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Investment and enterprise development for sustainable development

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Note by the secretariat

Summary

It is well recognized that the private business sector is a leading engine of economic growth and development. In particular, foreign direct investment of transnational corporations is an important business activity that has been identified as a principal source of financing for development and part of the means of implementation of the 2030 Agenda for Sustainable Development. In this document, some of the salient issues and policies related to the promotion, attraction and facilitation of foreign direct investment for sustainable development are highlighted, as detailed in a handbook prepared by the secretariat that will be presented to the Committee on Trade and Investment at its fifth session under the present agenda item. As most private sector businesses are small and medium-sized enterprises, also emphasized and reviewed are the role of these enterprises for sustainable development, the obstacles that they face and the policies that they need to help them integrate into global and regional value chains that are often dominated by transnational corporations.

I. Introduction

1. Foreign direct investment (FDI) is a cross-border business activity undertaken by both public and private sector transnational corporations that has become a leading source of external financing for development. FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. A threshold of 10 per cent of equity ownership is normally applied to qualify an investor as a foreign direct investor. When FDI results in the creation of a new subsidiary and/or manufacturing base or services centre in the host country, it is often referred to as greenfield FDI. Most FDI takes place through greenfield FDI or through mergers and acquisitions. Other forms FDI can take include reinvested earnings and joint ventures with local enterprises.

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2. The principal reason why countries want to attract FDI is that it brings external capital and as such contributes to financing for development. In addition, FDI is considered to be a potential source of technology, skills and access to foreign markets. However, FDI has been concentrated in a small number of emerging developing and developed countries, while countries with special needs, in particular least developed countries, have been less successful in attracting FDI as they often lack key determinants, such as well-developed infrastructure and local market, skilled labour, rule of law, and political, economic and social stability.[1]

3. One reason why developing countries are keen to attract FDI is that foreign enterprises tend to have superior products, technology and skill sets that could potentially be transferred to domestic private enterprises through the forging of backward and forward linkages that are part of regional or global value chains. As most private sector enterprises in any given economy are small or medium-sized enterprises, the focus of domestic enterprise development has traditionally and understandably been on the development of small and medium-sized enterprises and raising their capacity to effectively participate in such value chains. The issue of global value chains was comprehensively discussed in *Asia-Pacific Trade and Investment Report 2015: Supporting Participation in Value Chains*, a publication by the Economic and Social Commission for Asia and the Pacific (ESCAP),[2] and will be further reviewed in section III below.

4. The attraction of FDI and development of small and medium-sized enterprises as part of global value chain expansion are therefore strongly interlinked. With the adoption of the 2030 Agenda for Sustainable Development and the associated Sustainable Development Goals, sustainability has become the focus of development. While the attraction of FDI and development of small and medium-sized enterprises serve the economic dimension of sustainability under the right policy framework, the social and environmental dimensions of both FDI and small and medium-sized enterprises have to be reviewed in order to ensure that both contribute effectively to sustainable development across all three dimensions.

5. This has become particularly important with the rise of FDI flows among developing countries. As countries develop, enterprises in some of them, including small and medium-sized enterprises, have been able to engage in FDI themselves. Indeed, some of the emerging economies in the Asia-Pacific region, in particular China, have become leading sources of global FDI outflows. This has led to an increasing level of intraregional FDI flows, in particular among developing countries. Intraregional FDI trends are described in detail in *Asia-Pacific Trade and Investment Report 2017: Channelling Trade and Investment into Sustainable Development*, which is discussed in document E/ESCAP/CTI(5)/1, under agenda item 4. While increased South-South FDI has opened opportunities for least developed countries to attract FDI, it also raises concerns with regard to the sustainability of such FDI.

6. This document contains a review of the pertinent issues related to FDI attraction and small and medium-sized enterprise development for countries' sustainable development. The objective is to identify and define the policies and measures the Governments need to adopt and implement, individually and together in close consultation and collaboration with the private sector, to

[1] For information on FDI flows in Asia and the Pacific, see chapter 3 of *Asia-Pacific Trade and Investment Report 2017: Channelling Trade and Investment into Sustainable Development* (United Nations publication, forthcoming).

[2] United Nations publication, Sales No. E.15.II.F.15.

optimize the contribution of FDI and small and medium-sized enterprises to sustainable development. The review of FDI-related issues highlights some of the issues discussed in the ESCAP *Handbook on Policies, Promotion and Facilitation of Foreign Direct Investment for Sustainable Development in Asia and the Pacific*, which is to be discussed under the present agenda item.

II. Promoting and facilitating foreign direct investment for sustainable development

A. Role and importance of foreign direct investment in achieving sustainable development

7. Developing countries have often been unable to raise sufficient financing for development from domestic sources and have therefore relied on external capital flows. With declining external financial flows from official development assistance and foreign private bank lending in the wake of various global and regional crises, including the Asian financial crisis of 1997, FDI has become the most stable and relevant source of private external financing for development, along with export earnings and workers' remittances for many developing countries.[3] The Organization for Economic Cooperation and Development (OECD) estimates that FDI accounts for around 60 per cent of external capital inflows into developing countries.[4] The importance of FDI as a source of external financing for development was recognized in the 2002 Monterrey Consensus of the International Conference on Financing for Development. In its successor, the 2015 Addis Ababa Action Agenda of the Third International Conference on Financing for Development, FDI was identified as a mechanism that could facilitate sustainable development and the implementation of the Sustainable Development Goals when investments were directed to development-enhancing sectors, such as resilient infrastructure and renewable energy. As a source of financing for development, FDI also takes a prominent place as a means of implementation of the 2030 Agenda. The importance of FDI is recognized in many other international platforms and action plans, including those for least developed countries and countries with economies in transition.

8. While many countries have benefited from FDI, others have either failed to attract sufficient FDI flows in both quantitative and qualitative terms or failed to benefit from such inflows. This is particularly true for least developed countries and other countries with special needs, such as landlocked developing countries and small or isolated island developing countries, which often lack the fundamentals required to attract higher-quality FDI inflows and the absorptive capacity to benefit from such flows.

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[3] Showket Ahmad Dar, "FDI as a source of external finance to developing countries: a special reference to India and China", *IOSR Journal of Business and Management*, vol. 17, No. 1, Ver. I (January 2015), pp. 73-81 (available from www.iosrjournals.org/iosr-jbm/papers/Vol17-issue1/Version-1/L017117381.pdf); Homi Kharas, "Financing for development: international financial flows after 2015", 8 July 2014 (available from www.brookings.edu/research/financing-for-development-international-financial-flows-after-2015); *World Economic Situation and Prospects 2015* (United Nations publication, Sales No. E.15.II.C.2) (available from www.un.org/en/development/desa/policy/wesp/wesp_archive/2015wesp_full_en.pdf).

[4] OECD, "Investment for sustainable development", OECD and Post-2015 Reflections Series, Element 11, Paper 3 (Paris, 2013). Available from www.oecd.org/dac/Post%202015%20Investment%20for%20sustainable%20development.pdf.

9. With the adoption of the 2030 Agenda, issues related to the sustainability and contribution of FDI as a means of implementation of the Sustainable Development Goals have become more prominent. In other words, the mere presence of FDI does not necessarily imply development benefits. Where development benefits are derived, they may be economic only, at the cost of the environmental and social dimensions of sustainable development. This section contains a brief review of current knowledge of the impact of FDI on the three dimensions of sustainable development.

10. In theoretical terms, investment is recognized in Keynesian economic models as one of the components of economic growth, along with consumption, government spending and net exports. A review of the academic literature on the impact of FDI on economic growth finds that FDI contributes to economic growth through direct and indirect channels (such as multipliers) only to the extent that host countries have the absorptive capacity to benefit from FDI in the form of conducive policies, institutions, skills, infrastructure and so on.

11. FDI, as a source of financing for economic development, can in principle help close various gaps: the balance-of-payments gap, the domestic savings-investment gap and the government budget (revenue) gap. With regard to the balance-of-payments gap, FDI contributes not only to the capital account but also to the current account, to the extent that it may result in enhanced exports and export earnings. This effect can be offset to the extent that foreign investors repatriate profits and use imports in the production of export goods. Similarly, the savings-investment gap is bridged only to the extent that FDI contributes to net overall investment without crowding out domestic investment. With regard to tax revenue, generous incentives for foreign investors often offset the tax revenue collected. In addition, the use of tax havens and the practice of transfer pricing by transnational corporations also undermines Governments' ability to collect taxes from them. This issue is currently being addressed internationally, with the signing of the Multilateral Convention to Implement Tax-Treaty-Related Measures to Prevent Base Erosion and Profit Shifting by 70 countries on 7 June 2017.[5] In conclusion, the contribution of FDI to financing for development is not straightforward, potentially high but largely dependent on specific circumstances and policies in individual countries.

12. Apart from its contribution to capital inflows, FDI may also impact employment and skills development, in particular through the establishment of new production capacity (greenfield investment) in labour-intensive industries, and mergers and acquisitions may result in labour retention in the acquired firm (compared with the alternative of it being closed down). However, these employment gains are not guaranteed and the labour conditions of newly created employment may not meet international standards. The contribution of FDI to the employment of women in the garment industry in various least developed countries is well documented, though salaries in this sector remain very low. FDI may also create employment through the establishment of backward and forward linkages with domestic enterprises. However, a foreign company may also crowd out domestic enterprises in some sectors, resulting in a net loss of employment.

13. Transnational corporations may have a positive effect on domestic corporate governance and enhance the intensity of competition and innovation in host countries. However, in the absence of appropriate anti-trust laws, they

[5] Available from www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-BEPS.pdf.

may also abuse their superiority and force domestic competitors out of the market. While transnational corporations are often viewed as a source of technology, in particular through the establishment of functioning backward and forward linkages with domestic enterprises, there are instances when the technology transferred is outdated (especially with respect to environmental protection) or does not fit local conditions. In many cases, technology transfer, if it does take place at all, proceeds from the parent to a wholly-owned subsidiary and is therefore internalized and not diffused in the host country. Where it is necessary for a local affiliate or domestic enterprise that is part of the investor's value chain to have access to the technology, technology may be transferred while demonstration effects may lead to positive spillovers.

14. The impact of FDI gets more complicated when the social and environmental dimensions of sustainable development are included. While FDI can contribute to poverty reduction through economic growth, the evidence shows a mixed picture when social and environmental dimensions of poverty are considered. While FDI is known to contribute to the growth-enhancing effect (the economic dimension of sustainable development), its contribution to the distribution effect (social dimension) remains low. Generally, transnational corporations pay higher wages, may provide better working conditions than domestic enterprises and may contribute to skills enhancement in many developing countries, but they can also contribute to substandard working conditions and environmental degradation in the absence of proper social and environmental laws and regulations that are duly enforced. FDI can lead to land-grabbing and displacement of local communities without due compensation. The debate on the impact of FDI on the environment has particularly focused on the claim or hypothesis that transnational corporations will move environmentally unsustainable practices to countries with relatively lax environmental laws and regulations – so-called pollution havens – though the evidence for this hypothesis is mixed. On the positive side, FDI could contribute to the transfer of more environmentally friendly technologies and production practices.

15. With increasing South-South FDI, the social and environmental concerns assume special importance, as transnational corporations from developing countries may not adopt standards of responsible business conduct and may not be held accountable by their home Governments to the same extent as transnational corporations from developed countries. Transnational corporations from developed countries tend to have better corporate governance and be more socially responsible owing to the rule of law in these countries and demand pressure from an increasingly sophisticated and vocal domestic customer base and civil society. At the same time, it would be easier for least developed countries to attract investment from developing-country transnational corporations, as such investment would in many cases not have the same requirements as investment from developed-country transnational corporations. Developing-country transnational corporations would probably also provide products and services at more affordable prices than those provided by developed-country transnational corporations. However, lower prices are often the result of low wages and may represent products and services of substandard quality produced in an unsustainable manner.

16. FDI will remain indispensable primarily as a source of private capital in light of the enormous financing needs of developing countries, which are unlikely to be met by public revenue and official development assistance alone. At today's level of investment – public and private – in the sectors related to the Sustainable Development Goals in developing countries, an average annual

funding shortfall of some $2.5 trillion remains over the period 2015-2030.[6] With respect to infrastructure alone in Asia and the Pacific, a 2009 report by the Asian Development Bank (ADB) projected that total investment needs for four infrastructure sectors – transport, power, telecommunications, and water supply and sanitation – would be slightly more than $8 trillion (in 2008 prices) for the 11-year period from 2010 to 2020, or almost $750 billion per year.[7] The most recent ADB estimates include the costs of climate mitigation and adaptation (climate-adjusted estimate) for developing Asia amounting to $26 trillion over the 15 years from 2016 to 2030, or $1.7 trillion per year. Without climate-adjusted costs (baseline estimate), the required infrastructure investment would amount to $22.6 trillion, or $1.5 trillion per year.[8]

17. Whatever the source of FDI, it is important for Governments of least developed countries to ensure that FDI from any source renders a net positive impact on sustainable development in all its dimensions through the adoption of appropriate policy and regulatory frameworks. Some of these policies are reviewed below. A more detailed overview is given in the *Handbook* mentioned above.

B. Policy and legal framework for sustainable foreign direct investment

18. Over time, investment policies and strategies have evolved and investment promotion strategies have adapted from a focus on economic liberalization in the 1980s through improving the overall business and investment climate in the 1990s and 2000s to a focus on sustainability today. Increasingly, the value of proactive investment promotion and facilitation strategies has been recognized and, as a result, most countries have an investment promotion agency for that purpose in one form or another.

19. In formulating policies and legal and regulatory frameworks for sustainable FDI, a first step is to clarify the role and objectives of FDI attraction in the overall development framework and to ensure that FDI attraction as a policy is duly integrated into the overall policy framework for sustainable development. The policy framework needs to be adapted to the type of FDI that a country seeks to attract in line with its actual and potential competitive advantages. Given the role of FDI in many sectors, proper coordination among institutions and ministries involved in formulating sustainable development policies and associated laws and regulations – in particular in areas such as land, labour, telecommunications, banking, environment and trade – is essential to ensure a consistent FDI policy framework.

20. While economic liberalization, including investment liberalization, is essential to improve the efficiency of the economy, various crises, including the 1997 Asian financial crisis and the 2008 global financial crisis, have demonstrated the need to ensure prudential regulation and supervision and to improve the stability of the economy and investment environment. In other words, foreign investors value transparent, fair, non-discriminatory and

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[6] *World Investment Report 2014: Investing in the SDGs – An Action Plan* (United Nations publication, Sales No. E.14.II.D.1). Available from http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf.

[7] ADB and Asian Development Bank Institute, *Infrastructure for a Seamless Asia* (Tokyo, 2009). Available from www.adb.org/sites/default/files/publication/159348/adbi-infrastructure-seamless-asia.pdf.

[8] ADB, *Meeting Asia's Infrastructure Needs* (Manila, 2017). Available from www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf.

predictable rule of law that ensures property rights, among others. While many countries have adopted a national investment law, such laws may not prove sufficient over time and need to be complemented by laws in various other areas, resulting in a body of economic and business law that may no longer include or necessitate an investment law.

21. At present, many countries in the region have some way to go in strengthening a domestic climate conducive to both domestic and foreign investment, including the rule of law. The World Bank Ease of Doing Business indicators provide some insight as to the quality of individual countries' investment climates. Quite a few countries in the Asian and Pacific region rank in the bottom half even though quite a few have made progress over the past decade. The discrepancies are remarkable. While Singapore was ranked number two in the global 2017 rankings (it was number one in 2016), Afghanistan was ranked 183 out of 190 countries. Overall, 20 developing-country ESCAP members ranked in the top half, while 21 ranked in the bottom half. Improving the investment climate is therefore a priority in many countries. To a large extent, this relates to reducing bureaucracy and red tape and making it easier for businesses to start up and conduct operations. Given that much FDI is related to trade, trade facilitation to reduce trade costs involving the streamlining and harmonization of customs procedures, including the adoption of single windows and paperless trade practices, is also very important.

22. As competition for FDI has intensified among individual countries with similar competitive advantages, so has the use of ever more generous incentives, in particular tax incentives, to attract foreign investors. However, there is not much evidence that such incentives play a crucial role in the investment location decision. They certainly cannot turn a bad investment climate into a good one and cannot compensate for the lack of more essential requirements for the success of a standard investment project. They do, however, constitute a drain on public resources that could be used for more important development purposes, such as the provision of infrastructure, including special economic zones, that would also benefit investors. However, they can sometimes influence an investment decision in favour of a location that is otherwise very similar to other potential investment locations. They can also be linked to performance requirements as a quid pro quo. Any incentive regime should be transparent, time-bound, clearly linked to a specific policy objective and subject to thorough monitoring and evaluation.

23. A popular policy tool to attract FDI in an overall substandard investment climate is the establishment of special economic zones. Special economic zones can take many different forms, of which the export processing zone is probably the most popular. They have played an important role in the expansion of global value chains. However, special economic zones have a varied success rate. They have been generally successful in selected countries, such as China and Malaysia. However, often they are poorly designed, located in areas lacking competitive advantage and poorly managed. They also often have negative social and environmental impacts. Success factors for special economic zones include proper planning with due regard to social and environmental considerations, and proper design and management, preferably by a private operator. They should also have linkages with the rest of the economy, including domestic small and medium-sized enterprises. They should be demand-driven and provide top quality infrastructure. Lastly, they should conform to international legal obligations arising from the World Trade Organization agreements and free trade agreements.

24. Investment policy needs to be complemented by proactive investment promotion, in particular to address information asymmetries. Studies by the World Bank have shown that a 10-per-cent increase in an investment promotion budget leads to a 2.5-per-cent increase in FDI, while the net present value of proactive investment promotion is almost $4 for every $1 expended. The focus of investment promotion efforts depends on the level of development and the overall perception of investors of a particular location. Investment promotion, in the end, is really all about marketing a specific location to foreign investors. In many cases, such marketing should begin with a campaign to improve the image of the location or dispel negative and often unrealistic perceptions associated with it. Once investors are aware of the potential associated with a location, more active investment promotion involves investor-targeting in specific sectors from specific countries, down to individual companies.

25. Most countries have set up agencies that specifically engage in investment promotion and facilitation activities. Investment promotion is a distinct function from investment policy and requires an agency that works directly with investors. While investment promotion is often undertaken by specific ministries or departments within ministries, best practices have demonstrated that the ideal set-up is an autonomous agency with a board of directors from both the public and the private sector that reports directly to the Head of Government or Head of State, in order to ensure that it has the proper authority to perform one-stop functions and undertake the necessary coordination among the many government and private sector institutions involved in effective investment promotion. In recent years, the focus of investment promotion has shifted towards investment facilitation, which includes addressing information gaps and conducting site visits for investors in the pre-establishment phase, and providing one-stop services in the establishment phase and aftercare services in the post-establishment phase. Aftercare, in particular, has emerged as an essential service provided by investment promotion agencies for locations that already have a critical mass of investors. The rationale for aftercare is to close the gap between investment announcements and approvals on the one hand and actual realized investment on the other.

26. Within the context of the 2030 Agenda, both investment policy and investment promotion need to emphasize the sustainability of investment and promote both inward and outward investment in support of sustainable development, in the form of the Sustainable Development Goals. The adoption of sustainable FDI policies is increasingly important to support sustainable FDI from developing countries in other developing countries. Sustainable FDI policies are aimed at: (a) contributing to inclusive growth, poverty reduction and sustainable development through the benefits of FDI, by enhancing local productive capacities, strengthening social resilience and solidarity (including by reducing inequality) and improving environmental performance; (b) creating synergies with wider economic development goals or industrial policies and achieving seamless integration into development strategies; (c) fostering responsible investor behaviour and responsible business conduct; and (d) ensuring their effectiveness in terms of their design and implementation and in the institutional environment within which they operate.

27. The new generation of sustainable investment policies requires a comprehensive framework to guide and evaluate FDI projects and government policies on both inward and outward FDI. The United Nations Conference on Trade and Development (UNCTAD) has been at the forefront in promoting sustainable FDI through the launch of its Investment Policy Framework for

Sustainable Development.[9] Essential to such a framework are the strengthening of domestic social and environmental laws and regulations, the development of more vocal consumer groups and stronger civil society, and the conclusion of more inclusive and sustainable international investment agreements.

28. With regard to international investment agreements, there have been calls for a better balance between the rights and obligations of the investor on the one hand and the host country on the other, which has traditionally been considered to favour the investor. Of course, the objective of investment laws and bilateral investment treaties is precisely to grant protections to investors as an incentive for them to invest in a host country. However, with particular reference to international investment agreements and in the absence of a multilateral legal framework on investment, investors have often abused the treaty provisions or invoked the provisions of the most generous applicable treaty to their favour and to the cost of the host country Government. As a result, host countries have increasingly terminated such agreements or called for their renegotiation. Recent international investment agreements contain labour and environmental clauses that better balance the rights of the investor with those of the host country, while provisions on fair and equitable treatment, most-favoured nation and national treatment, and investor-State dispute settlement have also been made more precise to limit potential abuse. In addition, foreign investors and their home countries are increasingly required to adopt international standards of responsible business conduct such as the OECD Guidelines for Multinational Enterprises, applicable International Labour Organization agreements and principles under the United Nations Global Compact, the Global Reporting Initiative and the Guiding Principles on Business and Human Rights, to name a few. As part of its Investment Policy Framework for Sustainable Development, UNCTAD has issued a comprehensive road map for international investment agreement reform in support of sustainable development.

29. In conclusion, there is a need to adopt policies and regulations that make FDI better, improving not just the quantity but also the quality of FDI in terms of its net positive impact on the economic, social and environmental dimensions of sustainable development. As FDI is a cross-border phenomenon, international cooperation at the subregional, regional and global levels is required to harmonize laws, standards and policies related to FDI with a view to making it more sustainable and forging integrated markets that are more attractive for foreign investors. Modalities for international cooperation can be legally binding or voluntary. The experiences of the Association of Southeast Asian Nations (ASEAN), in the form of the ASEAN Investment Area and the provisions for cooperation contained in the current ASEAN Comprehensive Investment Agreement, are good examples of such cooperation.

[9] *World Investment Report 2012: Towards a New Generation of Investment Policies* (United Nations publication, Sales No. E.12.II.D.3) (available from http://unctad.org/en/PublicationsLibrary/wir2012_embargoed_en.pdf); UNCTAD, *Investment Policy Framework for Sustainable Development 2015* (Geneva, 2015) (available from http://investmentpolicyhub.unctad.org/Upload/Documents/INVESTMENT%20POLICY%20FRAMEWORK%202015%20WEB_VERSION.pdf).

III. Enterprise development for sustainable development

A. Importance and constraints of small and medium-sized enterprises

30. While definitions of small and medium-sized enterprises vary widely among individual economies, they are generally understood to constitute an important segment of Asia-Pacific economies, typically comprising over 95 per cent of national enterprises. Their contribution to gross domestic product, employment and exports is widely recognized. According to national sources and definitions, the contribution of small and medium-sized enterprises to employment varies from 30 per cent in Kazakhstan and 40 per cent in Bangladesh and India to over 95 per cent in Indonesia. Small and medium-sized enterprises, as measured by employment expansion rates, account for a significant share of job creation as smaller enterprises exhibit a higher net job creation rate as compared with large enterprises. The importance of small and medium-sized enterprises to exports also varies and is typically higher in developed countries but increases significantly when indirect exports are included, demonstrating the importance of their integration into global value chains. While they enhance dynamism in economies by bringing flexibility and fresh ideas, they can also stabilize societies by providing safety nets for disadvantaged workers.

31. Despite numerous assistance schemes adopted by Governments, including specialized development agencies and banks, small and medium-sized enterprises in the region continue to face significant resource constraints and have limited capabilities to compete effectively in global and regional markets. Despite their tremendous potential, small and medium-sized enterprises are still in a disadvantaged position with respect to essential business factors, such as capital, profitability, managerial skills, trained labour, brands and networking. Unless the complex issues and processes of their development are well understood, isolated efforts to energize the sector may not achieve a significant degree of success. In cooperation with various stakeholders, including business communities, bilateral and multilateral donors and development agencies, academia and non-governmental organizations, many government initiatives have been launched for the development of small and medium-sized enterprises. The results and impacts of these initiatives, however, have been mixed.[10]

32. The problems faced by small and medium-sized enterprises are even more severe when they are owned and/or managed by women. Women entrepreneurs, who often run small and medium-sized enterprises, including microenterprises, do not operate in isolation; they work under the same macro, regulatory and institutional framework as their male counterparts. However, it is necessary to dig deeper in order to understand the gender biases embedded in society which limit women's mobility, interactions, active economic participation and access to business development services. The business environment for women also reflects the complex interplay of different factors that ultimately result in the disadvantaged status of women in society. Women in many developing countries in Asia and the Pacific remain far behind men in the enjoyment of basic human rights, let alone participating with men on equal footing in economic activities.

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[10] *Studies in Trade and Investment 65: Globalization of Production and the Competitiveness of Small and Medium-sized Enterprises in Asia and the Pacific – Trends and Prospects* (United Nations publication, Sales No. E.09.II.F.23). Available from www.unescap.org/sites/default/files/0%20-%20Full%20Report_28.pdf.

B. Policy framework for sustainable development of small and medium-sized enterprises

33. Given the importance of small and medium-sized enterprises, Governments often pursue a combination of policies aimed at supporting them. These policies have been well documented in the ESCAP publication *Policy Guidebook for SME Development in Asia and the Pacific*, and are typically focused on the following areas: (a) strengthening the business environment, including rules and regulations aimed at simplifying business start-ups and operations; (b) promoting entrepreneurship through skills development programmes and incubation systems; (c) improving access to financing, both investment capital and working capital, by promoting, inter alia, venture capital, credit guarantee schemes, leasing and factoring; (d) strengthening public and private sector business development services to help small and medium-sized enterprises with accounting, legal issues, market information and so on; (e) facilitating access to technologies; and (f) improving overseas market access through export promotion and customs facilitation.[11]

34. In addition, many Governments have established an institutional framework for the development of small and medium-sized enterprises. Such institutions are typically handled by various governmental offices in such fields as commerce, industry, agriculture, enterprise development, investment and export promotion, and quality standards. There has been a trend to establish a sector-wide agency to develop and implement a coordinated and consolidated national policy on the development of small and medium-sized enterprises. Those initiatives include the SME Foundation in Bangladesh and the National Enterprise Development Authority in Sri Lanka, the establishment of which had been strongly recommended by the donor community.[12]

35. The success rate of these policies and institutions is mixed. With regard to the institutions, they often lack adequate resources, experience and/or authority to conduct comprehensive and concrete development initiatives in collaboration with other line ministries, thus not fully achieving their objectives. With regard to policies, they are usually well intended but are often poorly designed and implemented by government officials with little knowledge about markets and the dynamics of small and medium-sized enterprises. This is particularly prevalent in the area of financial assistance. Many Governments recognize the potential for market failures in credit markets, owing to asymmetric information and imperfect contract enforcement, for example, which makes it difficult for smaller enterprises to get external finance. As a result, they have often adopted multiple financial assistance schemes for small and medium-sized enterprises. However, these schemes often fail because: (a) they have difficulty identifying qualifying and deserving enterprises (leading to high debts of those that have access but fail to repay); (b) enterprises are not aware of them or need to submit too much paperwork to apply; (c) the size of the grant or loan available is too small or comes with too many conditions; or (d) the grant of loan is politically motivated and is not based on commercial considerations. When the private sector takes over, the success rate increases. A good case in point is the lending success of the Bangladesh-based Grameen Bank providing microcredit to the poor, mostly women. In this regard, government assistance is best aimed at providing private sector financial institutions with incentives to lend to small and medium-sized enterprises and reducing the associated risks. In addition,

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[11] *Policy Guidebook for SME Development in Asia and the Pacific* (United Nations publication, Sales No. E.12.II.F.2). Available from www.unescap.org/sites/default/files/0%20-%20Full%20Report_7.pdf.

[12] See www.smef.org.bd and www.neda.lk.

improved property rights help small and medium-sized enterprises to provide collateral for loans.

36. In the context of the present document, two areas of policy intervention receive special focus: integrating small and medium-sized enterprises into global value chains and facilitating internet-based solutions for their operations and financing. In both areas, FDI also plays a role and therefore both areas link FDI attraction with the development of small and medium-sized enterprises.

37. Integrating small and medium-sized enterprises into global value chains is directly related to the attraction of efficiency-seeking FDI, which is the driving force behind global value chains. The issue and importance of global value chains was comprehensively discussed in the *Asia-Pacific Trade and Investment Report 2015*. Obviously, linking small and medium-sized enterprises to these value chains holds great potential for their development and spillover effects on overall economic development through employment creation, skills development and technology transfer. However, such integration is not automatic and requires government intervention in various policy areas.

38. First, with regard to trade policy, there is scope to further reduce tariffs on imports required by small and medium-sized enterprises for further processing or on exports to other countries of parts and components produced by them. Second, there is scope to reduce non-tariff trade barriers and facilitate trade, in particular by simplifying and harmonizing customs procedures, adopting paperless trade and single-window systems and reducing trade costs overall. In this context, trade liberalization and facilitation measures should be implemented and associated agreements should be negotiated with special attention to the needs of small and medium-sized enterprises.

39. Third, the clustering of small and medium-sized enterprises to promote vertical and horizontal cooperation and help them become more competitive has been a long-standing policy recommendation. Clustering helps foster inter-enterprise linkages and collaborative relations with local support institutions, combines their strengths and helps them to jointly take advantage of market opportunities or solve common problems with a combined effort. Clustering also helps small and medium-sized enterprises to access and/or share technology and infrastructural facilities, such as in the context of special economic zones or special enterprise zones.

40. Fourth, linkages with foreign enterprises should be actively pursued and in this context, the capability of small and medium-sized enterprises to adopt more efficient production processes and diversify and improve the quality of their products and services is important. Foreign enterprises may help in this process if they see potential in local small and medium-sized enterprises. Alternatively, small and medium-sized enterprises from their own home country may follow them, providing local employment in the host country but crowding out local enterprises. Linkage and matching programmes have been pursued by investment promotion agencies in various countries of the region, such as the Industrial Linkage Programme and Global Supplier Programme in Malaysia, the Local Industry Upgrading Programme in Singapore and the Board of Investment Unit for Industrial Linkage Development in Thailand. All of these programmes address information gaps faced by investors and contain databases of domestic enterprises for potential partnerships. The establishment of such partnerships should not be a mandatory requirement for foreign investors as they need to maintain the reputation of their products and services and cannot afford to enter into partnerships which undermine their reputation. When the quality and

performance of local small and medium-sized enterprises is upgraded to satisfactory levels, linkages will automatically follow.

41. Finally, the Internet provides ample opportunities for small and medium-sized enterprises to engage in e-commerce and tap the opportunities provided by fintech platforms. E-commerce, both business-to-business and business-to-consumer, provides small and medium-sized enterprises with access to larger markets and reduces costs. With business-to-business, e-commerce also helps them to link with larger and foreign enterprises. For instance, large e-commerce companies such as Alibaba increasingly use local small and medium-sized enterprises as suppliers. However, the uptake by small and medium-sized enterprises is relatively small. E-commerce involves lot of digital activities pertaining to business, including online registration, advertising and marketing on the Internet, electronic billing and payment facilities, tracking of deliveries and customer support, for which small and medium-sized enterprises are not ready. In this context, electronic data interchange, electronic fund transfer and barcodes are some of the basic e-commerce technologies that are most likely relevant for small and medium-sized enterprises. It is therefore important for Governments to, first, provide the necessary information and communications technology (ICT) infrastructure, and second, help raise the capacity of small and medium-sized enterprises to use the Internet productively and design attractive websites. For that purpose, small and medium-sized enterprises need ICT skills development and access to appropriate ICT equipment and infrastructure, although in practice, a simple smartphone would sometimes be sufficient to conduct e-commerce transactions. Appropriate legislation is also needed to allow and ensure the security of online business transactions.

42. The Internet has also enabled the rise of digital financial technologies known as fintech. Fintech solutions – such as online resource mobilization (for example, crowdfunding and person-to-person lending), e-payments through mobile applications, e-accounting such as blockchain, working capital management and other financial transactions – have facilitated the financial management of small-scale business and help entrepreneurs access resources at manageable rates. Fintech also helps address information asymmetries and addresses the lack of a credit history of many borrowers through psychometric credit scoring.

43. By replacing cash with digital funds, fintech can facilitate the traceability of wealth generation, assure the security of end-user receipt of funds and aid in the establishment of credit. Fintech removes gender and racial bias in the distribution of capital and, hence, is a useful tool to support women entrepreneurs' access to capital. Already, crowdfunding is replacing traditional sources of financing as the main source of funds for women.

44. However, there are challenges associated with fintech which are similar to e-commerce in a wider sense, such as lack of adequate consumer protection, lending inexperience among investors, vendor risk management, adverse selection, limited information on best practices, lack of data security, transparency and privacy. As cash is still king, provisions need to be taken to integrate cash into a digital environment and allow for proper transition periods to replace cash with digital funds and currencies. Finally, Governments need to establish a proper regulatory framework to address some of these challenges on a priority basis.

45. Lastly, it is important for small and medium-sized enterprises to adopt practices and principles of responsible business conduct in their daily operations. While such principles are often considered an additional cost that small and medium-sized enterprises are not prepared to absorb, responsible business conduct should be presented as a long-term business survival requirement, in particular in light of changing customer awareness and demands for social and environmental responsibility. According to a report of the Business and Sustainable Development Commission, business leaders and entrepreneurs could unlock new market opportunities worth $5 trillion and generate 230 million jobs in Asia by 2030 through sustainable business models.[13] Too often, businesses on either a voluntary or mandatory basis embrace corporate social responsibility activities that result in charity events but do not address core business management and practices. In the end, it matters more how companies make their money than how they spend it. Governments have an obligation to promote responsible business conduct and provide the necessary policy and regulatory support. They should also actively support social enterprises and impact investment, which is an emerging and rapidly rising industry.

IV. The role and activities of the Commission in investment and enterprise development

46. Given the importance of the private business sector for sustainable development, in particular through their investment activities, Governments of developing countries in the region need to actively engage business in the formulation of policies and strategies for sustainable development through appropriate consultation mechanisms. It is important to forge a common understanding among all stakeholders at the national and subnational levels, and ideally also at the subregional and regional levels, on the way forward to achieve sustainable development on the basis of strong and functioning collaborative platforms. Business and foreign investors should not see the adoption of responsible business practices as a new legal requirement imposed on them by Governments that results in higher costs of doing business, but rather as an essential requirement to ensure the sustainability of their own business in the long term. In this regard, business and Government need to work together closely at all levels to improve the quality of FDI and strengthen the competitiveness and sustainability of small and medium-sized enterprises as key components of private sector development. ESCAP, as a regional agency with strong capacity to forge such collaborative platforms, assumes a key role in this regard and has undertaken various activities to promote sustainable FDI, develop small and medium-sized enterprises and promote responsible business conduct for that purpose through the three modalities of research and analysis, capacity-building and regional cooperation with a focus on countries with special needs, in particular least developed countries.

47. ESCAP works with the Global Compact Office to enhance the uptake of the Global Compact principles by businesses in the region through policy advocacy and capacity-building. ESCAP is unique among the regional commissions at having established various mechanisms to effectively engage business in achieving the Sustainable Development Goals, through the ESCAP Business Advisory Council and the ESCAP Sustainable Business Network. It also organizes the annual Asia-Pacific Business Forum, which has a strong focus on sustainability issues. These mechanisms are currently being reviewed

[13] Business and Sustainable Development Commission, *Better Business, Better World: Sustainable Business Opportunities in Asia* (London, 2017). Available from http://s3.amazonaws.com/aws-bsdc/BSDC_asia_web.pdf.

to make them stronger and more aligned with the work of ESCAP and the Sustainable Development Goals. This subject is further discussed in document E/ESCAP/CTI(5)/5, under agenda item 8 (b).

48. With regard to FDI, it is recognized that it is an essential component of the means of implementation of sustainable development. In this context, the secretariat has developed a comprehensive *Handbook on Policies, Promotion and Facilitation of Foreign Direct Investment for Sustainable Development in Asia and the Pacific*, which is to be discussed under the current agenda item. Based on the *Handbook*, a comprehensive training course has been prepared, which will be made available online in due course and can be implemented in any country upon their request. Already, in June 2017, the secretariat provided training in the area of FDI for governments of states and regions in Myanmar in cooperation with the Government of Myanmar and the Department for International Development of the United Kingdom of Great Britain and Northern Ireland. Additional advisory services and training are ready to be delivered later in 2017 and in 2018 at the request of individual countries.

49. The Asia-Pacific Foreign Direct Investment Network has been convened since 2010 as a regional platform for the exchange of experiences and best practices in FDI policy and promotion for sustainable development and capacity-building in this area. The 6th meeting of the Network was held in 2016 in conjunction with a regional seminar on international investment agreements. The 6th meeting and the seminar discussed current developments and challenges in investment rule-making, and explored possible ways of improving the international investment agreement system to ensure that it better supported the achievement of the 2030 Agenda and the Sustainable Development Goals. The 7th meeting of the Network will be held on 2 and 3 November 2017, immediately after the current session of the Committee on Trade and Investment. For future meetings of the Network, it is envisaged to evolve as a platform for discussions with foreign investors and to actively engage them in the process of achieving sustainable development.

50. With regard to small and medium-sized enterprises, advisory services were rendered to various countries of the Greater Mekong Subregion in 2016, in particular Cambodia, the Lao People's Democratic Republic and Viet Nam. Similar services will be rendered to other selected least developed countries in 2017. The secretariat is also in the process of finalizing five sectoral studies on integrating small and medium-sized enterprises into global value chains for the Greater Mekong Subregion under a Japan-funded project, with respect to the electronics/electrical, automotive, garments and textiles, agro-industry and tourism sectors. In order to promote digital solutions for small and medium-sized enterprises, online platforms have been developed in cooperation with the ESCAP Sustainable Business Network for Myanmar and for Kazakhstan (the latter under a project funded by the Republic of Korea) to enable access for small and medium-sized enterprises to resources, information and potential business partners and investors. Similar platforms for other least developed and landlocked developing countries are planned with a view to achieving subregional and region-wide platforms.

51. The secretariat organized various informal round tables on responsible business conduct in the areas of e-waste management and responsible use of and access to water by the resort industry in 2016. As a result, the secretariat now actively participates in the global inter-agency Issue Management Group on Tackling eWaste. As a follow-up to the water access round table, the secretariat plans to organize a regional meeting in Phuket, Thailand, later in 2017 in collaboration with Marriott Hotels on responsible water access by the resort industry and exchange of best practices and technology solutions in this

area. A high-level Sustainable Agro-Food Business Forum was held in September 2017 in collaboration with the Agricultural and Food Marketing Association for Asia and the Pacific – an intergovernmental non-profit organization in association with the Food and Agriculture Organization of the United Nations – as part of the activities of the ESCAP Sustainable Business Network's Task Force on Agriculture and Food. A monograph entitled "Toward socially responsible business in Asia and the Pacific: An overview of strategies for a sustainable future" was also published in 2017 as part of implementation of the work programme.

52. Sufficient resource mobilization has been an issue in undertaking the activities of the secretariat in the area of investment and enterprise development, as this area is not a traditional donor priority. The round tables on responsible business conduct mentioned above were organized with zero budget. However, with the approval and formulation of a United Nations Development Account project under the eleventh tranche on strengthening sustainable global value chains as a means of implementation for enhanced regional integration and sustainable development in Asia and the Pacific, funds are expected to be available to address all three areas in the course of 2018 in most subregions.

53. Through these new projects, the secretariat plans to strengthen its work in the area of FDI, small and medium-sized enterprises and responsible business conduct in a holistic and integrated manner with a view to help its members achieve the Sustainable Development Goals by 2030.

V. Issues for consideration

54. The Committee is invited to deliberate on the issues presented and provide guidance to the secretariat in these areas for its future work. In particular, the Committee may provide guidance on:

(a) The role of FDI in achieving sustainable development;

(b) Required policies and strategies to promote, attract and facilitate FDI for sustainable development;

(c) The role of the secretariat in this regard.