CHAPTER 2:

ENCOURAGING THE INTERNATIONALISATION OF SMES

by

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Internationalisation has become increasingly important to the competitiveness of enterprises of all sizes. In today's environment, SMEs that start with a global strategy can move quickly to take advantage of cross-border activities, which provides opportunities not only for revenue growth but also the exchange of knowledge and the enhancement of capabilities, thereby strengthening the long-term competitiveness of the firm. This chapter analyses the details of the different approaches, and the ways in which they are implemented, with regard to the variety of forms of SME internationalisation: intermittent exports, exports via agents, licensing or franchising and foreign direct investment in the overseas market. Despite the common understanding of the importance of internationalisation, there are still many internal and external barriers that impede the internationalisation of SMEs. This chapter identifies specific policy actions that could overcome market gaps and encourage the internationalisation of SMEs.

INTRODUCTION

Throughout 2005, the OECD's Local & Economic Development Programme (LEED) Trento Centre organised a series of capacity building seminars in South East Europe to assess key challenges in the area of entrepreneurship policy development. In April, a seminar was held in Montenegro focused on SME internationalisation. The aims of the seminar were to analyse the policies and instruments necessary to facilitate SME internationalisation. This paper has been prepared following that seminar.

The objectives of this paper are to:

- Investigate the opportunities and barriers to SME internationalisation and determine why certain SMEs are more likely to internationalise than others.

- Examine the current situation in South East Europe.

- Identify ways in which policy makers can target measures to address existing gaps or market failures in SME internationalisation.

THE ISSUES

Internationalisation and competitiveness

Internationalisation has become increasingly important to the competitiveness of enterprises of all sizes. In today's environment, small and medium-sized enterprises (SMEs) that start with a global strategy can move quickly to take advantage of cross-border activities, which provide opportunities not only for revenue growth but also the exchange of knowledge and the enhancement of capabilities, which strengthen the long-term competitiveness of the firm.

Entrepreneurship is one of the most important drivers of local economic development. New firm formation and the activities of SMEs help drive job creation and economic growth through accelerating innovation and promoting the full use of human, financial and other resources. The vitality of the new and small firm sector is therefore a major determinant of local competitiveness, which in turn influences national economic performance (OECD, 2005).

Public policy at local, regional and national levels can play a significant role in encouraging entrepreneurship and SME internationalisation by tackling various market failures which can occur. These will be analysed in further detail in this paper.

Entrepreneurship, SMEs and growth

Entrepreneurship is about creativity, innovation and growth. It is, by its very nature, a bottoms-up approach. A widely used definition from Harvard Business School is “entrepreneurship is the pursuit of opportunities beyond the resources you currently control” (Stevenson 1983, 1985; Stevenson and Jarillo, 1991). Entrepreneurship can be facilitated by creating an environment which provides incentives for entrepreneurs and reduces the barriers to starting and growing companies. However, entrepreneurship can not be “created” through top-down approaches.

Entrepreneurial economies are the result of multifaceted systems for nurturing high-impact entrepreneurship. Real opportunities arise from firms with new ideas that add unique value (Schramm 2004). Innovative entrepreneurs come in all shapes and forms, whether they start companies, grow existing firms, innovate within large companies or establish social enterprises. These are creative, proactive people pursuing a vision and galvanising the necessary resources along the way to make that vision a reality.

Entrepreneurs, as described above, are growth oriented although only a small segment of entrepreneurs are high growth oriented, meaning they are pursuing large, global markets with some unique and scalable technology or product. It is these high growth firms which are the largest source of job growth and wealth creation. These firms also tend to be more focused on internationalisation. In fact, many high growth firms, which are often venture-back companies, start with a global strategy from the onset. These firms are often referred to as “born global” or “gazelles”.

By definition, SMEs are “small and medium-sized” enterprises. The most standard classification of SMEs is by number of employees although sometimes revenues are also used. Many SMEs are of a stable size and are content to remain small. Firms in this category include many family businesses, most sole proprietorships and many other micro, small and medium sized firms. While SMEs are clearly a large and critical part of most economies around the world, SMEs differ greatly in their growth orientation. The term “SME”, which describes a firm’s size, is therefore not adequate for measuring entrepreneurship or anticipating internationalisation of firms. Growth orientation as well as both the inclination and ability to internationalise are important characteristics in SME internationalisation.

SME internationalisation

SME internationalisation can take many different forms, including exporting, the creation of alliances across national borders and the establishment of operations or offices in other countries. These approaches, and the ways in which they are implemented, will be discussed in further detail in the following section. This section will focus on opportunities and barriers to SME internationalisations well as motivations.

International opportunities for SMEs

Improved technology and communications have made it easier for firms of all sizes and in various locations to do business with each other. The globalisation of large firms and service providers has provided increased opportunities for SMEs to participate in different parts of the value chain of those companies (OECD, 2004). New and innovative corporate approaches, including more network-oriented operating models, provide more opportunities for SMEs to conduct business with larger firms. Better dissemination of management education and business tools has enhanced the competitiveness and quality of businesses across the spectrum. The reduction of language barriers and lower cost of travel have also facilitated internationalisation.

These factors provide substantial international opportunities for entrepreneurial SMEs, which often have greater flexibility and are better able to internalise market information than large firms (Liesch and Knight 1999). Certainly those firms which are growth oriented can benefit tremendously from pursuing larger and new niche markets, exploiting scale and technical advantages, upgrading of technologies or lowering and sharing costs, including R&D costs. Pursuing international opportunities is also a way of spreading risk and can also improve access to finance. Substantial knowledge and capabilities are also gained in the process, greatly enhancing the competitiveness of the firm.

Barriers to SME internationalisation

Despite the trends facilitating internationalisation, many barriers still exist – both internal to the firm and external. External factors impeding the internationalisation of SMEs include national and international administrative rules and burdens as well as formal and informal trade barriers. Internal barriers for SMEs trying to internationalise can include cultural differences, lack of information or skills, insufficient networks, language barriers and lack of access to necessary finance.

The European Commission's 2003 European Network for SME Research (ENSR) survey identified the most frequently cited barrier by SMEs to be the high cost of the internationalisation process (European Commission, 2004). Such costs include those associated with doing market analysis abroad, purchasing legal consulting services, translation of documents, adaptation of products to foreign markets, and travel expenses, in addition to the higher business and financial risk incurred.

Firm size appears to be a factor. The 2002 ENSR survey showed that fewer firms under 50 people internationalise (European Commission 2003). Clearly, high-growth oriented, "born global" firms are exceptions. The findings also confirmed that the size of the domestic market has an impact: smaller domestic markets drive SMEs, with a specialised or large production, to internationalise.

Many impediments to SME internationalisation may originate at the level of the national economy, institutions, and general infrastructure – related to issues of competition policy, legislative and regulatory frameworks, telecommunications infrastructure, research and education policy (OECD 2005). Resulting challenges can include standards and international compatibility issues, intellectual property protection, political risks, corruption and rule of law issues.

Other perceived and real challenges include heightened international competition from foreign firms. However, by striving to be competitive and responsive to changes in the market, SMEs can survive and thrive both locally and abroad. Also, by working collaboratively with other companies both large and small, SMEs can increase their ability to succeed internationally.

Many internal challenges also create barriers. According to the 2003 ENSR study, a frequently mentioned problem is the lack of an explicit strategy in the initial stages of the business formation. Studies and data have confirmed this hypothesis by demonstrating that most exporting results from unsolicited demands rather than from proactive efforts. Other issues mentioned in the ENSR study included the lack of know-how with respect to international activities, identifying partners and assessing market potential.

The section on policy approaches, later in this paper, will highlight ways in which policy makers and others can help reduce some of these barriers to SME internationalisation.

Motivations and drivers of SMEs internationalisation

Often firm growth is the main goal or motivation of international expansion. The 2003 ENSR enterprise study shows that the primary motivation behind internationalisation is very closely linked to maximising returns and minimising costs in purchasing, production and sales. Secondary motivations included strategic development of the company by gaining access to international competencies, technology and labour as well as capital.

Extensive literature identifies the international orientation of the owner-manager or other key decision makers in SMEs as a key determinant of the nature and extent of internationalisation. The willingness and ability of the CEO, owner manager or strategic leader is seen as dependent on his/her exposure to a range of factors, including existing formal and informal international contacts, knowledge of foreign competitors, experience of foreign cultures, language skills and educational background (Lloyd-Reason *et al.* 2004). Without a strong leadership commitment to internationalisation, SMEs are less likely to pursue cross-border activities.

A recent paper looking at the Cambridge high technology cluster (Myint *et al*. 2005) confirmed the important role of entrepreneurial individuals as drivers of growth, in the case of their research, within clusters. Their findings reveal a core group of Cambridge entrepreneurs as the key influence on the success of the cluster growth process and their links between the companies as the structural and relational social capital (Coleman 1988, Burt 2000).

Segmentation of SMEs by growth orientation

As discussed in the section above, motivation to internationalise is a key factor in SME internationalisation. However, many studies have shown that only a small percentage of SMEs are inclined to internationalise.

According to a study conducted by researchers in the UK (Sear *et al.* 2004), 56% of SMEs sampled across the Eastern part of the UK were simply not interested in internationalising. They had a local or niche market and did not feel the inclination or need to pursue international opportunities. It can be argued that for these SMEs, there is little that policy makers can or should do to encourage internationalisation.

Table 1. International orientation of SMEs

SME segment* (by interest in internationalising)	Characteristics*	Percentage* (of sample of UK SMEs)	Public Policy Interventions	Private Sector Role
Not interested	local niche/market	56%	General policies to support creation of SMEs	Limited
Curious	reactive export/import only	15%	Basic information on exporting	Limited
Tentative	International less than 15% of sales (export/import)	13%	Information on legislation & regulations, culture and finance	Potential partnerships, alliances
Enthusiastic	Pursuing international markets & strategy	10%	Transactional to strategic issues	Potential partners and/or M&A
Successful	High-added value and wealth creating	5%	Policies to support high growth companies, VCs,	Venture capital financing, M&A/IPO

sectors	education

Source: Author's summary of research findings in paper by Sear, Mughan and Lloyd-Reason (2004)

The next set of SMEs in the study comprised of firms which the researchers classified as "curious". This group constituted 15% of the SMEs in the research set. Their interest in internationalisation stemmed more from a reaction to the interests of their existing customers, who themselves might have opened new branches abroad and therefore required services or products in those countries. For this group of SMEs, policy makers and others can assist by providing basic information on exporting.

The next group of SMEs in the study was "tentative" about internationalisation. This group constituted 13% of the study. It consisted of those firms with less than 15% international sales. Policy makers and others can support these SMEs by providing information on legislation and regulations in specific countries as well as information on export finance.

The last two groups were categorised as either "enthusiastic" (10%) or "successful" (5%) in internationalising. The enthusiastic group was pursuing international markets and strategies. Useful support for them would include a range of assistance on transactional to strategic issues, primarily from private sector sources. Also, connections with potential partners or merger and acquisition (M&A) candidates could be helpful.

The final group, the "successful" international SMEs were usually in high-added value and wealth creating sectors, such as high technology or biotechnology. Possible support for these types of companies would include general policies to support high growth companies and venture capital. Education also plays a critical role both on the technical side as well as helping potential entrepreneurs learn how to grow companies. Other private sector firms tend to be very involved with these high growth firms, whether to provide venture capital financing, M&A or IPO expertise (investment banks, law firms).

This study highlights the fact that efforts to support and encourage SMEs to internationalise should be tailored, providing different levels and types of support for each target segment. There is not one policy approach which will suit all SMEs. While it is not always easy to identify which SMEs belong to each segment, providing a range of services and support should help draw SMEs to the right instruments.

In the study mentioned above, more than half of the SMEs were not interested in internationalising and 5% were already doing so successfully. It is the approximately forty percent in between which can benefit most from direct and specific support and policy interventions. Focused efforts and programmes are best spent on those segments of SMEs which have some interest in internationalising. At the same time, policy makers should continue to pursue general policies to support the creation and growth of SMEs as well as reducing barriers to international business and trade as these actions can encourage more SMEs to become interested in internationalising.

The following sections outline various ways SMEs can internationalise as well as policy approaches which can facilitate SME internationalisation.

Methods of SME internationalisation

While the vast majority of SMEs may not be interested or ready to move beyond national or local markets, there are many target segments with higher growth potential who would like to pursue international opportunities but may need help in overcoming various market failures or gaps in order to do so.

International expansion is a significant decision for small and medium-sized enterprises (SMEs) who traditionally have a small financial base, a domestic focus and a limited geographic scope (Lu and Beamish 2002). While some SMEs are “born global”, most lack the resources necessary to internationalise and traditionally they have appeared reluctant to engage in global business activities (Kirby and Kaiser 2003).

However, globalisation, technological advances, improved information flows and changes in organisational structures have facilitated SMEs ability to internationalise and are reflected in their increasingly active role in international markets. In addition to exporting and importing activity, SMEs have increasingly engaged in cross-border strategic alliances, mergers and acquisitions and inter firm networking and collaboration (OECD 2005). In their efforts to innovate, SMEs have increasingly relied on networks, clusters and partnerships which provide access to information, know-how and new technologies.

Traditionally, internationalisation was described as a gradual sequential process of various identifiable stages. Johanson and Widersheim-Paul (1975) found a regular process of gradual change involving the firm moving sequentially through four discrete stages: 1.intermittent exports; 2. exports via agents; 3. overseas sales via knowledge agreements with local firms, for example by licensing or franchising; 4. foreign direct investment in the overseas market. The rationale was that this approach minimises risk and investment amounts required at each point in time and allows for learning and experience gaining before further expansion. It was also observed that firms initially move to countries which are culturally similar to their own (a close psychic distance) and in close geographical proximity (Lloyd-Reason *et al.* 2004).

However, more recent research shows that firms do not necessarily follow any consistent pattern in their internationalisation although the driving forces behind the process remain the same (Benito and Welch 1993). The “New Venture Internationalisation Theory” emphasises the importance of entrepreneurial vision (with the entrepreneur as a central decision-maker in the firm) and the initial resource endowment of the firm in facilitating early internationalisation decisions (Autio and Sapienza 2000). This is especially essential in knowledge-intensive industries (McDougall *et al.* 1994, McDougall and Oviatt 1996).

It has been shown that the older a firm, the more established the routines and practices, and the higher level of organisational inertia and the more resistance to pursuing internationalisation (Lu and Beamish 2002). This research showed a “learning advantage of newness” for SMEs who internationalise at comparatively young ages. They concluded that the sooner the internationalisation, the easier the learning in the international environments, the faster the firm growth.

Context is also important. Certainly, internationalisation was different in the 1970s, than it was in the 1990s or than it will be in 2010. Economic, political and regulatory environments change as do the types of firms and management approaches.

Below are the various approaches to internationalisation, which we will look at in turn in the following sub-sections.

- Import/export.

- Strategic alliances/joint ventures.
- Foreign direct investment (FDI).

The table below highlights some potential advantages and disadvantages of each form of internationalisation.

Table 2. Comparing methods of internationalisation

	Exporting	Alliances	FDI
Benefits	▪ Relatively easy, fast	▪ Requires limited resources and market knowledge	▪ Increased firm competitiveness and growth
	▪ Low investment cost/commitment		▪ Location-based advantages
	▪ Flexible		▪ Development of new knowledge and capabilities
	▪ Lower risk		▪ Minimises transaction related risks
Challenges	▪ Possible lack of alignment with foreign sales agents	▪ Identifying the right joint venture partners is critical	▪ Complex, time consuming
	▪ Tariff and non-tariff trade barriers	▪ Structuring effective partnerships can be tricky	▪ High investment/commitment
	▪ Cost of transportation of goods		▪ Least flexible approach
			▪ Higher risk

Source: Author with reference to paper by Lu and Beamish (2002)

Import/export

While importing and/or exporting are the easiest and usually the first steps to internationalisation, only a small majority of SMEs are currently doing so. Many SMEs begin by importing goods from foreign suppliers and only start exporting in response to intermittent needs and demands (European Commission, 2004). Many other studies support those findings, including the UK study reviewed earlier, which showed that many firms begin exporting "reactively" based on the needs of existing customers rather than "proactively".

Table 3. SME internationalisation

Frequency of different types of internationalisation	Percentage of total (Europe-19) SMEs
Importing (foreign suppliers)	30%
Exporting	18%
Foreign collaborations	3%
Foreign subsidiaries or branches	3%

Note: The above percentages cannot be summed, since individual companies may figure in several categories.

Source: European Commission, 2004.

By selling directly or through sales agents to clients in new geographic markets, a firm broadens its consumer base and can potentially achieve a higher sales volume which provides the possibility of a higher production volume and expansion in production capacities to meet the market demands (Lu and Beamish 2002). Exporting is a relatively fast, easy and flexible way to enter foreign markets with low commitment and risk. It enables SMEs to respond quickly to changes in various markets, either reducing or expanding activities. It is easier to implement than other internationalisation approaches, such as creating alliances or setting up operations in foreign countries, which can be complex to structure and implement. The downside to exporting includes exposure to tariff and non-tariff trade barriers and the potential lack of alignment between the foreign sales agents and the SME.

Studies have shown that most import and exports are with neighbouring countries. ENSR 2002 research results showed that, within the Europe-19 countries surveyed, neighbouring countries constituted the easiest and most frequent business partners. A study of the internationalisation process in four European transition countries (Lloyd-Reason *et al.* 2004) showed that the first recipient country selected for export is often due to "previous contacts". In addition, collaborative alliances of various types with overseas companies are usually with those already active in the country.

Strategic alliances and joint ventures

Another way for firms to internationalise is through strategic alliances and joint ventures. Benefits of these alliances include access to financial resources, pooled research efforts, product development and wider distribution channels. Alliances are becoming increasingly important as international competition drives specialisation and the trend for larger companies to increasingly outsource activities (OECD, 2005).

Joint ventures enable SMEs with limited productive resources and/or market knowledge to enter international markets. Alliances and networks can take many forms including joint research and development, manufacturing, marketing, sourcing of inputs, or co-operation on distribution. However, research conducted by Kirby and Kaiser reveals that initiatives appear to have been successful but that they are not without their problems and in many ways the experiences of SMEs involved seem similar to those of the large multi-national enterprises. They argue that the key to success appears to be the choice of the joint venture partner and concludes that, given the limited resources of small firms, assistance is required to help them locate and select appropriate partners (Kirby and Kaiser, 2003).

Clusters and networks

Operating in international markets demands resources, experience, skills and knowledge many of which small businesses often lack. For SMEs, one way to acquire these skills is to cooperate with other small firms (Nummela, 2002). Although smallness is usually related to some advantages, such as flexibility and innovativeness, it also creates some problems that can be significant obstacles to internationalisation. These problems may be based, on insufficient financial resources, skills of how to operate on foreign markets or knowledge of the markets. By co-operating with other internationalising SMEs the partners could use their sparse resources more efficiently, divide costs and risks related to foreign markets, obtain information and learn new skills which are needed in the foreign markets.

Clusters and other networks can help in developing and securing international alliances by increasing productivity, innovativeness and competitive performance of local firms, creating a more efficient division of labour between enterprises and facilitating joint development and marketing initiatives. These networks – which can include vertical supply-chain relationships and horizontal clustering – also have enormous potential. Networks link entrepreneurs with potential sources of financing, human skills, partners, suppliers and information. Through such networks entrepreneurs share information and assessments of broader cooperation. Benefits include (UNDP 2004):

- Enabling the transfer of skills, technology and quality.

- Ensuring that foreign direct investment has positive spill over effects.
- Bringing companies into the formal sector.
- Creating the capacity to govern transactions through commercial contracts.
- Opening markets and the supply of inputs to smaller firms through networks of larger partners.
- Improving the ability of small and medium sized enterprises in such networks to get financing on commercial terms.
- Increasing the choice and lowering the prices for consumers by bringing a greater variety of goods to the market.

Foreign direct investment (FDI)

Foreign direct investment can be a better way to achieve firm growth, although for most countries, only a small fraction of SMEs have established subsidiaries abroad (OECD 2005). Outward FDI, or the establishment of a subsidiary or branch abroad, allows a deeper penetration of the foreign markets which can result not only in an increase in sales but also in the gaining of knowledge and technical expertise which might not have been possible from the firm's home base. Inward FDI also provides opportunities for SMEs by serving as a vehicle for SMEs to access international markets by joining value chain of multinationals as well as providing an efficient way to diffuse technology and better business methods for SMEs to enhance their international competitiveness.

Outward FDI by SMEs generally occurs after successful experience gained in exporting and/or forming alliances. The ENSR 2003 survey showed that only 3% of SMEs in Europe have subsidiaries, branches or joint ventures in other countries (countries in the survey ranged from 0.5% to 10%). High growth "born global" firms normally have this integrated in their strategy from the beginning.

Box 1. Outward FDI

Exports and outward direct investment have often been characterised as alternative strategies. Firms can either produce at home and export, or produce abroad and substitute local sales of foreign affiliates for exports. It is not surprising, therefore, that there are concerns that outward direct investment may lead to loss of investment, exports and employment from the home economy, leading to a "hollowing out" of domestic industry. Recent economic research, however, casts doubt on these assumptions and suggests that outward direct investment is beneficial to the home economy under certain conditions. For example, by enabling multinationals and their domestic suppliers to expand into new markets and to gain access to new technologies, "horizontal" outward direct investment can secure well-paid jobs in the home economy. "Vertical" outward direct investment can facilitate a restructuring of industry in the home economy up the value-added chain by moving some labour intensive production processes overseas to more cost competitive locations, allowing the domestic operations to concentrate on "strategic" high value-added activities that pay higher wages.

Source: OECD, 1998

There are multiple ways in which SMEs can invest abroad. Certainly, the firm can build a subsidiary or branch from scratch. Another option is to invest through a merger or acquisition (M&A). By either purchasing or merging with an existing company, the SME can gain immediate access to foreign markets, along with an established market presence and an experienced management team. However, there can be significant integration issues, including some initial misalignment of objectives and operational procedures.

SMEs face considerable barriers when attempting to engage in FDI given their limited financial, managerial and information resources and their attitude to risk, however, such limitations can be overcome. Similar to exporting, FDI broadens a firm's customer bases through entering into new markets, enables the firm to achieve a larger volume of production, and grow. In addition, FDI provides further benefits which can lead to sustainable growth of firm, including contributions to the development of new knowledge and capabilities by providing access to various location-based advantages.

POLICY OPTIONS

The role of government

The entrepreneurial ecosystem generally includes micro, small and medium sized companies, multinational corporations, local chambers of commerce, associations, cooperatives, foundations and network of individuals. It also includes local government, universities and other research organisations, banks and financial systems. For the whole system to function well, trust is a key component. For maximum benefit, all of these sectors need to work together in a coherent and collaborative way.

Local governments and development agencies are very active in the design and delivery of entrepreneurship programmes, including promoting exports and internationalisation. Given their proximity to SMEs, local governments should be empowered by national governments to take the appropriate, targeted actions for promoting the growth and internationalisation of SMEs. The work of specialised agencies geared towards supporting and promoting SMEs also plays a very important role in SME internationalisation. These agencies often supply valuable information, provide critical networking platforms and allow for the exchange of ideas and best practice.

Public policies are critical to providing the right environment and incentives at the national, regional and local levels. However, the role of the government should be facilitative, not dictatorial, and public financial support should never be more than 50%. Most top-down prescriptions do not yield the intended results. Also, too much public financial support, without co-investment by the private sector or market, can hinder rather than help by creating possible market distortion. As mentioned earlier, these SMEs must be market-driven and competitive. If they are overly dependent upon public support, they surely will not be sustainable.

The environment is constantly changing as are the opportunities for SMEs. Governments, specialised agencies, academia and others supporting SMEs also need to modify approaches as necessary, being entrepreneurial themselves, based on the changing context otherwise their efforts end up addressing problems of the past and therefore inefficient in dealing with current and future issues.

Range of policy approaches

While there are multiple actors and many potential areas for action, there are no standard products or approaches that will work in every circumstance. As a first step, data is needed about the SME population in a given country or region before the appropriate actions or policies can be developed. Once the SMEs are identified, they should be segmented, not just according to size and industry, but also according to growth orientation.

Further assessment is then required to determine the needs of those groups of SMEs. At that stage, it is important to reach out to the SMEs and to hear directly from them regarding the challenges and opportunities they face. Effective dialogue between policy makers and SMEs is often less than desirable. SMEs have varying needs and managers have limited time. Support and interventions therefore need to be both targeted and of good quality.

There are a number of areas in which actions can be taken to reduce the barriers to conducting business abroad and, in fact, many efforts are already in place or being tested in various countries and regions. Below is a list of key areas for action and associated policy recommendations for addressing the market gaps that impede the internationalisation of SMEs.

Creating an openness to internationalisation

To create a culture of internationalisation there needs to be a positive attitude towards international markets. Public institutions play a key function in influencing attitudes and motivations by providing information and incentives. Specialised agencies, public-private partnerships and other support mechanisms create a context of social cohesion which can contribute to positively to building and sustaining an entrepreneurial and internationally focused environment.

As seen in many regions and clusters around the world, pioneers or champions play an important scouting role which can often later be leveraged by the whole local system. In addition, role models are important for changing attitudes and raising awareness. Examples should be made and publicised of local entrepreneurs who have been successful in internationalising.

Strategy formulation in small firms tends to be a less formal and less comprehensive process, with key decision makers taking contingency-based decisions derived from the practical knowledge they hold. Programs specifically focused on further developing the international orientation of leaders and key decision makers in SMEs could be extremely valuable (Lloyd-Reason *et al.* 2004).

Encouraging entrepreneurs to learn foreign languages is also critical. Without the ability to communicate, there is little chance that any business can be conducted across borders.

Making information about international trade and business readily available

SMEs need to know how and where to access basic information about exporting and international trade. Providing easily accessible information with regard to specific information on tax, regulations and finance in foreign countries is therefore important in creating a broader pool of SMEs who decide to internationalisation.

Encouraging the provision of targeted and quality business support services

A variety of business support services are provided by various players, both public and private. These included counselling, consulting and competence development through functional workshops and related activities. However, the quality of those programs is mixed and the content varied. Also, awareness of these programs is low. In addition, many of these programs focus too heavily on exporting, rather the range of internationalisation options available to SMEs (European Commission, 2004).

Areas in which SMEs wanting to internationalise often seek outside support include: technology, product standards and quality; access to, and use of, information related technologies; export directed training programmes; legal and accountancy services with a specialist export orientation; finance and marketing. However, there is concern that SMEs have resorted to using such services in a haphazard and ad hoc manner, reflecting the particular needs perceived at any given point in time by the key decision makers themselves rather than using such support services as part of a strategic approach to internationalisation (Lloyd-Reason *et al.* 2004).

Perhaps some type of modular, accredited programs could improve not only the quality of these functional programs, but also their use among SMEs by providing clear modules, perhaps even with certifications. In addition, there should be some quality measures, benchmarks, standards or minimum satisfaction ratings for these functional programs to ensure they are meeting the needs of the SMEs. Charging fees is one way to ensure that the product is meeting a demand.

Reforming education

In order to help prepare SME to access foreign markets, public authorities have recognised the importance of fostering competitiveness and productivity through training, modernisation of production equipment and methods and technology transfer. Education plays a key role, both immediate technical and managerial training.

Longer term improvements in educational systems and teaching methods (from “rote” method to more creative, interactive learning methods). The World Employment Report (ILO, 2001) highlights the increasing importance of ‘…a variety of foundation skills, such as the ability to learn, to communicate and to analyse and solve problems, all of which are essential to work environments that rely on rapid innovation, and the interpersonal exchange and creation of knowledge’.

Governments and universities have begun to put educational reform high on their agendas. Universities in Europe are undergoing tremendous change through the implementation of the Bologna agreement which is creating more standards between institutions of higher education. However, curriculum content must be rapidly overhauled as well and geared towards developing problem-solving skills which are greatly need in today’s knowledge based society.

In addition, many technical and scientific universities have been establishing contacts with the private sector to build partnerships and links to promote technology transfer and the spin out of new companies. Business schools are also increasingly integrating business people and entrepreneurs in their activities.

These changes are steps in the right direction but more needs to be done to foster an entrepreneurial and international mindset amongst students, who will become the workforce of tomorrow. Universities should formalise entrepreneurship as an important part of the curriculum and ensure students are exposed to all of the entrepreneurial growth phases, not just the start-up phase. There should be more international content within the curriculum as well as faculty with international experience themselves. On the later point, more must be done to facilitate faculty collaboration, exchanges and research across borders (Twaalfhoven and Wilson 2005). Apprenticeship has always played an important role in training and development. Creating internships for young people to work in foreign countries could be useful as well as targeted training programs for groups of entrepreneurs, focused on development of management capabilities.

Building of networks (cross sector and cross border)

Many support measures exist to help SMEs to link up with and engage in joint activities and ventures with overseas partners. These include corporate matchmaking services, customised market research intelligence and assistance with standards and quality issues. Also, the creation of networks in which entrepreneurs can come together for advice and mutual support is important. This provides an opportunity for shared learning about successes, failures and best practices. Regional development agencies and other related organisations are playing important roles in initiating opportunities for SMEs to establish cross border networks.

- Possible public policies to promote alliances and networks among SMEs include:
  - Improve SMEs access to information about networking opportunities.
  - Encourage co-operation between all stakeholders: SME associations, public agencies and intermediary organisations.
  - Strengthen international linkages between national and regional hubs of relevant information flows.
- Increase the participation of SMEs in research and innovation networks.
  - Greater SME involvement in existing (regional, national and global) public-private partnerships.
- Support the emergence and maintenance of innovative clusters.
  - Stimulate collaboration between public and private research institutions.
  - Improve the availability of market information.
  - Strengthen co-operation among firms.
- Identify and promote best practice policies which support company innovation through cluster development.
  - Exchange experiences at the national and international levels.

Providing financial incentives and assistance.

Public sector agencies provide specific tools such as grants for the commercialisation of products as well as financial and insurance support. Export credit insurance continues to be provided widely as well as other traditional types of trade-related support such as assistance for participation in international fairs and trade missions (OECD 2005). Another policy measure is to support export consortia, to make available special funds to finance SME presence in international markets, or to favour access to credit on favourable conditions for international SME activities.

Supporting the development of a vibrant financial and venture capital community is also critical to the long-term sustainability of SMEs and high-growth oriented and internationally minded entrepreneurs. Measures should be taken to address the primary funding gap, which is at the seed or early stage of new ventures.

Cutting the administrative burden of cross border activities.

As seen earlier in this paper, administrative costs and burdens is one of the leading barriers for SME internationalisation. An OECD background report (OECD 2004) prepared for the Istanbul SME Ministerial Conference recommended that governments encourage the smooth, cross-border growth of SMEs by reducing the need for internationally active SMEs to comply with multiple sets of rules or requirements.

Important areas in this regard include standards, intellectual property rights, financial market regulations and other regulatory domains.

Encouraging trade and investment.

The benefits of trade are well documented. So are some of the barriers to trade. Tariffs, quotas and distance from large markets greatly increase the cost of goods, sometimes enough to prevent trading completely. Global and regional agreements have lessened these barriers but more reform is needed (World Bank, 2005).

The OECD (2004) recommended that governments promote the role that foreign direct investment can play as a vehicle for SMEs to access international markets. In particular, the inclusion of local SMEs in the supply chains of multinational enterprises, and their resultant (indirect) involvement in exporting activity can lead to significant diffusion of technology and more efficient business models, thereby raising the international competitiveness of SMEs.

Proactive targeting of potential sources of inward FDI is increasingly seen as an important element of regional development strategies, especially in supporting export orientation, employment levels, technology transfer and cluster developments amongst SMEs in the region (Lloyd-Reason *et al.* 2004).

Policies on outward FDI have three levels: capital account liberalisation; passive promotion, usually through bilateral investment treaties and double taxation treaties; and active promotion. In the last area, even in the largest developed home countries (United States, United Kingdom, Japan, Germany etc.), outward FDI requires and receives active public assistance (UNCTAD 1999). This is usually in the form of an outward investment promotion agency, a development finance institution, or an investment guarantee scheme. Their services cover a wide range of areas, including information and promotional services, feasibility studies, project development, financing and guarantees (European Council 2002).

Reinforcing the legal framework.

There should be a level playing field between old and new firms. This can be done by protecting IP and discouraging monopolies and unfair trade practices. Developing nations must resist pressures from existing businesses to preserve markets and prevent innovation (Schramm 2004). In term of intellectual property rights, SMEs lack a good working understanding of the system and consequently under exploit current forms of IP protection.

In transition countries, enforcement of the legal framework is critical. Policies need to be consistent and equally applied. Otherwise, many SMEs will continue to operate “under the radar screen” in the informal sector.

THE SOUTH EAST EUROPE CONTEXT

SME internationalisation in South East Europe

The 2003 South East Europe (SEE) Regional Enterprise Policy Performance Assessment (OECD-EBRD, 2003) specifies that small and medium-sized enterprises (SMEs) play a crucial role in the transition processes in South East European countries. However, securing accurate data on SMEs in transition countries is extremely difficult due to both a paucity of accurate statistics as well as the high incidence of SMEs operating in the informal economy. Regardless, there is broad agreement that while the current contribution of small and medium sized enterprises (SMEs) to the internationalisation process in transitional economies is understated, there is also a consensus that much untapped potential exists (Lloyd-Reason *et al.* 2004).

Integration with Europe provides many incentives for countries in the region. Croatia began full membership talks with the EU in October 2005 and both Serbia and Montenegro and Bosnia Herzegovina began preliminary stages which should lead to talks. In December 2005, FYR of Macedonia gained formal status as a candidate. Talks with Albania continue. Meanwhile, various economic deals have been done between the Balkans and the EU (The Economist, 2006). While providing access to an enlarged economic area, EU enlargement will also require SMEs to face a more complex and dynamic environment which will require greater competitiveness in terms of improved quality, efficiency and management practices (Szabo, 2002).

As might be expected, competitiveness in the region is currently lower than in the rest of Europe (World Economic Forum 2005). The highest scoring country from the region was Croatia, which ranked 63 in the overall Business Competitiveness Index but was behind all of the EU countries, including the ten new members. Romania and Bulgaria followed at overall BCI ranks of 67 and 78 respectively.

Table 4. 2005 Competitiveness rankings

	Slovenia (EU)	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Albania	FYR of Macedonia	Bulgaria	Romania	Moldova
Business (BCI)	32	63	94	86	112	83	78	67	93
Growth (GCI)	32	62	95	80	100	85	58	67	82

Source: World Economic Forum Competitiveness Report 2005 (116 countries ranked. Results based on in country responses to surveys)

The 2006 Doing Business (World Bank, 2006) report ranks the overall ease of doing business in countries around the world. As a benchmark for the ease of importing and exporting, the table below compares the number of days it takes for each. Interestingly, it takes more days to import than export.

Table 5. 2006 Doing business statistics

	Slovenia (EU)	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Albania	FYR of Macedonia	Bulgaria	Romania	Moldova
Overall ease of doing business (ranking)*	63	118	87	92	117	81	62	78	83
Importing (days)	24	37	43	44	38	35	24	28	35
Exporting (days)	20	35	32	32	37	32	26	27	33

*Ranking has been obtained on a total of 155

Source: Doing Business in 2006 (World Bank & IFC)

While progress has been made in SEE countries, much remains to be done to maximise the potential contribution of SMEs to new jobs, growth, productivity, and competitiveness. Strategies, plans and newly established agencies focusing on SMEs require both resources and a commitment to implementation with coordination at the national, regional and local levels. The 2003 SEE Regional Enterprise Policy Performance Assessment (OECD-EBRD, 2003) identified six key areas which are critical to developing a supportive environment for small businesses. These include an institutional framework for SME policy, rule of law and the regulatory environment, tax policy for small businesses, financial instruments for fostering small businesses and advisory services supplied to new and small businesses. Until a basic framework is in place, it will be difficult for SMEs in the region to thrive, much less to internationalise.

Imports, exports and FDI

Currently, very few SMEs in the region are international but the situation is changing. As seen in table 6 below, the growth rates of imports and exports in the South East Europe countries have been strong. The rapid growth in exports mainly reflects strong foreign demand, but also could indicate a better access to the markets as a result of EU enlargement of the new EU member countries. Under the Stabilisation and Association Process arrangements, 80 percent of exports from the Western Balkans benefit from free market access to the EU. Some of those countries did not have prior preferential trade agreements, only MFN status, with the countries that acceded to the EU in May 2004 (UNECE, 2005).

Table 6. 2003 growth rates in imports and exports (rates of change and shares, per cent)

	Slovenia (EU)	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Albania	FYR of Macedonia	Bulgaria	Romania
Imports	26.7	32.4	22.1	18.8	24.1	15.3	35.9	34.4
Exports	23.3	25.7	35.4	11.5	35.2	22.2	30.7	27

Source: Economic Survey of Europe, UNECE 2005, p.93

From the mid-1990s, *inward foreign direct investment* (FDI) was gaining importance in an increasing number of CEE countries, reinforcing a successful reintegration of these countries into the world economy. *Outward FDI* has not yet reached a level similar to that of inward FDI, although official statistics on FDI may underestimate the real size of outward FDI. What is available usually confirms the young status of those investments. In most CEE countries, outward FDI seems to be hampered by a lack of management skills and know-how necessary to undertake investments abroad and to run a foreign business venture successfully (UNCTAD, 1996), when compared to those of Western firms. In the longer run, outward FDI from CEE is likely to gain in importance as accession countries are expected to lose comparative advantage in simple manufacturing (assembly) operations based on low wages (European Council, 2002).

Table 7. South East Europe: FDI flows 2004 (as percentage of gross fixed capital formation)

	Croatia	Bosnia & Herzegovina	Serbia & Montenegro	Albania	FYR of Macedonia	Bulgaria	Romania	SEE REGION
FDI flows								
Inward	11.4	29.7	24.6	26.0	16.2	49.2	31.7	27.6
Outward	*3.3*	*0.1*	*..*	*..*	*0.1*	*-4.5*	*0.4*	*0.5*
Performance index*								
Inward	33.0	**	**	42.0	72.0	12.0	35.0	
Outward	*32.0*	**	**	*103.0*	*98.0*	*125.0*	*77.0*	

*FDI performance index covering 140 and 132 economies respectively

**Not covered by the survey.

Source: World Investment Report 2005

A look at the western Balkan countries

Croatia

The EPPA of Croatia (OECD-EBRD, 2005a) reported that, in overall terms, good progress had been made in setting out and beginning implementation of new policies to support the growth and development of SMEs. Croatia developed a well articulated and far reaching enterprise policy framework and launched a series of initiatives directed at providing financial and operational support to SMEs, at national and regional level. During 2004, Croatia launched new financial facilities for SMEs and refinanced existing ones, introduced new e-government schemes and endorsed the ‘one stop shop’ concept as a way to speed-up regulatory simplification.

Bosnia and Herzegovina

In the years since the war, Bosnia and Herzegovina has faced numerous transition challenges such as the establishment and development of a democratic society and the return of refugees and displaced persons at the same time as a transition to a market economy. According to the EPPA of Bosnia and Herzegovina (OECD-EBRD, 2005b), the authorities of the country are increasing the levels of support to the SME sector with the creation of SME-oriented organisations at national, regional and local levels and the approval of the Development Strategy Framework and the Interim Poverty Reduction Strategy Programme, both having an important private sector development focus. Recent legislative and regulatory changes have been implemented simplify and improve the business environment.

FYR of Macedonia

In recognition of the growing importance of SMEs to the national economy, the Macedonian authorities are increasingly supporting the SME sector (OECD-EBRD, 2003a). This political support is reflected in developments such as a programme to stimulate domestic and foreign investment, a strategy to support entrepreneurship and competitiveness of SMEs, a new Agency to support of entrepreneurship and competitiveness and a co-ordinating Council for Entrepreneurship and Competitiveness, which includes participants from relevant ministries, private sector and other SME stakeholders.

Serbia and Montenegro

The EPPA of Serbia and Montenegro (OECD-EBRD, 2005c) indicates that the country has made progress in implementing better policies for the SME sector. The overall picture is that of a gradual, but limited and uneven progress over the broad spectrum of the policy dimensions outlined by EPPA. As might be expected, few SMEs in the country are international. Challenges include the lack of competitiveness of domestic enterprises, products and services, the need to modernise production, processing, packaging, and to find new ways of selling and the necessity to adjust standards and other quality regulations to those of the EU. Understanding of legal regulations, especially in the areas of tax policy and custom duties is also important.

Albania

According to the EPPA of Albania (OECD-EBRD, 2004), SMEs make up the vast majority of private businesses in the country but most firms do not yet possess the required skills to compete with western European markets and are facing a number of constraints that, if not addressed, will continue to prevent the SMEs from achieving their full potential. Poor law enforcement, very weak corporate governance, both at the macro and at the enterprise levels, a lack of management skills, as well as underdeveloped banking systems and crumbling infrastructure, constitute major impediments to the development of the private economy and the attraction of foreign direct investment (FDI).

According to the Regional Development Agency (RDA) in Albania, the procedures for start-ups are still complicated and the labour market policy needs further improvement as does the legal and institutional environment. The informal economy remains high, around 30-40%, according to estimates by RDA. Challenges for SME integration in regional and European markets include: quality standard of products & competitive prices; specialisation of less sophisticated products based on competitive advantages; investments in traditional, local products with export potential; focus on marketing channels & export strategies; better use of the economic potential of expatriate communities; use of SME clusters in the SEE region combined with domestic market needs; investments in high technology to replace old technologies; transfer of know-how, amine to a better access of foreign markets.

Regional networks and international development activities

Clearly regional networks and links to EU are tremendously important for the internationalisation and development of the region. In addition, it would be helpful for SMEs to collaborate more with each other to maximise the chance of success. The authorities in the region are increasing the levels of support to the SME sector, in recognition of its growing importance to the national economy. This political support is manifested in developments such as the creation of SME-oriented organisations at national, regional and local levels. These include ministries and specialised agencies geared toward SME development, which can also play important roles in SME internationalisation.

In the box below are some examples of efforts being undertaken by various organisations in the region to encourage the growth and internationalisation of SMEs.

Box 2. Key organisations promoting internationalisation in SEE

SMECA. Smeca is an export credit agency which has as its mission to support sustainable economic growth in Serbia and Montenegro, increase the level of export activities and reduce the deficit in the balance of payments. SMECA does so by providing domestic enterprises with the necessary financing, security and technical assistance to gain market share and enter new international markets. Exporting is supported through export credit insurance, working capital loans and guarantees, exporter performance insurance and guarantees, factoring, import insurance and guarantees and consulting services. Import is supported through political risk insurance and import insurance and guarantees. Further information can be found on www.smeca.cg.yu.

RDA. The Regional Development Agency (RDA) in Albania launched the PPC Program, a qualification program for junior executives and young professionals in SEE countries designed to help companies enhance their business performance. The program is geared towards companies who want to export their goods and services as well as those looking to establish cooperation with foreign partners. So far, the program has yielded good results. Key components of the program include the focus on export-oriented entrepreneurs, providing capacity building and training as well as the charging of fees to ensure market relevancy and continuity.

Montenegro Business Alliance. The Montenegro Business Alliance (MBA) was founded in 2001. It is a coalition of more than 400 Montenegrin companies, entrepreneurs, business associations and international companies representing over 25% of GDP in Montenegro. The main activities of MBA are advocacy on the business agenda, promotion of MBA members, education, seminars and conferences. One of these activities is called “Business to Business”, which are a series of events to renew economic relationships between SEE countries, organised in coordination with similar organisations from other countries). For more information see www.visit-MBA.og

CEED. The Center for Entrepreneurship and Economic Development (CEED) in Serbia and Montenegro was established in1993. The goals of CEED are to improve the business environment and promote it regionally as well as around the world, to change the mindset of the people by introducing best practices and promoting successful case studies and to raise a new generation of entrepreneurs. The primary services offered by CEED include 1) research, economic surveys and SME database development 2) policy analysis and recommendations 3) business consulting services 4) business plan development for aspiring entrepreneurs 5) basic and advanced business training for start-up and established firms 6) support for women entrepreneurs 7) publishing. CEED’s initial efforts have focused issues such as time consuming and expensive business registration processes, high taxes and levies, lack of competitive knowledge and modern technology and the gray economy. For more information, see www.visit-ceed.org

CONCLUSIONS AND POLICY RECOMMENDATIONS

In conclusion, there are two broad areas in which policies can support the internationalisation of SMEs by addressing existing market failures:

1. Creating the right framework conditions.
    a. Legal and regulatory.
    b. Trade and investment.
    c. Education, training and culture.
2. Supporting specific SME policies and initiatives.
    a. Reducing the administration burden of cross border activities.
    b. Supporting appropriate financial instruments.
    c. Facilitating quality advisory services for new and small businesses.
    d. Encouraging networks (local, regional, international).

These were discussed in further detail in section 3.2. The contextual issues need to be dealt with at the national and international levels while the specific policies and services are best handled at the national and local levels.

For the countries in the SEE region, SME policies are being put in place and specific initiatives are increasingly being supported. Intermediaries are being established to help in this process. These include specialised agencies, NGOs and private sector organisations. At the same time, progress is being made on improving the framework conditions, which clearly must be in place in order for the economy and SMEs to thrive and grow.

For countries with sufficient framework conditions in place, focusing support on specific activities and services is important to encourage SMEs to internationalise. This includes providing the necessary information to help SMEs internationalise, including detailed information about doing business abroad as well as training and information about the various ways to internationalise. It also includes providing financial incentives and assistance as well as facilitating networks at the local, regional and international levels. The service providers should be in close dialogue with SMEs to understand their specific needs and the services should be targeted appropriately to each market segment.

Policy makers should focus on reducing the administration burden of cross border activities, facilitating both import and exports and encouraging collaboration between SMEs and larger firms, both locally and internationally.

Globalisation is a reality, not a trend or a fad, and it is driving internationalisation in all markets, including at the local level. Globalisation brings new challenges but also provides unprecedented opportunity to rejuvenate old businesses, grow new ones and to create new jobs (Kanter, 1995). There are challenges in going global but the risks are even greater in waiting for globalisation to reach the local market and having to deal reactively with the consequences.

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