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ODI's Submission to the European Commission Consultation

"Strengthening the role of the private sector in achieving inclusive and sustainable growth in developing countries"

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Key messages

- ODI's Private Sector and Markets team believes that the European Commission should address private sector core issues including access to finance, training and better integration of SMEs in local and international markets, as well as ensuring that businesses operate as efficiently as possible. The business regulatory environment should be a key component of a holistic private sector strategy.
- Issues with regard to using the private sector as a service delivery channel or the implementation of inclusive business practices, may then be considered.
- Businesses increasingly want to understand, measure, communicate and improve their development impact, often driven by the imperative of 'sustainable business' rather than 'development' per se.
- ODI's Private Sector & Markets Programme provides conceptually robust and practical solutions that promote market-led development.

Introduction

Is the European Commission addressing the 'right' issues?

The European Commission's "Issues Paper" touches on some of the most relevant topics in private sector development. It addresses key questions such as finance, skills training, green growth and support to small and medium-sized enterprises (SMEs), as well as important follow-on issues such as inclusive business and the private sector as a delivery channel. However, we feel that the paper would benefit from a greater focus on the business regulatory environment, which we believe should be a key component of any private sector strategy. An effective business regulatory environment ensures effective growth of private enterprises by setting up clear and transparent rules and regulations, helps to provide incentives to set up systems and institutions that private actors require (such as good market information systems and an efficient financial sector), and helps create effective market and communication linkages between companies, civil society, governments and the private sector. These systems are also necessary for efficient and sustainable delivery of services through the private sector, such as healthcare or education.

What components should the European Commission focus on in the Communication?

European Commission efforts should primarily focus on access to finance, training and better integration of SMEs in local and international markets as well as on ensuring that businesses operate as efficiently as possible (for example, by adopting green production practices). Secondarily, issues such as using the private sector as a delivery channel and inclusive business should be addressed.

ODI & Private Sector Development

ODI has a strong track record of work on the private sector. Work in the field is led by the institution's Private Sector & Markets (PSM) programme which is staffed with experts from business, donor organisations, and academia. PSM's expertise on development issues as well as sustainable business puts it in a strong position to offer in-depth advice to companies on the opportunities and risks faced in developing countries. The PSM programme and related ODI teams have worked on a wide range of relevant issues, including the impact of multinationals on developing countries' economic growth, social entrepreneurship, state fragility, and natural resources. It has also worked with several large UK and international corporates to increase understanding of development impact and identify viable ways to improve, including measuring and communicating the impact of business activity, analysing the impacts of various ethical and development-related trade initiatives, assessing the supply chains of large organisations sourcing supplies from developing countries to improve development impact and working on innovative models for engagement between business and donors.

Responses to the Questions

Stepping up EU Support to (M)SMEs

Question 10: What best practices in SME support are available in the EU that could be relevant in development cooperation? How can EU SME internationalisation policies contribute to the achievement of development goals?

Given the extent to which multiple EU SMEs have grown over the last five decades, there is enough scope to share EU experiences with developing country micro, small and medium enterprises ((M)SMEs). The EU has set up a number of successful initiatives that could be replicated within developing countries, either at the national level or regional level. These include:

- The Competitiveness and Innovation Framework Programme, which can help foster innovation, improve energy efficiency and support the uptake of information and communications technology (ICT) in (M)SMEs.
- The EUREKA network, in order to create links between (M)SMEs and research and development (R&D) institutes.
- The High Growth and Innovative SMEs Facility – the GIF Facility – which aims to help (M)SMEs achieve high growth and take part in innovative commercial activities, as well as establishing and financing SMEs through the provision of risk capital.

The EU is currently implementing regulatory measures such as improvements for SME access to capital markets and better visibility of SMEs within (i.e. making more information available on the role, health and needs of SMEs in the EU, as well as the opportunities and challenges they face). The EU also closely monitors SME lending which helps to identify their financing needs subsequently adjusting financial institution capital requirements that are earmarked for SME loans. The experiences from these systems can be studied and best-practice, technical support and institutional strengthening (or building) can be applied to developing countries.

Question 11: How can domestic firms and industries in developing countries be better integrated into global value chains? Can global value chains function as a source of economic governance in fragile and post-crisis countries?

Integration into the global value chain system for (M)SMEs hinges on the ability to competitively produce goods and hire skilled labour, multinational supply chains that support the inclusion of (M)SMEs, the ability to access international markets and the capacity of (M)SMEs to access sources of investment finance. Whilst programmes such as Aid for Trade can help improve market access and competitiveness, there is more scope for the EU to help improve access to finance for SMEs. Current work being done by multiple Development Finance Institutions (DFIs) across Europe (such as the German Investment and Development Corporation, DEG, the Dutch Development Bank, FMO or the UK's Commonwealth Development Corporation, CDC) already channels finance towards financial institutions that target SMEs in developing countries. In order not to duplicate Member State efforts, there is scope to intervene at the regulatory level. This would entail helping developing countries set up credit rating agencies, setting up programmes to improve business skills and financial literacy for SME owners and managers, or providing training and financial incentives to developing country financial institutions to allow them to offer financial training to SMEs as part of their core product offering. The EU can also provide technical assistance to commercial finance institutions in developing countries that cater to (M)SMEs in order to mitigate any negative impacts on SME lending (which is already considered to be risky in certain markets) from international frameworks such as the Basel 3 Agreement.

Question 12: Which instruments could the EU use to promote innovation, technology development and transfer, and to ensure learning opportunities and the adaptation of new technologies in developing countries, including clean and low-carbon ones?

A number of EU Member States already promote innovation & technology development and transfer in developing countries through their business partnership programmes. These programmes link small and medium companies in EU countries to small, innovative, enterprises in developing countries. The benefits are twofold: (1) access to markets (in both directions); and (2) technology transfer towards low income country SMEs. The programmes also tend to target national (M)SMEs which may not otherwise have the financial capacity to invest in emerging markets and only usually provide up to 50% of funds for any investment project. The advantages of such programmes are: (1) they enhance growth in developing countries; and (2) they leverage private sector partners to invest in low income countries and take developmental concerns into consideration for their operations.

In order to promote business partnership programmes that can bring positive contributions to their target markets, the EU could set up an overarching EU programme, open to all EU enterprises that wish to participate. Its main directive should be to make sure that such a programme targets businesses in developing countries with the potential to grow, but are constrained due to limited access to finance, limited market access or insufficient technical know-how. Participating businesses would need to commit to a sustainable growth plan after donor participation has ceased. Such a programmes would create additionality by promoting investments that would not have otherwise have occurred in the targeted countries (and markets) as well as potentially acting as a catalyst (i.e. incentivising other companies to invest in target markets) which could spur further market growth. These programmes are currently run according to individual EU Member State priorities. However a similar partnership, set up at the EU level could help coordinate efforts and reach a wider number of both EU and developing country enterprises.

Vocational training and capacity development

Question 15: How to encourage more systematic public-private collaboration for the definition and implementation of reforms and programmes related to VET?

An approach that has proved successful in Australia is the Industry Skills Council concept. Skills Councils bring together representatives of industry to co-ordinate input and support the vocational training sector and promote relevance to industry needs. This approach has been emulated in Bangladesh and India. ODI research in Vietnam shows that even within strongly state-focused vocational training systems, training institutions can develop strong and productive links with industry (in terms of work experience for teachers, placements for students, input on curriculum, supply of equipment) if more progressive institutions are given even limited leeway to innovate (Pompa, 2014 - forthcoming). The EU could also look at supporting more purely private sector led initiatives. ODI, for example, is producing case studies of skills development support provided by selected independent business associations to their members in Myanmar (Pompa, 2014 - forthcoming).

Question 16: What approach to the provision of capacity development services to companies should the EU pursue? Should services be offered at subsidised rates, through co-financing mechanisms or more market-based approaches? Which principles would have to be met when providing direct support to companies?

An important consideration is to ensure that beneficiary companies have a say in the selection of capacity development services to ensure they are appropriate to their needs. Imposing particular providers on companies can lead to unproductive relationships. It is generally recognised that at least part payment for services by companies themselves will ensure that the support is more demand driven and valued by companies.

Access to finance

Question 17: What strategy should the EU pursue in providing microfinance and supporting financial inclusion? What areas of interventions should be targeted, or left to other partners, and what delivery channel should be used? What do you consider the EU's comparative advantage and added value to be in this area?

We recommend that the EU provide support through specialist agencies that have strong technical expertise and experience, as well as knowledge of local markets. Support should be focused on regulatory reform, technical assistance, research and training rather than financing the portfolios of particular institutions. External finance, extended on soft terms, often has a distorting effect in terms of disincentivising internal mobilisation of funds by microfinance institutions and is usually not sufficiently large scale to make a significant difference in specific markets.

Question 18: How to ensure that financial services are delivered in a way that is responsible, transparent, and likely to generate benefits for poor clients?

Responsible and transparent delivery of financial services to poor clients requires a strong regulatory framework that protects depositors, promotes sound financial management by microfinance institutions and allows for fair market entry and competition. Equally, if not more important, is the need for strong supervision capacity from the central bank or other regulator. Supervision of microfinance institutions requires different approaches with which few conventional bank regulators are familiar. Donor support for microfinance supervision – not just regulation – should be given careful consideration.

Working in closer partnership with the private sector

Question 20: What are your experiences with running or participating in public-private mechanisms or platforms for dialogue, information on support programmes, and knowledge sharing on development partnerships in your country or sector? Should the EU engage in supporting further private-public dialogue on development policies, programmes and partnerships?

Public-private dialogue and information platforms can play a useful role in bringing parties together to address specific business and development issues. However, the dialogue needs to be action oriented and should avoid the delay and disruption that are sometimes associated with cumbersome co-ordination processes. There also needs to be a clear awareness that, to achieve any buy-in, dialogue needs to address a business as well as a development need. A number of business associations ODI has interviewed have indicated quite high levels of frustration with donor dialogue processes in which they have participated, where the goal is unclear and follow-up has stalled.

Question 22: What are the risks for donors like the EU of engaging directly with the private sector and what principles or minimum criteria have to be applied to manage these risks?

We suggest four key principles for donors when working with the private sector:

1) Additionality: donors should not finance activities that private entities would finance themselves anyway;
2) Neutrality: support for private companies should not provide them with an unfair advantage over their competitors;
3) Sustainability: support should lead to a lasting development impact that is commercially viable in the long-term;
4) Value for money: as with all donor spending, but particularly with financing of private sector entities, support should be based on a realistic cost benefit analysis.

Using the private sector as a 'delivery channel' for development

Question 25: Under what conditions can Private-Public Partnerships (PPP) be an effective tool for delivering infrastructure services and public goods?

One of the key determinants of the success of PPPs to develop infrastructure is in making sure that the contractual agreement between parties is clear, transparent, enforceable and has accurately assessed the risks associated with the investment and how these risks will be shared by the parties. Given it is a complicated technical issue, donors need to ensure that they provide the best technical and legal advice and support. Successful PPPs require: (1) a clear legal and regulatory framework to be in place which supports the drafting and implementation of these agreements; (2) competent and accountable public authorities to manage the state commitment to such contracts; and (3) the presence of a selection of private sector companies with sufficient technical and financial capacity to participate in such investments. It is important also to be clear that such partnerships should be viewed as mutually beneficial business partnerships rather than mechanisms for aid delivery.

Private sector contributions to inclusive growth

Question 26: When, and under what conditions, should the EU engage with companies to encourage innovation and facilitate private sector investment into low-income markets?

There has been considerable interest in the idea of donors promoting innovation within the private sector through such mechanisms as challenge funds or awards. Pursuit of this approach, however, should be based on a comprehensive understanding of the constraints faced by business in developing particular markets. These might involve quite fundamental external factors that may be difficult to overcome through business innovation alone. External factors include regulatory barriers, political interference, limited access to finance, poor infrastructure. Initiatives to promote business innovation may be most applicable in situations with a relatively conducive and open business environment. In countries or sectors where research facilities are underfunded or have weak linkages with the private sector, the argument to target funding on business innovation may be particularly strong.

Question 27: What risks or constraints deter companies from investing or scaling up inclusive business models? What role can there be for donors and/or CSOs in working with companies to mitigate these risks and constraints?

Constraints that deter companies from investing or scaling up inclusive business models include: (1) lack of finance; (2) hesitancy or risk aversion within senior management or board; (3) lack of clearly documented and credible evidence of financial viability and/or social impact; (4) limited markets, particularly if the inclusive business model fulfils a niche market; (5) insufficient human resources with required skills and specialist knowledge; and (6) competition from other companies. Above all, it is important for donors and civil society organisations (CSOs) to understand the business reasons why companies may choose not to scale up inclusive business pilots. In this regard, it may be useful to provide assistance to companies to validate and document the financial and social impact of pilot activities as a solid basis on which companies can decide to expand or replicate them.

The role of the private sector in the transformation towards a green economy

Question 28: How can private sector investment in green industries and innovation be promoted in developing countries (e.g. sustainable, low-carbon agriculture, renewable energy, clean technologies for cooking and burning fuels, recycling, eco-services etc.)?

Investment in green industries in developing countries occurs where there are financial incentives to do so. Companies move towards green solutions if there are business incentives such as reducing operational costs, securing access to resources or seeking access to markets that require adherence to 'green' standards. In developing countries, a lack of knowledge or investment finance capabilities may constrain such investments.[1] A particularly successful initiative aimed at overcoming these constraints in Kenya, was set up by the Kenyan Association of Manufactures.[2] The initiative helps companies assess how they could improve their operational efficiency by reducing expenditure on energy and resource (i.e. electricity, material and water usage) and also creates networks between companies and financial institutions in order to facilitate investments for energy efficiency. In Cambodia, a similar initiative run by UNIDO's Cambodia Cleaner Production Efficiency programme acted in a similar manner.[3] Both programmes proved successful and profitable for participating enterprises as long-run savings greatly outweighed initial costs in the medium-term. The EU, with its strong focus on energy efficiency and greenhouse gas emission mitigation standards and systems, could set up similar, larger-scale initiatives at the national or regional level, in order to transfer skills, knowledge and potentially back funding in order to incentivise such actions at a broader level.

Question 29: What does it take to achieve "leap-frogging" of developing countries to a green economy (i.e. economic development without repeating the "grow first, clean up later" path)? In particular how can the EU support private sector engagement that avoids investments in production and consumption practices based on outdated, inefficient and polluting practices and technologies that will "lock-in" development path in unsustainability for many years to come?

The incentives for developing countries to move towards green investment choices are similar to those (but at a far larger scale) for companies. Countries will choose the green option (i.e. investing in hydropower in Nepal or geothermal energy in Kenya) where it makes economic and political sense to do so. The barriers are also similar. These include financial, technical and institutional constraints. The incentives for countries to move towards climate compatible development (CCD) can be summarised as:

1) A recognised need to adapt to and mitigate the effects of climate change;
2) Achieve energy security and natural resource efficiency;
3) Capitalise on new 'green' economic opportunities;
4) Improve access to climate finance;
5) Strong national leadership to move towards CCD.[4]

The EU could foster research and technical capacity building into activities such as ecosystem services (which effectively value natural capital use or conservation in economic and social terms), promote energy efficiency measures (see question 28 above) as well as help developing countries access international climate finance. The EU could also provide support to government leadership in a similar vein to what the Climate Development Knowledge Network (CDKN)[5] provides i.e. helping to develop national green growth and climate change plans or providing training at the institutional level (both national and sub-national).

The role and responsibility of the private sector in a post-2015 framework

Question 30: Which post-2015 goals and targets could the EU possibly promote in the areas of inclusive and sustainable growth and private sector development?

There is increasing consensus that a new post-2015 framework should include an economic dimension alongside a more traditional social focus. References to inclusive growth, structural change and the need for more and better jobs abound in debates about the new goals. If the economic dimension is included in a new framework

[1] See: http://community.businessfightspoverty.org/profiles/blogs/green-growth-the-role-of-the-private-sector
[2] See: http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8593.pdf
[3] See: http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8592.pdf
[4] See: http://cdkn.org/wp-content/uploads/2013/02/CDKN_Working_Paper-Climate_Compatible_Development_final.pdf
[5] http://cdkn.org/

through goals, targets or indicators, ultimately it will be the private sector that will make it happen. Suggestions for inclusion of these issues in a new post-2015 framework[6] include:

- *Inclusion of economic transformation and jobs in an opening statement to shape social norms and resource allocation*: The language in the opening statement of a new agreement (akin to the Millennium Declaration) could emphasise the need for economic transformation, inclusive growth and jobs to signpost the importance of the issue.

- *Reporting on relevant goals, targets and indicators to change behaviours*: This could include a specific goal or target for jobs and goals for infrastructure and education and supplementary (optional) indicators for other enablers of inclusive growth and jobs. Optional guidance on supplementary indicators (e.g. under a poverty or jobs goal or as part of local implementation plans for the goals) on other important drivers/enablers of growth could be provided on, for example, institutional capacity, the macro-economic and regulatory environment and access to finance.

- *A target for reporting business impact on development.* Arguably if more large businesses were to report on their economic and social impact, such as jobs supported through the supply chain, training provided and wages paid relative to the minimum wage and poverty line, tax paid, among others, this could help to highlight their areas of greatest impact and encourage positive behaviours and competition among their peers. The inclusion of recommendations for corporate reporting in a new framework could help make its use more widespread.

Question 31: Should the international and local private sector be given a responsibility to meeting post-2015 goals in areas such as sustainable consumption and production, decent job creation, greenhouses gas emissions, resources efficiency, food security, or energy?

Some suggest that the post-2015 agenda could also cover the accountability of corporate actors, under a more general goal on transparency and accountability, drawing on momentum that is building around the transparency agenda and discussions held at Rio+20. Business operations have economic, social and environmental impacts. The logic of enhancing reporting on these issues – often referred to as non-financial disclosure – is that it provides governments and civil society organisations with information to hold these actors to account. In doing so, it can incentivise responsible behaviour (the ‘do no harm’ agenda) and showcase those companies that decide to go the extra mile, seeking to maximise their positive impact.

Under a transparency/governance goal, a new post-framework could recommend that governments set mandatory reporting for large businesses as a listing requirement.[7] Ultimately, self-regulation has not achieved widespread disclosure of non-financial information. For large firms, a post-2015 framework could recommend that governments make the release of economic, social and governance information a mandatory listing requirement. This could be monitored through an indicator, such as the number of countries with regulations that mandate the inclusion of non-financial information as a listing requirement.

[6] See: http://www.odi.org.uk/publications/7349-business-post-2015-development-framework-next
[7] See: http://www.odi.org.uk/publications/7349-business-post-2015-development-framework-next

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