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SUSTAINABILITY STANDARDS, SMEs AND GVCs: RECOMMENDATIONS FOR THE G20

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EXECUTIVE SUMMARY

Participation in global value chains (GVCs)[2] by developing countries is limited but holds substantial growth prospects. South Africa and Kenya have the potential to steer regional integration opportunities and act as gateways to favourable investment grounds for multinational corporations (MNCs). This brings with it opportunities for GVC development that small and medium enterprises (SMEs) can take advantage of. SMEs play a significant role in the formal and informal sector, both of which are crucial to the two countries', and their neighbours', economies. Integrating them into GVCs thus holds potential developmental gains in the form of job creation, economic growth and poverty reduction.

We consider the challenges Kenyan and South African SMEs face when integrating into GVCs, with particular focus on voluntary sustainability standards (VSS)[3] as potential enablers of, or barriers to, MNC incorporation of SMEs. We also provide a series of related recommendations for G20 leaders' consideration.

POLICY RECOMMENDATIONS

1. The G20 should continue to foster the development of policies that support regional integration and contribute to ease of doing business in Africa, in order to develop constructive and competitive RVCs that are attractive to foreign players, enhancing opportunities for African countries to act as gateways.

2. The G20 should affirm its commitment to maintaining and extending open international markets, which are crucial for African countries' growth prospects, and to assisting the poorest countries, in particular in sub-Saharan Africa, to integrate into GVCs.

3. The G20 should support further investigation of financing options to support SMEs' uptake of VSS through IFIs over which it has influence. This agenda should continue beyond the remit of the current German G20 presidency, since it forms part of the Sustainable Development Goals (SDG 9.3).

4. The G20 could consider regulating VSS to accommodate small entities in developing countries, and creating an oversight mechanism of groups that establish these VSS, in conjunction with the approach taken by the WTO's Technical Barriers to Trade and Sanitary and Phytosanitary Measures agreements. The purpose would be to consider whether some VSS are overly burdensome and act as NTBs rather than facilitators of market access, particularly in the gateway economies of South Africa and Kenya.

5. Developing countries should signal their clear commitment to a greater UCS agenda by investing in strengthening their domestic PFM and ESF systems.

OVERVIEW OF SMEs INTEGRATING INTO CROSS-BORDER VALUE CHAINS AND THE SUSTAINABILITY STANDARDS REQUIREMENTS

MNCs are at the heart of GVC distribution in the African region and are mainly concentrated in more favourable financial and investment locations or regional 'gateways' such as South Africa and Kenya, which are recognised lead economies that have the potential to enable the development of cross-border value chains (both GVCs and regional value chains, or RVCs). These two countries have well-established standards institutions when compared with other African countries, which is a key factor to service a GVC hub. Their ability to share their experiences and capacities could foster better understanding of the importance of standards in their respective regions.

Access to cross-border value chains via MNCs is difficult for the many smaller enterprises that supply various products into those production processes, owing in part to the stringent requirements that VSS impose on upstream suppliers. Sustainability standards fall in the broader universe of standards but refer specifically to a 'set of criteria defining good social and environmental practices in an industry or production process'.[4] These private standards are intended to promote sustainability concerns within value chains, which in turn are intended to enhance GVC integration and continuity while taking cognisance of the impacts of production and business operations, incorporating environmental, labour and human rights concerns. Sustainability standards foster sustainable production processes and could result in the creation of business opportunities, giving access to new markets where sustainability standards are required.

However, critics argue that sustainability standards have transitioned into a form of non-tariff barriers (NTBs) and, as such, are a major determinant of access to markets. While it is true that uptake of standards should develop producers' capabilities, which may lead to enhanced productivity and efficiency, often this costly practice requires organised actions between upstream and downstream players in the value chain. Consequently, standards can act as a barrier for upstream SMEs to access cross-border value chains. Addressing the issue of legitimacy of standards is important as some VSS, owing to their complexity, may negatively influence the participation of SMEs in GVCs through overly burdensome requirements exceeding technical mandatory regulations. It is therefore important to address the balance between VSS that enhance sustainability and those that inhibit GVC development. SME inclusion vis-à-vis GVC standards is hindered by a variety of factors, as illustrated in Figure 1.

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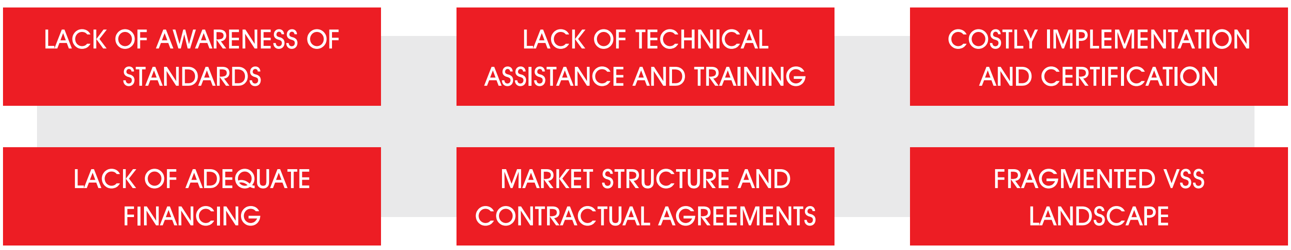
FIGURE 1: OBSTACLES RELATED TO STANDARDS THAT SMEs FACE IN ACCESSING MNC VALUE CHAINS



Source: Authors' own research

Lack of awareness is a major factor hindering the uptake of sustainability standards by SMEs, and centres on their lack of understanding of the value that adopting these standards could bring to their businesses. However, reaching out to SMEs is challenging, especially informal SMEs, when they do not belong to value chains within which advice on standards is available. The dispersed nature of SMEs, and the opportunity costs they incur to gain such understanding, should be addressed.[5] Business organisations that are networks containing MNCs and SMEs, such as the South African Chamber of Commerce and Industry and the Kenyan Association of Manufacturers, could be mobilised to bring more SMEs into the equation. Ensuring there is transparency of the standards implementation process, costs associated, assessment methodologies and dispute resolution processes will allow SMEs to make more informed decisions and streamline the process of gaining awareness. Mobilising financial and institutional support for SMEs to engage in standards adoption should be considered by the G20 and related institutions, for example by supporting national standards bodies to establish multi-stakeholder dialogue forums and awareness campaigns, as has been done in India, China and Brazil.

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Furthermore, SMEs often lack the **technical capacity** to understand the requirements of these sustainability standards and how to adhere to them on a consistent basis.[6] Capacity-building initiatives were highlighted in the case of Siemens, which seeks to boost the competitiveness of SMEs in its supply chains. Where possible, cooperation mechanisms between companies that can drive low cost and high uptake of information technology (IT) tools should be developed, for example, enabling the creation of digital self-assessment questionnaires for producers. Greater Internet access will also allow standards bodies to collect data and understand how these producers are performing to gauge the sustainability gaps better, ie, to target funding or interventions to these sectors. Support from the G20 and related institutions would be to foster IT-driven initiatives designed to build knowledge of SME ecosystems in poor countries through better-focused development assistance initiatives, and tasking of international financial institutions (IFIs). This could build on SME survey data in collaboration with the likes of South Africa's Silicon Cape Initiative. The G20, working with the B20, could do more to support and facilitate MNC/SME interactions to raise awareness of SMEs on VSS and standards in general. This could be done by supporting business-to-business discussions, particularly at the regional level, and working with regional business associations.

Ensuring there is transparency of the standards implementation process, costs associated, assessment methodologies and dispute resolution processes will allow SMEs to make more informed decisions and streamline the process of gaining awareness

More **institutional support mechanisms** to adopt and adhere to sustainability standards are essential. These would include extending the geographical presence of standards bodies for SMEs to make use of testing facilities, documentation support, and support for the implementation of the standards process. Much of this hinges on access to the Internet, as the majority of procurement processes are centrally regulated.[7] Therefore a push for Internet access, especially in remote regions where SMEs may be dispersed, is required.

Attaining these standards and ensuring their ongoing implementation is financially costly to SMEs. The **costs of attaining certification and implementing** sustainability standards are a well-known barrier. These costs are often independent of the value of the SMEs' operations, obliging them to incur fixed costs that limit profit margins. Since SMEs bear most of the costs of certification and implementation, cost-sharing mechanisms between SMEs, standards bodies and MNCs should be promoted as an incentive for the adoption of standards.[8]

Naturally, costs relate to **financing**, with access to finance being a constant issue for SMEs. Financing is relevant for funding not only the growth and operations of SMEs but also the up-skilling costs incurred to enter value chains and the maintenance costs to adhere to sustainability standards. Resolving gaps to finance is essential. Government finance is still present, but it should be more accessible and timely, and hold less conditionality for SMEs to take advantage of it.[9] More innovative financing options other than debt should be investigated and promoted, such as equity financing.

The **regulatory framework of markets and the contractual relationships** between SMEs and the respective MNCs they supply should be examined. In South Africa some SMEs are realising that several value chains offer no viable growth trajectory, creating a disparity where SMEs suffer from the lack of upgrading within supply chains owing to a lack of support from lead firms.[10] By contrast, some MNCs adopt upstream SMEs or suppliers of their choosing and foster their growth and development. However, MNCs assimilate these SMEs into their value chains on a long-term basis and that can lead to these SMEs losing their intellectual property rights.[11] The support structure offered by MNCs to their suppliers appears to depend on the nature of their contractual arrangements and the business strategy of the particular MNC. This, in turn, is dependent on whether competition exists between many suppliers and one MNC, where SMEs would face additional unnecessary costs, versus having an MNC pick and choose its SME suppliers, where the MNC has an interest to protect its brand. Governments should accordingly consider retail companies' buyer's incentives, and manage their bargaining powers through regulated contractual agreements.[12]

The **duplication of VSS requirements** is where the issue of harmonisation of standards becomes critical. VSS are growing rapidly in number, whereas the governance of these standards and the intentions behind their creation are being questioned.[13] On the policy front the legitimacy of these standards should be examined, as it is difficult for SMEs to know which standards to comply with and what testing is necessary for their specific products, with instances of duplicate testing being recorded.

ENDNOTES

1 Anna Ngarachu is a Researcher at Tutwa Consulting Group; Peter Draper is Managing Director of Tutwa Consulting Group.

2 We refer to GVCs particularly as cross-border value chains.

3 Also referred to as private voluntary standards. ISEAL (International Social and Environmental Accreditation and Labelling Alliance), 'Learn about sustainability standards', http://www.isealalliance.org/multimedia/learn-about-sustainability-standards, accessed 4 April 2017.

5 Personal interview, Babalwa Ntlangula, Standards Developer: Systems and Services, SABS (South African Bureau of Standards), Pretoria, 10 April 2017.

6 G20, *Promoting Standards for Responsible Investment in Value Chains*, Report to the High-Level Development Working Group, September 2011, http://unctad.org/sections/dite_dir/docs/diae_G20_CSR_Standards_Report_en.pdf, accessed 3 April 2017.

7 Owino K, 'Kenya Case Study – Value Chains, Private Sustainability Standards and SMEs'. Nairobi: Institute of Economic Affairs Kenya, 2017.

8 ITC (International Trade Centre), *Social and Environmental Standards: Contributing to More Sustainable Value Chains*, 2016, http://www.intracen.org/publication/Social-and-Environmental-Standards-Contributing-to-More-Sustainable-Value-Chains, accessed 11 April 2017.

9 Skype interview, Duane Newman, Managing Director, Cova Advisory, Pretoria, 12 April 2017.

10 Draper P & C Pswarayi, 'SMEs and GVCs in the G-20: Implications for Africa and Developing Countries', Discussion Paper. Pretoria: GEG Africa, 2016.

11 Personal interview, Dumisani Mngadi, SMME Manager, SABS, Pretoria, 10 April 2017.

12 Von Broembsen M, 'You Can't Bite the Hand that Feeds You: The Commercial and Contractual Relations between the Four Large South African Food Retailers and their SME Suppliers', Working Paper. Cape Town: REDI3x3, 2016.

13 GEG Africa Study Group Event, Lily Sommers, African Trade and Policy Centre, Pretoria, 8 June 2017.

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