often behind the "liability of foreignness ", a term coined by Zaheer (1995) to express the competitive disadvantage of foreign firms compared with local firms that have better access to relevant information regarding markets, culture and institutional environment.

[9] "Challenges and concerns for small and medium-sized enterprises (SMEs) doing business in third countries", European Parliament, March 2021.

[10] These could include increased reporting and transparency demands related to financial and non-financial company performance, money-laundering prevention or double-taxation issues.

Figure 13 Investment abroad by link and firm size, selected developing countries (Per cent)



Source: UNCTAD, based on Orbis, BvD data.

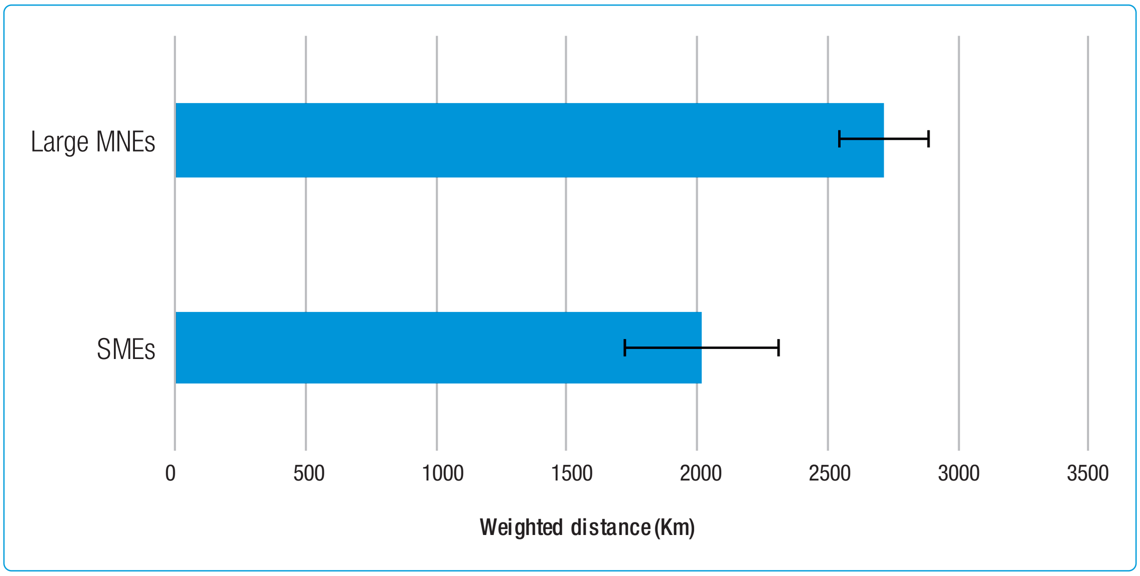
Note: cultural ties countries for Argentina are Spain and Italy, for Morocco are Arab speaking countries, France and Portugal (Spain is bordering), for Ghana is the United Kingdom.

SMEs in Morocco are more likely to invest in France, Spain, Portugal and Italy. France and Spain, which host most of the investment by Moroccan SMEs, also host the largest number of Moroccan emigrants. Investment by these small companies is driven by market-seeking strategies, to provide services to the Moroccan diaspora in these European countries. Moreover, Moroccan migrants can help facilitate investment by SMEs. For instance, Mastoura, which produces and sells hijab clothing for women, has subsidiaries in Spain.

In contrast, cultural ties and regionalization do not seem to explain investment by large MNEs from Morocco. They invest mostly in France and Switzerland and in African countries such as Côte d'Ivoire, Senegal and Tunisia. Importantly, the average distance of SMEs in Morocco to their foreign subsidiaries is significantly shorter than that of large MNEs (figure 14).

Finally, looking at the sectors in which Moroccan firms invest abroad shows that foreign subsidiaries operate largely in trade, construction or IT. Construction investment is mostly in Italy, and investment in the IT sector is limited to France.

Figure 14 Distance of the subsidiary from the parent firm in Morocco, by firm size



Source: UNCTAD, based on data from ORBIS and the Moroccan Observatory of Very Small, Small and Medium Enterprises.

Evidence from low-income countries in Africa (Ng'ombe et al., 2023) highlights that SMEs in Malawi, Zambia and Zimbabwe often work synergistically with developed-economy MNEs, acting as their "delivery arm" in the small markets in their immediate region. MNEs that had identified a competent SME provider either directly or indirectly (by way of an "anchor" contract) supported the internationalization of that SME into other, similar countries in the region. This was of benefit to the MNEs, because they could externalize the risk of operating in the region and still derive some sales from it. This opens a new way of understanding MNE-led development.

2.3.2.2. Innovation and capacity-building

SMEs' innovation is a key determinant of their productivity and long-term growth, and helps enhance the capacity of firms to grow and adapt to market challenges. Innovation activities can play an important role in the internationalization of a firm, as SMEs that innovate are more likely to engage in global markets than non-innovative firms. The case study on SMEs in Türkiye provides evidence in support of the role of innovation in the internationalization process of SMEs (Koymen et al., 2023). SME policies in Türkiye are defined as part of a multi-year action plan. The Organization for the Development of Small and Medium Enterprises (KOSGEB) developed the KOSGEB Strategic Action Plan 2019–2023 to contribute to a coordinated delivery of SME policy (box 5). The main objectives of the plan include promoting innovation, technology and R&D; fostering entrepreneurship; and strengthening the skills, internationalization and productivity of SMEs. It also has specific provisions for monitoring and evaluation. The proactive and up-to-date policy support makes Türkiye a particularly relevant case for studying the role of innovation policies in promoting FDI by SMEs.

Box 5: SME innovation support policies in Türkiye

A background study by Koymen et al. (2023) details the support programmes provided to SMEs in Türkiye. The country supports innovative activities by SMEs through two main entities: the Organization for the Development of Small and Medium Enterprises (KOSGEB) and the Scientific and Technological Research Council of Türkiye (TUBITAK). KOSGEB is the main body executing SME policies in the country. It was established in 1990 to provide services and to support SMEs in the manufacturing sector. In 2009, with increasing value production and employment by SMEs in other sectors, the coverage of KOSGEB was expanded. Today, it offers a wide range of incentives to SMEs, including low-interest loans, technical and managerial support, and training programmes. In 2018, its support programmes were updated with a vision to prioritize SMEs that produce innovative, technological and high value added products, that aim to carry these products to international markets and that are export oriented (KOSGEB, 2018).

The major programmes operated by KOSGEB and its Enterprise Development Centres (IGEM) and Technology Development Centres (TEKMER), are structured like the ones prevailing in more developed countries. The laboratories operated by KOSGEB provide SMEs with access to testing and analysis equipment and methodologies that would otherwise not be available to most small firms. The technological and managerial assistance provided to SMEs enrolled in the programmes helps these firms to cope successfully with their business problems. TUBITAK specifically focuses on scientific and technological research and supports R&D activities of SMEs, providing grants and support programmes (box table 5.1).

Box table 5.1 Type of innovation support programmes in Türkiye

KOSGEB incentives	TUBITAK incentives
R&D and innovation support programme	Industrial R&D projects grant programme
Product development and innovation support programme	University-Industry collaboration support programme
SMEs technological product investment support programme	SME R&D start-up support programme
Industrial application support programme	International industrial R&D grant programme
Strategic product support programme	Research, technology development, and innovation projects in priority areas grant programme
General SME support programme	Technology transfer office support programme
SME development support programme	Venture capital funding programme (Tech-InvesTR)
Foreign market operations support programme	Frontier R&D laboratory support programme
	Capacity building for R&D grant programme

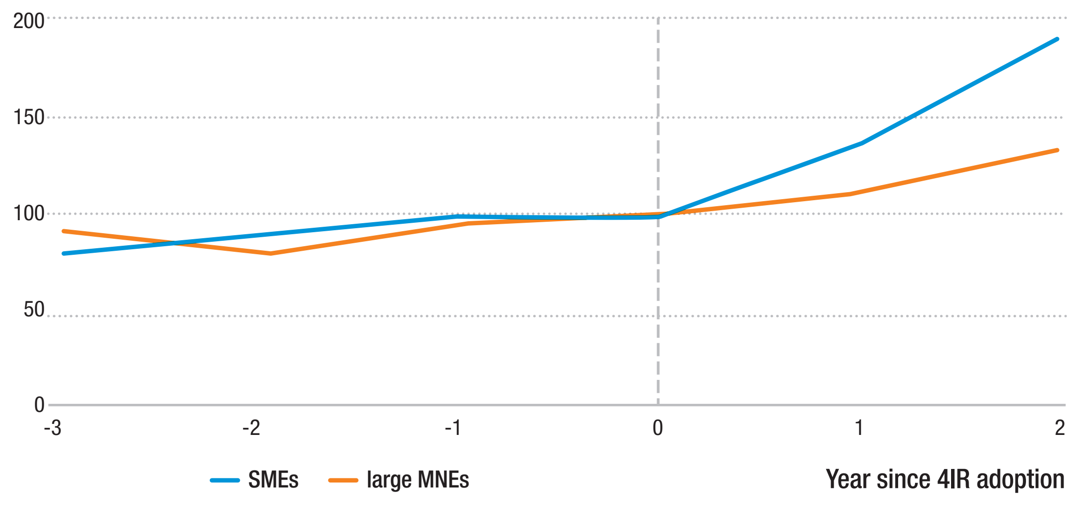
Source: Koymen et al. (2023).

2.3.2.3. Digitalization and technology adoption

Digitalization and technology adoption are creating new prospects for SME internationalization by facilitating the emergence of small bornglobal firms and offering new opportunities for established SMEs to scale up, enhance productivity and become global players. Information and communication technologies reduce costs related to distance, entry and more generally information, thereby lessening SMEs' networking disadvantage and facilitating their international investment. By reducing governance and transaction costs, the application of digital technologies also improves bottom-up access to global value chains for SMEs (UNCTAD, 2020). In addition, digitalization enables firms, most notably the smaller ones, to use new and innovative digital tools to overcome barriers to growth, helping facilitate payments, enabling collaboration, avoiding investment in fixed assets with cloud-based services and using alternative funding mechanisms such as crowdfunding (OECD, 2021).

In a background study for this report, Park et al. (2022) find that Fourth Industrial Revolution technologies facilitated FDI by SMEs but had a dampening effect on the growth of international production networks of larger firms (figure 15). Smaller companies quickly adopted digitalization technologies and leveraged this technological advantage in laggard economies to gain market presence, in particular in the services sector. At the same time, their smaller size slowed their adoption of automation technologies. As a consequence, their growth strategy has been to search for neighbouring economies with low production costs.

Figure 15 4IR technology adoption and FDI stock in the Republic of Korea, by firm size (Index)



Source: Park et al. (2022).

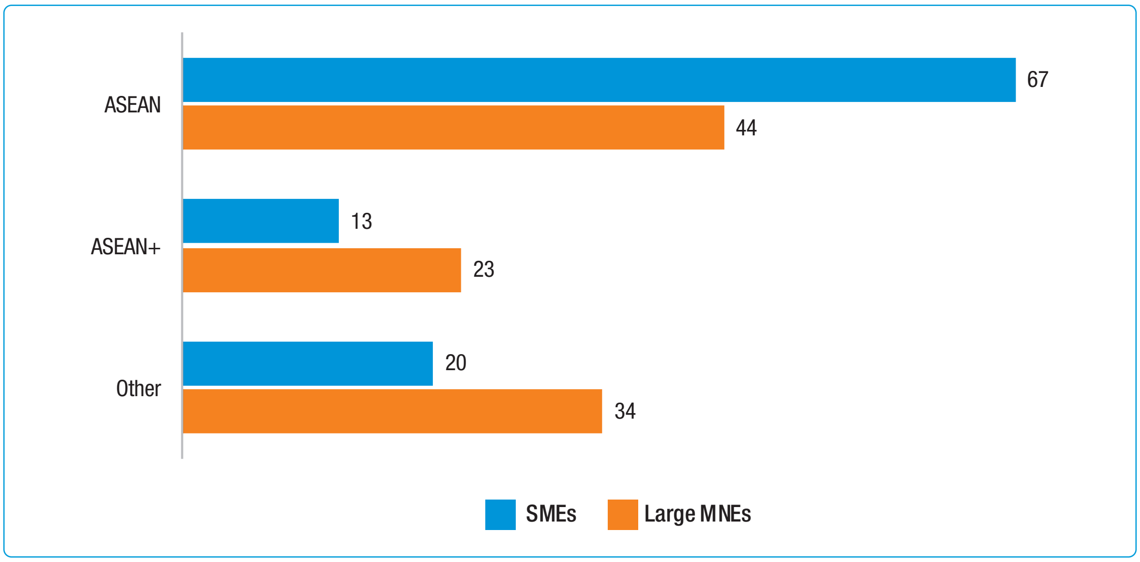
Note: The vertical dashed line represents the period when firms started the utilisation of the Fourth Industrial Revolution technologies (Internet of Things, Cloud, Big Data, 5G, Artificial Intelligence, Block Chain, 3D Printing, Robotics, Virtual/ Augmented Reality). Total stock of FDI is normalized to year 0 level (i.e. year 0 = 100).

2.3.2.4. Trade participation

According to the stage model of internationalization, a firm starts by exporting to a country, then sets up a selling subsidiary and finally builds a production subsidiary. Experience in a country tends to have an influence on a firm's investment there rather than in other countries. Even if multinational SMEs do not engage in exports, the location patterns of their affiliates follow the main drivers of trade – large market size, short distance, common language, lower tariffs.

As the empirical assessment undertaken in this report shows, two thirds of foreign affiliates of Thai SMEs are in other ASEAN countries, and a further 13 per cent are in countries with which the ASEAN regional grouping has a bilateral trade agreement (ASEAN+) (figure 16). The remaining 20 per cent are often joint ventures with developed companies. This compares to less than half of the foreign affiliates of larger MNEs in ASEAN countries and higher percentages both in ASEAN+ and in other countries.

Figure 16 Location of foreign affiliates of Thai multinationals, by firm size (Per cent)



Source: UNCTAD based on Orbis, BvD data.
Note: ASEAN+ include Australia, China, Hong Kong, India, Japan, New Zealand, and Republic of Korea.

3

ASSESSING INVESTMENT POLICIES FROM THE PERSPECTIVE OF SMEs: A POLICY FRAMEWORK

This chapter reviews existing policies that promote inward and outward FDI, and their effectiveness with respect to smaller investors. It aims to identify policy gaps and challenges and evaluate the extent to which current policies align with the determinants and success of SMEs' inward and outward FDI. Existing policies often focus on large MNEs; that is, implicitly or explicitly, SMEs are often overlooked in policy design. From an SME perspective, FDI is often a make-or-break decision, whereas for an MNE it is one of many decisions – hence the importance of focusing on the investment promotion and facilitation mechanism for smaller companies.

This chapter proposes a framework for the analysis of investment policies and their relevance for SMEs, as well as some practical policy recommendations to support SMEs' internationalization efforts, notably through FDI. On the basis of this analysis, the subsequent chapter highlights key priority areas for policy action and examples of successful implementations thereof.

The policy framework analyses (1) the general policies – i.e. inward and outward policy measures as well as international investment agreements that affect FDI by SMEs; (2) the differential impact on SMEs compared with large MNEs and (3) the priority areas for intervention. In particular, for each measure, the framework indicates whether, in comparison with large MNEs (indicated with pluses or minuses with respect to the impact or challenge for large MNEs):

- SMEs face more or less difficulty in meeting or accessing the requirements or regulations.
- The measure is more or less relevant to SMEs (for example because of the benefits associated with it or the applicability to SMEs).

Whenever the challenges to access and the benefits are comparatively larger for SMEs, the framework identifies priority areas where policymakers should intervene to support SMEs' internationalization process.

3.1. INWARD INVESTMENT POLICIES

Inward investment policies and measures fall into three broad categories: (1) regulatory measures, (2) restrictions and (3) promotion and facilitation measures.

Regulatory measures include local content requirements, technology-sharing requirements, regulation of foreign personnel entry and other sector-specific regulations (including for example minimum capital requirements or mandatory licensing) (table 2). Compared with large MNEs, it is harder for SMEs to fulfil or to comply with these requirements. For example, local content requirements may be more difficult to meet whenever there are information asymmetries and foreign companies do not have good knowledge of potential local suppliers and partners. Thus, successfully integrating into the host economy is crucial for SMEs as they cannot import most of their inputs as large MNEs sometimes do.

Restrictions on ownership are typically meant to protect the domestic industry. SMEs rarely represent competition for local businesses. Investment restrictions include total foreign ownership restrictions, partial ownership restrictions or joint-venture requirements, and screening procedures. Total investment restrictions are typically formulated in terms of negative lists of industries closed to FDI. In this case there is no differential impact by investor size.

More common are requirements to set up joint ventures with local companies. In this case, SMEs can be at disadvantage with respect to large MNEs as they have less knowledge of local companies. Also, being small, they may have less bargaining power when setting up a partnership. However, finding the right local partner might be a springboard for SME expansion in a new market.

Thanks to their size, SMEs are less likely to undergo screening procedures, unless they are active in an industry with national security concerns. Also, most screening procedures apply to foreign acquisitions of domestic companies; as shown in chapter 1, SMEs are less likely to enter foreign markets through acquisitions.

Investment facilitation and promotion measures represent more than half of the policies implemented to attract and support inward FDI (UNCTAD, 2023b). The main facilitators of these measures are IPAs, and in specific instances SEZs. Investment promotion policies include financial incentives in the form, for example, of tax incentives, loans and grants that can be (i) discretionary or subject to negotiation by firms with governments, (ii) conditional on certain criteria or (iii) not conditional (for example, for a specific industry or underdeveloped region).

In most cases, gaining access to these incentives tends to be much harder for SMEs than for large MNEs. This is because requirements to benefit from these incentives include performance indicators (exports, employment creation, output and R&D investment) that are tilted towards large MNEs. Even non-conditional incentives can aim to attract FDI in industries or regions that do not offer easy access to partners, investors, infrastructure and knowledge.

Investment facilitation tools range from expanding information provided to investors, facilitating and streamlining administrative procedures and requirements, and providing matchmaking services and aftercare services (such as providing support to local subsidiaries in public procurement, creating new leads for expansion projects and establishing technical committees to resolve implementation problems for major projects). These services are especially relevant to SMEs, as they target specific challenges that are disproportionally larger for SMEs. For example, help in conducting a market analysis, and assistance with administrative procedures, legal issues (including expatriate entry and visa support), and business and tax registration are crucial given SMEs' lack of specialized internal resources. However, in the provision of these services SMEs are often overlooked. IPAs are mostly evaluated on the amount of capital or jobs, exports or innovative activities that they bring to the host economy; consequently they tend to focus their efforts on larger companies and larger investment projects.

The most important investment promotion tools, as highlighted in the 2022 annual IPA survey conducted by UNCTAD, are support for information and search (mostly for real estate), help to access direct tax incentives and support for value chain activities. Measures related to the regulatory framework, access to financing, support in interaction with governments and MNEs, ease of doing business, support in marketing campaigns and high-tech investment were highlighted by only a handful of respondents (UNCTAD, 2022).

Table 2. Inward investment policies and SMEs

Policy/measure	Differential impact on SMEs (compared with large MNEs)		Description	Priority area for intervention
	Relevance	*Challenge*		
Regulatory				
Local content requirements	-	+	• SMEs may have a smaller network of suppliers and thus be more inclined to source locally. • SME often face greater difficulties in finding the right supplier or network.	✓
Technology-sharing requirements	+	+	• Manufacturing SMEs installing new production facilities abroad are typically sharing their technology. • For SMEs operating highly innovative technologies in niche markets, sharing would undermine their competitive edge.	✓
Regulation of foreign personnel entry	+	+	• SMEs are less likely to be constrained by limits on foreign personnel entry. • Limits on the duration of foreign personnel entry can negatively affect the SME manager's ability to set up a local affiliate.	✓
Other sector-specific regulation	+	+	• Other sector-specific regulations can have varied effects.	✓✓
Restrictions				
100% ownership restriction (by industry; e.g. negative lists)	=	=	• Ownership restrictions have the same effect across company sizes.	✓
Partial ownership restrictions/joint venture requirements	++	++	• SMEs may encounter more difficulties finding a local partner owing to information asymmetries. • SMEs have a different weight in negotiations when setting up joint ventures or partnerships with larger counterparts. • For SMEs the decision to invest overseas may increase the risk of failure; hence the choice of the right partner is relatively more important.	✓✓✓
Screening	-	+	• Most screening procedures apply to M&A deals. SMEs are less likely to enter foreign markets through acquisitions. • Being small players, SMEs are less likely to undergo screening procedures. • There are exceptions for companies operating in national security and/or high-technology industries.	✓
Promotion and facilitation				
Discretionary fiscal or financial incentives (or in kind – infrastructure, land)	+	++	• Because SMEs have less bargaining power than larger MNEs, it can be more difficult for them to access discretionary incentives.	✓✓
Fiscal or financial incentives conditional on meeting certain criteria (key performance indicators)	++	++	• Most incentives are conditional on key performance requirements such as contribution to employment, technology development, innovation/R&D investments and exports, where large MNEs have an advantage. • SMEs may struggle to access these incentives.	✓✓✓
Fiscal or financial incentives not conditional (for certain industries or regions)	+	++	• Unconditional incentives often aim at developing a certain region or industry. • Because of information asymmetries, accessing incentives can be more challenging for SMEs. • In some high-tech or research-intensive industries, SMEs may find access difficult. • Investing in regions where infrastructure is suboptimal and networking and partnering opportunities are fewer may be challenging for SMEs.	✓✓
Information provision, streamlining of administrative procedures, hand-holding	++	++	• The main providers of facilitation services – IPAs and SEZs – often pursue larger MNEs, overlooking SMEs, because their performance is evaluated on the amount of employment, technology, assets or exports generated. • Having a smaller workforce to devote to administrative and market analysis tasks, SMEs benefit relatively more from these services.	✓✓✓
Matchmaking	++	=	• Matchmaking services are most relevant for SMEs as their network is smaller and their ability to find the right suppliers, customers or partners may be limited.	✓✓
Ombudsperson	-	-	• An ombudsperson typically focuses on domestic SMEs but can be important for foreign SMEs experiencing issues with State agencies.	✓

Source: UNCTAD.

Note: This table presents an assessment of existing inward policy toolkits and measures – regulatory, restrictions and promotion and facilitation, and identifies priority areas for intervention, for the promotion of FDI by SMEs. These areas are further discussed in chapter 4.

3.2. OUTWARD INVESTMENT POLICIES

Outward investment policies entail a set of regulations, guidelines and strategies to support domestic firms in investing in foreign markets. Typically, they aim at increasing access to financing in the form of loans, equity participation and grants; providing investment guarantees and insurance; offering fiscal facilitation, and making available more specific investment facilitation tools that include capacity-building support services, including market research, training, networking opportunities and expert guidance (table 3).

Table 3. Outward investment policies and SMEs

Policy/measure	Differential impact on SMEs (compared with large MNEs)		Description	Priority area for intervention
	Relevance	*Challenge*		
Financing support	+	-	• Loans, grants and capital participation measures are often geared to SMEs. • Benefits for SMEs are relatively larger as they often are financially constrained.	✓
Fiscal facilitation	++	-	• Home-country fiscal incentives consist of exemption of taxes on remitted income. • SMEs are less likely to engage in tax arbitration schemes and may benefit from reinvesting foreign income in headquarters activities and capacity.	✓✓
Investment guarantees and insurance	+	++	• Investment guarantee schemes may require that the project contribute to the host economy and respect social and/or environmental norms, thus influencing the ability of SMEs to access these schemes. • Guarantees and insurance schemes cover non-commercial (MIGA) and commercial (EXIM banks) risks.	✓✓✓
Facilitation and support services	++	-	• Outward facilitation and support services can include the provision of guidelines, training, information, help with market research, networking opportunities and expert guidance; they are mostly geared to SMEs.	✓✓

Source: UNCTAD.

Note: As in table 2, this table presents an assessment of key outward policy toolkits, and identifies priority areas for intervention, for the promotion of FDI by SMEs. These areas are further discussed in chapter 4.

Often access to these measures for SMEs is comparatively easier than for larger MNEs. These tools are geared towards SMEs, to foster their internationalization and make them more competitive globally. In other cases, outward promotion tools may aim to develop or support the productive capacity of host economies (typically developing ones), in which case investors may be required to contribute significantly (e.g. by creating jobs) to the host economy or to adopt high environmental and social standards, impairing in this way the ability of SMEs to access such schemes.

3.3. INTERNATIONAL TRADE AND INVESTMENT AGREEMENTS

Trade agreements and in particular trade facilitation measures can help SMEs start to export and enter new markets. As discussed in chapters 1 and 2, internationalization by trade can help SMEs grow and become more competitive. In addition, they learn about foreign markets, demand, standards, competitors and suppliers, thus facilitating further expansion of their business by FDI (table 4). As MNEs, and especially SMEs, often internationalize by expanding in neighbouring countries and within home regions, regional trade and cooperation arrangements such as the South African Development Community or ASEAN are important vehicles for investment promotion. Regional trade agreements ease access to foreign markets, lowering tariffs and internationalization costs, harmonizing norms and regulations, and working towards currency stability within the region. Often, trade agreements include an investment dimension.

Table 4. International Trade and Investment Agreements and SMEs

Policy/measure	Differential impact on SMEs (compared with large MNEs)		Description	Priority area for intervention
	Relevance	*Challenge*		
Trade facilitation/regional trade agreements	++	+	• Trade agreements and trade facilitation measures facilitate SMEs' exports. Exports can help SMEs learn about foreign markets and in turn facilitate their investment overseas.	✓✓
International investment agreements	--	++	• SMEs have limited access to the enforcement mechanism under investment treaties because of the high financial hurdles (i.e. costly and lengthy international arbitration procedures with uncertain outcome).	✓

Source: UNCTAD.

International investment agreements (IIAs) aim to offer protection to foreign companies in the countries where they invest. Yet, traditional IIAs, such as bilateral investment treaties, provide limited benefits to SMEs. Less than 7 per cent of IIAs mention SMEs specifically (UNCTAD, 2018). Old-generation IIAs focus on protection of investment, rather than on measures that promote internationalization or facilitate establishment in the host country, providing limited measurable effect on FDI and on SME internationalization more specifically. In addition, IIAs typically feature broad, vague formulations and include few exceptions or safeguards, which could limit countries' policy space to pursue legitimate development goals, including SME-related development strategies. Finally, SMEs have limited access to enforcement mechanisms under IIAs because of the high financial hurdles involved (i.e. costly – median of more than $1 million – and lengthy international arbitration procedures with uncertain outcomes) (UNCTAD, 2015, 2018; and Hodgson et al., 2021).

Recent IIAs have begun to remedy this gap by incorporating provisions targeted at addressing the needs of SMEs. Most commonly, the aim has been to preserve policy space, e.g. through exceptions and reservations to national treatment obligations for SME-related measures (an example is the 2018 United Arab Emirates–Zimbabwe bilateral investment treaty). Some broad economic agreements with investment provisions, including megaregional ones, such as the Comprehensive and Progressive Trans-Pacific Partnership (2018), the Canada–European Union Comprehensive Economic and Trade Agreement (2016), the Regional Comprehensive Economic Partnership (2020) or the Investment Protocol to the African Continental Free Trade Area, also include dedicated cooperation chapters or provisions for the promotion or support of SMEs. The majority of such cooperation commitments remain shallow, and data on their effectiveness in supporting SMEs are limited (UNCTAD, 2023c).[11]

In addition to the traditional focus on protection, a number of recent IIAs have also gradually embraced investment facilitation commitments. More than half of all IIAs signed since 2015 contain transparency requirements for investment measures, and the share of other investment facilitation provisions related to the host country's regulatory environment is also growing. Over 30 per cent of recent IIAs contain commitments on the part of States to stakeholder engagement, including through the right to comment on proposed regulatory measures or the establishment of a focal point with competencies related to investment. Some, such as the Angola–European Union Sustainable Investment Facilitation Agreement (2023), incorporate specific provisions promoting SMEs. If they are effectively implemented in the contracting States, such facilitation commitments may offer important benefits for SME development.

UNCTAD's Investment Policy Framework for Sustainable Development (IPFSD) provides specific policy options to promote SMEs in IIAs, for example, through the inclusion of country-specific reservations to national treatment obligations for measures related to companies of a specific size (e.g. SMEs).[12] Investment promotion provisions can also play a role in support of SMEs, for example through a joint investment promotion body that could design, implement and monitor progress on thematic work plans (e.g. on promotion of linkages and on issues related to SMEs and value chains). Finally, IIA provisions promoting SMEs can be complemented by MIGA's targeted support to SMEs.[13]

[11] UNCTAD, based on IHEID (2023). The survey analysed the content of 78 IIAs signed between 2015 and 2023, which contain a textual reference to SMEs.

[12] https://unctad.org/system/files/official-document/diaepcb2015d5_en.pdf.

[13] https://ieg.worldbankgroup.org/sites/default/files/Data/reports/chapters/sme_chap3.pdf.

4

PRIORITY AREAS FOR INTERVENTION: IMPROVING ACCESS AND MAXIMIZING BENEFITS

4.1. INVESTMENT POLICY PRIORITIES

The assessment of policy toolkits in chapter 3 revealed that many investment promotion policies and support programmes tend to be designed with larger firms in mind and often overlook the unique characteristics and challenges faced by SMEs. To close this gap, policymakers should facilitate access by SMEs, to maximize the benefits and relevance of these measures for smaller businesses. Priority areas were identified for intervention, on the basis of the empirical analysis and the new policy framework presented in the report – those where SMEs encounter more challenges while potentially benefitting the most from the provisions. They are inward, outward and general support policies:

- **Incentives.** Smaller businesses often struggle to access incentives as these mostly target large projects. In this context, performance indicators could be customized to SMEs. Assessment of small businesses' contribution to the host economy could take into consideration other SME features, for example their ability to integrate in a cluster, to provide for a special or underserved demand as the cases of Latin America and Morocco show, to adopt a certain technology, or to innovate as indicated by the study of the Republic of Korea.
- **Investment facilitation** (information provision, transparency of rules and regulations, and streamlined administrative procedures) is generally more important and more beneficial for SMEs than for large firms, which can hire outside advisers to help navigate administrative requirements. The facilitation services that are more geared towards larger firms are typical IPA and SEZ activities such as supporting site visits, feasibility studies and impact assessments. Even if SMEs have traditionally not been at the core of SEZ policies in recent years, there has been growing interest in how to leverage SEZ policies to support smaller businesses by promoting the establishment of partnerships across companies of all sizes, local and foreign (UNCTAD, 2023b). The evaluation criteria for IPAs and SEZs could be broadened, for example, by including the number of projects and the longer-term growth performance of new subsidiaries. For this, information matters: it is essential that all agencies use digital platforms to allow SMEs to be well informed about (i) which agencies and offices (in addition to IPAs and SEZs) can provide support and expertise, (ii) what incentives and support programmes are available to them, (iii) what administrative procedures to follow to set up a company, (iv) what guidelines and training materials are available (including for example on industrial standards applicable in the country or on building cost frameworks) and (v) networking opportunities. According to UNCTAD (2023a), more IPAs are using digital processes and tools throughout the entire investment cycle, in alignment with broader e-government initiatives. These efforts concentrate on providing information, streamlining administrative procedures and tracking data. The numbers of government digital information portals and digital single windows – including the adoption of e-procedures – have grown significantly in both coverage and quality in recent years (the number of countries with digital information portals has increased from 130 to 169 since 2016).
- **Business linkages and joint ventures.** Small businesses often benefit from external assistance with networking and finding the right partner. IPAs or other local agencies can help design accessible matchmaking programmes and events to help small businesses connect and foster sustained and successful partnerships with local companies. Also, training opportunities for SMEs should enable investors to be ready for partnering with a local company. Policymakers could also assess whether joint-venture requirements in sectors with predominantly SME operators are an excessive barrier to entry.
- **Overseas investment support.** Information about programmes, incentives and support available is key for SMEs. In addition to information, fiscal and financial incentives should be combined with facilitation services. An example is the non-profit Indian SMEs Forum, which in addition to a range of support programmes for supporting SME innovation, manufacturing and access to finance, also offers a platform called the International Trade Desk, which facilitates international knowledge interchange programmes, thereby enabling Indian entrepreneurs to get an overview of global markets and how to expand their business networks and opportunities overseas.

FDI promotion schemes in Brazil, Chile, France and Spain, in addition to loan and grant schemes, include an array of support services: market research, training, networking opportunities, financial support mechanisms and expert guidance (see for example Invest Chile, 2022). In the case of the provision of investment guarantees and insurance schemes, the requirements should be tailored to SMEs so to facilitate their participation. For example, in addition to national agencies and bilateral financial institutions, multilateral stakeholders such as the members of the European Development Finance Institution[14] and MIGA (World Bank Group) provide investment support for SMEs investing abroad. MIGA also facilitates political risk insurance and credit enhancement for cross-border private-sector investment. MIGA protects investments against non-commercial risks such as losses arising from an inability to legally convert local currency into hard currency, from a government's breach or repudiation of a contract with an investor, as well as against loss from, damage to or disappearance of tangible assets caused by political acts of war or civil disturbance. Among the different schemes that MIGA offers, its Small Investment Programme facilitates investments by SMEs in key sectors related to the Sustainable Development Goals (UNCTAD, 1999, 2023a).

- **Regulatory requirements of inward investment.** The main difficulty for SMEs in complying with host-country regulatory requirements is linked to their knowledge and expertise in dealing with these issues. In the most stringent cases, policymakers could consider lifting these requirements (such as minimum capital investment, technology sharing and personnel entry) for smaller investors.

4.2. GENERAL SME SUPPORT POLICIES THAT AFFECT FOREIGN INVESTMENT BY SMES

The empirical analysis in chapter 2 suggested that SMEs face specific barriers that shape their internationalization opportunities and location decisions. Maximizing the development benefits of SME internationalization requires recognizing their importance and addressing these barriers:

- **Access to capital.** SMEs often lack access to financing for overseas expansion projects owing to insufficient collateral, unpredictable returns and information asymmetries. Support programmes for SMEs that facilitate access to new sources of funding, including developing necessary regulation of digital finance, can help domestic and foreign SMEs thrive and can also be an effective FDI promotion policy.
- **Infrastructure development.** Infrastructure improvements, especially in information and communication technology and digitalization, improve productivity, abate logistical barriers and facilitate both inward and outward investment. Digitalization of SMEs is of great importance as it facilitates access to resources, including finance (e.g. peer-to-peer lending), training and recruitment channels, as well as government services. For example, Malaysia is indirectly supporting the internationalization of SMEs through the Industry4WRD Readiness Assessment Intervention Programme, launched by the Malaysia Investment Development Authority in 2019. The programme, specifically designed for Malaysian SMEs operating in manufacturing and related services sectors, aims to facilitate the transition of SMEs to Industry 4.0, thereby improving their productivity and accelerating business growth.[15]
- **Innovation and capacity-building** can help SMEs scale up and become competitive in the international market. Governments can facilitate and ensure the access of SMEs to innovation assets through technological and managerial training, networking events and workforce skills programmes, as well as research programmes with universities and the necessary complementary infrastructure.

[14] Members of the association, which provides long-term financial solutions for investors, including SMEs, include BIO (Belgium), CDC Group (United Kingdom), Cofides (Spain), DEG (Germany), Finnfund (Finland), FMO (the Kingdom of the Netherlands), IFU (Denmark), Norfund (Norway), OeEB (Austria), Proparco (France), SIFEM (Switzerland), Simest and CDP Development Finance (Italy), SOFID (Portugal) and Swedfund (Sweden).

[15] Source: https://smegrantmalaysia.com/mida-grant-mida.

Access to innovation assets such as technology and data is critical for firms of all sizes, but it is typically more relevant for SMEs as they are more dependent on external sources of knowledge. The European Intellectual Property Rights help desk is an example of best practice. The help desk offers SMEs practical support to secure their intellectual property in the form of patents and trademarks. Enhancing the utilization of such services among SMEs could be further facilitated by improving signposting and implementing targeted promotional campaigns to raise awareness and promote their availability.

- **Cluster or hub creation, networking and matchmaking.** For firms of any size, investing in foreign markets requires a process of developing advantageous network relationships. This can be facilitated through a thriving hub where SMEs can find at once customers, suppliers, investors, partners, qualified support and expertise, and talented employees. SEZs can provide a valuable choice for developing this type of cluster, integrating companies of all sizes. For example, in the United Arab Emirates, the Dubai Multi Commodities Centre has been successful in attracting start-ups and foreign SMEs in technology and telecommunication and other services, thanks to the presence of Astrolabs, the technology centre it set up with Google, through incubator and accelerator programmes and a set of support measures (fDi Intelligence, 2022). The Centre has been successful in designing a package of support measures targeting both SEZ tenants (large and small) and the domestic SMEs operating outside the zone that cover all the key entrepreneurship policy areas – namely, regulatory environment; education and skills development; technology exchange and innovation; access to finance; and awareness and networking – and implement them in coordination with SEZ promotion (UNCTAD, 2023b).
- **Export promotion** can foster outward investment since exports lead to an expanded international presence and potentially foreign investment. For example, the Australian Trade and Investment Commission (Austrade) programme provides financial support in the form of grants to SMEs for up to eight years, as well as practical advice on how to enter international markets. The latter includes a guide on how to compare and select markets and diversify a business strategically as well as how to use a proper online market search tool. Moreover, Austrade's TradeStart network offers SME exporters the combined resources of Austrade and each partner organization, providing local assistance and a direct link to Austrade's services and overseas network.

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This policy report has explored the challenges and opportunities associated with the internationalization of SMEs, based on novel research and case studies in a variety of regions and across different industries. The empirical and policy analysis shows that compared with larger companies SMEs face considerable – longer-term – barriers to internationalizing. Owing to their limited size, SMEs do not benefit to the same degree from economies of scale, face more difficulties accessing financial resources as well as managerial and technical skills, and are often more affected by bureaucracy and poor infrastructure than large firms. In addition, relative to large firms, SMEs have less bargaining power, relatively higher compliance costs and smaller networks. These specific challenges hamper SME growth and, in particular, their internationalization process.

The report presents a policy framework to help the SME internationalization process by reducing the common investment policy bias in home and host countries towards large MNEs. It presents ways and means to maximize the development impact of SME FDI. The framework was discussed and validated by experts and key stakeholders at the 8th World Investment Forum, held in Abu Dhabi in October 2023. The original background studies prepared for the report were published in various issues of *Transnational Corporations,* UNCTAD's peer-reviewed academic journal.

The report has presented practical guidelines to help policymakers and investment stakeholders address the key objectives for the promotion and facilitation of foreign investment by SMEs. In addition to the traditional investment-related toolkits, the report also highlights other domestic policy areas that can influence and have a positive impact on SME FDI including the promotion of SMEs innovation capabilities such as Türkiye's targeted policies, the creation of industrial hubs and innovation clusters through SEZs' incentive policies, the adoption of industry 4.0 technologies as in the Republic of Korea and regionalization as in Latin America.

UNCTAD will continue working with partners to advance thinking and policy analysis on the impact of FDI and the activities of multinational enterprises, including SMEs. In addition to policy-oriented research and technical assistance, UNCTAD will continue to convene the multi-stakeholder community to debate investment and development issues, particularly through the biennial World Investment Forum.

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