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**Report VI**

# **The promotion of sustainable enterprises**

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## Executive summary

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### Promotion of sustainable enterprise

This report for the 2007 session of the International Labour Conference is a contribution to the broad and wide-ranging international debate on the promotion of enterprise. The central role of the private sector, in all its forms, is increasingly recognized as key to development challenges including employment creation. The report takes stock of the developments and experiences from a decent work perspective, with particular emphasis on how to strengthen the contribution of enterprises to productive and equitable economic and employment growth. The report will inform the general discussion, the intended outcomes of which are:

- ❑ a stocktaking of the international debate on the role of the private sector and sustainable enterprise in overall social and economic development;
- ❑ an assessment of the relevance and implications of recent trends for the implementation of the ILO's Decent Work Agenda;
- ❑ an ILO contribution, centred on the Decent Work Agenda, to the global debate on the role of the private sector in overall social and economic development;
- ❑ recommendations for ILO work to enhance coherent policies and strategies that promote decent work through sustainable enterprise development.<sup>1</sup>

### The concept of a sustainable enterprise

The promotion of sustainable enterprises is a broad and wide-ranging subject, not least because enterprises take many forms, not just in terms of size, sector and spatial dimensions but also in terms of how an enterprise is managed and governed and its legal status and operational objectives. All enterprises are part of society; they shape and are shaped by the communities in which they operate.

Promoting sustainable enterprises is about strengthening the institutions and governance systems which nurture enterprises – strong and efficient markets need strong and effective institutions – and ensuring that human, financial and natural resources are combined equitably and efficiently in order to bring about innovation and enhanced productivity. This calls for new forms of cooperation between government, business and society to ensure that the quality of present and future life (and employment) is optimized whilst safeguarding the sustainability of the planet.

The importance of enterprise as the principal source of growth and employment cannot be overstated. Economic growth is fuelled, first and foremost, by the creativity

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<sup>1</sup> ILO: *Date and agenda of the International Labour Conference – (a) Agenda of the 96th Session (2007) of the International Labour Conference*, GB.294/2/1, Governing Body, 294th Session, Geneva, Nov. 2005.

and hard work of entrepreneurs and workers. Driven by the quest for profits, enterprises innovate, invest and generate employment and wage income.

Enterprises need to ensure that their core business activities continue to add value and are undertaken efficiently and effectively. Enterprises also need a supportive enabling environment characterized by, among other things, the existence of open, rule-based, predictable and non-discriminatory markets and a non-corrupt and well-governed economy. Enterprises benefit from operating in value chains characterized by high-quality industries, with prosperous consumers and investors. Enterprises also benefit from enterprise-level, sectoral and national mechanisms for effective social dialogue.

A distinction is made between enterprise development per se and the development of *sustainable* enterprises. The concept of “sustainable enterprise” is related to the general approach to sustainable development – forms of progress that meet the needs of the present without compromising the ability of future generations to meet their needs – an approach which postulates a holistic, balanced and integrated perspective on development. However, sustainable development is about more than just environmental issues; it requires the integration of all three pillars of development – economic, social and environmental.

The social dimension of sustainable development typically includes “a commitment to promote social integration by fostering societies that are stable, safe and just and which are based on the promotion and protection of all human rights and on non-discrimination, tolerance, respect for diversity, equality of opportunity, security and participation of all people including the disadvantaged and vulnerable groups and persons”.<sup>2</sup> A central tenet of the social pillar of sustainable development is, of course, the generation of secure livelihoods through freely chosen productive employment. Sustainable development is therefore a framework for the general global dialogue on growth and development, but also for the more specific discussion on enterprise development and, within that, it provides a sound framework for the debate on regulation and voluntary action in the sphere of business.

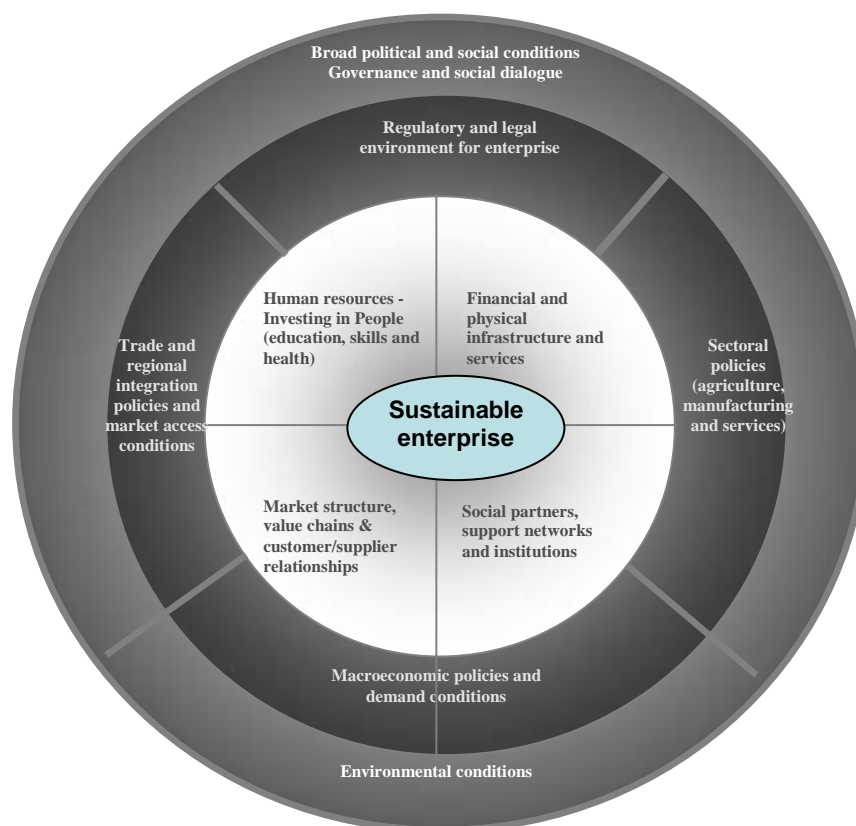
Thus, in contrast to narrowly defined, traditional perspectives which depict enterprises in terms of linear input–output relationships centred solely on maximizing short-term economic value, an integrated approach to sustainable enterprise development takes a more holistic and long-term view. Figure 1.1 (Chapter 1) illustrates in a stylized form distinctions between three overlapping and interdependent operational and policy spheres (micro, macro and meta levels). At the centre are the sustainable enterprises, which comprise a number of different stakeholders, including shareholders, employers, employees and customers, as well as relationships with suppliers, governments and the broader community.

The micro level refers substantively to what goes on within the enterprise or its immediate environment (the management of human and financial resources and use of physical resources like energy, transport and communications systems) and to the direct interface between enterprises and their customers and suppliers. It also refers to workplace organization, to support networks and institutions and, within this, to the role that social dialogue and social partners play in fostering sustainable enterprises. Thus, at the micro level, it is necessary to consider the sustainability of an enterprise in terms of the structure of the sector or market in which it operates and, in particular, its relationship with suppliers and customers along the value chain.

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<sup>2</sup> *The Copenhagen consensus* – a summary of principle commitments of the World Summit for Social Development, Copenhagen, 1995, Commitment 4.

Figure 1.1. An integrated approach to sustainable enterprise development  
(Chapter 1)



At the next level – the macro level – there are a set of policy areas which directly define the competitive and enabling environment and determine the sustainability and growth potential of enterprises. These policy areas are: macroeconomic policies (fiscal, monetary and exchange rate), particularly those affecting demand conditions; specific policies at the sectoral level – agriculture, manufacturing and services – as well as geographical or regional enterprise development policies, investment promotion and industrial policies; trade and regional integration and market access policies; and the specific regulatory and legal environment for doing business.

At the meta level are the broad political, economic, social and environmental conditions which determine, among other things, the quality of institutions and governance in a society. Included here are a range of factors which might not be specific to enterprise but which effectively influence broader private sector development and general societal outcomes such as stability, inclusivity and the challenges posed by issues like inequality and corruption. The sustainable stewardship of the natural environment is also covered at this level, as are governance issues and the role that social dialogue can play in fostering the conditions for sustainable enterprises.

The rise of globalization and the broadening and deepening role of the private sector in the domestic economy have given rise to new challenges and opportunities. Globalization has compounded the economic, social and environmental challenges facing enterprises. All these changes have brought about a new and evolving relationship between business and development.

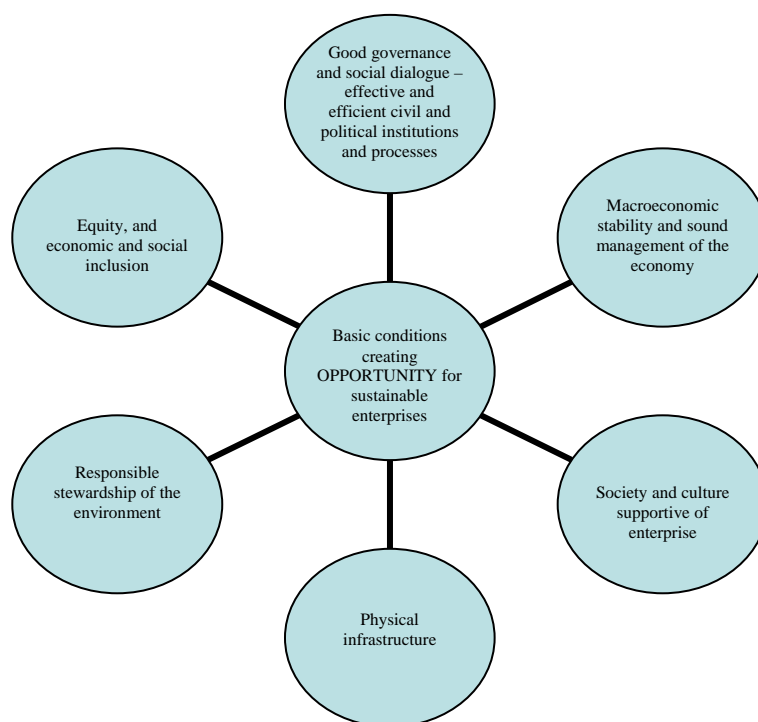
There is a symbiotic relationship between enterprise and development – business thrives where society thrives – and the private sector has a vital role to play in helping

countries to achieve the Millennium Development Goals (MDGs), not least the headline target of halving the US\$1 a day poverty head count, while MDG 8 specifies that a global partnership for development, including cooperation with the private sector, should underpin international efforts. This makes creating the right conditions for profitable and sustainable enterprise development and private investment a high priority in development policy and for the Decent Work Agenda.

## Creating opportunity for sustainable enterprises: Basic conditions

For any enterprise, irrespective of size, the sector it operates in or its legal structure, the broad political, social, economic and environmental context – the basic conditions shown in figure 3.3 (Chapter 3) – is vitally important. It is generally accepted, for example, that peace, a trusted and respected legal system, appropriate levels of social development and relatively predictable and stable political institutions, all have a major bearing on the sustainability of enterprises. These broad “meta conditions” provide the framework for wealth creation: they are necessary for fostering enterprise growth but they are not in themselves sufficient, as they do not actually create wealth themselves. The relationship between such broad parameters and enterprise growth is very complex but some general principles can be discerned.

Figure 3.3. Basic conditions creating the opportunity for sustainable enterprises (Chapter 3)



The structure of civil and political life is undoubtedly an important determinant of competitiveness, economic growth and sustainable enterprise. Good governance – which encompasses respect for human rights, functioning democratic institutions, freedom of expression, equal rights for women and men, effective mechanisms for social dialogue, and so forth – generally provides a sound basis for sustainable development.



Governments which maintain macroeconomic stability and ensure transparency and due process in policy-making, which safeguard property rights, channel tax revenues back into the economy through productivity-enhancing investments in human capital and physical infrastructure, ensure that good laws are made and upheld, that public order and security is maintained and that there is proper stewardship of the natural environment, are likely to create the best socio-economic conditions for sustainable enterprises to flourish.

There is ample evidence to show that enterprise is severely constrained in an economy where property rights are inadequately defined. When property owners, whether material or intellectual, are not guaranteed their rights, they are unwilling to invest further, while potential new entrants to the formal market will have incentives to disguise their activities and remain in the informal economy, outside the realms of decent work. Similarly, enterprise is likely to be built on a more secure foundation when society embraces a broad-based culture supportive of enterprise.

Equity and economic and social inclusion are important basic conditions for sustainable enterprises. Inequality of assets and opportunity hinders the ability of poor people to participate in and contribute to growth. High levels of income inequality weaken the poverty reduction impact of a given growth rate and can undermine the political stability and social cohesion needed for sustainable growth. Social inclusion – whether based on gender, ethnicity or any other factor – is inherent in sustainable societies and strengthens the potential for sustainable enterprises.

## Evolving and contemporary approaches to enterprise development

Enterprise development policies and programmes, and private sector development more generally, figure highly in plans and strategies concerned with promoting growth and development. Notwithstanding the diversity of national contexts, motivations and objectives for undertaking enterprise or private sector development, there is an emerging body of good practices grounded in a wide range of practical, project-based experiences in this field. It is possible to distinguish three broad trends (or paradigms) which have evolved over the past 30 or so years (see table 2.1, Chapter 2). These paradigms represent a somewhat stylized distinction between approaches which, in practice, are complementary and overlap.

**Table 2.1. Evolving approaches to enterprise development: The three paradigms (Chapter 2)**

Paradigm 1	Paradigm 2	Paradigm 3
Targeted enterprise-level interventions	Plus the enabling environment	Competitiveness
Business development services (BDS) Financial services (FS)	Business development services (BDS) Financial services (FS)  Business (enabling) environment (BEE)	Business development services (BDS) Financial services (FS) Business (enabling) environment (BEE)  Investment climate (IC) Making markets work for the poor (MMW4P) Value chains (VC)

Early approaches to enterprise development – paradigm 1 – emphasized strengthening the “sector” by building the capacity of individual enterprises through business development services (BDS) and financial services (FS). These approaches were often targeted at particular sizes of enterprises, particular subsectors, particular groups of people, or based on a spatial dimension, such as part of an area-specific rural development programme. However, there emerged a growing concern that enterprise-specific interventions were being constrained by external factors inherent in the environment and were limited in terms of outreach. Thus, a new paradigm emerged – paradigm 2 – which added the business (-enabling) environment (BEE) to the enterprise-level interventions.

As increased attention was given to the business environment, and the private sector was no longer viewed as an amalgam of enterprises categorized primarily by size but as an integrated system of product and service markets governed by a regulatory framework responsive to changes in demand, a third paradigm emerged, concerned ultimately with national competitiveness. This paradigm embraced improvements to the investment climate, focused largely on enhancing the opportunities, incentives and conditions for attracting investment and promoting the growth of formal, often larger enterprises, and with bottom-up approaches concerned with making markets work, particularly in terms of ensuring that opportunities reach down to the poor and that markets are inclusive and equitable.

Making markets work and improving the investment climate is not simply about unleashing market forces. It is an approach which recognizes that efficient markets need effective institutions, and that markets cannot always be left to themselves to allocate resources efficiently. If markets do not work, market failure is said to occur. There are four broad areas of potential market failure: provision of public goods; the abuse of market power; positive and negative externalities; and asymmetric information. In each case, governments have a role in ensuring that markets work better and in the broader public interest.

## The regulatory and legal environment: Issues and policies

The business-enabling environment is a broad concept which covers a range of factors, external to the enterprise, that affect enterprise formation and growth. A good business environment enables entrepreneurs to expand their activities and creates incentives for them to formalize their businesses. Experience shows that a good business environment encourages investment and promotes higher levels of growth. A strong evidence base has built up to show that inappropriate regulations, excessive “red tape” and bureaucratic obstacles, lengthy business registration procedures, ineffective safeguards of property rights, corruption and weak commercial justice systems, all constrain businesses, especially in poorer countries.

Of the many factors which influence the business environment, aspects of the legal and regulatory environment invariably figure highly on most policy agendas. Of particular significance are: the framework of laws and regulations covering such things as business registration, licensing, taxation, employment, access to credit and other types of finance; contract enforcement; protection of property rights; and bankruptcy provision.

Ultimately, improving the business-enabling environment is expected to strengthen the capacity for wealth creation, productive employment and decent work. In developing

countries it is often seen as a mechanism for helping to tackle poverty reduction. However, regulatory policy-making presents a conundrum. There are constant demands for more regulation to protect, for example, the environment, workers or consumers, but where regulation is poorly designed or overly complicated it can impose excessive costs and constrain productivity.

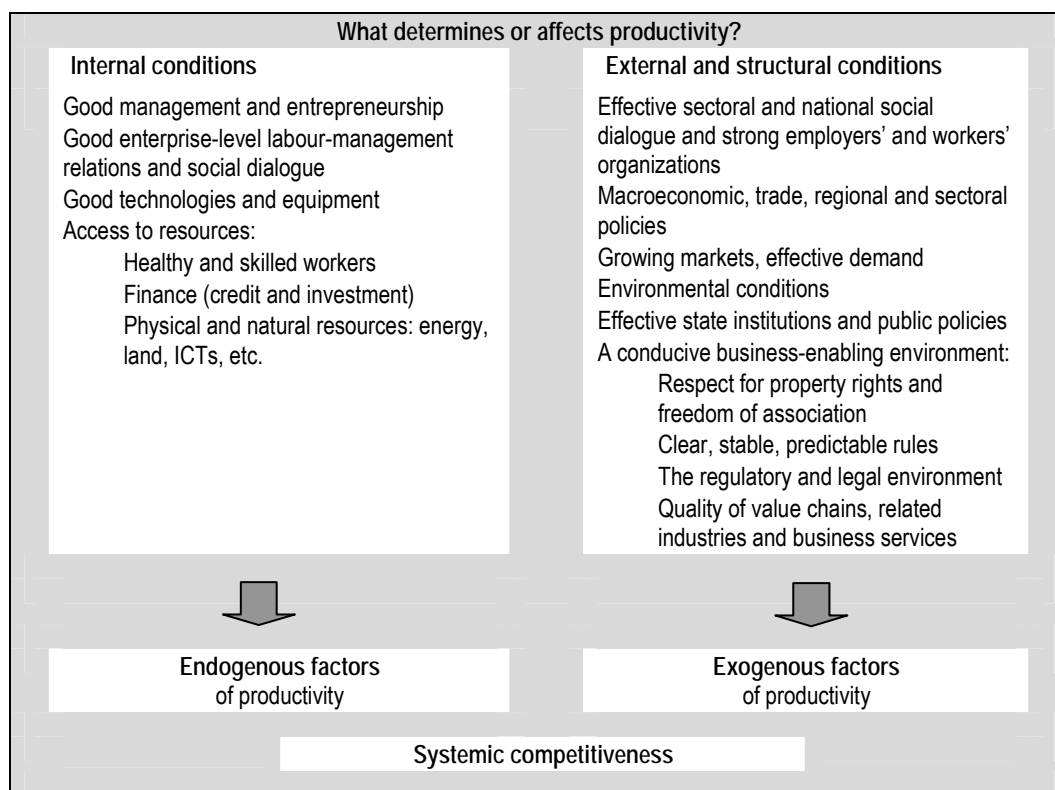
Governments thus face the difficult challenge of getting the balance right, providing proper protection to different groups, and making sure that the impact on those being regulated is proportionate. This is a vital challenge because the efficient functioning of markets and enterprises is in the interest of public authorities, businesses, citizens and the social partners, and is increasingly determined by the regulatory frameworks in which they operate.

Regulatory reform is not simply deregulation, nor is it only a matter of costs: it is about appropriate regulations, smart regulations, effective and efficient regulations. Regulations and administrative procedures are needed to implement public policies. Private enterprises depend on adequate regulatory frameworks to ensure fair competition (“level playing fields”), to make markets work better (through regulations on contract enforcement and the protection of intellectual property rights) and to ensure the sustainability of markets (through regulations on waste management, and fuel and energy use).

## Creating wealth and decent work through competitive enterprises and nations

Competitiveness has its foundation in productivity, and enterprises become sustainable by being competitive themselves and functioning in a competitive environment (figure 4.1, Chapter 4). This is fundamental for making markets work, increasing choice, stimulating innovation and creating wealth. The concept of competitiveness is vitally important, but difficult to define and measure, and problematic because virtually everything may matter for competitiveness; what matters most is likely to change over time as economies and societies develop, and will vary from one location or sector to another.

**Figure 4.1. Internal and external influences on productivity**  
(Chapter 4)



Because of the depth and breadth of the concept of competitiveness, there is broad agreement that the most informed approach to assessing it is by reference to a wide range of factors. There are two international surveys of competitiveness produced annually which attempt to present a systematic and holistic assessment of the competitiveness of nations. These are the Global Competitiveness Report (GCR) and the World Competitiveness Yearbook (WCY). Both surveys make use of secondary data from national and international sources, and also conduct specific surveys of business leaders/executives. Both publications weight together a large number of variables to produce overall indices of competitiveness, covering a large number of countries and territories.

Although there is no magic formula for enhancing national competitiveness, broad trends can be discerned indicating the relative importance of different factors according to levels of development. Overall, though, it appears that, irrespective of levels of development, business environment factors as a group are a greater determinant of differences in competitiveness across countries than are enterprise-level factors. Governments clearly have a role to play in fostering national competitiveness through public policy which stresses systemic competitiveness and integrates reforms in the business environment with skills upgrading, investment in research and development and appropriate industrial, regional, trade, investment and competition policies.

## Sustainable economic integration through trade and value chains

One of the oldest insights in economics is that the size of the market is an essential determinant of the potential for enterprises to grow and take advantage of economies of scale, of opportunities for countries to have a more diversified, more competitive and higher-productivity economy and, therefore, of creating productive employment and decent work and achieving higher standards of living.

A conducive environment is critically influenced by trade policies and the investment climate. Opening up an economy and integrating it into larger markets is an important strategic direction to increase competition, improve productivity and promote diversification, but it must be done wisely because not all patterns of integration into the world economy have the same effect on growth and jobs.

Although globalization has the potential to yield significant long-term welfare gains, in the short term, safeguards are required to minimize the costs of adjustment. Appropriate policies need to be put in place to assist developing countries in overcoming supply-side production constraints and to enable exporters to meet the requirements of international markets, diversify exports and increase added value. Making it easier to trade by increasing market access, improving trade rules, encouraging the growth of sustainable value chains and strengthening ethical and fair-trade principles and practices in trading relationships, are all important trade-related dimensions of promoting sustainable enterprises.

## The role of enterprise in society

Enterprises operate in ever more complex social and economic systems in which they are subject not only to commercial and economic pressures but also to social and environmental pressures from governments, civil society groups, consumers, suppliers and their owners, managers and workers.

The issue of the social responsibility of business is not new but it has become more prominent in recent years. The ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, dating from 1977 and updated most recently in 2006, is one of the earliest international instruments covering the social dimension of business. Conceptually, the increased attention given to the role of business in society is grounded in the basic message of sustainable development, namely, that in the long term, economic growth, social cohesion and environmental protection go hand in hand. Promotional instruments like the United Nations Global Compact, and reporting mechanisms like the Global Reporting Initiative (GRI), have enhanced the profile of social and environmental dimensions of business.

The main contribution of business in helping to address the multiple challenges of sustainable development, productive employment and decent work rests on the creation and growth of viable enterprises. This comprises the core business activities such as producing safe and affordable products and services, generating income and investment, and creating decent jobs. However, progressive enterprises now realize the value of being “ahead of the curve” in terms of corporate responsibility, not least because social and environmental criteria are increasingly influencing consumer decision-making and the investment decisions of individuals and institutions.

Even though there is a strong ethical or normative case, and often a sound business case, for enterprises to integrate social and environmental requirements, as expressed by

international standards and national laws and practices, into their operations, this does not imply that all enterprises will necessarily do so. Nor does it negate the important role that government has in maintaining laws, regulations and standards – including as they relate to the international labour standards – and in providing appropriate promotional policies to encourage the formation and growth of sustainable enterprises.

Businesses, either individually or through their representative organizations, can add great value to relevant public policy dialogues by participating in, for example, national poverty reduction strategy planning and donor-based forums, trade and environmental policy-making, and global dialogues on issues such as climate change, biodiversity, money laundering, national security, corruption and human rights issues. Such dialogues serve to underscore the importance of productive employment and decent work as a global goal.

In parallel, forward thinking, progressive enterprises are increasingly adopting and implementing responsible business practices and standards to set a positive example for sustainable private sector development, including in developing countries. This is grounded in a range of social, ethical and environmental instruments, codes of conduct and reporting formats such as the Equator Principles for project finance and the Extractive Industries Transparency Initiative (EITI) for the oil, gas and mining sector.

## Financial and physical infrastructure and services

Sustainable enterprises of all sizes and types need access to financial and physical infrastructure and services. Financial infrastructure refers to the legal and regulatory framework for the financial sector and the institutions and systems which enable financial sector intermediaries to operate effectively. Financial services cover a range of financial products or instruments, including credit, savings, insurance, leases, equity investments, payment services and remittances.

Inclusive financial markets are necessary for fostering sustainable enterprises because all enterprises require financial services. Small and medium-sized enterprises (SMEs) are often under-served by financial intermediaries, especially in developing countries, and addressing this “missing middle” should be a major objective of policies with a view to strengthening the inclusivity of financial infrastructure and services for sustainable enterprises. As the example of social finance illustrates, financial services can be used to promote productive and decent work outcomes, and one powerful and rapidly growing instrument for this is through investments that specifically address or target social and environmental factors.

Physical infrastructure is a key component of the investment climate, with the potential to reduce business costs and enable enterprises and individuals to access markets. It is crucial to agriculture and rural development, a key enabler of trade and integration, important for offsetting the impact of geographical dislocation and sovereign fragmentation, and critical for improving access to world markets. It is fundamental to human development, including the delivery of health and education services to poor people.

## Human resources: Investing in people

Sustainable enterprises recognize people as a source of competitive advantage and treat their employees both as assets and as agents for change. In the light of new and evolving structures of production and work, enterprise success and productivity is likely

to depend increasingly on human resources. Globalization makes investing in people more important than ever, and this involves investing in the quality of working life through appropriate workplace organization, workplace practices, conditions of employment, and human resource development and management.

The competitiveness and viability – and even survival – of enterprises increasingly depends on the ability to ensure that employees are motivated, skilled and committed. This is best achieved in a progressive workplace environment characterized by a spirit of mutual trust and respect, non-discrimination and good labour–management relations. Evidence suggests that employees are motivated by many different things, and that creating a positive work environment boosts not only morale but also productivity and competitiveness. Appropriate workplace practices, including conditions of work, particularly as they relate to occupational safety and health (OSH), as well as sound labour–management relations and human resource development policies, are vitally important for the promotion of sustainable enterprises.

However, investing in people is also about public policies to foster a skills- and knowledge-based approach to employability. The design and implementation of coherent economic policies which address the demand side of the economy are also vital to ensuring that the potential of an employable workforce is maximized. The benefits of investing in people are likely to be greater if they take place in parallel with broader improvements to the basic conditions, the investment climate, and an appropriate national framework for effective social dialogue.

## Social partners, social dialogue and tripartism

Institutions and organizations matter for sustainable enterprise development. Employers' and workers' organizations working together with governments are capable, under certain circumstances, of creating enabling and basic conditions for sustainable enterprise development in three areas: democratic governance; economic efficiency; and social equity. In terms of governance, they can promote greater political accountability and provide an effective means for dialogue and conflict management, making politics more transparent and less divisive.

Employers' and workers' organizations also play an important economic role. They influence, directly or indirectly, working conditions at the enterprise level, as well as the policy and regulatory environment in which enterprises operate. Evidence indicates that their impact on competitiveness and productivity can be very positive. In terms of social equity, both types of organizations can perform an important function in enhancing social inclusion and combating all forms of discrimination. Their interaction, along with the State, also has important consequences for income distribution.

It is clear, however, that not all employers' and workers' organizations are equally capable of making the type of positive contributions in each of these three spheres. Three key conditions are necessary to enhance their development potential: freedom (the right to organize and collective bargaining); strength (sufficient institutional capacity); and external factors (functioning and supportive markets and state institutions).

## Abbreviations and acronyms

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BASI	(ILO) Business and Social Initiatives Database
BDS	business development services
BEE	business-enabling environment
CEFE	competency-based economies through formation of enterprise
CEO	chief executive officer
CSR	corporate social responsibility
DFID	Department for International Development (United Kingdom)
DWCP	Decent Work Country Programme
ECOSOC	Economic and Social Council
ED	enterprises development
EITI	Extractive Industries Transparency Initiative
EPZ	export processing zone
ETI	Ethical Trading Initiative
EU	European Union
EYB	Expand Your Business
FDI	foreign direct investment
FS	financial services
GATT	General Agreement on Tariffs and Trade
GCR	Global Competitiveness Report
GDP	gross domestic product
GEA	Global Employment Agenda
GEM	Global Entrepreneurship Monitor
GRI	Global Reporting Initiative
GTZ	Gesellschaft für Technische Zusammenarbeit (Germany)



HIV/AIDS	human immunodeficiency virus/acquired immune deficiency syndrome
IOE	International Organisation of Employers
ICFTU	International Confederation of Free Trade Unions
ICT	information and communication technology
IFC	International Finance Corporation
IPA	investment promotion agencies
IT	information technology
KAB	Know about Business
LED	local economic development
MDG	Millennium Development Goal
MMW4P	making markets work for the poor
MNC	multinational corporation
MSE	micro- and small enterprises
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organization
OECD	Organisation for Economic Co-operation and Development
OSCE	Organization for Security and Co-operation in Europe
OSH	occupational safety and health
PPD	Public-private dialogues
PPP	Public-private partnerships
RIA	regulatory impact assessments
RTO	registered training organization
SARS	Severe Acute Respiratory Syndrome
SEED	(ILO) Programme on Boosting Employment through Small Enterprise Development
SIDA	Swedish International Development Cooperation Agency
SIYB	Start and Improve Your Business
SME	small and medium-sized enterprises
SRI	socially responsible investment
TNC	transnational corporation
UNCTAD	United Nations Conference on Trade and Development

UNDAF/CCA	United Nations Development Assistance Frameworks/Common Country Assessments
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
VET	vocational education and training
WBCSD	World Business Council for Sustainable Development
WCY	World Competitiveness Yearbook
WEF	World Economic Forum
WHO	World Health Organization
WIRED	Workforce Innovation in Regional Economic Development
WTO	World Trade Organization

# Chapter 1

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## Introduction – The concept of sustainable enterprises

1. There is a broad and wide-ranging international debate on the promotion of enterprise and a growing recognition of the central role of the private sector, in all its forms, in addressing key development challenges including employment creation. As requested by the Governing Body, this report for discussion at the International Labour Conference takes stock of these developments and experiences from an ILO decent work perspective, with particular emphasis on how to strengthen the contribution of enterprises to productive and equitable economic and employment growth. The report will inform the general discussion, the intended outcomes of which are:

- ❑ a stocktaking of the international debate on the role of the private sector and sustainable enterprise in overall social and economic development;
- ❑ an assessment of the relevance and implications of recent trends for the implementation of the ILO's Decent Work Agenda;
- ❑ an ILO contribution, centred on the Decent Work Agenda, to the global debate on the role of the private sector in overall social and economic development;
- ❑ recommendations for ILO action to enhance coherent policies and strategies that promote decent work through sustainable enterprise development.<sup>1</sup>

2. The ILO has always been concerned with the conditions of labour, poverty reduction and employment promotion, as described in the Preamble to the Constitution and in the Declaration concerning the aims and purposes of the International Labour Organization adopted in 1944 at Philadelphia. The role of enterprises figures implicitly in these foundation documents. However, it is only in more recent times that the ILO's work on enterprises has been formalized in particular instruments.<sup>2</sup> The principal and most specifically relevant instrument with regard to enterprise creation and development is the Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189). Also of relevance is the Employment Policy Convention, 1964 (No. 122), as well as the accompanying Recommendation (No. 122), the Employment Policy (Supplementary Provisions) Recommendation, 1984 (No. 169) and the Promotion of

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<sup>1</sup> ILO: *Date and agenda of the International Labour Conference – (a) Agenda of the 96th Session (2007) of the International Labour Conference*, GB.294/2/1, Governing Body, 294th Session, Geneva, Nov. 2005, para. 21.

<sup>2</sup> As part of the ILO follow-up on the World Summit for Social Development (Copenhagen, Mar. 1995), which endorsed the importance of SMEs for employment and poverty reduction, the Office prepared a Governing Body paper – ILO: *The role of enterprise development in employment promotion and social progress – An ILO strategy*, Committee on Employment and Social Policy, Governing Body, 268th Session, Mar. 1997, GB.268/ESP/1 – which ultimately led to the creation of an ILO programme for enterprise development, which became known as SEED (Programme on Boosting Employment through Small Enterprise Development).

Cooperatives Recommendation, 2002 (No. 193). The ILO's approach to promoting enterprise is also guided by the fundamental labour Conventions, by reports and conclusions from recent International Labour Conferences,<sup>3</sup> by the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (updated 2006) and by the Global Employment Agenda (GEA) (2003) and successive discussions of its technical core elements and, in particular, the fifth element on promoting decent employment through entrepreneurship.<sup>4</sup> The report of the World Commission on the Social Dimension of Globalization of 2004 also provides important guidance. The approaches contained in these instruments and reports reflect contemporary advances in thinking and practice in the promotion of enterprise.

3. This report takes stock of the international debate on the role of the private sector, in all its forms, in overall social and economic development. This debate has been particularly active in, among other institutions, the World Bank Group and the OECD. On the basis of a decent work perspective, this report places particular emphasis on how to strengthen the contribution of enterprises to productive and equitable economic and employment growth. It includes a review of contemporary thinking, experiences and emerging good practices in the promotion of enterprises, illustrating how trends and paradigms have evolved in recent times. Emphasis is placed on the need to foster competitive markets and a business environment which facilitates growth along and across value chains, and this is placed in the context of globalization and trade. Enterprise does not happen in a vacuum; it is a part of society, and is both shaped by and serves to shape the communities in which it operates. This important factor is mainstreamed throughout the report.

4. Making markets work and promoting enterprise growth is about strengthening the institutions and governance systems which nurture enterprises – strong and efficient markets need strong and effective institutions – and ensuring that human resources are developed to bring about innovation and enhanced productivity. These are central and recurrent themes in the report. Central to generating the growth of enterprises are well functioning and inclusive financial markets which will have a major bearing on the nature and type of enterprise in a given economy, depending on, for example, the relative prevalence of short-term or long-term financing instruments and ways of raising capital.<sup>5</sup> Similarly, physical infrastructure and services like energy, transport and communications, which underpin economic activity, will also have a major influence on the nature and growth of enterprises, and this is also covered in the report. Furthermore, sustainable growth of enterprises and environmental protection are inextricably linked, and this calls for new forms of cooperation between government, business and society to ensure that the quality of present and future life (and employment) is maximized.<sup>6</sup> The report thus maps out what promoting sustainable enterprises could mean for the ILO, and

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<sup>3</sup> Such as ILO: *Decent work*, Report of the Director-General, International Labour Conference, 87th Session, Geneva, 1999; *Reducing the decent work deficit: A global challenge*, Report I(A), Report of the Director-General, International Labour Conference, 89th Session, Geneva, 2001; and *Decent work and the informal economy*, Report VI, International Labour Conference, 90th Session, Geneva, 2002.

<sup>4</sup> See, ILO: *Review of the core elements of the Global Employment Agenda*, Committee on Employment and Social Policy, Governing Body, 286th Session, Mar. 2003, GB.286/ESP/1(Rev.); and ILO: *Promoting decent employment through entrepreneurship*, Committee on Employment and Social Policy, 289th Session of the ILO Governing Body, Mar. 2004, GB.289/ESP/1.

<sup>5</sup> R.G. Rajan and L. Zingales: *Saving capitalism from the capitalists – Unleashing the power of financial markets to create wealth and spread opportunity* (Princeton, Princeton University Press, 2004).

<sup>6</sup> S. Schmidheiny: *Changing course: A global business perspective on development and the environment* (Cambridge, MIT Press, 1992).

suggests areas and approaches by which the Office and constituents can add value to the promotion of sustainable enterprise by creating the appropriate conditions and environment to foster the creation of wealth and more and better jobs. The importance of this theme was underlined by a recent Economic and Social Council (ECOSOC) ministerial declaration in the following terms:

We are convinced of the urgent need to create an environment at the national and international levels that is conducive to the attainment of full and productive employment and decent work for all as a foundation for sustainable development. An environment that supports investment, growth and entrepreneurship is essential to the creation of new job opportunities. Opportunities for men and women to obtain productive work in conditions of freedom, equity, security and human dignity are essential to ensuring the eradication of hunger and poverty, the improvement of the economic and social well-being for all, the achievement of sustained economic growth and sustainable development of all nations, and a fully inclusive and equitable globalization.<sup>7</sup>

## The concept of sustainable enterprise

5. The importance of enterprise as the principal source of growth and employment cannot be overstated.<sup>8</sup> Enterprises – from micro-enterprises, through to small, medium-sized and large companies – are the principal source of economic growth and employment creation and are at the heart of economic activity and development in nearly all countries. Growth is fuelled first and foremost by the creativity and hard work of entrepreneurs and workers. Driven by the quest for profits, enterprises innovate, invest and generate employment and wage income. Their contribution to the generation of employment varies from country to country, but overall, private enterprises generate the majority of jobs, creating opportunities for people to acquire knowledge, to apply their skills and talents, and to improve their well-being. Enterprises provide the goods and services needed by everyone from consumer goods through to health care, food and shelter. Enterprises are a major – often the main – source of tax revenues and therefore typically constitute the foundation on which public provision of health, education and other services rests. Enterprises are important to all economies, whether they are seeking to develop from low-income status, in transition, or seeking to compete as diversified modern economies in highly innovative globalized markets. Entrepreneurship and enterprise are vital stimulants that bring about change and progress by ensuring that economies remain dynamic, innovative and competitive.<sup>9</sup> Nevertheless, the public sector is a major source of employment and will continue to have a role to play [in creating jobs]. All the evidence, however, suggests that the most significant source of new employment will come from entrepreneurship and small and medium-sized enterprises (SME) in the private sector, including cooperatives or similar organizations which are a rapidly expanding part of the economy.<sup>10</sup>

6. In this sense, the concept of an enterprise takes on a broad definition. Drawing on approaches aligned to the traditional theory of the firm, an enterprise is an economic

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<sup>7</sup> ECOSOC: *Draft ministerial declaration of the High-level Segment on “Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development”*, E/2006/L.8, July 2006, para. 1.

<sup>8</sup> W.J. Baumol: *Entrepreneurship, management and the structure of payoffs* (Cambridge, MIT Press, 1993), especially early chapters on enterprise and entrepreneurship in economic theory.

<sup>9</sup> W.J. Baumol: *The free market innovation machine – Analysing the growth miracle of capitalism* (Princeton, Princeton University Press, 2002).

<sup>10</sup> ILO: *Review of the core elements of the Global Employment Agenda*, GB.286/ESP/1(Rev.).

undertaking which integrates employers and workers, and its activities are understood in terms of the employment relationship, the particular production or operational techniques adopted by the enterprise, the quantity of what is produced and the price at which this output is sold.<sup>11</sup> In order to be viable, enterprises need access to healthy and skilled workers and need to be well managed and organized; this calls for entrepreneurial and management skills, as well as opportunities for workers and managers to develop competencies and skills and an environment which facilitates knowledge sharing and good workplace practices. In this regard, enterprises will benefit from enterprise-level, sectoral and national-level mechanisms for effective social dialogue. Enterprises need to ensure that their core business activities continue to add value and are undertaken efficiently and effectively. Enterprises obviously interface with customers and suppliers, so they also benefit from operating in value chains characterized by high-quality related industries, with prosperous consumers and investors. Enterprises also need a conducive enabling environment characterized by the existence of open, rule-based, predictable and non-discriminatory markets and a non-corrupt and well governed economy.<sup>12</sup>

7. An important development in the evolution of the concept of an enterprise came with the legal invention of the company, financed by outside shareholders and facing limited liability. This legal form has been “one of the great catalysts of world history” and “gave birth to the Industrial Revolution” and the modern capitalist system.<sup>13</sup> Obviously, not all enterprises take this legal form but the fact that outside investors could finance enterprises, and individuals did not risk personal bankruptcy when organizing a commercial venture, facilitated an explosion of innovation and entrepreneurial activity and underpinned the conditions for a “massive step forward in the evolution of firms”.<sup>14</sup> This legal invention has influenced much commercial law including, as it relates to property rights, the law of contract and bankruptcy. It has also facilitated the evolution of managerial capitalism which, although it has taken many forms, has an historical precedent based on this legal history.<sup>15</sup>

8. This report introduces the concept of sustainable enterprise, and in so doing makes a distinction between enterprise development per se and the development of sustainable enterprises. The concept of sustainable enterprise is related to the general approach to sustainable development, originally enunciated in the Brundtland Report, as “forms of progress that meet the needs of the present without compromising the ability of future generations to meet their needs”,<sup>16</sup> an approach which postulates a holistic, balanced and

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<sup>11</sup> A definition adapted from G. Bannock et al.: *Dictionary of Economics* (London, The Economist in association with Profile Books, 1998), para. 98.

<sup>12</sup> There is a systemic relationship between these levels. In the same way that a fast car will not get far on a poorly maintained road and a well maintained road will not transform the performance of a bad car, so too there must be a mutual, symbiotic relationship between enterprises and a good environment for doing business for enterprises to be sustainable.

<sup>13</sup> J. Micklethwait and A. Wooldridge: *The company – A short history of a revolutionary idea* (London, Weidenfeld and Nicolson, 2003).

<sup>14</sup> P. Ormerod: *Why most things fail ... and how to avoid it* (London, Faber and Faber, 2005), pp. 1–16.

<sup>15</sup> A. Chandler and T. Hikino: *Scale and scope – The dynamics of industrial capitalism* (Cambridge, Harvard University Press, 1990).

<sup>16</sup> This definition is taken from the World Business Council for Sustainable Development (WBCSD) (<http://www.wbcsd.org>), which in turn has based its definition on how the Brundtland Commission defined sustainable development. See, *Our common future: Report of the World Commission on Environment and Development* (the Brundtland Report), 1987. Historians of sustainable development may argue that the concept owes its birth to the 1972 United Nations Conference on the Human Environment in Stockholm which, among other things, led to the creation of UNEP.

integrated perspective on development and which has subsequently been elaborated and endorsed through declarations emanating from a number of high-level global development forums, including the United Nations Conference on Environment and Development held at Rio de Janeiro in 1992 and the World Summit for Social Development held at Copenhagen in 1995. The concept of sustainable development is partly based on the principle that decisions taken at every level in society should have due regard to their possible environmental consequences.<sup>17</sup> In this way, sustainable development is about growth – based on biodiversity, the control of environmentally damaging activity and the replenishment of renewable resources – which can protect or even enhance the natural environment. This includes the responsible use of divisible natural resources used directly for production such as trees, water and land.<sup>18</sup>

9. However, sustainable development is about more than just environmental issues. It requires the integration of all three pillars of development: economic growth, social progress and environmental issues. The social dimension of sustainable development typically includes “a commitment to promote social integration by fostering societies that are stable, safe and just and which are based on the promotion and protection of all human rights and on non-discrimination, tolerance, respect for diversity, equality of opportunity, security and participation of all people including the disadvantaged and vulnerable groups and persons”.<sup>19</sup> A central tenet of the social pillar of sustainable development is, of course, the generation of secure livelihoods through freely chosen productive employment.<sup>20</sup> Sustainable development, therefore, is a framework for the general global dialogue on growth and development but also for the more specific discussion on enterprise development and, within that, it provides a sound basis to frame the debate on regulation and voluntary action in the sphere of business.<sup>21</sup> The Organization’s position on sustainable development was originally set out by the Tripartite Meeting of Experts on Environment and the World of Work and endorsed by the Governing Body in 1992<sup>22</sup> and was most recently reviewed by the Governing Body in 2005.<sup>23</sup>

10. While avoiding the pitfalls of a semantic argument, it is useful to further analyse the concept of “sustainable enterprise”. Separately, the concepts “sustainable” and “enterprise” are reasonably well understood, although they can be defined and used in different ways and contexts. However, put the two words together and it becomes very difficult to agree on a common definition of what “sustainable enterprise” really means. Enterprise can be defined in many ways: as “an undertaking, especially a bold or

<sup>17</sup> A seminal book on the subject of business and sustainable development is S. Schmidheiny: *Changing course: A global business perspective on development and the environment*, op. cit.

<sup>18</sup> See <http://www.greenbiz.com/toolbox/> for material on how businesses can respond positively to the environmental challenges incumbent on the “triple bottom line”.

<sup>19</sup> *The Copenhagen consensus* – a summary of principle commitments of the World Summit for Social Development, Copenhagen, 1995, Commitment 4.

<sup>20</sup> ILO: *The ILO’s contribution to the World Summit on Sustainable Development (Rio+10)*, Committee on Employment and Social Policy, Governing Body, 283rd Session, Mar. 2002, GB.283/ESP/4.

<sup>21</sup> G. Ryder: “The social responsibilities of business and workers’ rights”, in *Labour Education* (Geneva, ILO, 2003), No. 130, 2003/1, pp. 21–24.

<sup>22</sup> ILO: *International cooperation on environment and sustainable development*, Committee on Employment and Social Policy, Governing Body, 267th Session, Nov. 1996, GB.267/ESP/Inf.1.

<sup>23</sup> ILO: *Promoting sustainable development for sustainable livelihoods*, Committee on Employment and Social Policy, Governing Body, 294th Session, Geneva, Nov. 2005, GB.294/ESP/2 (an account of how the ILO’s Decent Work Agenda supports the promotion of sustainable development).

difficult one”, simply as “a business firm”,<sup>24</sup> or in more economic terms, as one of the factors of production, along with land, labour and capital,<sup>25</sup> or as “one or more firms under common ownership or control”.<sup>26</sup> In one ILO report on decent work and the informal economy, an enterprise was defined as “a unit engaged in the production of goods or services for sale or barter”,<sup>27</sup> a definition which obviously extends to non-profit institutions. The OECD defines enterprise as “a legal entity possessing the right to conduct business on its own; for example to enter into contracts, own property, incur liabilities for debts, and establish bank accounts. It may consist of one or more local units or establishments corresponding to production units situated in a geographically separate place and in which one or more persons work for the enterprise to which they belong”.<sup>28</sup> The idea of “sustainable” has multiple meanings, such as, quite simply, to “maintain or keep going continuously”<sup>29</sup> or in development parlance, “to meet the needs of the present without compromising the ability of future generations to meet their own needs”. Although the concept of sustainable development is in common usage and often extended to the world of work and business,<sup>30</sup> the idea of sustainable enterprise is less common and less well understood.

11. Thus, in contrast to narrowly defined, traditional perspectives which depict enterprises in terms of linear input–output relationships centred solely on maximizing short-term economic value, an integrated approach to sustainable enterprise development takes a more holistic, integrated and long-term view (illustrated in figure 1.1), which makes a stylized distinction of what in practice are overlapping and interdependent operational and policy spheres (micro-, macro- and meta-levels). At the centre are the sustainable enterprises which comprise a number of different stakeholders, including shareholders, employers, employees and customers, as well as relationships with suppliers, governments and the broader community. Thus, “enterprises are economic entities pursuing profit through fair competition, but they must also be socially useful. Enterprises contribute to social development by providing goods and services created according to ethical practices. With renewed awareness of the close links between social and corporate development, enterprises are expected to create a sustainable society through business activities comprehensively reflecting economic, environmental, and social aspects”.<sup>31</sup>

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<sup>24</sup> *Concise Oxford Dictionary of Current English* (Oxford, Clarendon Press, 1990). A similar range of definitions can be found for “enterprise” in other languages.

<sup>25</sup> Enterprise in this sense is, of course, not treated as an “entity” but as an input to production, which is perhaps more analogous to the concept of “entrepreneurship”. Such a definition should not, of course, imply that labour is treated as a commodity.

<sup>26</sup> Enterprise defined in G. Bannock et al.: *Dictionary of Economics* (London, The Economist in association with Profile Books, 1998).

<sup>27</sup> ILO: *Decent work and the informal economy*, Report VI, International Labour Conference, 90th Session, Geneva, 2002, glossary of terms, p. 125.

<sup>28</sup> OECD: *Structural and demographic business statistics*, extract from 2006 edition (Paris, OECD, 2006), p. 415.

<sup>29</sup> *Concise Oxford Dictionary of Current English*, op. cit.

<sup>30</sup> See, for example, the Global Compact (<http://www.unglobalcompact.org>), WBCSD (<http://www.wbcd.org>) and the International Business Leaders Forum (<http://www.iblf.org>). Also see ILO: *Promoting sustainable development for sustainable livelihoods*, Committee on Employment and Social Policy, Governing Body, 294th Session, Geneva, Nov. 2005, GB.294/ESP/2.

<sup>31</sup> Japan Business Federation: *Employers, be righteous and strong*, Committee on Management and Labour Policy, Japan Business Federation (Nippon Keidanren), position paper, 2006, p. 33.



12. The micro level refers substantively to what goes on within the enterprise or in its immediate environment (the management of human and financial resources and use of physical resources like energy, transport and communications systems) and to the direct interface between enterprises and their customers and suppliers. It also refers to workplace organization, to support networks and institutions and, within this, to the role that social dialogue plays in fostering sustainable enterprises. Thus, at the micro level, it is necessary to consider the sustainability of an enterprise in terms of the structure of the sector or market in which it operates and, in particular, its relationship with suppliers and customers along the value chain, which implies the need to place the sustainability of the enterprise in the context of the quality of related industries. A useful tool of analysis in this regard is the classic structure–conduct–performance paradigm of industrial organization, which depicts *market structure* as determined by basic demand and supply conditions, *market conduct* as determined by the number of buyers and sellers in the market, cost structures and barriers to entry, and *performance* as an outcome of pricing behaviour and investment patterns.<sup>32</sup> The discussion will link value chains and market structure issues into a broader analysis of market access, including through the integration of enterprises into the global economy.

13. Crucial to the sustainability of enterprises are the various stakeholder support networks and institutions which exist to make markets work. These support networks and institutions refer specifically to tripartism and social dialogue but also to other networks that help to increase people's trust and ability to work together and expand their access to wider institutions, such as political or civic bodies. This includes membership of formalized groups (like employers' and workers' organizations), which often entails adherence to mutually agreed or commonly accepted rules, norms and sanctions; and relationships of trust, reciprocity and exchanges that facilitate cooperation, reduce transaction costs and strengthen advocacy around common interests. In all cases, the ILO Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87) is fundamental. Support networks and institutions also include consumers' groups and specific cause-related or special interest groups and standard-setting and certification bodies which help make markets work better.

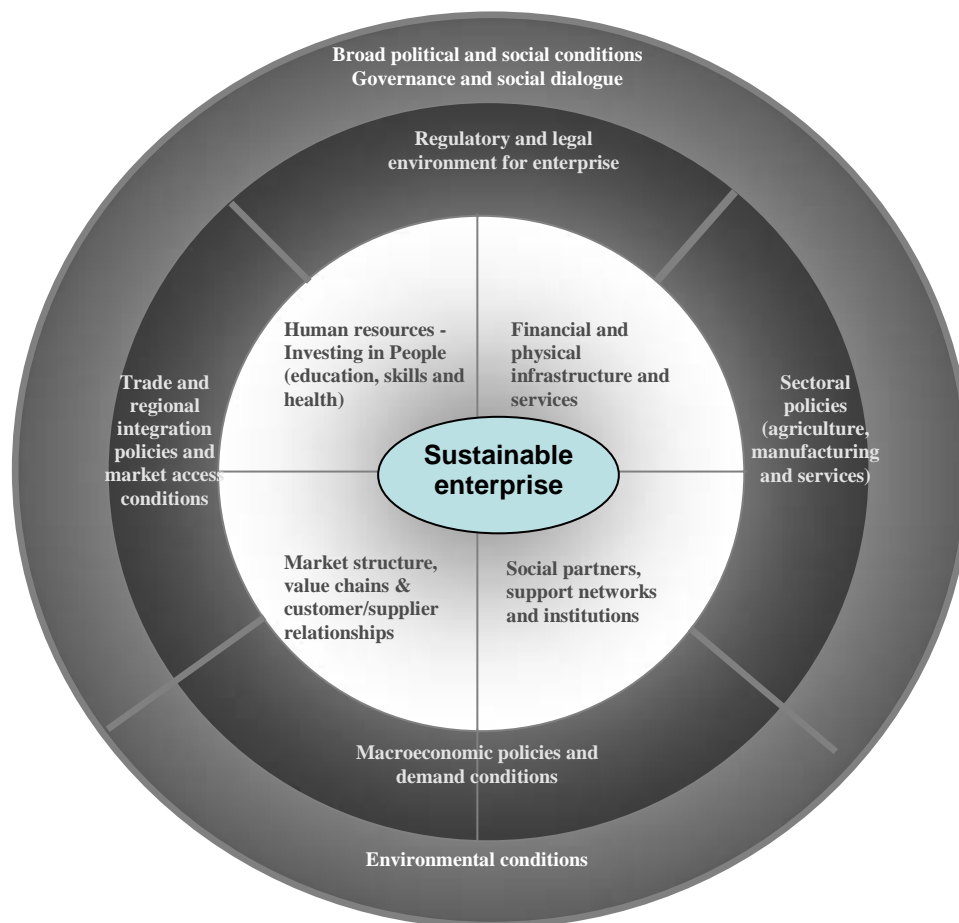
14. The micro level also covers the various resources which go into making an enterprise sustainable. This includes the natural resources which all enterprises use in their operations, such as water and energy and the physical resources or infrastructure which principally comprises energy, transportation and communications systems. Financial services are very important because they directly support the creation and growth of sustainable enterprises and also have a major influence on how natural and physical resources are managed and used, so particular attention is devoted to a discussion of strengthening financial infrastructure and services for sustainable enterprises. Of principal importance are human resources, which include the education, skills, knowledge and good health that together enable workers and employers to engage productively to pursue and achieve their livelihood objectives on the basis of decent work. Sustainable enterprises are those which truly value this resource and ensure that all who are engaged in the activities of the enterprise have appropriate skills sets, capacities and lifelong learning possibilities. Sustainable enterprises will also value the importance of providing social protection for their workers in line with appropriate international labour standards.<sup>33</sup>

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<sup>32</sup> F.M. Scherer: *Industrial market structure and economic performance* (Boston, Houghton-Mifflin, 1970).

<sup>33</sup> R. Silva and M. Humblet: *Standards for the XXIst century – Social security* (Geneva, ILO, 2002).

Figure 1.1. An integrated approach to sustainable enterprise development



15. At the next level – the macro level – there are a set of policy areas which directly determine the competitive and enabling environment, and the sustainability and growth potential of enterprises. These are the macroeconomic policies (fiscal, monetary, exchange rate), particularly those affecting demand conditions; specific policies at the sectoral level – agriculture, manufacturing and services – as well as geographic or regional enterprise development policies, investment promotion and industrial policies; trade and regional integration and market access policies; and the specific regulatory and legal environment for doing business, which includes a whole range of factors including business licensing and registration, contract enforcement, investor and worker protection, and bankruptcy law.

16. At the next level – the meta level – are the broad political, economic, social and environmental conditions which determine, among other things, the quality of institutions and governance in a society. Included here are a range of factors which might not be specific to enterprise but which effectively influence broader private sector development and general societal outcomes such as stability, inclusivity and the challenges of addressing issues like inequality and corruption. The sustainable stewardship of the natural environment is also covered at this level, as are governance issues and the role that social dialogue can play in fostering the conditions for sustainable enterprises.

17. Collective bargaining is a core element of the larger concept of social dialogue, on which the ILO itself is based.<sup>34</sup> In this context, the 2002 International Labour Conference resolution concerning tripartism and social dialogue stated that “legitimate, independent and democratic organizations of workers and employers, engaging in dialogue and collective bargaining, bring a tradition of social peace based on free negotiations and accommodation of conflicting interests”.<sup>35</sup> One of the ILO’s main continuing roles is to promote freedom of association and the right to bargain collectively as part of good labour market governance, contributing to the development of sustainable enterprises and sustainable economic and social progress. Thus, the importance of good governance in labour relations cuts across the micro, macro and meta levels and is as important for nurturing the growth of sustainable enterprises as it is for managing enterprise failure, including through socially responsible enterprise restructuring and equitable bankruptcy proceedings.

18. Given that there are many types of enterprises (home-based enterprise, informal economy traders, sole proprietorships, joint stock companies, family businesses, cooperatives and so forth) and contexts in which they operate (different sectors, types of markets, legal systems, and so on), what makes them sustainable, over what time frame (short-, medium- or long-term) and from whose perspective (employees, managers or owners) will vary quite considerably. What an itinerant micro-entrepreneur selling eggs on a street in Lagos might best do to make her egg-selling enterprise more sustainable is likely to be very different from what a chief executive officer (CEO) of a multinational company in Amsterdam might consider important for making her company sustainable. Similarly, sustainability may well be interpreted differently in a family business compared to a limited liability company. However, without undervaluing these differences, all enterprises must be “viable” – that is, feasible; practicable especially from an economic standpoint ... capable of living or existing in a particular climate, etc.<sup>36</sup> while at the same time being cognizant of the effects of their activities on the social, political and natural environment in which they operate. To be sustainable, profits are essential but beyond profits, there are other dimensions which are increasingly being taken into account, such as social and environmental dimensions. It is in this broad sense that this paper uses the notion of sustainable enterprises and does so from the perspective of both the internal and external conditions which allow enterprises to keep competing in the marketplace, to grow and to generate profits and decent jobs. In addition, promoting sustainable enterprise is not only about promoting the growth of existing enterprises but also about stimulating the creation of new enterprises, because both dimensions are important from the point of view of productive employment, the creation of decent work and sustainable development.

19. There are legal, social and ethical parameters to the concept of sustainable enterprise. Clearly, some economic activities, such as trade in illegal drugs or arms, might be lucrative but cannot be called sustainable, nor can enterprises which resort to child labour or forced labour. To be sustainable, an enterprise has to be viable, but illegal activities clearly are not sustainable, although it should be recognized that there are

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<sup>34</sup> “Social dialogue” is defined by the ILO to include all types of negotiation, consultation or simply the exchange of information between or among, representatives of governments, employers and workers, on issues of common interest relating to economic and social policy.

<sup>35</sup> ILO: *Provisional Record* No. 21, Report of the Resolutions Committee, International Labour Conference, Geneva, 90th Session, 2002. pp. 21/24–21/26 quoted in ILO: *Collective bargaining and the Decent Work Agenda*, Committee on Employment and Social Policy, Governing Body, 297th Session, Nov. 2006, GB.297/ESP/2, para. 4.

<sup>36</sup> *Concise Oxford Dictionary of Current English* (Oxford, Clarendon Press, 1990).

many degrees of compliance by enterprises with both civil and criminal legal codes. It is also well established that private enterprise does not always internalize all the social costs of doing business, and there is therefore a regulatory role for government to ensure that nationally, and increasingly internationally, defined standards are maintained, for example, with regard to occupational safety and health standards or the health or environmental impact of certain business activities (including advertising standards for tobacco companies or safety and health standards for food manufacturers). It is also apparent that, if a market left to itself does not allocate resources efficiently, there is a role for government to help make markets work better, for example, through competition or antitrust policy or the provision of public goods. Thus, in promoting sustainable enterprise, government has a fundamental role in ensuring that conditions are conducive to the creation and growth of enterprise, that legal standards are upheld and that market failures are addressed. Given that markets can malfunction both when governments intervene too much and when they intervene too little, governments have to play a balanced role with a focus on “smart” regulations.

## A new role for enterprise in society: The market economy and globalization

20. The evolution in contemporary thinking about enterprise and the market economy is rooted in fundamental changes in society which can be traced back to factors associated with the end of the cold war, the break up of the bipolar world and a reassessment of the role of government in the economy. Throughout the world and most obviously in what came to be called transition economies, a general shift took place from command-based, top-down planning towards market-based, bottom-up approaches, with a trend towards public sector reform and a new balance between the role of the state, society and the market as well as a renewed emphasis on the role of enterprise in society. In many developing countries there was a great expansion in interest in and support to small and micro-enterprises and in providing financial services (FS) for livelihood and income-generation purposes through microfinance institutions, which typically targeted particular disadvantaged groups, such as women or the landless. Governments – often in tandem with donors – were quick to provide support to enterprise and financial development in all its forms, in the belief that fostering enterprise and entrepreneurship was essential to creating broad-based growth and economic opportunities for all.<sup>37</sup>

21. In parallel with this renewed emphasis on enterprise and the private sector at the national level, the advent of globalization has fundamentally changed the conditions of competition around the world and the way of doing business. Firstly, domestic enterprise has been exposed to foreign competition in manufactures, services and agriculture. In 1990 total trade in goods and services amounted to 32 per cent of gross domestic product (GDP) for OECD countries and 34 per cent for emerging or developing country markets. By 2001, these numbers were 38 per cent and 49 per cent respectively. In the period 1994 to 2004, the value of world trade in merchandise (exports and imports) more than doubled. Much of this increased trade is due to significant improvements in, and

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<sup>37</sup> Donors produced guidelines on best practices in business development services (BDS) and enterprise finance in the mid-1990s and much of current thinking in the field was disseminated through joint donor and government research and programmes. The Donor Committee for Enterprise Development produced the “Pink Book” on “Micro and small enterprise finance: Guiding principles for selecting and supporting intermediaries” and the “Blue Book” on “Business development services for small enterprises: Guiding principles for donor intervention” and endorsed policy papers prepared by the OECD Development Assistance Committee (DAC) on micro-enterprises and the informal sector and on development cooperation in support of private sector development. See <http://www.sedonors.org>.

reductions in the costs of, transportation and telecommunications. Secondly, there has been a marked increase in capital mobility which, as with trade, has also opened up access to technology, skills and international markets. World foreign direct investment (FDI) flows have increased enormously, by 60 per cent as a measure of GDP over the period from 1990 to 2003, with the biggest increase – a fivefold one – recorded for FDI to low-income countries.<sup>38</sup> There is thus a heightened challenge for governments to ensure that their economies are internationally competitive in order to attract foreign capital. Thirdly, the rise of the knowledge-based economy plays a critical role in increasing productivity and, by extension, competitiveness. To develop international competitiveness, enterprises need to keep pace with international developments in information and communication technology (ICT) and knowledge management. This has prompted many governments to pay far greater attention to stimulating entrepreneurship, improving the human resource base and developing linkages between enterprise and science.

22. The rise of globalization and the broadening and deepening role of the private sector in the domestic economy have given rise to new challenges and opportunities. In many countries, the government now looks to the private sector to provide goods and services which in the past the government alone provided, and, with the rise of globalization, governments need to consider their regulatory and promotional role in a broader context. For example, investment, fiscal and competition policies now all have to be considered in the light not just of the domestic economy but increasingly in terms of regional and indeed global considerations. In a number of countries, there are regular public-private dialogues and formal partnerships for the provision of goods and services such as the building and operation of physical infrastructure. There has been a growth in the so-called third sector or social sector – comprising, at least in part, enterprises driven principally by social objectives. In some countries, there is a changed perception of the role of business in society with increased attention given to the issue of how profits are made and of business conduct with regard to its operations and interactions with others.

23. Globalization has compounded the economic, social and environmental challenges facing enterprises. Profound examples of this are provided by the impact on business of the heightened threat of global terrorism, the global challenge posed by computer viruses and other threats to the integrity and security of information technology (IT) systems, and by the economic, as well as social, impact of public health crises like Severe Acute Respiratory Syndrome (SARS) and avian influenza. Challenges such as local environmental degradation, global climate change, the growing strength and diversity of cause-related pressure groups and other civil society organizations, ethnic conflict, human immunodeficiency virus/acquired immune deficiency syndrome (HIV/AIDS) and weak health and education systems, are all features of societies which can add directly to the costs and risks of doing business but which also present new opportunities as well as challenges. For example, in many countries the high incidence of HIV/AIDS increases operating costs, disrupts supply chains, adversely impacts on hiring, training and other personnel costs, security costs, and insurance costs, and ultimately not only pushes up the costs of labour but also of capital. Such social and environmental factors can create both short-term and long-term financial, market and reputational risks and force up the costs of doing business. Those enterprises that understand and address these challenges can improve their risk management, reduce their costs, improve their resource efficiency and enhance their productivity and profitability. In short, they can become more sustainable enterprises. Furthermore, some of the most successful and innovative

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<sup>38</sup> World Bank: *Global development finance 2006* (Washington, DC, World Bank, 2006).

enterprises are developing new products, services and technologies and even transforming their business models to address social and environmental challenges and thereby turn such challenges into opportunities to enhance innovation, value creation and competitiveness.

24. All these changes have brought about a new and evolving relationship between business and development. Business “must work with governments and other actors in society to mobilize global science, technology and knowledge to tackle the interlocking crises of hunger, disease, environmental degradation and conflict that are holding back the developing world”.<sup>39</sup> Furthermore, it is widely accepted that “it is the absence of broad-based business activity, not its presence, which condemns much of humanity to suffering. Indeed, what is utopian is the notion that poverty can be overcome without the active engagement of business”.<sup>40</sup> There is a symbiotic relationship between enterprise and development – business thrives where society thrives – and the private sector has a vital role to play in helping countries to achieve the Millennium Development Goals (MDGs), not least the headline target of halving the US\$1 a day poverty head count, whilst MDG 8 specifies that a global partnership for development, including cooperation with the private sector, should underpin international efforts.<sup>41</sup> However, the principal and most fundamental way in which private enterprise can support development is through the pursuit of profit and the addition of economic value; this makes creating the right conditions for enterprise development a high priority in development policy and for the Decent Work Agenda.

25. It is evident that the ease of doing business and prospects for sustainable enterprise vary from country to country and even within countries. The environment, whether that means the broad civil and political institutions or processes, the level of economic and social development, or the more specific business-related factors which enable or facilitate the creation and growth of enterprise, is a vital factor. Some of these challenges faced by enterprises are illustrated in box 1.1. A key argument in this report is that governments are in a position to make markets and competition work better, by taking the lead in making business easier and less expensive and in determining the nature and level of regulation. Unleashing entrepreneurship and competitive forces is vitally important for fostering employment and creating decent work but competitive markets do not necessarily square private interests with the public good. Regulation is thus needed to make sure that workers experience a decent working environment, that employers’ interests with respect to, for example, property rights and the enforcement of contract laws are protected and that consumers’ interests are safeguarded (Chapter 5). Institutions, including representative employers’ and workers’ organizations, also have a crucial role to play in fostering open, competitive, rule-based markets. Furthermore, in an age of economic interdependence and the ubiquity of globalization, governments, workers and employers increasingly recognize that the sustainability of enterprises is greatly influenced not just by their domestic environment but by the wider international environment in which they, their consumers and suppliers operate.

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<sup>39</sup> UN Secretary-General, Kofi Annan, quoted in the preface, UNDP/IBLF: *Business and the Millennium Development Goals: A framework for action*, a joint UNDP/International Business Leaders’ Forum publication (2003).

<sup>40</sup> UN Secretary-General, Kofi Annan, quoted in *Joint views of the International Organisation of Employers (IOE) and the International Chamber of Commerce (ICC) to the ECOSOC High-level Segment, 3–5 July 2006*, Geneva (Geneva, IOE/ICC, 2006), p. 1.

<sup>41</sup> UN Millennium Development Goals (2000), online at <http://www.un.org/millenniumgoals>.

**Box 1.1****The challenge of promoting enterprise – the importance of the business enabling environment**

In India, the 2,150 km journey of a typical cargo by road between two of India's great metropolises, Kolkata and Mumbai, can take up to eight days due to stops at various check points for, among other things, fiscal checks, payment of tolls, checks at state borders, limits on the movement of trucks due to security concerns or congestion restrictions, not to mention the condition of the roads themselves. In total, it is typically the morning of day eight before the truck reaches its customer in Mumbai, having averaged 11 km per hour and spent 32 hours waiting at toll booths and checkpoints.

Source: "The long journey", in a report on Indian business, in *The Economist*, 3–9 June 2006.

It takes two procedures and two days to start a business in Australia but 14 procedures and 153 days in Mozambique. In Singapore it takes seven hours and two signatures to clear goods through customs but in Bangladesh, it takes seven days and 38 signatures. If you were building a warehouse in Bosnia and Herzegovina, the fees for hooking up with utilities and compliance with building regulations would amount to 87 times average income and if you were paying all business taxes in Sierra Leone, they would take 164 per cent of your company's gross profit.

Source: *Doing business in 2006*, World Bank/IFC.

According to the World Bank, Brazil's informal economy is huge, close to 40 per cent of national income in 2003. This is corroborated by the World Economic Forum's Executive Opinion Survey which ranks Brazil 91 out of 125 countries for the prevalence of its informal sector. The oversized informal sector is thought to account for close to half of all barriers to labour productivity growth in the country. It also cuts across all economic sectors, encompassing companies which operate partially or totally outside the law, gaining comparative advantage vis-à-vis regular companies, either by evading taxes and social contributions, ignoring safety and product quality regulation or disregarding intellectual property rights. The existence of this burgeoning parallel economy represents a drag on the country's development prospects not only because it subtracts market shares and profits from law-abiding firms, thereby undermining their ability to invest in R&D, innovation and training, but also because it depresses the economy's overall productivity levels.

Source: *Global Competitiveness Report 2006–2007*, World Economic Forum, p. 38.

## The diversity of enterprise

26. Enterprises come in a wide variety of shapes and sizes. In many countries, a significant amount of overall economic activity can be classified as informal.<sup>42</sup> As illustrated in figure 1.2, the size of the informal economy tends to vary inversely with the level of development. The bulk of economic activity in low-income countries is usually made up of informal activities – typically of the order of 70 per cent of the workforce<sup>43</sup> and 30 per cent of national income<sup>44</sup> – and it appears that in many poorer countries, the informal economy is getting bigger largely because the growth of the labour force is outstripping the growth of employment opportunities in the formal economy. It usually

<sup>42</sup> Definitions of informal economy vary (see ILO: *Decent work and the informal economy*, Report VI, 90th Session of the International Labour Conference, 2002) and any given enterprise might be formal in some senses such as in the strict sense of being legally registered but informal in other senses, in terms of functioning under the radar of fiscal or labour laws, for example. See the ILO web pages on the informal economy at <http://www.ilo.org/dyn/infoecon/iebrowse.home>.

<sup>43</sup> ILO: *Decent work and the informal economy*, Report VI, op. cit.

<sup>44</sup> V. Palmade and A. Anayiotos: *Rising informality – Public policy for the private sector*, Note No. 298 (Washington, DC, World Bank, 2005).

includes a disproportionate number of women and people from disadvantaged groups in society and a large number of own-account survival-orientated income-generating activities.<sup>45</sup> Some people who work in the informal economy do so by choice but a far greater number are there out of necessity, because of a lack of alternative income and employment-generating options: either they have lost a job in the formal economy or more likely, have failed to find one. Informality may bring some short-term advantages but often prevents such enterprises from accessing resources, information and markets and undermines incentives for micro-entrepreneurs to invest in both capital and labour.<sup>46</sup>

27. There is, of course, a continuum between formality and informality, with employers and employees moving between the two and many enterprises juggling different aspects of formality and informality: they may, for example, be formally registered but fail to pay workers' social benefits or evade certain taxes. Thus, the informal economy is central to the lives of most poor people, most obviously as a source of incomes and employment but equally as a provider of goods and services because even if many of the goods purchased by poor people are actually manufactured in the formal economy – possibly in another country – their sale and distribution is likely to take place in the informal economy. However, despite their numerical significance and ubiquity in many societies, most informal enterprises cannot be classified as sustainable enterprises if they operate illegally or do not integrate into their operations ethical values and social and environmental requirements as expressed by international standards and national laws and practices.<sup>47</sup>

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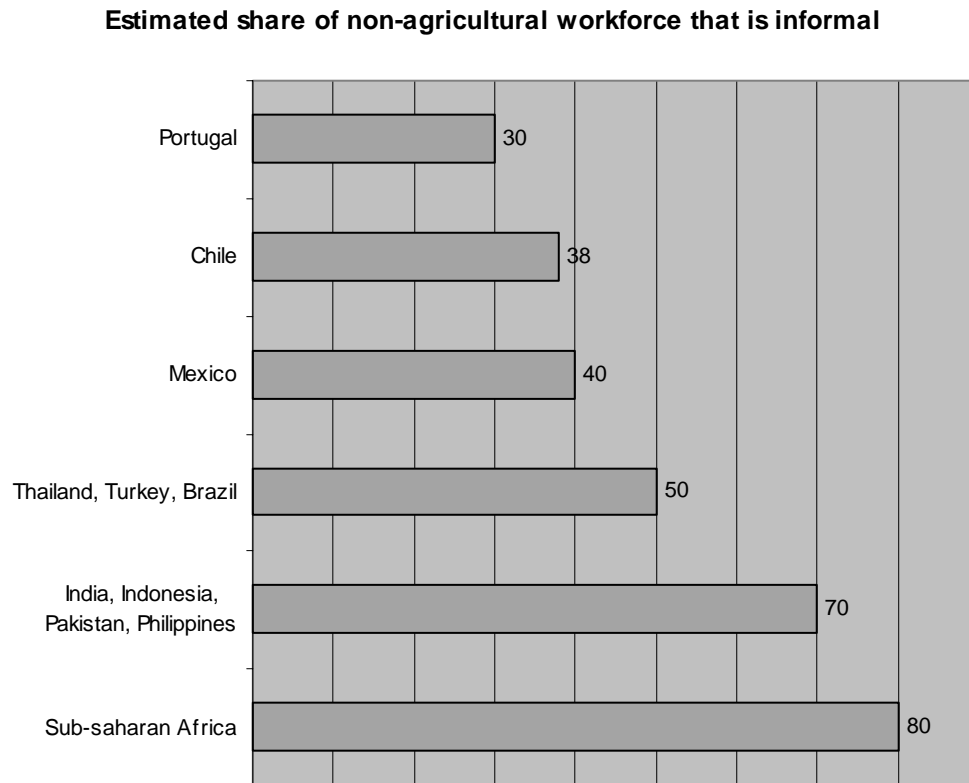
<sup>45</sup> G. Reinecke and S. White: *Policies for small enterprises: Creating the right environment for good jobs* (Geneva, ILO, 2004); and G. Reinecke: *Small enterprises, big challenges – A literature review on the impact of the policy environment on the creation and improvement of jobs within small enterprises*, SEED Working Paper No. 23 (Geneva, ILO, 2002).

<sup>46</sup> H. de Soto: *The mystery of capital – Why capitalism triumphs in the West and fails everywhere else* (New York, Basic Books, 2000).

<sup>47</sup> However, it has to be recognized that some informal enterprises obviously have the potential to become sustainable enterprises and that in some countries, the legal and regulatory framework might make it difficult for informal enterprises to formalize their operations by, for example, making it unnecessarily difficult or costly to register or obtain licences.



Figure 1.2. Informality thrives in poorer countries



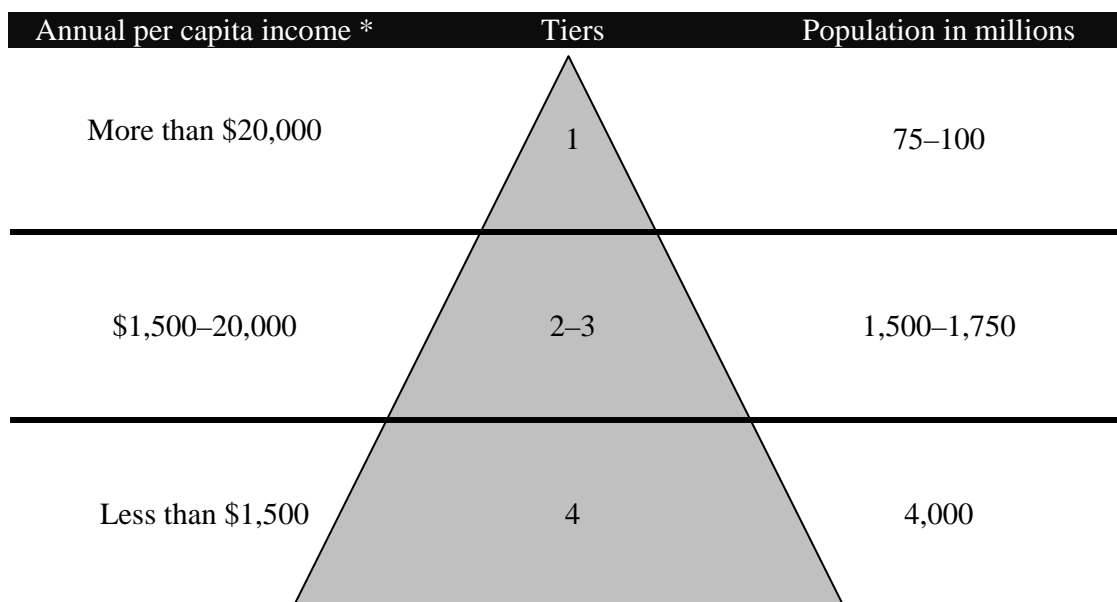
Source: World Bank and ILO quoted in *Unleashing entrepreneurship: Making business work for the poor* (United Nations Development Programme (UNDP), 2004), Ch. 2.

28. Most poor people in developing countries engage in private sector activities through farming and associated agribusiness. Enterprise, both on farm and off farm, is a major feature of rural economies, where 75 per cent of the world's population living on less than US\$1 a day are to be found. Furthermore, by default or design, the private sector is meeting the needs of poor people in areas where government services are inadequate or absent, such as in slums and rural areas. In some developing countries, a significant proportion of primary education is provided by private schools and some 63 per cent of health care expenditures in the poorest countries are private, almost twice the 33 per cent in high-income countries that belong to the OECD.<sup>48</sup> Given that almost half the world's population – 2.8 billion people – live on less than US\$2 a day and over a billion live on less than US\$1 a day, some commentators have identified the poor as a huge reserve of “resilient and creative entrepreneurs and value-conscious consumers”, representing a “whole new world of opportunity”: the fortune at the bottom of the pyramid depicted in figure 1.3. This perspective challenges the assumption that the poor have no purchasing power and therefore do not represent a viable market, by asserting that they are, in fact, brand-conscious and value-conscious by necessity, and that they represent a huge potential consumer market – US\$13 trillion at purchasing power parity – for those enterprises prepared to “create the capacity to consume” with new approaches

<sup>48</sup> UNDP: *Unleashing entrepreneurship: Making business work for the poor*, Commission on the Private Sector and Development, report to the Secretary-General of the United Nations (New York, UNDP, 2004).

to marketing and distribution and through the development of new products and services.<sup>49</sup>

Figure 1.3. The world economic pyramid



Based on purchasing power parity in US\$.

Source: Adapted from C.K. Prahalad: *The fortune at the bottom of the pyramid – Eradicating poverty through profits* (New Jersey, Wharton School Publishing, University of Pennsylvania, 2005), p. 4.

29. Generally, SMEs<sup>50</sup> become more important (as a proportion of GDP) and informality less important as countries become wealthier (see figure 1.4).<sup>51</sup> In the OECD, for example, over 95 per cent of enterprises are classified as SMEs and account for 60–70 per cent of the working population.<sup>52</sup> In Europe, 91 per cent of enterprises are classified as micro businesses, employing between one and nine people and only 1 per cent are large enterprises, with more than 250 employees.<sup>53</sup> It is perhaps with SMEs that the “spirit of enterprise” is most readily associated. The very fact that SMEs are numerous is said to favour a competitive environment which prevents collusive practices that can occur when there are few producers. Of course, there is typically even more competition in informal economies and among micro-entrepreneurs where numbers are even greater, but SMEs are more likely to have greater capacity to innovate and to derive economic benefits from the specialization of production processes. Their small scale

<sup>49</sup> C.K. Prahalad: *The fortune at the bottom of the pyramid – Eradicating poverty through profits* (New Jersey, Wharton School Publishing, University of Pennsylvania, 2005), Ch. 1.

<sup>50</sup> Definitions of enterprise size vary quite significantly, so what could be classified as a medium sized enterprise in one country might be classified as a micro-enterprise in another. Similarly, within a country, what might appear to be a small enterprise classified by number of employees might not be so if defined in terms of assets or turnover. For example, when James Wolfensohn became President of the World Bank in 1995, he left a “small company” with about 15 employees but which handled about US\$15 billion of transactions per year whilst some large companies by number of employees might have relatively small turnovers by volume or value. Thus, the only conclusion which can be drawn on the matter of size is that each country should set its own appropriate limits depending on its size, population and level of economic development (ILO, *Job Creation in Small and Medium-Sized Enterprises Recommendation*, 1998 (No. 189)).

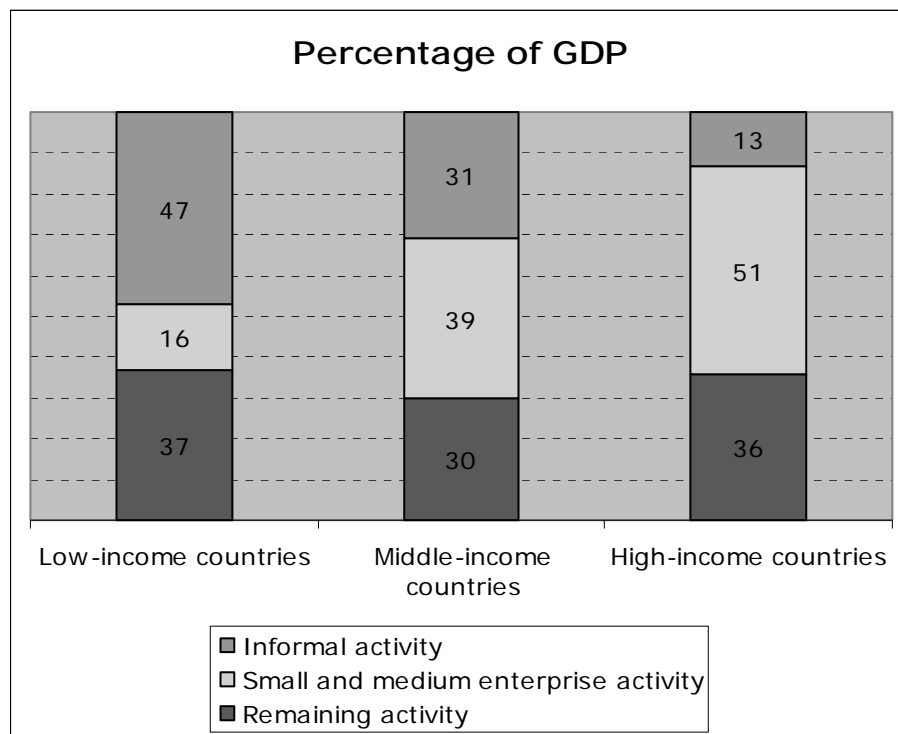
<sup>51</sup> UNDP: *Unleashing entrepreneurship: Making business work for the poor*, op. cit., p. 13.

<sup>52</sup> OECD: *Small and medium-sized enterprises: Local strength, global reach*, Policy Brief (Paris, OECD, 2000).

<sup>53</sup> [http://ec.europa.eu/enterprise/smes/facts\\_figures\\_en.htm](http://ec.europa.eu/enterprise/smes/facts_figures_en.htm).

combined with close owner–management organizational structures is also said to allow SMEs to respond more quickly to external changes than large enterprises with bigger structures, thereby increasing their potential for dynamism. SMEs are also likely to play a vital coordination or intermediary role between micro- and large enterprises, constituting a strategic bridge toward improving the competitiveness of the broader private sector. This is especially important in the global environment, given the ever-increasing importance of subcontracting and global/national value chains. In many economies, the SME sector is also likely to be characterized by high “death rates” (enterprise failure) as well as high growth rates (enterprise start up).

Figure 1.4. SMEs become more important as countries become wealthier <sup>54</sup>



Source: Ayyagari, Beck and Demircuc-Kunt (2003) quoted in *Unleashing entrepreneurship: Making business work for the poor*, op. cit.

30. However, it is the medium- to larger scale enterprises, and particularly multinational or transnational corporations (MNCs/TNCs), which have a major influence on global value chains and drive global and domestic capital flows through trade, investment, debt and other forms of finance. The growth of MNCs has mirrored the rise of globalization. For example, from a mere 7,000 in 1970, the number of multinationals had grown to over 63,000 in 2000. Along with their 821,000 subsidiaries spread all over the world, these corporations directly employ over 90 million people, or less than 5 per cent of the world’s labour force (of whom some 20 million are in the developing world), but produce around 25 per cent of the world’s gross product. The largest 1,000 MNCs are estimated to account for about 80 per cent of the world’s industrial output, and it is estimated that, of the 100 largest economies in the world, about half are multinational

<sup>54</sup> Low-income countries = less than US\$765 annual income per capita; middle-income countries = between US\$766 and US\$9,385; and high-income countries = greater than US\$9,386.

companies.<sup>55</sup> The largest 100 TNCs (by assets) employ about 15 million people; three-quarters of these TNCs are headquartered in the European Union (EU) and the United States. Such large corporations drive global capital flows, with FDI inflows totalling US\$916 billion in 2005. However, this masks large differences between countries and regions. Africa, for example, captures less than 3 per cent of global FDI, and most of this is from mining and oil companies which have little choice but to go where the minerals are.<sup>56</sup>

31. In addition to considering the diversity of enterprise from the point of view of size, it is also important to recognize that enterprises have a variety of legal structures and way of operating.<sup>57</sup> Sole proprietorships, limited liability, publicly listed companies and franchises are all common forms of private enterprises which operate on a for-profit basis, generating returns for owners and wages for workers. However, although some private enterprises may also pursue some not-for-profit activities – trading on the basis of certain ethical or social positions or seeking outcomes which complement their profit objectives – some enterprises have specific social mandates; that does not necessarily imply that they are run any less efficiently than for-profit private enterprises but only that they have a distinct legal structure and way of operating.<sup>58</sup> Cooperatives, for example, play a major economic and social role in certain sectors in certain countries.<sup>59</sup> Worldwide, it is estimated that over 100 million people are employed in cooperatives and over 800 million people are members of cooperatives. For example, consumer cooperatives dominate supermarket trade in Singapore, electricity cooperatives supply 36 million homes in the United States, over 80 per cent of all retail trade in Kuwait is handled by cooperatives, and virtually all milk production in Norway and Uruguay is done by cooperatives.<sup>60</sup> In many countries, cooperatives play a key role in certain supply chains, particularly in the food processing sector. As with all types of enterprises, cooperatives also need a conducive enabling environment and access to resources in order to be sustainable.

32. In some countries, the State also plays a key role in the ownership and management of highly respected companies which play a major role in the commercial life of their respective countries. The United States Postal Service, a federal agency with 700,000 regular employees and an annual operating revenue of US\$70 billion and SBB Swiss Railways, a joint stock company wholly owned by the Swiss Confederation, with over 27,000 employees, are both examples of efficient, highly respected companies, which make a vital contribution to their respective national economies. Furthermore, in many

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<sup>55</sup> M. Gabel and H. Bruner: *Globalinc: An atlas of the multinational corporation* (New York, The New Press, 2003).

<sup>56</sup> United Nations Conference on Trade and Development (UNCTAD): *World investment report 2006* (Geneva/New York, UNCTAD, 2006); and World Bank: *Global development finance 2006* (Washington, DC, World Bank, 2006).

<sup>57</sup> Many countries have introduced specific types of business organization to cope with the complexity of modern commerce, such as *société à responsabilité limitée (SARL)* in France or the German *Gesellschaft mit beschränkter Haftung (GmbH)*. See also the Council of the European Union Regulation No. 2157/2001 on the statute for a European company (SE), which allows companies from at least two different Member States, to establish themselves under EU law as one legal entity, the “Societas Europea” (SE), <http://www.union-network.org/unieuropeanews.nsf/EuropeanCompany?openpage>.

<sup>58</sup> An example is the John Lewis Partnership, the United Kingdom’s largest department store, which has over 60,000 “partners” (people who work in the business) and turnover in excess of £5 billion; it is also the country’s largest, longest surviving and probably most successful example of worker co-ownership.

<sup>59</sup> ILO: *Promotion of cooperatives*, Report V(I), International Labour Conference, 89th Session, Geneva, 2001.

<sup>60</sup> See <http://www.coop.org/coop/statistics.html>.

developed countries, although representing only a small part of the economy, there has been a rapid growth in what can be called social enterprises. The United Kingdom Government defines social enterprises as businesses with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximize profit for shareholders and owners. Based partially on figures derived from the United Kingdom Government's Annual Small Business Survey 2005, and partially on existing information, it is estimated that there are at least 55,000 social enterprises, representing about 5 per cent of all businesses and a combined turnover of about £27 billion which contributes £8.4 billion to gross value added (0.85 per cent of total GDP).<sup>61</sup>

33. Clearly, enterprise takes many forms not just in terms of size, sector and spatial dimensions but also in terms of how the enterprise is managed and governed and in terms of its legal status and operational objectives. Indeed, the multi-divisional, multi-product enterprise will itself comprise a complex array of legal and organizational forms.<sup>62</sup> However, the fundamental principles of all successful enterprises are universal: achieving efficiency and effectiveness to ensure profitability through a mix of minimizing costs and maximizing revenues. It is clear that various basic conditions and enabling environment factors have a major bearing on the sustainability of enterprises. However, the fact that enterprises are neither static nor homogenous implies that there is considerable variation in their operational and policy-level preferences and priorities. The effect on enterprises of different policies will vary according to enterprise size, sector of operation, and location, the extent to which its operations are integrated into global value chains, and the degree to which its activities are relatively labour- or capital-intensive.

34. There are also very important gender dimensions to policy-making in enterprise development<sup>63</sup> and different poverty related outcomes against which policy should be framed.<sup>64</sup> For example, in some societies, women often face particular difficulties in access to credit (perhaps due to laws and practices related to property titles for use as collateral) which need to be considered in framing access policies for FS. Similarly, when women do have access to credit, there is evidence to indicate that, in some societies, they are more likely than men to reinvest the proceeds from the activities they finance with credit in the household and in their children rather than in less responsible activities.<sup>65</sup>

35. The remainder of this report is structured into nine interrelated chapters. Each chapter focuses on a particular aspect of the international debate on the role of the private sector and sustainable enterprise in overall social and economic development and draws out the key implications for the ILO in the context of the Decent Work Agenda. The chapters correspond to the main elements included in figure 1.1 and constitute building blocks of an integrated approach to promoting sustainable enterprises. The concept of a sustainable enterprise is shown to be predicated on business realities as well

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<sup>61</sup> Based on information obtained from the Small Business Service site: <http://www.sbs.gov.uk/sbsgov/action>.

<sup>62</sup> J. Roberts: *The modern firm: Organizational design for performance and growth* (Oxford, Oxford University Press, 2004).

<sup>63</sup> L. Mayoux: *Jobs, gender and small enterprises – Getting the policy environment right*, SEED Working Paper No. 15 (Geneva, ILO/SEED, 2001).

<sup>64</sup> P. Vandenberg: *Poverty reduction through small enterprises – Emerging consensus, unresolved issues and ILO activities*, SEED Working Paper No. 75 (Geneva, ILO/SEED, 2006).

<sup>65</sup> L. Mayoux: *Microfinance and the empowerment of women – A review of the key issues*, Social Finance Programme, Working Paper No. 23 (Geneva, ILO, 2000).

as on social, economic and environmental considerations. Decent work, in all its dimensions, from the capacity of enterprises to put into practice international labour standards to their ability to promote and benefit from social dialogue, is seen as an essential component of sustainability. The basic premise is that “sustainability is a viable business approach for companies as it expands the limits to growth and therefore enhances their competitive position”.<sup>66</sup>

36. Chapter 2 on evolving and contemporary approaches to enterprise development attempts to distinguish between overlapping paradigms related to government and donor-driven approaches on enterprise and entrepreneurship promotion. Success in promoting sustainable enterprises is predicated on certain basic conditions related to the economic, social, political and natural environment and on what can, in general terms, be called good governance, including with respect to social dialogue and the labour market. This is the subject of Chapter 3. Chapter 4 covers factors, endogenous and exogenous to the enterprise, which determine both productivity and competitiveness and the capacity for employers and workers to realize decent work. It addresses the various methods for assessing competitiveness and the challenges of creating wealth through competitive enterprises and nations, and includes a brief discussion of competition, industrial, investment and regional policies in fostering competitive and productive enterprises. The specific legal and regulatory environment for doing business is covered in Chapter 5. Globalization has a major impact on the way in which business takes place, and Chapter 6 addresses equitable approaches to trade, market integration and supply/value chains. The social and environmental impact of enterprises is a recurrent theme throughout the report but Chapter 7 is devoted to documenting key approaches and issues related to the role of enterprise in society.

37. There is a strong interdependence between the policy and operational levels – or factors external and internal – to sustainable enterprises (see figure 1.1). For example, the way in which natural resource endowments are managed and exploited (at the meta level) will have a significant bearing on a country’s trading relationships. Thus, trade policies and the domestic legal and regulatory environment (the macro level) will influence the market structure of the sector or sectors and will shape the relationship between suppliers and customers along a value chain (the micro level). Thus, notwithstanding the limitations inherent in such a stylized representation of sustainable enterprise as depicted in figure 1.1, the last three chapters focus on factors closer to the enterprise operational level. These chapters cover issues related to the use of financial and physical infrastructure and services (credit, energy, ICTs, transport, and so on) for unlocking opportunities for sustainable enterprises (Chapter 8) and the management of human resources and investing in people to promote decent work and productive workplaces (Chapter 9). The final chapter then brings together the policy and operational levels with a discussion of the role of the social partners, social dialogue and tripartism for strengthening the sustainability of enterprises (Chapter 10). The report concludes with a list of suggested points for discussion.

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<sup>66</sup> *The Sustainability Yearbook 2006* (Zurich, SAM Group/PriceWaterhouseCoopers, 2006), p. 7.

## Chapter 2

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### Evolving and contemporary approaches to enterprise development

38. The purpose of this chapter is to outline evolving generic approaches to the subject of enterprise development. The focus is on the evolution of donor-supported approaches in developing and transition countries and the changing role of government as regulator, facilitator and promoter of enterprises. There are many elements to enterprise development some of which are concerned with factors internal to enterprises and others are more focused on external factors and there is a wide variety of methods and practices which reflect, among other factors, the diversity of enterprises by scale, sector and spatial dimensions. Although the canvas is a broad one, particular attention is devoted to approaches targeted at promoting entrepreneurship and the formation and expansion of micro, small and medium-sized enterprises. No attempt is made to present a taxonomy of or assessment on the many specific instruments used to support enterprise development.

39. Today, there is broad consensus that the private sector is a key engine of growth and that it has a vital role to play in realising the development challenges encapsulated in, for example, the MDGs. So it is hardly surprising that enterprise development policies and programmes and private sector development more generally figure highly in plans and strategies concerned with promoting growth and development in low- and middle-income countries.<sup>1</sup> A body of knowledge<sup>2</sup> has been built up in the field of enterprise and private sector development and most governments, many donors and a wide range of national and international organizations invest considerable resources in supporting private sector development generally and SME development in particular.<sup>3</sup> Thus,

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<sup>1</sup> Private sector development can best be described as “a way of doing things” (World Bank: *Private sector development strategy: Directions for the World Bank Group* (Washington, DC, World Bank, 2002)) rather than a particular “sectoral approach” and can be defined as “to create more, better and decent jobs and sustainable livelihoods by helping markets to function well and by stimulating the growth of the local private sector”; Canadian International Development Agency (CIDA): *Expanding opportunities through private sector development* (Quebec, CIDA, 2003). Enterprise development is a subset of private sector development.

<sup>2</sup> There is a prolific body of literature and analysis outlining the rationale, empirical evidence on the importance of and potential impact of enterprise and/or private sector development. Examples of generic reports on this topic include: C. Lindahl: *Wealth of the poor: Eliminating poverty through market and private sector development*, SIDA Studies No. 14 (Stockholm, Swedish International Development Cooperation Agency (SIDA), 2005); ILO: *Decent employment through small enterprises: A progress report on SEED activities* (Geneva, ILO, 2003); UNDP: *Unleashing entrepreneurship: Making business work for the poor*, Commission on the Private Sector and Development (New York, UNDP, 2004); World Bank: *World Development Report 2005* (Washington, DC, World Bank, 2004); and House of Commons, International Development Committee: *Private sector development: Fourth report of session 2005–06* (London, House of Commons, Stationery Office, 2006).

<sup>3</sup> At the fore is the World Bank Group. In the fiscal year 2005, the International Finance Corporation (IFC), the Bank’s private sector arm, committed financing of US\$6.45 billion for 236 projects in 67 developing countries and in its 11 regional technical cooperation facilities, it employed over 900 people in the field and spends about US\$60 million per year (see <http://www.ifc.org>). In comparison, the ILO has about 25 field-based enterprise specialists and related technical advisers.

notwithstanding the diversity of national contexts, different motivations or objectives for undertaking enterprise or private sector development and the depth and breadth of the subject, there is an emerging body of good practices grounded in a wide range of practical, project-based experiences in this field.<sup>4</sup> It is possible to distinguish three broad trends (or paradigms) which have evolved over the past 30 or so years (table 2.1). These paradigms represent a somewhat stylized distinction between approaches which, in practice, are complementary and overlap.<sup>5</sup> For example, making markets work for the poor (MMW4P) may entail but not be limited to the provision of business development and/or FS. The point is not to claim rigid distinction between paradigms but to illustrate the evolution in thinking on enterprise development.

Table 2.1. Evolving approaches to enterprise development: The three paradigms

Paradigm 1	Paradigm 2	Paradigm 3
Targeted enterprise-level interventions	Plus the enabling environment	Competitiveness
Business development services (BDS) Financial services (FS)	Business development services (BDS) Financial services (FS)  Business (enabling) environment (BEE)	Business development services (BDS) Financial services (FS) Business (enabling) environment (BEE)  Investment climate (IC) Making markets work for the poor (MMW4P) Value chains (VC)

## Targeted enterprise-level interventions

40. Early approaches to enterprise development<sup>6</sup> emphasized strengthening the “sector” by building the capacity of individual enterprises through entrepreneurship training, management services, extension services and skills development which gradually, over time, morphed into business development services (BDS). In addition, enterprise development typically involved the provision of credit (often provided on the basis of subsidized rates of interest or special quotas for the “sector”) which, in turn, over time, evolved into more broadly conceived and market-driven FS. Thus, early approaches to enterprises development (ED) were largely concerned with addressing enterprise-level challenges or obstacles through a combination of BDS and FS. At the outset, such services were typically delivered directly by governments or government-related agencies but over time, evolving good practices encouraged the use of private sector or civil society intermediaries to deliver both financial and non-FS.<sup>7</sup>

<sup>4</sup> IOE: *Approaches and policies to foster entrepreneurship: Guide for employers* (Geneva, IOE, 2005).

<sup>5</sup> These paradigms reflect contemporary history, taking their starting point at a period roughly 30 years ago. Obviously, this does not imply that financial or BDS did not exist before this. In some senses, their existence is as old as the concept of enterprise itself.

<sup>6</sup> One of the first works to focus on the policies, structures and initiatives for the small enterprise sector and its role in economic and social development was P.A. Neck and R. Nelson: “Small enterprise development: Policies and programmes”, an ILO *Management Development Series* publication, No. 14 (Geneva, ILO, 1977).

<sup>7</sup> See Consultative Group to Assist the Poorest (CGAP) web site at <http://www.cgap.org>, for further information on microfinance including guidance on good practices; and Committee of Donor Agencies for Small Enterprise Development: *Business development services for small enterprises: Guiding principles for donor intervention*



41. Financial services are most often equated with credit but actually embrace a broad range of financial products designed to support enterprise growth, including savings instruments, insurance and equity, money transfer services as well as a myriad of types of credit. Financial services targeted at low-income clients are referred to as microfinance,<sup>8</sup> a form of financial intermediation which came to prominence in the 1980s as a response to perceived failures and shortcomings of predominantly state-directed lending programmes, characterized by poor operational performance in the delivery of subsidized credit to poor farmers.<sup>9</sup> Since then, microfinance has evolved enormously into a diverse and sophisticated industry with a high profile in development especially in countries like Bangladesh, Bolivia and Indonesia, which were at the forefront of the rapid growth of the industry in the 1990s. It is an industry serving hundreds of millions of predominantly women micro-entrepreneurs (about 80 per cent) around the world with loans averaging about US\$80 in South Asia to US\$900 in Latin America.<sup>10</sup>

42. Microfinance is mainly about the provision of working capital loans but also includes loans for fixed capital, consumer credit, savings, insurance and even money transfer services. In fact, any type of financial service targeted at poor people aimed at supporting them to run businesses, build resources, stabilize consumption and shield themselves against risks can be labelled microfinance. Although an instrument predominantly for developing countries, there are also microfinance programmes in some poor communities within industrialized countries as well.<sup>11</sup> As businesses grow, their financial needs tend to change and lenders are more likely to appraise loans on more conventional criteria such as cash flow or formal collateral rather than the more innovative approaches used by micro-lenders, such as group-based peer pressure. Other financial products or services, such as leasing, usually for the acquisition of fixed assets, longer term loans and raising finance through equity are likely to become more important and appropriate as the scale or sophistication of an enterprise increases.

43. Although research on the direct constraints facing MSE in developing countries repeatedly identifies financial issues as a very high priority for entrepreneurs, it is clear that, in most cases, finance alone will not bring about sustainable enterprise development.<sup>12</sup> In addition to the technical and vocational skills inherent in the particular enterprise activity, business people will need a range of technical and management services to compete in markets. Such business development (BDS) services include training, consultancy and advisory services, marketing assistance, information, technology development and transfer, and business linkage promotion. A distinction is sometimes made between “operational” and “strategic” business services. Operational services are those needed for day-to-day operations, such as information and

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(Washington, DC, Committee of Donor Agencies for Small Enterprise Development, 2001) at <http://www.sedonors.org/groups/group.asp?groupid=3>.

<sup>8</sup> ILO: *Microfinance for employment creation and enterprise development*, Committee on Employment and Social Policy, Governing Body, 285th Session, Nov. 2002, GB.285/ESP/3.

<sup>9</sup> It can be argued that microfinance was reborn in the 1980s but it is not really a new concept. The Raiffeisen banks and other savings and credit cooperatives that emerged in Europe in the nineteenth century, for example, were effectively microfinance institutions in all but name.

<sup>10</sup> <http://www.cgap.org>.

<sup>11</sup> ILO: *Good practice guide – Microfinance for self-employment in industrialized countries* (Geneva, ILO Social Finance Programme, 2002).

<sup>12</sup> G.J. Buckley: “Microfinance in Africa – Is it either the problem or the solution?”, in *World Development*, Vol. 25, No. 7, July 1997; and M. Sievers and P. Vandenberg: *Synergies through linkages – Who benefits from linking finance and business development services?*, ILO SEED Working Paper No. 64 (Geneva, ILO, 2004).

communications, management of accounts and tax records, and compliance with labour laws and other regulations. Strategic services, on the other hand, are used by the enterprise to address medium- and long-term issues in order to improve the performance of the enterprise, its access to markets, and its ability to compete. As with FS, best practices in the delivery of BDS (or business support services as they are more commonly called in industrialized countries) suggest careful or selective use of subsidies and encourage, where feasible, cost recovery, partly to strengthen the potential financial sustainability of the service provider and to help nurture the market for such services and partly to get a measure of true demand and to ration supply. Good practices suggest that, where possible, business support services and FS should not be provided directly by donors or governments but by business or commercially orientated intermediaries.<sup>13</sup>

#### **Box 2.1**

##### **ILO: Integrating decent work into entrepreneurship development**

The ILO has been involved for many years in improving access of enterprises to BDS, primarily through the capacity building of intermediary service providers. Over this time, the ILO has developed considerable expertise, credibility, networks, tools and experiences. A number of important BDS programmes and approaches have been developed and continue to be implemented successfully and to evolve (e.g. Start and Improve Your Business (SIYB), Know about Business (KAB) and Expand Your Business (EYB), together with applications tailored to the use of mass media or targeted at particular groups such as cooperatives).

The ILO approach to BDS differs from that of other BDS programmes in the way that it seeks to integrate decent work into the training. Furthermore, these programmes have often provided the credibility and entry point for other enterprise development interventions. BDS market development initiatives are increasingly part of broad development initiatives rather than stand-alone programmes. These broad programmes aim to improve sector competitiveness, develop the private sector, strengthen the agricultural sector, help MSE compete in global markets, reduce poverty, create jobs, or empower disenfranchised groups. Most have a geographical or subsectoral focus or both and are increasingly taking an enterprise system-wide approach so as to address the constraints that hinder enterprises' participation in value chains and thus ensure that benefits of globalization are shared more equitably.

The KAB programme aims to contribute to the creation of an enterprise culture within countries and societies. This is done by making young people, in secondary education and in technical and vocational training institutions, more aware of their important role in shaping the future economic and social development of their country and of the benefits and opportunities that entrepreneurship and self-employment may bring.

## **The business-enabling environment (BEE)**

44. This approach – which could be called paradigm 1 – was sometimes targeted at particular sizes of enterprises; at particular subsectors such as traders, artisans, manufacturers of handicrafts, carpenters and so forth; at particular groups of people such as women or young people; or according to a spatial dimension, such as part of an area-specific rural development programme. However, there emerged a growing concern that enterprise-specific interventions were being constrained by external factors inherent in the environment and that these issues needed to be identified and addressed. Some

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<sup>13</sup> Among the many enterprise development training packages which are built around BDS principles, are SIYB developed by the ILO and the Competency-based Economies through Formation of Enterprise (CEFE) package developed by the German Gesellschaft für Technische Zusammenarbeit (GTZ).

argued that the type of approach implied in paradigm 1 addressed the symptoms of dysfunctional markets (such as access to finance) but did not address the causes (e.g. weak investment climate; poorly defined property rights; uncertainty; and the absence of regulatory frameworks for innovative credit programmes such as those relying on non-traditional forms of collateral). It was also evident that BDS or FS could only cover a relatively limited number of beneficiaries and that programmes concerned with delivering FS and particularly BDS would invariably not have the scale or scope to address the needs of the majority of micro- and small businesses in most countries. Thus, a new paradigm emerged – paradigm 2 – which added the business (enabling) environment (BEE) to the enterprise-level interventions. Hence, it became a question of combining BDS, FS and changes to the BEE to bring about successful enterprise development.<sup>14</sup>

45. A good business environment enables entrepreneurs to expand their activities and creates incentives for them to formalize their businesses. Even with access to business and FS, entrepreneurs will be discouraged from taking reasonable risks in, for example, hiring labour or investing in training or skills development of workers or even in terms of maintaining acceptable standards of safety and health at the workplace, if the environment for doing business is volatile, precarious or constraining. Experience indicates that a good business environment encourages investment and promotes higher levels of growth and a strong evidence base has built up to show that inappropriate regulations, excessive red tape and bureaucratic obstacles, lengthy business registration procedures, ineffective safeguards of property rights, corruption, weak commercial justice systems and so forth, constrain businesses, especially in poorer countries.<sup>15</sup> However, it soon became apparent that improving the BEE<sup>16</sup> is a complex and often slow process involving many stakeholders, some with vested interests in the status quo. Improvements to the business environment called for policy changes, not only to laws and regulations but also in the attitudes and behaviour of entrepreneurs themselves, as well as the public officials responsible for implementing and enforcing an efficient and effective BEE.

## Towards systemic competitiveness

46. Paradigms 1 and 2 tended to focus attention on both ends of the enterprise spectrum, namely micro- or quite small enterprises (informal economy, microfinance, etc.) and, to a lesser extent, large enterprises. Some observers, in some countries, identified a neglected “missing middle”: those enterprises which could be termed SMEs (depending, of course, on country-specific definitions). Some went further and argued that it was inappropriate to focus on size and irrespective of whether one focused on size or not, what really mattered for promoting growth and poverty reduction was the quality of the business environment and the efficiency of markets.<sup>17</sup> This perspective was reinforced in light of the increasing globalization of production, which generated

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<sup>14</sup> S. White: *Donor approaches to improving the business environment for small enterprises*, Working Group on Enabling Environment, Committee of Donor Agencies for Small Enterprise Development, Washington, DC, July 2004 (<http://www.sedonors.org>).

<sup>15</sup> See Donor Committee for Enterprise Development, Working Group on the Business Environment, at <http://www.sedonors.org/groups/group.asp?groupid=2> for a wide range of reports on this topic.

<sup>16</sup> The term “business-enabling environment” is often shortened to simply “business environment” but the adjective is used here to illustrate the desired outcome and to conceptually distinguish the paradigms.

<sup>17</sup> T. Beck, A. Demircug-Kunt and R. Levine: *SMEs, growth and poverty*, Public Policy for the Private Sector, Note No. 268 (Washington, DC, World Bank, 2004).

considerable interest in analysing international (and, by extension, national) production systems from the perspective of clusters and value chains: a set of value adding activities through which a product (or service) passes from the initial production or design stage to final delivery to the consumer. Thus, in this context, the private sector is no longer viewed as an amalgam of enterprises categorized primarily by size but as an integrated system of product and service sectors governed by a regulatory framework which responds to changes in demand.

47. Therefore, a third paradigm can be identified, concerned ultimately with national competitiveness. This paradigm – paradigm 3 – combines “making markets work” with targeted improvements to the broader investment climate of countries.<sup>18</sup> As applied to developing countries, making markets work typically targets poverty reduction outcomes and so is framed in terms of “making markets work for the poor” (MMW4P). In essence, improvements to the investment climate are largely about enhancing the opportunities, incentives and conditions for attracting investment and the growth of formal, larger enterprises, while MMW4P is about making sure that these opportunities reach down to the poor, that markets are inclusive and equitable. Obviously this is a stylized representation and, in practice, there are considerable overlaps as well as complementarities between the two approaches.

**Box 2.2**  
**What is the investment climate?**

The investment climate reflects the many location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand. A good investment climate is not just about generating profits for firms – if that were the goal, the focus could be limited to minimizing costs and risks. A good investment climate improves outcomes for society as a whole. That means that some costs and risks are properly borne by firms. And competition plays a key role in spurring innovation and productivity and ensuring that the benefits of productivity improvements are shared with workers and consumers. Thus, a good investment climate:

- is not just about generating profits for firms but about improving outcomes for society as a whole;
- drives growth by encouraging investment and higher productivity;
- enhances the lives of people directly: as employees, entrepreneurs, consumers and as users and recipients of tax-funded services and transfers;
- encourages firms to invest by removing unjustified costs, risks and barriers to competition;
- encourages higher productivity by providing opportunities and incentives for firms to develop, adapt and adopt improvements to the way they operate;
- makes it easier for firms to enter and exit markets in a process that contributes to higher productivity and growth;
- increases incentives for micro-entrepreneurs to move from the informal to the formal economy;
- can expand the resources that governments have available to fund public services.

Source: World Bank: *World Development Report 2005* (New York, World Bank/Oxford University Press, 2004), pp. 1–15.

<sup>18</sup> In practice, there is much overlap between these two concepts but, generally, it could be argued that whilst the World Bank group has probably been the most visible proponent of the investment climate approach, SIDA and Germany’s development agency, GTZ, have probably been the most prominent proponents of the making markets work (for the poor) approach. A number of agencies, such as the United Kingdom Department for International Development (DFID), tend to embrace both approaches.

48. MMW4P is an integrated approach concerned with developing efficient markets for all stakeholders, including employers, employees and consumers. MMW4P is about removing barriers, distortions and inefficiencies which prevent markets from meeting the needs of each of these stakeholders. It is also a holistic approach because it is concerned with the needs of each stakeholder in the market: those who employ, those who work for them and those who use the products and services of the enterprises. In many countries, many entrepreneurs face many obstacles. In fact, sometimes markets hardly work at all, at least for large segments of the population. Typically, formal credit markets do not work for micro- and small entrepreneurs, with banks and other financial institutions often reluctant or unwilling – for a variety of reasons, some more justifiable than others – to lend to these potential customers, thereby leaving them to informal markets with all the negative externalities that this implies. Another case of where markets simply do not work is with respect to some export markets, which might be blocked to many small and some not so small entrepreneurs – especially in developing countries – because of excessively cumbersome bureaucratic procedures or the imposition of various trade and tariff barriers. Likewise, government procurement and tendering procedures may not take place on a “level playing field” and either directly or indirectly be biased to favour particular types of enterprises or particular people.

**Box 2.3**  
**What is MMW4P?**

Making Markets Work for the Poor (MMW4P) is an approach that aims to accelerate pro-poor growth by improving outcomes that matter to the poor in their roles as entrepreneurs, employees or consumers. MMW4P focuses on changing the structure and characteristics of markets to increase participation by the poor on terms that are of benefit to them. It addresses the behaviour of the private sector and therefore reinforces the strengths of market systems, rather than undermining these systems. In this way, MMW4P is based on recent thinking about how to use market systems to meet the needs of the poor and how to support the private sector through market mechanisms that bring about sustainable change.

Source: Adapted from DFID: *Making market systems work better for the poor (M4P) – An introduction to the concept*, Discussion Paper prepared for the Asian Development Bank/DFID (United Kingdom) “learning event”, ADB Headquarters, Manila, Feb. 2005; and for further details, including on project experiences, see <http://www.markets4poor.org/m4p/index.htm>.

49. Making markets work is not only about market opportunities for the output of businesses but also about making markets work for the inputs to a business: many businesses in developing countries struggle because of weak markets for or poor access to essential inputs such as fertilizers, seeds or pesticides, in the case of agricultural activities, or reliable sources of energy or spare parts for manufacturing activities. Thus, against this background, making markets work emerged as a key element of enterprise development, especially in the context of promoting opportunities for employment and income generation for the poor and other disadvantaged groups. The importance of making markets work is predicated on the belief that markets act as a vehicle for promoting competition, enhancing choice, fostering innovation and creating wealth (box 2.4) but – for the market failure reasons outlined below – this does not imply that markets should be left to themselves or that they offer a panacea for the multiple development challenges facing low-income countries.

<b>Box 2.4</b> <b>How markets can enhance lives and enable sustainability</b>	
<b>Wealth creation</b>	<b>Choice</b>
The market system, underpinned by political democracy and informed societal values, offers the best prospect for ensuring economic growth and prosperity for all. The decentralized, practical and changeable nature of the market system provides a context capable of tapping the creative dynamism of free enterprise. Once engaged, the market system is able to generate common but differentiated benefits for savvy entrepreneurs, workers, owners and society at large.	The market, in a transparent and democratic society, empowers consumers with the freedom to choose how best to enhance their quality of life. A WBCSD stakeholder dialogue on this issue emphasized that, as individuals, each of us judges what constitutes “quality of life” and what most improves our own lives.
<b>Competition</b>	<b>Innovation</b>
Open markets provide competition, which plays a vital role in driving business towards resource efficient provision of goods and services. Competition within the market is vital for business and society to understand and test how to best meet people’s needs with more sustainable solutions.	If we are to become more sustainable in the way we live our lives, we need to find new ways to satisfy our needs and aspirations. We need to find new ways to do old things, as well as new ways to do new things. Markets liberate ingenuity by encouraging experimentation and rewarding those ideas that meet people’s needs and aspirations most efficiently.
Source: C. Holliday and J. Pepper: <i>Sustainability through the market: Seven keys to success</i> (Geneva, WBCSD, 2001), p. 7.	

50. The challenge is twofold: to make markets work and to make them work better. Obviously, these twin challenges are closely interlinked; two sides of the same coin. However, the important thing to stress is that an integrated, holistic approach is necessary to increase the likelihood of promoting sustainable enterprise and ultimately strengthening the growth process. For example, credit markets might be made to work better through increasing the amount of funds available to micro-entrepreneurs and improving access to credit through a reduction, say, of conventional collateral requirements, but unless there are entrepreneurs prepared to take the risks incumbent on taking on debt and unless there is sufficient liquidity and demand for the entrepreneurs’ products or services, then the market for credit will not function as well as it could have. Similarly, even if an entrepreneur can identify market opportunities in overseas markets and is not obstructed by trade barriers, without an appropriately skilled and competent workforce, she is unlikely to be able to move up the value chain and exploit the possibilities of export markets. Thus, enterprise development involves generating and sustaining growth through improvements in the investment climate and then using this growth to make markets work for the benefit of all stakeholders so that enterprises become sustainable and generate profits and decent jobs.

51. The approach of MMW4P and making improvements to the IC puts emphasis on pursuing level playing fields and fostering open, competitive, rule-based markets. A first point of reference is often the regulatory framework and, in particular, regulations which push up the costs of doing business or discriminate in some way against particular types of businesses (or types of business people). Barriers to entry can be particularly onerous – especially in poorer countries – with some new entrepreneurs faced, for example, with

needing dozens of permits in order to legitimize the creation of a new enterprise. By most measures, it is in Africa that entrepreneurs typically face the biggest obstacles to setting up a formal sector enterprise.<sup>19</sup> Conversely, it is richer countries that generally have lower barriers to entry for budding entrepreneurs. The most obvious effect of barriers to entry is to thwart enterprise creation, encourage informality and feed nepotism and vested interests. In some cases, there can also be barriers to exit which give rise to similarly negative outcomes, as in the case of larger scale, non-competitive and failing enterprises which do not go out of business due to inefficient bankruptcy procedures. In addition to barriers to entry and exit, a particularly pervasive feature of some economies are barriers to competition, which can take many forms.

52. In some markets there is a very uneven playing field with explicit or, more often, dubious and opaque favours and preferences bestowed on particular enterprises or sectors. Sometimes this favouritism is targeted at state-owned enterprises, sometimes at those enterprises belonging to the ruling elites, their cronies or other vested interests, and can include subsidies, protected markets, preferential access to credit, various types of price fixing and opportunities to evade legal and fiscal requirements. This serves to stimulate “rent seeking” and reduces the incentives for other enterprises to enter the market, thus constituting a barrier to competition. Such dysfunctional markets typically give rise to poorly defined property rights and serve to discriminate most heavily against the poor, both as consumers (higher prices, less choice) and as workers or potential entrepreneurs (fewer opportunities). Some practices which distort markets can be quite subtle, such as restricting information so that competition is curtailed, and some practices may actually be designed to increase opportunities for enterprise and stimulate productive investment, but ultimately serve to achieve the opposite (a criticism commonly levelled at some subsidized agricultural credit programmes, for example). Many practices which distort markets effectively increase transaction costs – costs associated with uncertainty and imperfect information – which obviously increase when rules and regulations are ineffective or arbitrary.

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<sup>19</sup> See World Bank: Investment Climate Surveys (<http://www.worldbank.org>); the World Economic Forum, Global Competitiveness Report (GCR) (<http://www.weforum.org>); and K. King and S. McGrath: *Enterprise in Africa – Between poverty and growth* (London, Intermediate Technology Publications, 1999).

### Box 2.5

#### Credit, mobile phones and making markets work for the poor

Launched in 2003, MTN *villagePhone* Uganda is a joint venture of the Grameen Foundation (Bangladesh) and MTN, Uganda's leading telecommunications company. It is the first application of Grameen Telecom's very successful village phone programme outside of Bangladesh. It is based on a business model that provides the poorest of the poor with access to valuable telecommunications services.

In partnership with local microfinance institutions, the company creates opportunities for individuals in impoverished rural areas to become village phone operators (VPOs). By negotiating special airtime rates with MTN, *villagePhone* enables VPOs to provide affordable services for their customers, who no longer need to travel great distances to towns with regular telephone services. VPOs use microcredit to buy phone equipment that allows them to sell mobile phone services in areas where electricity is often unavailable and the MTN network is accessible only with a booster antenna.

Given access to phones, rural micro-entrepreneurs earn better prices for the goods they produce, increase their productivity and save the time and expense of travelling to communicate messages. Studies show that the cost of communicating without access to village phones can be up to eight times more expensive than the cost of a phone call. This profitable enterprise exemplifies a successful alliance among NGO, microfinance and private sector participants. It shows how successful partnerships can result in real economic and social benefits for all concerned.

Source: IFC: *Making a difference* (Washington, DC, IFC, 2006), pp. 8–9.

## Market failures

53. MMW4P and improving the IC is not simply about unleashing market forces. It is an approach which recognizes that efficient markets need effective institutions and that markets cannot always be left to themselves to allocate resources efficiently.<sup>20</sup> If markets do not work, market failure is said to occur, and there are four broad categories of market failure. In each case, governments have a role in ensuring that markets work better. These four categories are: public goods; the abuse of market power; positive and negative externalities; and asymmetric information. Public goods refer to things that can be consumed by everybody in a society or nobody at all – what economists call non-excludable, non-rival, non-rejectable markets – like national defence, which are usually provided for by government and paid for through compulsory taxation. Other examples include law enforcement (including the system of property and other rights), clean air and other environmental goods. Effective enterprise development requires a state capable of providing public goods efficiently, including effective judicial systems and national defence and security. The abuse of market power results from cases where a single or small number of buyers or sellers exert significant influence over prices or output and is usually addressed through competition (or antitrust) policy. Market failures arising from externalities or asymmetric information are particularly important to a discussion of promoting sustainable enterprise.

54. Externalities are economic side effects: costs or benefits arising from an economic activity that affect somebody other than the people engaged in the economic activity but are not reflected fully in prices. Externalities can take either positive or negative forms. In the case of positive externalities, benefits to society are not fully captured by a private operator so the market will provide too little of the good or service. Basic education, some types of research, some primary health care – such as the prevention of

<sup>20</sup> T. Altenburg and C. von Drachenfels: "The 'new minimalist approach' to private sector development – A critical assessment", in *Development Policy Review*, Vol. 24(4), Blackwell Publishing/Overseas Development Institute, July 2006, pp. 387–411.



communicable diseases – are examples and the usual approach is for such market failures to be addressed by public provision, publicly funded subsidies to the private sector or some hybrid of public–private provision such as where private enterprises compete for the provision of selected parts of a government subsidized service.

55. A very important aspect of the investment climate which is often characterized by market failure, subject to high positive externalities and is increasingly the subject of public–private collaboration, is physical infrastructure (roads, electricity, ports, water and sewerage, etc.). Generally, enterprises with access to efficient transport, reliable energy supplies and modern telecommunications services tend to perform better than firms without them. They invest more and their investments tend to be more productive. Not surprisingly, poorer countries tend to experience more and greater infrastructure constraints than richer countries and it also appears that larger firms typically rate infrastructure constraints – especially reliable electricity supplies – as more severe constraints to business growth than do smaller enterprises.<sup>21</sup>

56. A determining factor in the provision and maintenance of much infrastructure is, of course, the matter of financing what are often seen as “natural monopolies”, or at least activities in markets which confer the potential abuse of market power. In such cases, the underlying problem in the provision of the infrastructure is, on one hand, the fear by customers/users that firms will use their market power to overcharge (because the consumer will have few, if any, other alternatives) and, on the other hand, firms aware that their investments are likely to be rather immobile, fear that governments will use their regulatory power to prevent them from covering their costs. The typical result is a market failure. However, the benefits of good infrastructure are considerable and a good investment climate is both a cause of improvements to infrastructure and a consequence of good infrastructure.<sup>22</sup> Governments have various policy options in seeking to address market failures in infrastructure, many of which require balancing regulations which limit market power without unduly weakening property rights. This is important for making markets work with respect to both large enterprises and small-scale providers of infrastructure, as well as in the case of the purely public provision of infrastructure.

57. Negative externalities refer to the costs to society which private producers do not pay for, and examples include pollution, environmental damage and public health hazards. Markets tend to overproduce such negative externalities and so governments typically respond with regulations, involving a ban, if necessary, or a tax on the activity. Such policies can sometimes give rise to incentives or opportunities for new markets or economic activities to develop. Ways to encourage this include subsidies or fiscal incentives to support the development of fuel-efficient cars or socially responsible investments (SRIs), or regulations banning, limiting or setting standards on certain economic activities which give rise to particular externalities, with respect to advertising standards for tobacco advertising, for example.

58. The final category of market failure refers to asymmetric information. Encouraging sustainable enterprise is also about reducing asymmetric information. However, this is a more subtle type of market failure which basically refers to the very common occurrence whereby somebody involved in a market transaction knows more than somebody else. Obviously, in some senses, this can be a source of competitive advantage but in other senses information asymmetries can distort people’s incentives and result in significant

<sup>21</sup> G. Batra et al.: *Investment climate around the world – Voices of the firms from the world business environment survey* (Washington, DC, World Bank, 2003).

<sup>22</sup> UNCTAD: *Foreign direct investment and performance requirements – New evidence from selected countries* (Geneva/New York, UNCTAD, 2003).

inefficiencies. Examples are numerous, such as governments selling mobile phone licenses without knowing what buyers are prepared to pay for them (hence the use of auctions); lenders not knowing how likely a borrower is to repay (hence the use of collateral or solidarity-based peer pressure for group-based loans); and a used car seller knowing more about the quality of a car being sold than do potential buyers (hence the use of independent assessments from car mechanics). Further examples of challenges arising from asymmetric information are given in box 2.6, illustrating the various concepts by reference to insurance markets (although the challenges and different concepts can be applied equally to many other sectors and types of market). Clearly, governments have an interest in reducing asymmetric information in order to make markets work better and to encourage sustainable enterprise by, for example, ensuring transparency of information in procurement, ensuring that information about access to credit is readily available, through policies which ensure an optimal level of investment in education and skills, by helping to disseminate information on market opportunities, by establishing and upholding trading standards, and so forth.

### **Box 2.6**

#### **Principals, agents, adverse selection and moral hazard**

Insurance is an important means of reducing risk in business and an efficient system of insurance can contribute to economic growth by encouraging entrepreneurial risk-taking and by enabling people to choose which risks they take and which they protect themselves against. However, private markets in insurance often work badly – or not at all – especially in poor countries.

To begin with, insurance markets are characterized by significant agency costs which arise when somebody (the principal) hires somebody else (the agent) to carry out a task and the interests of the agent conflict with the interests of the principal. The owners of the insurance business would like managers (or insurance agents) to run the business in ways that maximize the value of the company as measured by share value or profits but the managers may pursue other objectives like maximising the number of clients or policies sold irrespective of the effects on shareholder value or profitability.

One way to lower agency costs is by establishing rigorous rules and procedures or for the principal to closely monitor what the agent does but perhaps the most effective way is to make the interests of the agent more like those of the principal by, for example, paying agents (i.e. managers/employees) partly with shares or other instruments related to the overall viability of the business, so that the agents have a powerful incentive to act in the interests of the principal by maximizing value.

However, the challenges incumbent on making insurance markets work also rest with the relationship between the insurance company and its clients or customers. Asymmetric information is a common problem in insurance markets, giving rise to adverse selection. Basically, insurance will often not be profitable when buyers have better information about their risk of claiming than does the seller. Ideally, insurance premiums should be set according to the average risk attributable to a randomly selected person in the insured slice of the population. When there is adverse selection, people who know they have a higher risk of claiming than the average of the group will buy the insurance, whereas those who have a below average risk may decide it is too expensive to be worth buying. In this case, premiums set according to the average risk will not be sufficient to cover the claims that eventually arise because there will be more above average risk clients. Putting up the cost of premiums is likely to exacerbate the problem. However, one way to reduce adverse selection is to make the purchase of insurance – such as for business premises – compulsory, so that those for whom insurance priced for average risk is unattractive are not able to opt out.

Finally, there is the problem of moral hazard. Notwithstanding the problems of principal-agent theory and adverse selection, it is probable that people with insurance may take greater risks than they would do without it because they know they are protected, so the insurer may get more claims than it bargained for. This is the problem of moral hazard.

## Government- and donor-supported enterprise development

59. Governments and donors support enterprise or private sector development through many channels and in many different ways.<sup>23</sup> Although this chapter has depicted an evolution in approaches to enterprise development leading to one which emphasizes MMW4P and improvements to the investment climate, this does not imply that other interventions involving the provision of financial or non-FS, for example, are less valid, less important or even less common. Rather, the evolution in thinking and practice stresses the complementarities or cumulative value of different approaches and the value of integrated, systemic approaches, especially when multiple objectives are at stake. Given that most governments and donors also seek to address the bigger and broader goals of poverty reduction and equitable development, many enterprise development initiatives which seek to stimulate entrepreneurship and market development are targeted at particular groups which are perceived as experiencing some sort of disadvantage or particular challenges when it comes to participating in the economy. Such target groups might be the rural poor, women, youth, or a particular ethnic group, occupational category or sector (box 2.7 illustrates the arguments in favour of, and the benefits associated with, support for women micro- and small-scale entrepreneurs).

60. Many enterprise development initiatives and projects are driven by equity considerations and a challenge inherent in such approaches is to minimize the skewing or biasing of outcomes by directing support to one group and not another and thereby conferring competitive advantage on the recipient of support. For example, when a donor provides support to a fair-trade coffee exporter in country A, by default it creates what might be perceived as unfair competition with the fair-trade coffee exporter in country B. Similarly, encouraging the supply of credit to particular disadvantaged groups – such as rural, landless women – may not necessarily lead to the most optimal economic outcomes because of low levels of technology, little diversification of economic activities, low margins and very high levels of competition which are likely to characterize the economic activities of such disadvantaged groups, whether they are beneficiaries of credit or not. Such challenges give further credence to the benefits of integrated approaches to enterprise development and also serve to illustrate that successful enterprise development in poor countries is often predicated not only on the basis of effectiveness or efficiency arguments but also on the basis of equity considerations.<sup>24</sup> The challenge is to help foster equitable but dynamic markets which can lead to economic diversity, higher productivity and hence economic growth and development.

<sup>23</sup> See A.O. Miehlsbradt and M. McVay with J. Tanburn: *The 2006 reader – Implementing sustainable private sector development – Striving for tangible results for the poor* (Turin, ITC/ILO, 2006) for many practical project-based examples; and OECD: *Promoting private investment for development – The role of ODA* (Paris, OECD, 2006) for a more policy-oriented discussion.

<sup>24</sup> OECD: *Effective policies for small business: A guide for the policy review process and strategic plans for micro, small and medium enterprise development* (Paris, OECD/UNIDO, 2004).

**Box 2.7**  
**Supporting women micro- and small-scale entrepreneurs**

In many societies women are disadvantaged when it comes to setting up and running their own enterprises, so governments and donors are often active in encouraging women entrepreneurship as a means of addressing both short-term and longer term or intergenerational gender inequalities. Obstacles typically faced by women entrepreneurs include:

- social stratification of roles with men dominating the marketplace and controlling economic resources and women engaged in unpaid household work;
- customs preventing women undertaking certain economic activities;
- limited time to undertake enterprise activities due to child bearing, child rearing and household tasks;
- different traditional or legal rules concerning property rights and the rights to use property which, among other things, may limit women's access to finance;
- intra-household power structures which give men power over financial resources and decision-making.

Consequently, there are specific programmes targeting women to ensure that they have access to BDS, to credit and savings programmes and that reforms to the policy environment embrace gender equality, such as ensuring that the right to own or inherit property extends to women, for example. Most donors support such initiatives and the ILO has a number of well-established programmes to support women's entrepreneurship and gender equality, such as WEDGE, now operational in a number of countries, including the Lao People's Democratic Republic, where particular progress has been reported, and which makes use of the Get Ahead training toolkit for women entrepreneurs, developed by the (ILO) Programme on Boosting Employment through Small Enterprise Development (SEED) unit.

There is ample evidence to show that, where women in developing countries have been given support to establish their own MSE, they have done so successfully, creating enduring enterprises, with sound credit histories (women are typically "better" micro-credit clients than men) and a stronger tendency (than men) to reinvest the returns to the enterprise in the well-being and future development of their children. In short, reducing gender-based inequalities is likely to lead to the expansion of economic opportunities and sustainable development. See, for example, P. Richardson et al.: *The challenges of growing small businesses: Insights from women entrepreneurs in Africa*, SEED Working Paper No. 47 (Geneva, ILO, 2005) and, in the context of industrialized countries, OECD: *Women entrepreneurs in SMEs: Realising the benefits of globalization and the knowledge-based economy* (Paris, OECD, 2001).

61. In pursuit of efficiency and equity objectives, donors and governments tend to place particular emphasis on supporting the development of MSE<sup>25</sup> (box 2.8 provides some examples of successful and innovative ILO activities in small enterprise development). Small enterprises play a central role in economic growth and poverty reduction but they are not in and of themselves necessarily better than large firms, either in efficiency or equity terms.<sup>26</sup> There is evidence to suggest, for example, that "on average, jobs in small enterprises are less productive, less remunerated, less secure ... than jobs in larger enterprises, even after controlling for observable worker characteristics, such as education, sex and age",<sup>27</sup> implying that, "a significant proportion of the workforce in many economies earn lower wages, with fewer rights, in

<sup>25</sup> J. Tendler: "Small firms, the informal sector and the devil's deal", in *Bulletin*, Institute for Development Studies, University of Sussex, Vol. 33, No. 3, Summer, July 2002.

<sup>26</sup> T. Beck, A. Demircuc-Kunt and R. Levine: *SMEs, growth and poverty*, op. cit.

<sup>27</sup> G. Reinecke: *Small enterprises, big challenges*, op. cit.

small, low-productivity establishments”.<sup>28</sup> However, a fundamental and perhaps the most significant justification for supporting the development of MSE is the very fact that in virtually all countries, they account for by far the largest share of economic activity and employment. But it is not just a question of overall size. The justification for supporting MSE also rests with their dynamism, potential to innovate, competitive capacity and overall role in fostering economic progress.

### Box 2.8

#### ILO success stories in small enterprise development<sup>29</sup>

The ILO Small Enterprise Media in Africa (SEMA) project in Uganda has empowered the poor to advocate for their own business interests by supporting commercial small business radio programming. Nationally, 75 per cent of radio listeners tune in regularly to small business radio and listenership among the poorest strata of the population was 65 per cent, equally divided between men and women. The shows provide valuable information, market linkages and advocacy services. The majority of listeners report that the shows are highly or quite beneficial to their businesses, with one-third reporting that they have expanded their business as a result of putting into practice what they learned on the radio.

Source: A.O. Miehlebradt and M. McVay with J. Tanburn: *The 2005 reader – From BDS to making markets work for the poor* (Turin, ITC/ILO, 2005), p. 4.

Redturs is an ILO market-oriented initiative to foster new business opportunities with rural and indigenous communities in Latin America with the objective of improving their living and working conditions. The initiative centres on a network, both real and virtual, of communities and federations devoted to supporting the sustainable development of tourism and seeking “compatibility between the objectives of economic efficiency and those of cultural identity and the preservation of natural resources”. The initiative has expanded to cover more than 200 community tourist destinations in over 12 countries and among the key tools developed is a web site used to market the destinations and a capacity building manual on community tourism business. Redturs has served both to improve the business orientation of communities and has expanded their market opportunities.

Source: <http://www.redturs.org>.

ILO/SEED/ITC-Turin have developed a highly successful set of tools and training courses covering a variety of issues in enterprise development, all of which can be readily tailored to suit particular needs. One training package – Creating an Enabling Environment for Small Enterprise Development – aims to improve the skills of participants to analyse, design and implement programmes for reforming and improving the business environment for small enterprises and has proved particularly popular and successful both as a two-week programme delivered in Turin and as a shorter, customized training model delivered in situ in a number of countries undertaking reform activities.

Source: <http://www.itcilo.org>.

The SIYB China project is implemented by the Ministry of Labour and Social Security (MOLSS) with technical support from the ILO and financial inputs from the United Kingdom Department for International Development (DFID) and the Government of Japan. The objectives of the SIYB China project include strengthening the capacity of MOLSS to implement a multi-component national employment promotion programme for business start-up training for laid-off workers and rural-urban migrants. The programme

<sup>28</sup> ILO: *World Employment Report 2004–05 – Employment, productivity and poverty reduction* (Geneva, ILO, 2005), p. 230.

<sup>29</sup> See also ILO: *Evaluation of the InFocus Programme on Boosting Employment through Small Enterprise Development*, Programme, Financial and Administrative Committee, Governing Body, 288th Session, Nov. 2003, GB.288/PFA/11; and P. Vandenberg: *Poverty reduction through small enterprises – Emerging consensus, unresolved issues and ILO activities*, SEED Working Paper No. 75 (Geneva, ILO, 2006).

comprises vocational and functional skills training, micro-credit and policy support, and MOLSS has introduced the SIYB training packages as standard business start-up and management training modules for potential entrepreneurs among the target group. The training component of the national employment promotion programme has evolved to become the largest national SIYB programme in the world, with more than 270,000 men and women trained in 2005 alone. According to an evaluation carried out by the ILO, 39 per cent of all trainees started their own business and created on average 1.7 new jobs, translating into almost half a million new employment opportunities.

Source: ILO documents; and <http://www.ilo.org/public/english/region/asro/bangkok/japanmb/siyb.htm>.

62. In many countries, well connected large firms may dominate markets and be protected by government and sheltered from competition, they may operate at sub-optimum levels in terms of output, income generation and productivity. In such an environment – an uneven playing field – small firms are held back and struggle to challenge incumbents, whilst the underperforming incumbents continue to operate to the detriment of new and better firms. When markets function reasonably well, there is constant churning meaning that new businesses are established and either grow or die (“creative destruction”). Those that grow into larger enterprises tend to become more productive, generating more income for owners and wages for workers, so that economic progress has become associated with growing average firm size.<sup>30</sup> However, some argue that “rewarding firms for being small is not the point of SME policies and support schemes. Creating a functioning ecology of firms is – where new ones can emerge, where existing ones can contract and work with each other depending on the requirements of the sector”.<sup>31</sup>

63. Approaches to enterprise development have traditionally focused on project-level technical assistance and finance. But with the accent on making markets work and reforms to the investment climate, there is an added emphasis on broader public–private policy dialogues and on mainstreaming enterprise and private sector development into national planning frameworks and in employment strategies. The OECD Jobs Strategy, the revised Lisbon Agenda of the EU and the ILO’s GEA are examples. Public–private dialogues are a ubiquitous and essential feature of fostering private sector development and achieving development outcomes in many countries. The basic principle is simple: governments that listen to stakeholders in the private sector are more likely to promote sensible, workable reforms and when these stakeholders understand what government is trying to achieve, they are more likely to support these reforms. A distinction is made here between public–private partnerships (PPP) in which a government or public service or private business venture is funded and operated through a partnership of government and one or more private sector companies (as in some infrastructure projects, for example) and public–private dialogues (PPD) in which government and the private sector establish formal mechanisms for dialogue, such as on business environment or investment climate reform. In the real world, of course, best practices in public–private dialogues are not always easy to achieve (see box 2.9), but there is a body of emerging good practices<sup>32</sup> and, in principle, there is ample scope for building on the many tried and trusted approaches to social dialogue.<sup>33</sup>

<sup>30</sup> T. Beck, A. Demircuc-Kunt and R. Levine: *SMEs, growth and poverty*, op. cit.

<sup>31</sup> M. Klein (Vice-President for Private Sector Development, World Bank–IFC) quoted in IFC: *2004 Annual review – Small business activities* (Washington, DC, World Bank Group/IFC, 2004), p. 6.

<sup>32</sup> World Bank: *Competitive partnerships – Building and maintaining public–private dialogue to improve the investment climate: a resource drawn from the review of 40 countries’ experiences*, Policy Research Working Paper No. 3683 (Washington, DC, World Bank, 2005); and Bannock Consulting: *Reforming the business enabling environment – Mechanisms and processes for private–public sector dialogue*, paper prepared for

**Box 2.9****Challenges for effective public–private dialogue for investment climate/business-enabling environment reform**

- ❑ Governments in partner countries often do not understand the private sector well.
- ❑ This failure to understand the private sector has helped to sustain a trust deficit between the public and private sectors.
- ❑ Through a combination of historical influences, lack of capacity and lack of incentives, governments tend not to be very adept at listening to the private sector (but, conversely, might be accused of being too adept in some countries).
- ❑ This often leads to prescriptive policy-making, lacking in sufficient analytical rigour and less likely to be tailored to unlocking the growth potential of the (broad-based) private sector.
- ❑ For its part, the private sector often makes contradictory and unrealistic demands on government.
- ❑ A lack of analytical skill, conflicting interests and capacity constraints makes it difficult for both the private sector and government to prioritize individual issues in the reform process.
- ❑ Without dialogue, government tends to follow the loudest, most powerful voices, which rarely speak in the best interests of private sector growth and investment as a whole, or in the interests of poverty reduction.

Source: Adapted from Bannock Consulting (2006), op. cit., p. 28.

64. Public–private dialogues are not only a vehicle for pursuing specific business-related policy reforms, to the investment climate, for example,<sup>34</sup> but also for developing and implementing national planning instruments including national poverty reduction strategies,<sup>35</sup> of which enterprise or private sector development strategies are often an important constituent part. Enterprise and broader private sector development feature prominently in most United Nations Development Assistance Frameworks/Common Country Assessments (UNDAFs/CCAs) and are central to the ILO's Decent Work Country Programmes (DWCPs). In both cases, policy formation is informed through effective social dialogue.<sup>36</sup> Good practice encourages government – private sector dialogues through councils, advisory bodies, committees and other bodies which involve a full spectrum of representatives from the domestic and international private sector, including informal, small entrepreneurs and workers' organizations.<sup>37</sup>

International Workshop on Public–Private Dialogue, Paris, 1–2 Feb. 2006 – <http://www.publicprivate-dialogue.org> – (Bannock Consulting Ltd, 2006).

<sup>33</sup> G.J. Buckley and G. Casale: *Social dialogue and poverty reduction strategies* (Geneva, ILO, 2006); L. Rychly and M. Vylitova: *National social dialogue on employment policies in Europe*, Social Dialogue, Labour Law and Labour administration Department, Working Paper No. 8, Geneva, ILO, Apr. 2005; and A. Sivananthiran and C.S. Venkata Ratnam: *Social dialogue at enterprise level – Successful experiences* (New Delhi, ILO, 2004).

<sup>34</sup> See, for example, CIPE: *Creating a voice for entrepreneurs in Montenegro*, Center for International Private Enterprise REFORM Case Study No. 0601, Aug. 2006 (Washington, DC, CIPE, 2006).

<sup>35</sup> A good example – The Ghana National Medium Term Private Sector Development Strategy 2004–08 – can be found at <http://www.ghana.gov.gh/pbcopin/nmtp.pdf>. In turn, this has been effectively integrated in the national poverty reduction strategy – The Ghana Growth and Poverty Reduction Strategy 2006–09, which can be found at [http://siteresources.worldbank.org/INTPRS1/Resources/Ghana\\_PRSP\(Nov.2005\).pdf](http://siteresources.worldbank.org/INTPRS1/Resources/Ghana_PRSP(Nov.2005).pdf).

<sup>36</sup> ILO: *Employment strategies for decent work country programmes – Concepts, approaches and tools for implementing the Global Employment Agenda*, Committee on Employment and Social Policy, Governing Body, 295th Session, Mar. 2006, GB.295/ESP/1/1.

<sup>37</sup> UNDP: *Unleashing entrepreneurship*, op. cit., p. 39.

## Chapter 3

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### Creating opportunity for sustainable enterprise: Basic conditions

65. Irrespective of the size of an enterprise, the sector it operates in or its legal structure, the broad political, social, economic and environmental context is vitally important for all enterprises. It is generally accepted, for example, that peace, a trusted and respected legal system, appropriate levels of social development and relatively predictable and stable political institutions have a major bearing on the sustainability of enterprises. These broad “metaconditions” provide the framework for wealth creation; they are necessary for fostering enterprise growth but they are not sufficient as they do not actually create wealth itself. The relationship between such broad parameters and enterprise growth is complex but some general principles can be discerned.

### Good governance and social dialogue

66. The structure of civil and political life is undoubtedly an important determinant of competitiveness, economic growth and sustainable enterprise. Good governance – equated with human rights, democratic institutions, freedom of expression, equal rights between men and women and so forth – generally presage sustainable development. However, the relationship between enterprise or private sector development on the one hand and human rights, democracy and freedom on the other, is multifaceted. For example, there are a number of countries which have placed limits on such rights but which have at the same time developed successful market economies and experienced strong economic growth. Although there are many factors which determine the structure of civil and political life and there are undoubtedly many forms in which sustainable enterprise can flourish, governance always matters, especially in terms of the effect on reducing corruption and increasing accountability. In particular, stable, transparent and predictable laws and institutions are widely considered essential preconditions for sustainable enterprise development.

67. As articulated in the ECOSOC ministerial declaration on generating full and productive employment and decent work for all:

We call upon all countries to promote good governance, which is essential for sustainable development, and reaffirm that sound economic policies, solid democratic institutions that are responsive to the needs of the people and improved infrastructure are the basis for sustained economic growth, poverty eradication and employment creation, and that freedom, peace and security, domestic stability, respect for human rights, including the right to development, the rule of law, gender equality, market-oriented policies and an overall commitment to just and democratic societies are also essential and mutually reinforcing.<sup>1</sup>

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<sup>1</sup> ECOSOC: *Draft ministerial declaration of the high-level segment on “Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development”*, E/2006/L.8, para. 16.



68. Effective social dialogue is a means for fostering better workplace relations and helping to nurture sustainable enterprise development. Social dialogue is defined by the ILO to include all types of negotiation, including of collective bargaining agreements, consultation or simply exchange of information between or among representatives of governments, employers and workers on issues of common interest relating to economic and social policy. It can exist as a tripartite process with government or on a bipartite basis between the social partners and can take place through informal or formal, institutionalized channels (or most often a combination of the two). Social dialogue takes place at the national, regional or enterprise level and can be inter-professional, sectoral or a combination of all of these. The enabling conditions for social dialogue are:

- ❑ strong, independent workers' and employers' organizations with the technical capacity and access to the relevant information to participate in social dialogue;
- ❑ political will and commitment to engage in social dialogue on the part of all the parties;
- ❑ respect for the fundamental rights of freedom of association and collective bargaining; and
- ❑ appropriate institutional support.<sup>2</sup>

69. A principal objective of social dialogue itself is to promote consensus building and democratic involvement among the main stakeholders in the world of work. Successful social dialogue structures and processes have the potential to resolve important economic and social issues, encourage good governance, advance social and industrial peace and stability and boost economic progress. Social dialogue is therefore both a means and an end in the promotion of sustainable enterprises.<sup>3</sup> The ECOSOC ministerial declaration on generating full and productive employment and decent work for all states that:

We recognise that appropriate institutions and regulation, including frameworks for social dialogue, are important elements for the effective and fair functioning of labour markets. This includes the adoption and implementation of labour laws that protect workers' rights.<sup>4</sup>

70. Governments which safeguard property rights, channel tax revenues back into the economy through productivity-enhancing investments in human capital and infrastructure, ensure that public officials clearly distinguish between public goods and private gain and ensure that good laws are made and upheld and public order and security are maintained, are likely to create the best socio-economic conditions for sustainable enterprises to flourish. There is ample evidence to show that enterprise is severely constrained in an economy where property rights are inadequately defined.<sup>5</sup> When property owners, whether material or intellectual, are not guaranteed their rights, they are unwilling to invest further, while potential new entrants to the formal market will have incentives to disguise their activities and remain in the informal economy and outside the realms of decent work. Similarly, a lack of transparency and predictability in government operations and evidence of corruption serves to undermine business confidence and is likely to lead to misallocation of resources and ultimately to welfare losses to society as a whole. If government decision-making is based on favouritism or if

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<sup>2</sup> G.J. Buckley and G. Casale: *Social dialogue and poverty reduction strategies* (Geneva, ILO, 2006), p. 18.

<sup>3</sup> ILO: *The employment relationship*, Report V(I), International Labour Conference, 95th Session, Geneva, 2006.

<sup>4</sup> ECOSOC: *Draft ministerial declaration of the high-level segment*, op. cit., para. 17.

<sup>5</sup> See, for example, A. Lopez-Claros et al.: *Global Competitiveness Report 2005–2006* (Geneva, World Economic Forum, 2005).

the executive meddles in the sphere of the judiciary, inefficiency is likely to increase, property rights will be eroded, dispute settlement will be confused and the costs of doing business will rise.

### Box 3.1

#### The rule of law and the importance of property rights

Market economies presuppose the existence of private property and the right to use, transfer, trade and own property as a basic necessary condition for the effective and efficient functioning of markets. Property consists of immovable property (land) and personal property which may be tangible, such as machinery, or intangible, such as contract rights or copyrights. Whether the subject is a slum dweller seeking to ensure property rights for her roadside shop or a title deed for her house in order to access a loan or whether the subject is an MNC seeking to protect intellectual property rights on a globally traded product, the principle is the same. In order for a market to function, property rights must be secure and protected against fraud, theft, crime and uncompensated government seizure. Property must be verifiable, meaning that the status of ownership can be readily determined through registries and objective legal rules. Property should also be transferable and should permit secured lending.<sup>6</sup>

Another crucially important feature of properly functioning market economies is contractual rights and freedoms. Contracting parties must be able to freely consent to the restrictions and opportunities of legally binding contracts in order to benefit from cooperation and exchange. This covers law of contract, bankruptcy legislation, company law, banking laws and so forth. Obviously, in all countries, there are parameters which define contractual rights and freedoms, in line with public policies such as non-discrimination. Some laws that limit freedom of contract in concrete ways, such as imposing maximum hours, prohibitions on the use of forced labour and anti-discrimination requirements in employment relationships or by banning fraud and usury in consumer transactions or by restricting certain types of collusion and oligopolistic behaviour, are actually compatible with and enhance the development and growth of sustainable enterprises. In contrast, other practices are likely to inhibit the growth of sustainable enterprises, such as laws or policies which force foreign investors to enter into certain types of partnerships with domestic companies, those that unnecessarily limit choice by, for example, protecting local interests at the expense of outsiders, or that allow courts to radically alter contracts to suit certain vested interests. The basic principle, of course, pertains to the rule of law and the existence of formal rights enforcement mechanisms through independent, efficient and professional legal systems and forms of dispute resolution.

71. The importance of good governance and anti-corruption measures also applies to the private sector: it is insufficient to equate corruption to narrow definitions centred on the “abuse of public office for private gain”. In a number of countries, for example, powerful private sector interests often exert undue influence in shaping public policy, institutions and legislation and there are many examples where firms collude with politicians for their mutual benefit. Furthermore, an economy is best served not only by well run government but also by businesses that are run in an ethical fashion, where laws are respected and operations are conducted in a transparent way.<sup>7</sup> Private sector transparency and respect for the rule of law is indispensable for sustainable enterprise, not least in terms of information disclosure and in adherence to auditing and accounting

<sup>6</sup> B. Balkenhol and H. Schütte: *Collateral, collateral law and collateral substitutes*, Working Paper No. 26 (Geneva, ILO Social Finance Programme, 2001).

<sup>7</sup> See OECD: *Principles of corporate governance* (Paris, OECD, 2004); and UNCTAD: *Guidance on good practices in corporate governance disclosure* (New York and Geneva, United Nations, 2006).

standards,<sup>8</sup> which help to create level playing fields for making markets work and fostering competitive and dynamic enterprise.

72. For a number of reasons – from the profile of major corporate scandals like that of Enron or Parmalat to frustrations at the pace of development in Africa and elsewhere – the issue of corruption has risen up the political agenda and there are now a number of comparable, regularly updated worldwide measures of governance or corruption, such as the Governance Indicators of the World Bank, the Executive Opinion Survey of the World Economic Forum, the Corruption Perception Index of Transparency International and the political and civil liberties and freedom of the press indicators of Freedom House. Such data provides evidence of the importance of good governance for stimulating growth and development and there is now a fairly compelling body of evidence to suggest that there is a strong causal impact of institutional quality on per capita incomes even in the short run and that the correlation between governance (measured by the World Bank's Governance Indicators) and competitiveness (measured by the World Economic Forum's Global Competitiveness Index) is extremely high.<sup>9</sup> The relative importance of governance (or conversely, the relative problem of "misgovernance") obviously varies from country to country but executive surveys like those of the Global Competitiveness Report (GCR) and the World Competitiveness Yearbook (WCY)<sup>10</sup> tend to show that executives in OECD countries rate labour regulations, bureaucracy and taxes as the more problematic areas for their businesses, whilst executives in developing and emerging economies tend to consider bureaucracy and corruption to be the largest constraints, implying that the perceived impact of corruption on doing business seems to vary inversely with the level of economic development. However, this does not imply that corruption is *due to* low income nor that bad governance in poorer countries should somehow be discounted because of a lower level of per capita national income. In fact, there is strong evidence to indicate that better governance is a *cause* of higher economic growth.<sup>11</sup>

## Equity and economic and social inclusion

73. In addition to good governance in the civil and political sense, it is evident that the state of the economy will have a major bearing on the scope for sustainable enterprise. There is a large and diverse body of theory and applied analysis of the cause and nature of economic growth but conclusions are not always easy to draw. However, it is clear that a country's macroeconomic policy and aggregate economic performance have a major influence on the sustainability of enterprises. It is also generally accepted that economic growth is a necessary – but not in itself sufficient – condition for development and poverty reduction. Countries which have experienced strong growth have generally also achieved significant reductions in poverty. One of the best examples of this is China, where economic growth averaging over 8 per cent has been sustained for 20 years with

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<sup>8</sup> D. Kaufmann and T. Vishwanath: "Towards transparency: New approaches and their application to financial markets", in *World Bank Research Observer* (Washington, DC, World Bank, 2001), Vol. 16, issue 1, pp. 41–57.

<sup>9</sup> D. Kaufmann: "Myths and realities of governance and corruption" in *Global Competitiveness Report 2005–2006*, op. cit., pp. 83–84.

<sup>10</sup> A. Lopez-Claros et al.: *Global Competitiveness Report 2005–2006* (Geneva, World Economic Forum, 2005); and IMD: *WCY 2006* (Lausanne, IMD, 2006).

<sup>11</sup> D. Kaufmann: "Myths and realities of governance and corruption" in *Global Competitiveness Report 2005–2006*, op. cit., p. 86.

the result that 400 million people have been lifted out of poverty.<sup>12</sup> It is also widely accepted that private enterprises are at the heart of economic success. For example, private investment and the increases in productivity it generates, drives sustainable growth. A study of 84 countries from 1960–2000 found that increased total factor productivity – rather than the accumulation of physical capital or of human capital, for example – accounted for 41 per cent of economic growth.<sup>13</sup> However, whilst some countries have experienced strong growth, it is evident that many countries experienced economic decline during the 1990s, the majority of which are to be found in Africa. Furthermore, according to the United Nations Development Programme (UNDP) *Human Development Report 2003*, some 54 countries were poorer in the early years of 2000 than they were in 1990 and for these – and some other countries – it is evident that global economic progress has not translated into comparable levels of poverty reduction when measured in non-monetary terms.<sup>14</sup> These countries also tend to score very poorly on measures of national and business competitiveness.

74. Although the determinants of growth and development are many and complex, enterprise undoubtedly plays a fundamental role in bringing about growth and development, but it does not do so alone. If civil and political institutions are weak and if broad-based, inclusive health and education provision is lacking, then there will be little scope for sustainable enterprise and limited prospects for sustainable development. There is likely to be much more scope and potential for the formation and growth of sustainable enterprises in societies where governments ensure that people are healthy and adequately educated. Similarly, the pattern of growth is significant for both poverty reduction and the development of sustainable enterprise. This point is well illustrated by those countries afflicted by what has been termed the “resource curse”. Such countries, although rich in natural resources, tend to experience short periods of high growth, determined essentially by raw material prices, that is not sustainable and fails to either benefit the poor or give rise to the development of sustainable enterprises because of a damaging cycle combining economic dependency, corruption and conflict. Inclusive, balanced growth is likely to create the best conditions for the formation and growth of sustainable enterprises. In developing countries, this means pro-poor growth.

75. The rate at which the average income of the poor is rising will determine whether growth is pro-poor. This rate is made up of two components: the rate of economic growth and the distribution of the resulting rise in average incomes. Whilst growth is necessary for the incomes of the poor to rise, the distribution component should also favour, or at least not disadvantage, the poor if the rate of poverty reduction is to be maximized. It is important to note that it may not be necessary to trade-off growth against distribution: strong overall growth can, in the right circumstances, be compatible with a decline in inequality and, by the same token, redistributive policies need not preclude strong economic growth. The key issue is to identify those factors that affect the magnitude and direction of each component. There is mounting evidence that high initial levels of inequality both lower the rate of growth and increase the likelihood of negative distributional effects. In addition, the pattern of growth, both geographically and across different sectors of the economy, is also important. If growth is broad-based,

<sup>12</sup> World Bank: *World Development Report 2005* (Washington, DC, World Bank, 2004), and Overview (<http://www.worldbank.org/wdr/>).

<sup>13</sup> B. Bosworth and S.M. Collins: “The empirics of growth: An update” (The Brookings Institution, Washington, DC, 2003); and World Bank: *World Development Report 2005* (Washington, DC, World Bank, 2004), pp. 26–30.

<sup>14</sup> UNDP: *Human Development Report 2003* (New York, UNDP, 2003); and *Unleashing entrepreneurship: Making business work for the poor*, Commission on the Private Sector and Development, report to the Secretary-General of the United Nations (New York, UNDP, 2004).

encompassing the whole country and economy, it is likely to be faster and provide greater opportunities for the poor. Similarly, rapid growth in those regions in which the poor live and those sectors from which they earn a living will also assist poverty reduction and the creation and growth of inclusive economies and sustainable enterprises.<sup>15</sup>

76. Similarly, inequality matters for pro-poor growth and the promotion of sustainable enterprises. Inequality of assets and opportunity hinders the ability of poor people to participate in and contribute to growth. High and rising levels of income inequality lowers the poverty reduction impact of a given rate of growth and can reduce the political stability and social cohesion needed for sustainable growth.<sup>16</sup> Gender is a particularly important dimension of inequality in societies. Women face particular barriers concerning assets, access and participation in the growth process, with serious implications for the ability of growth to be pro-poor. Rising inequality is not an inevitable consequence of the growth process, as long as there is a mix of policies that address both growth and distributional objectives (through taxation and targeted public policy), strengthen empowerment and deal with biases and inequalities as they pertain to, for example, gender, race, caste, disability or religion. Therefore, policies to increase equity and social inclusion could be considered part and parcel of approaches to promote sustainable private sector development, especially if they focus on investments in human resources through quality, universal and free basic education and health services; physical infrastructure which is accessible to a wide section of society; land reform; and institutions protecting the property rights of the poor.

77. In particular, and in the context of the basic conditions which foster an environment for the formation and growth of sustainable enterprises, it is important that governments establish a functioning social security system for providing protection to and the well-being of workers and their families. There is no single right model of social security but social security is recognized as a basic human right and a fundamental means for creating social cohesion and thereby helping to ensure social peace and social cohesion. As concluded by the International Labour Conference, “social security, if properly managed, enhances productivity by providing health care, income security and social services ... it is an instrument for sustainable social and economic development. It facilitates structural and technological changes which require an adaptable and mobile labour force. It is noted that while social security is a cost for enterprises, it is also an investment in, or support for, people”.<sup>17</sup> A recent ILO study showed that there is a strong correlation between social expenditure per capita and productivity measured in GDP per hour worked, demonstrating that a productive and competitive economy and a decent social transfer system can coexist.<sup>18</sup> From a microeconomic point of view it is easy to make the case that people that are healthy, work in a safe workplace, enjoy basic income security and enjoyed a proper education, adequate health care and nutrition

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<sup>15</sup> OECD: *The DAC guidelines – Poverty reduction* (Paris, OECD, 2001); and OECD: *Accelerating pro-poor growth through support for private sector development* (Paris, OECD, 2004).

<sup>16</sup> OECD: *Pro-poor growth Policy statement and issues for discussion*, DAC high-level meeting, 4–5 Apr. 2006; and G.E. Perry et al.: *Poverty reduction and growth – Virtuous and vicious circles* (Washington, DC, World Bank, 2006).

<sup>17</sup> ILO: Report of the Committee on Social Security, *Provisional Record* No. 16, International Labour Conference, 89th Session, Geneva, 2001 (para. 3 of the Conclusions); see also ILO: *Social security – A new consensus* (Geneva, ILO, 2001).

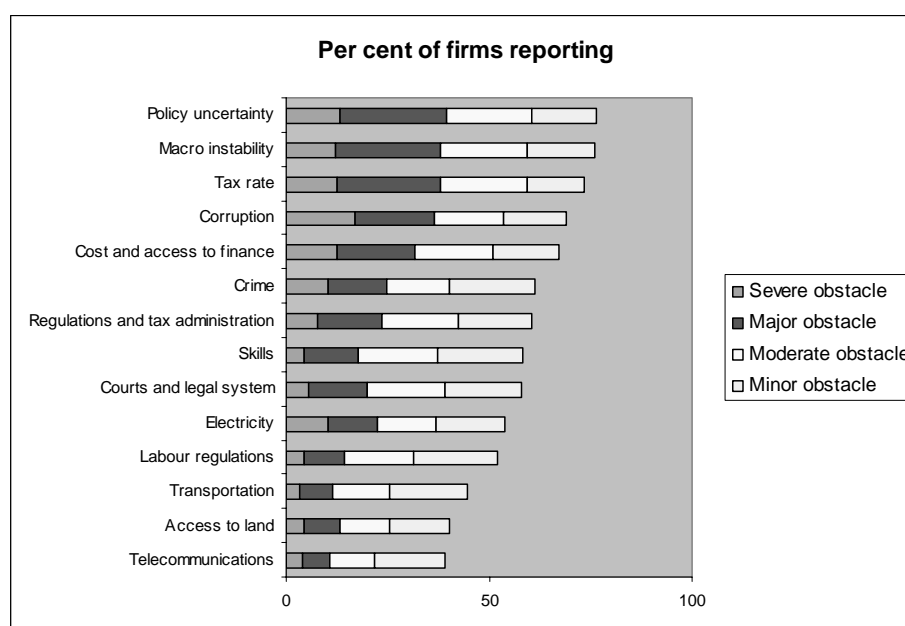
<sup>18</sup> ILO: *Changing patterns in the world of work*, Report of the Director-General, Report I(C), International Labour Conference, 95th Session, Geneva, 2006, para. 129.

provided or facilitated by the national social security system while they grew up, are more productive than others.

## Macroeconomic stability and sound management of the economy

78. Sustainable enterprise is brought about through a convergence of factors which all, in one form or another, are about enhancing the systemic competitiveness of enterprises, but this is all predicated on the state of the economy and, in particular, how the economy is managed. Governments and central banks usually seek to maximize growth while keeping inflation and unemployment down, and the principal instruments for this are managing interest rates and money supply through monetary policy, changes in taxation and public spending through fiscal policy and management of trade and exchange rate policy. However, there are no magic formulas for determining what tax rates, interest rates or exchange rates to apply to promote sustainable enterprise development, but there are principles,<sup>19</sup> and perhaps foremost among them is the importance of stability and continuity to macroeconomic policy-making. How well governments manage the economy is a key determinant of levels of investment and growth in the private sector. For example, the World Bank's Investment Climate Surveys – covering more than 26,000 firms in 53 countries – repeatedly show that, while priority constraints can vary widely across and within countries, in the aggregate, it is policy uncertainty and macroeconomic instability which are most consistently highlighted as principal determinants of investment (figure 3.1). Linked to stability and consistency in macroeconomic policy-making is the principle that such policy-making should be relatively transparent and non-discretionary, meaning that policy is made according to due process and involves a measure of predictability, according to, for example, manifesto promises of elected governments.

Figure 3.1. Most frequently reported major obstacles to firm operation in developing countries



Source: World Bank Investment Climate Surveys.

<sup>19</sup> See, for example, OECD: *Policy framework for investment* (Paris, OECD, 2006).

79. What macroeconomic stability and policy certainties are designed to achieve, of course, is economic growth and it is hardly surprising that surveys of enterprises repeatedly highlight the state of the market as having a major influence on their operations. An ILO study on creating the right environment for good jobs found that across seven low and middle-income countries, “the market” was the major factor positively influencing employment decisions (and, by extension, enterprise growth) in MSE.<sup>20</sup> However, the state of the market is, of course, a two-way process. Governments help create the conditions for determining price levels, aggregate demand, the level and nature of disposable incomes and so forth but enterprises also add to the demand for their products and services, most obviously through their sales and marketing strategies but also through their investment in human capital and technology. How this mutual relationship plays out depends on the particular market in question and the level of development of a particular country. For example, growth in Finland is probably more dependent on the pace of private sector-led technological innovation in, for example, telecommunications, whilst in Zimbabwe government-led social and economic stability would probably have a more significant impact on growth prospects.

80. The development of sustainable enterprises cannot be achieved without addressing demand-side constraints, but demand as a source of growth has often been neglected. Policies, especially in poorer countries, which seek to engineer supply-side measures for generating private sector growth without due attention to the dynamics of demand are likely to have limited impact. Inclusive growth and development requires a strategy which pays attention to the dynamics of domestic demand as well as supply-side constraints and external markets. Thus, in seeking to stimulate demand, it is important to ensure that policies encourage dynamically growing sectors of the economy to strengthen linkages with other parts of the domestic economy. The challenge, of course, is to foster a virtuous circle in which the demand stimulus from the dynamic sector generates investment and employment in other sectors.

### Box 3.2

#### Creating a strong macroeconomic environment for enterprise formation and growth

It is impossible to prescribe a model set of macroeconomic policies for promoting the formation and growth of enterprises because national circumstances will differ and policies will need to be adapted to country-specific factors. There are no “vending machine” approaches but policies which reflect open and diversified economies are likely to be conducive to helping foster a positive business and investment climate:

**Development of a medium-term government economic strategy.** The development of a medium-term economic strategy is critical. A documented strategy increases the perception of stability among investors and financial markets. A well developed strategy based on careful consideration of the various economic and fiscal issues leads to policies followed not in response to immediate political circumstances but in the pursuit of national objectives.

**Disciplined fiscal policy.** Variations in fiscal policy leading, among other things, to fluctuating tax rates, frustrate investors both foreign and domestic. The prospect of large debts worries international financial institutions. Controlled government spending, combined with competitive tax rates and a simple and stable tax system, promote FDI and the development of SMEs.

**Strong support for international trade.** A liberal trade policy is important because it provides enterprises with greater market access and attracts foreign investors seeking to export to other regional markets. In contrast, a protectionist image

<sup>20</sup> G. Reinecke and S. White: *Policies for small enterprises: Creating the right environment for good jobs* (Geneva, ILO, 2004).

discourages investors. Strong trade policy support implies entering into bilateral, regional and multilateral free trade agreements, unrestricted use of foreign currency in trade and a non-corrupt and functional customs system.

**Facilitating national and international capital market flows.** Although there are various monetary policy instruments available to central banks, governments and the private sector need to work together to support effective monetary policy by facilitating national and international capital market flows through policies supporting currency convertibility, relatively flexible exchange rates, inclusive, accessible domestic financial markets and relatively low and stable interest rates.

Source: Adapted from Organization for Security and Co-operation in Europe (OSCE): *Best practice guide for a positive business and investment climate* (Vienna, OSCE, 2006), p. 42.

## Physical infrastructure

81. The state of physical infrastructure, such as roads, energy, water, ports and telecommunications, together with basic health and education, are vital both for the well-being of people in general and also for enabling the growth of enterprises. Well maintained infrastructure improves business by speeding the transport of goods and services, including raw materials, by sustaining energy intensive production and making information readily accessible and communication timely. Poor physical infrastructure acts as a break on the formation and growth of enterprise. “Technical inefficiencies in roads, railways, power and water alone caused an estimated US\$55 billion a year losses in the early 1990s – an amount equal to 1 per cent of the GDP of developing countries or twice the annual budget for financing infrastructure in the developing world. These losses fall on firms, large and small – and on individuals, especially the poorest. Low quality roads can shut small producers off from regional markets – and encumber large producers with shortages of critical inputs.”<sup>21</sup>

82. Most governments recognize the importance of providing and maintaining infrastructure for development in general and for fostering private sector growth in particular, but have often struggled to meet the financing or fiscal challenge incumbent on providing and maintaining infrastructure. Increasingly, governments have relied on a combination of private participation and increased competition to improve infrastructure.<sup>22</sup> However, although maintaining high-quality infrastructure is largely about capital investment, it is not solely a financing matter. Efficient contracting, open bidding, regulatory credibility and private and public managerial capability are also very important factors. The ILO, for example, has played an important role in raising awareness of how labour-based techniques and use of local materials can be more cost effective than equipment based methods. Labour-based contracts can be encouraged by opening opportunities for local small-scale contracts through breaking projects into small and technically and managerially straightforward contracts. The ILO has also used its employment-intensive investment programme as a platform to successfully advocate for labour based contracting practices and the protection of working conditions and worker rights through revamped procurement policies and practices,<sup>23</sup> in line with the ILO Labour Clauses (Public Contracts) Convention, 1949 (No. 94).

<sup>21</sup> UNDP: *Unleashing entrepreneurship*, op. cit., p. 15.

<sup>22</sup> World Bank: *World Development Report 2005* (Washington, DC, World Bank, 2004), op. cit., p. 134.

<sup>23</sup> ILO: *Independent evaluation of ILO's strategy for employment creation through employment-intensive investment*, ILO Evaluation Report, Sep. 2006, p. 33.



## Responsible stewardship of the environment

83. The natural environment is another fundamental aspect to consider in promoting sustainable enterprise. Human activity over the past 50 years has changed the world's environment more extensively than ever before, largely to meet growing demands for food, water, land and habitat. This is obviously a function of progress, of human development, but it has not come without costs and serious questions are now being raised concerning the sustainability of this type of development. The UNDP has estimated, for example, that if the whole world's population were to enjoy a lifestyle similar to that of the industrialized countries today, it would require the resources of five and a half planet Earths.<sup>24</sup> This calls on governments – in collaboration with international bodies and the private sector – to act to protect the environment, to preserve the natural capital on which society (and, of course, business) depends for its very existence.<sup>25</sup> There are many ways in which this can be done, just like there are many policy instruments available to governments for addressing the political or economic conditions for fostering sustainable enterprise. For example, figure 3.2 illustrates – using the case of the carbon sequestration market – how governments and the private sector can work together using the market to address environmental policy.

Figure 3.2. Practical steps for environmental policy-making

<b>What</b>	Define the system to be protected Within the boundaries of this system, establish a protection objective	Define a standard for performance measurement The measurement should provide a quality characterization of the state of the system	Create a licence to operate that is legally transferable	Create one or several exchanges to trade these licences Exchanges can report transaction volume and prices, Options and Futures can also enhance the trade
<b>Steps</b>	➤ objective	➤ measurement	➤ property	➤ exchange ➤
<b>Who</b>	The performance objective is defined by stakeholder dialogue A performance framework is set by voluntary programmes or covenants between government, the business sector concerned and key stakeholders	Using the set measurement standard, all relevant actors report progress toward their performance commitments	Government recognizes and guarantees ownership of such licences	A private or public initiative

### Illustrative example

Carbon sequestration market	National greenhouse gas emission reduction targets	International measurement standards for greenhouse gases	Corporate internal trading schemes	The Chicago Climate Exchange
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Source: WBCSD: *Sustainability through the market: Seven keys to success*, Geneva, WBCSD, 2001, p. 38.

<sup>24</sup> WBCSD: *From challenge to opportunity – The role of business in tomorrow's society* (Geneva, WBCSD, 2006), p. 15.

<sup>25</sup> Environmental challenges often call for global initiatives and most multilateral environmental agreements, such as those addressing climate change, biodiversity, desertification or toxic chemicals, have specific provisions for, and depend for their implementation on, the private sector in all its forms.

84. The urgency of addressing such global environmental challenges should not be understated. In a world of surging population growth, rapid urbanization, the depletion of natural resources and climate change, it is not an exaggeration to suggest that the ultimate test of global good governance will be measured in terms of how sustainable development is managed.<sup>26</sup> Without careful stewardship of the environment, it is likely that the very existence of some countries will be threatened. Climate change, for example, is affecting sea levels, which threatens the habitation of not only those living on small islands but millions of people living in coastal areas of countries like Bangladesh. In sub-Saharan Africa, where a third of the people are already malnourished, climate change is likely to have a major impact on food production through its effect in terms of higher temperatures and shorter rainy seasons. And even in Europe, the effect of climate change was most evident during the summer heatwave of 2003, which directly contributed to agricultural losses of about US\$15 billion and led to the deaths of 35,000 vulnerable people.<sup>27</sup> Furthermore, as the pressure on natural resources mounts, it is possible that greater competition for use of these resources may provoke increased corruption and conflict.<sup>28</sup>

85. However, the environment also creates opportunity for sustainable enterprise. Following the logic of “eco-efficiency” – doing more with less – there are many examples where businesses have reduced their environmental impacts and also their costs (by reducing resource use, waste or pollution) and developed new products or services which deliver better design and functions for lower impact and higher market share.<sup>29</sup> Businesses themselves have a vested interest in pursuing “eco-efficiency” and the market can provide signals for businesses to act in this way, but government can often make markets work better in the eco-efficiency sense by providing appropriate incentives, or by establishing standards or regulations.<sup>30</sup> Typical examples include the use of taxation policy to encourage the use of energy-efficient technologies, in areas such as house building, or regulations on sulphur emission limits on fuel, which have encouraged companies to innovate, or public campaigns to raise awareness about recycling of household waste, which in some countries has spawned a whole new recycling industry. There are many examples of effective public–private approaches to

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<sup>26</sup> UNDP: *Human Development Report 2006* (New York, UNDP, 2006).

<sup>27</sup> N. Stern: *The economics of climate change: The Stern review*, H.M. Treasury, United Kingdom Government, Dec. 2006. This report estimates that a 2–3° Celsius rise in temperatures could reduce global economic output by 3 per cent. If temperatures rise by 5 per cent, up to 10 per cent of global output could be lost and there is a 50 per cent chance that this will happen over the next 50 years. Furthermore, to stabilize at manageable levels, emissions would need to stabilize in the next 20 years and fall between 1 and 3 per cent after that and that this would cost about 1 per cent of global GDP.

<sup>28</sup> See Global Witness (<http://www.globalwitness.org>) which campaigns to achieve change by highlighting the links between the exploitation of natural resources, conflict and corruption. Global Witness has pioneered independent forest monitoring as a tool to combat illegal and unsustainable logging; encouraged revenue transparency in the extractive industries sector including helping establish the Publish What You Pay coalition (<http://www.publishwhatyoupay.org>); and helped instigate the Kimberley Process Certification Scheme, an international agreement to prevent the trade in conflict diamonds, <http://www.kimberleyprocess.com>.

<sup>29</sup> C.S. Brown: *The sustainable enterprise: Profiting from best practice* (London, Kogan Page, 2005).

<sup>30</sup> For example, government policies in the United States encourage the making of ethanol from corn by providing subsidies to farmers to grow corn, to refineries for mixing it into fuels, to service stations for installing pumps to sell it and to consumers for buying it and some states even have laws requiring that a certain amount of ethanol is mixed into petrol, in order to bolster demand. Similarly in Europe, the European Union wants 5.75 per cent of all transport fuel to come from non-fossil sources and 18 per cent of power from renewable sources by 2010. Furthermore, by way of example, despite having a good distribution grid (which solar does not require) and not a great deal of sunny weather, government support has made Germany the biggest solar energy market in the world.

particular environmental challenges, such as the decision by the Panama Canal Authority to provide land deeds and loans to farmers who protect the water resources needed by the canal, thus effectively assigning value to watershed management. There are also many other examples of where the private sector has responded voluntarily to address such tragedy of the commons<sup>31</sup> environmental issues, as in the case of the fishing industry, where a number of major food companies helped establish the Marine Stewardship Council,<sup>32</sup> whose logo on a fish product indicates that the fish it contains comes from sustainable fisheries. The environment, then, presents both challenges and opportunities for sustainable enterprise; ignoring them is not an option.<sup>33</sup>

## Society and culture supportive of enterprise

86. In terms of the basic conditions which create the opportunity for sustainable enterprise, and in addition to the economic, environmental and political factors already mentioned, there is the matter of social and cultural factors that influence entrepreneurship. Within the context of “culture”, it is important to consider as a basic condition, the way in which social structures and culture influence enterprise and entrepreneurship and, in particular, the existence of a “spirit of enterprise” or what can be called enterprise culture. The importance of social and cultural influences on entrepreneurship and the formation of new enterprises is well recognized. Indeed, the ILO recommends that “member States should adopt measures ... to create and strengthen an enterprise culture, meaning an environment that favours initiative, enterprise creation, productivity, environmental consciousness, quality (employment), good labour and industrial relations, and adequate social practices which are equitable. To this end, Members should consider: (1) pursuing the development of entrepreneurial attitudes ...”.<sup>34</sup>

87. What drives entrepreneurship is the subject of much theorizing.<sup>35</sup> One early and enduring approach argues that human creativity is the most important factor. In this regard, Schumpeter gave birth to a school of thought which characterizes the market as a process of “creative destruction” in which new enterprises and innovations make the old ones obsolete through constant structural change, creating evolution and development.<sup>36</sup> But what lies behind this creative destruction – the process of business transformation that accompanies radical innovation – or more particularly, the entrepreneurial spirit which underpins it? One school of thought is that the culture and institutions of a society determine the nature and extent of entrepreneurial activities. This has its basis in the

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<sup>31</sup> An economic term which – originally applied to the problem of overgrazing on common pasture land – refers to the tragedy afflicting common resources where, because no individual, business or group has meaningful property rights that would make them think twice about using this common resource, much of it becomes destroyed. Contemporary examples include over-fishing and polluting the atmosphere.

<sup>32</sup> See <http://www.msc.org> and the Forest Stewardship Council (<http://www.fsc.org>) which is a similar body established to promote sustainable forest management.

<sup>33</sup> L.R. Brown: *Plan B 2.0: Rescuing a planet under stress and a civilization in trouble* (New York, W.W. Norton & Co., 2006).

<sup>34</sup> ILO: Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189). The integration of decent work and the promotion of entrepreneurship is covered in further detail in ILO: *Promoting decent employment through entrepreneurship*, Committee on Employment and Social Policy, Governing Body, 289th Session, Geneva, Mar. 2004, GB.289/ESP/1.

<sup>35</sup> T. Grebel: *Entrepreneurship: A new perspective* (London, Routledge, 2004) provides a good overview of different perspectives on and definitions of entrepreneurship.

<sup>36</sup> J. Schumpeter: *The theory of economic development* (New York, Oxford University Press, 1961).

classic Weber theory on the role of Protestant ethics in Western societies, later renewed to explain the rise of East Asia with the spirit of Confucianism. In a similar vein, there is a wide body of analysis focused on individual or ethnic traits which suggests that entrepreneurs often see themselves, or are seen or treated by others, as “outsiders” in society owing to personal traits, ethnic origin or some other cultural or social factor. From Schumpeter onwards, most commentators agree that entrepreneurship is not simply about innovation but also about copying and adapting, and some research argues that those who copy and adapt tend to be more important for growth and employment.<sup>37</sup> In addition to having the capacity to innovate, copy or adapt, it is also important to have the means to turn these capacities into marketable products or services and to ensure that these creative capacities are legally protected. The fact that between 1991 and 2004, 1.8 million citizens of OECD countries were granted United States patents, compared to only 20 from 46 least developed countries<sup>38</sup> may reflect less on entrepreneurial capacities in these countries and more on global inequalities in the distribution of knowledge, education and research capacities as well as in the sphere of weak domestic legal frameworks and difficulties associated with protecting intellectual property rights.

**Box 3.3**  
**The spirit of enterprise**

Most people have a reasonably clear view of what an entrepreneur is but may struggle to define what qualities best describe an entrepreneurial person. Are they born or made? Does the spirit of enterprise rise out of necessity or from the luxury of choice? Perhaps the following parable most neatly distinguishes an entrepreneurial mindset:

*A shoe manufacturer sent two sales people to Africa to study the prospects for expanding its business. The two travelled together to rural Africa and observed the same things. After a few days, the first sent back an email saying: “No one wears shoes; situation hopeless”. The other wrote back triumphantly: “No one wears shoes; glorious opportunity”.*

88. The level of “entrepreneurial activity”<sup>39</sup> varies between and within countries and there are a number of surveys which provide insight into why this is. The Eurobarometer survey,<sup>40</sup> for example, identifies and analyses what motivates (and demotivates) people from setting up a business, reporting on the basis of quite extensive surveys, that 61 per cent of respondents from the United States would like “to be their own boss” but only 45 per cent of Europeans would, which is attributed to a number of factors such as Europeans’ apparently greater fear of failure or desire for a regular income. The same survey also points out significant variation between European countries in their proclivities and attitudes towards entrepreneurial activities, highlighting differences between northern and southern European countries and between Eastern and Western Europe, for example. However, the most comprehensive survey of entrepreneurship is probably the Global Entrepreneurship Monitor (GEM), which has been conducted since

<sup>37</sup> J.A. Schmitz: “Imitation, Entrepreneurship and Long-Run Growth”, *Journal of Political Economy* (University of Chicago Press), Vol. 97, No. 3, June 1989, pp. 721–739.

<sup>38</sup> UNCTAD: *The least developed countries report 2006 – Overview* (Geneva, UNCTAD, 2006), p. 18.

<sup>39</sup> Entrepreneurial activity usually refers to people who set up and run their own enterprises but entrepreneurial characteristics can also be displayed by employees and the term intreprenurship has been coined to refer to employees of companies who display “entrepreneurial characteristics” like seeking to create change, to break new ground, to innovate and “think out of the box”.

<sup>40</sup> [http://ec.europa.eu/enterprise/enterprise\\_policy/survey/eurobarometer\\_survey2004.htm](http://ec.europa.eu/enterprise/enterprise_policy/survey/eurobarometer_survey2004.htm).

1999 and now covers over 30 countries.<sup>41</sup> Box 3.4 captures some of the highlights from the *Global Entrepreneurship Monitor – 2005 Executive Report*.<sup>42</sup>

**Box 3.4**  
**Highlights from the Global Entrepreneurship Monitor**

There is a strong variation across countries both in the frequency and the quality of entrepreneurial activity. Middle-income countries tend to exhibit higher percentages of individuals starting a business than high-income countries.

With respect to early-stage (that is, nascent or new) entrepreneurial activity, countries such as New Zealand, Thailand and the Bolivarian Republic of Venezuela exhibit very high rates of individual involvement compared to other countries such as Belgium, Hungary and Japan, which lie at the other end of the spectrum.

The ratio of opportunity-driven to necessity-driven business owners is higher in high-income countries than in middle-income countries.

Higher growth rates of GDP per capita in middle-income countries are mirrored in the higher innovativeness and growth potential of entrepreneurial activity in these countries.

The age distribution of people involved in entrepreneurial activity follows an inverted U-shape curve.

Women across the globe are less optimistic and less confident in their entrepreneurial skills and are more concerned about failure.

The creation of appropriate institutions conducive to the development of markets is the fundamental responsibility of governments interested in promoting entrepreneurship in their countries. Peace and stability are necessary conditions for the development of an entrepreneurial society.

Source: *Global Entrepreneurship Monitor – 2005 Executive Report*.

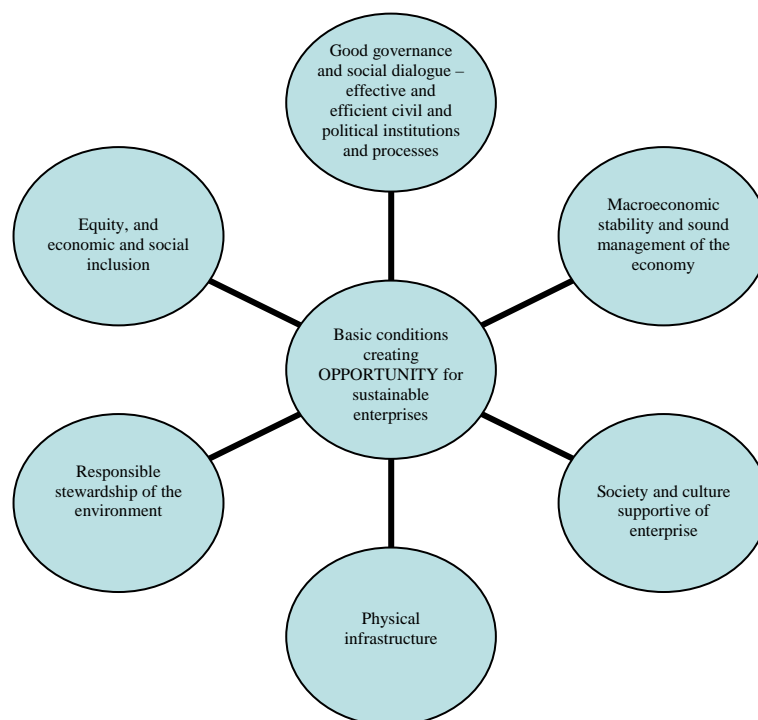
89. In conclusion, the basic conditions for creating the opportunity for sustainable enterprise are many and somewhat complex, but figure 3.3 attempts to summarize them. The following sections of this report will cover in detail the specific policies which governments, social partners and others can adopt in order to promote sustainable enterprises, including policies aimed at enhancing national and enterprise level competitiveness, enterprise specific legal and regulatory policies, as well as those policies and strategies related to trade, regional integration and market access. The role of enterprise in society and the impact of enterprise on the natural environment is a recurrent theme throughout the report but key issues are brought together in a chapter on the role of enterprise in society. However, before this, it is useful to underscore the point that these basic conditions not only create the opportunity for sustainable enterprise but, taken as a whole, constitute the foundation for sustainable development and decent work.

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<sup>41</sup> See <http://www.gemconsortium.org/>, a multinational research programme coordinated by Babson College in the United States and the London Business School in the United Kingdom. Its stated objectives are to describe and analyse entrepreneurial processes within a wide range of middle and high-income countries, economies, cultures and ethnicities and focuses on three main objectives: to measure differences in the level of entrepreneurial activity; to uncover factors determining the levels of entrepreneurial activity; and to identify policies that may alter the level of entrepreneurial activity.

<sup>42</sup> M. Minniti et al.: *Global Entrepreneurship Monitor – 2005*, report on women and entrepreneurship (Babson College, United States, and London Business School, United Kingdom, 2006).

Figure 3.3. Basic conditions creating the opportunity for sustainable enterprises

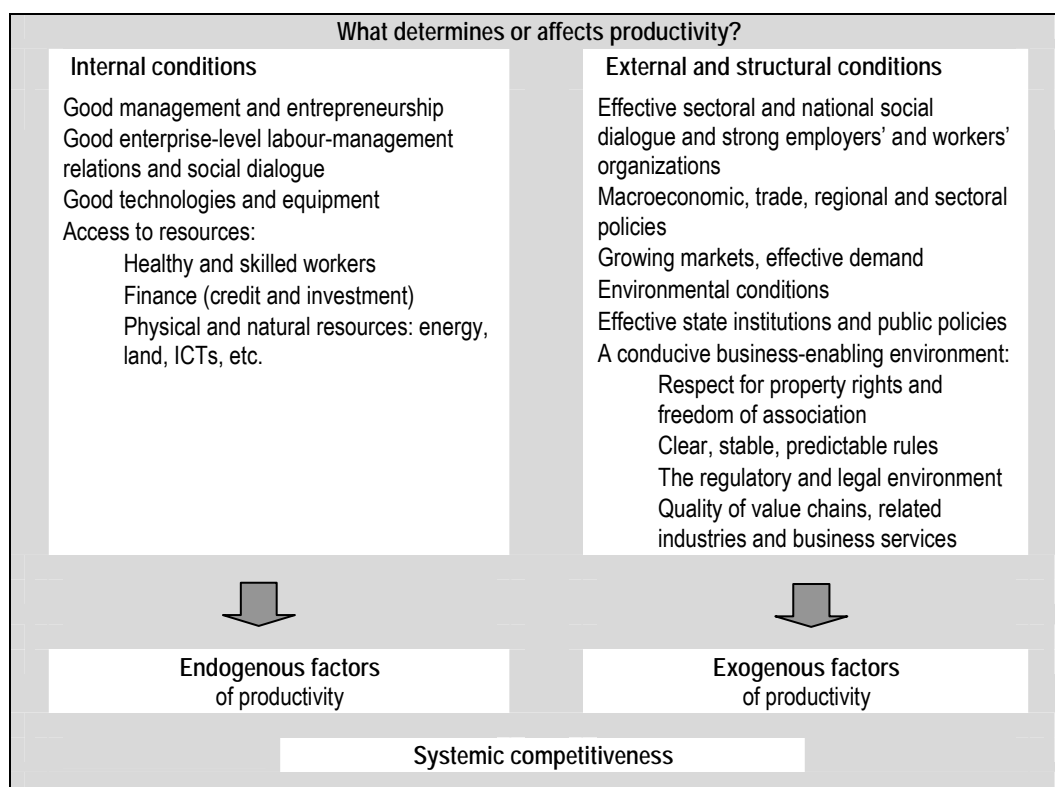


## Chapter 4

### Creating wealth and decent work through competitive enterprises and nations

90. Although virtually everyone agrees on the importance of competitiveness, especially in light of an ever globalizing world characterized by outsourcing and the mobility of labour, assets and production processes, the term is used in a variety of contexts to describe different, sometimes unrelated and occasionally conflicting concepts. Competitiveness can be described and defined in many different ways: a common approach is to consider on the one hand factors endogenous to the enterprise such as the productivity of labour or capital in a particular enterprise and, on the other hand, to consider factors exogenous to the enterprise such as the BEE (figure 4.1). Central to an analysis of competitiveness are the macroeconomic, political, legal and social circumstances that underpin a successful economy – the basic conditions. However, these broad conditions, although certainly necessary, are not sufficient to create wealth; in effect they provide the opportunity for wealth creation but do not, of themselves, create wealth.

Figure 4.1. Internal and external influences on productivity



## Productivity: The key to competitiveness

91. Wealth is actually created by competitive, sustainable enterprises and most particularly by the people who own, manage and work in them. A wide range of practical experience at the enterprise level exemplifies the fact that the promotion of decent workplace practices increases productivity and improves the financial performance of enterprises. Crucial in this is building the capacity and productivity of employees through appropriate workplace organization and by establishing open and honest communications channels leading to their heightened engagement.<sup>1</sup> Evidence suggests that where communication serves to align employee and management understanding and knowledge, employees will better understand and share the strategy of an enterprise and will be more likely to want to help implement it.<sup>2</sup> Engagement will also enrich the employment relationship and potentially heighten the emotional connection to a job and organization that goes beyond simple job satisfaction and that enables and commits people to performing well. Such engagement is usually positively correlated to lower employee turnover, improved productivity and enhanced commercial outcomes, including sales growth, customer satisfaction and total shareholder return.<sup>3</sup>

92. There are many practical examples of positive correlations between employee involvement and productivity.<sup>4</sup> Employee involvement can be facilitated in many ways (see Chapters 9 and 10), but social dialogue and industrial relations always constitute the principal foundation stone on which effective enterprise level employer–worker relations are grounded. Strategies to enhance employee involvement in workplace decision-making are typically most successful when integrated with other enterprise strategies under an overarching strategy that emphasizes the mutual interests of employees and employers. Employee involvement, for example, plays a major part in innovation at the enterprise level, which is usually key to enterprise competitiveness. Innovation is not just a technological phenomenon that finds expression in new products and production processes. Rather, innovation is a social process that depends upon people, their knowledge, their qualifications and skills as well as their motivation and job satisfaction.

93. Good working conditions and forms of work organization that are conducive to empowerment and employee involvement are a key prerequisite to improving labour productivity and for strengthening the innovativeness and competitiveness of enterprises. This in turn implies an interrelation with other workplace practices such as training and development or working time arrangements. For example, a study in the Netherlands concluded that only 25 per cent of the influence on innovation success in that country originated from technological innovation such as R&D and ICT investments, while 75 per cent rested upon social innovation such as management knowledge and the way this knowledge is acquired, integrated and applied,<sup>5</sup> implying that a comprehensive

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<sup>1</sup> A.L. Tolentino: *Workers – Stakeholders in productivity in a changing global economic environment*, Enterprise and Cooperative Development Department, ILO, Geneva, EMD/18/E, 1997.

<sup>2</sup> T.A. Kochan and P. Osterman: *The mutual gains enterprise – Forging a winning partnership among labour, management and government* (Boston, Harvard Business School Press, 1994).

<sup>3</sup> R.S. Kaplan and D.P. Norton: *The strategy focused organisation* (Boston, Harvard Business School Press, 2001).

<sup>4</sup> J. Addison et al.: “Worker participation and firm level performance”, in *British Journal of Industrial Relations*, Vol. 38, No. 1 (Mar. 2000), pp. 7–48; and I.C. Imoisili and A.V. Henry et al.: *Productivity improvement through strengthening management-labour cooperation* (Port-of-Spain, ILO, 2004).

<sup>5</sup> H. Volberda, F. van den Bosch and J. Jansen, of RSM Erasmus University, Department of Strategic Management and Business Environment, conducted a large-scale survey (Apr. 2005) of more than 9,000 Dutch organizations. The survey examined the organizational and environmental set-ups of innovative organizations. It



approach that actively involves employees should be an integral part of strategies aimed at improving competitiveness. The international labour standards, particularly as they relate to freedom of association, collective bargaining, social dialogue and tripartism, provide the fundamental basis on which to ground effective communication and dialogue, both at the enterprise level and beyond.

**Box 4.1**  
**Collective bargaining, productivity and competitiveness**

Collective bargaining provides enterprises with a mechanism to encourage participation in the workplace. The literature on the value of participation has examined benefits related to the ability to secure trust and commitment in employment relations and thus improve productivity and efficiency. Indeed, there is now a growing body of evidence showing that workplace participation through collective bargaining can enhance firm performance and that firms with higher degrees of worker participation outperform other firms.<sup>6</sup>

Collective bargaining has also been shown to enhance training intensity and human capital accumulation in companies, thereby increasing productivity. In this respect, in OECD countries, there is increasing social dialogue and collective bargaining on continuous training. In countries with training levies and/or funds, these have usually been given a framework through bipartite or tripartite agreements at sectoral and/or national levels. In this way, collective bargaining can contribute to investment in training, even in countries where trade union density and/or collective bargaining coverage are not high.

In addition, greater employee participation in the workplace reduces monitoring costs, with benefits in terms of efficiency. How and to what extent competitiveness is dealt with through collective bargaining varies considerably from one country to another. However, collective bargaining is, of course, only one means of enhancing productivity and competitiveness and is typically underpinned by “basic conditions” like level of infrastructure, health and education and complemented by government regulations and other factors.

94. Enterprises become sustainable by being competitive themselves and functioning in a competitive environment. The ways in which enterprises and nations compete in the marketplace have been a subject of study for many years, with antecedents in early approaches to the study of economies, for example, in terms of the elaboration of the principles of absolute and comparative advantage (not to be confused with the more recent and distinct concept of competitive advantage). Many management theories are effectively about competitive advantage, but the concept itself is a fairly recent phenomenon, defined as “a function of either providing comparable buyer value more efficiently than competitors (low cost) or performing activities at comparable cost but in unique ways that create more buyer value than competitors and hence command a premium price (differentiation)”.<sup>7</sup> The basic tool for examining the activities of an enterprise and identifying how they interact and perform to achieve competitive

also compared the organizational outcomes of innovative organizations, versus non-innovative organizations (<http://www.erasmusinnovatiemonitor.nl>).

<sup>6</sup> T. Fashoyin, E. Sims and A. Tolentino: *Labour-management cooperation in SMEs – Forms and factors* (Geneva, ILO, 2006); S. Hayter: “Collective bargaining and income equality in an integrating world”, in *Labour Education* 2002/3, No. 128: *Paying attention to wages* (Geneva, ILO, 2002); and M. Ozaki: *Negotiating flexibility – The role of the social partners and the state* (Geneva, ILO, 1999).

<sup>7</sup> M. Porter: *Competitive advantage, creating and sustaining superior performance* (New York, Free Press, 1985) addresses firm or enterprise-level competitiveness; *Competitive strategy: Techniques for analysing industries and competitors* (New York, Free Press, 1980) covers competitiveness at the industry level; and *The competitive advantage of nations* (New York, Free Press, 1990) addresses the issue of how the choice of location by an internationalizing business could be a source of competitive advantage.

advantage is the concept of the value chain. By analysing enterprises from a series of linked activities, a value chain can be constructed, identifying in a systematic manner the idea of synergies and thereby enabling managers to get ahead of the competition and to stay there.

95. The concept of competitiveness is vitally important but also problematic, as virtually everything matters for competitiveness and what matters most is likely to change over time as economies and societies develop, and will vary from one location or sector to another. For example, in economies dominated by the export of primary commodities or relatively simple or standard manufactures, factor prices, commodity prices, exchange rate fluctuations and business cycles are likely to be key determinants of competitiveness, at least in the short term. However, in more advanced, innovation-driven economies, the most significant factors conferring competitive advantage are likely to include the quality of higher education systems, expansion of the technology frontier and the development of deep, sophisticated clusters. As Porter argues in the *Global Competitiveness Report 2005–2006*, “while macroeconomic shifts, political developments, resource price swings, and spurts of trade and foreign investment can drive growth in GDP per capita for periods of time, the only reliable basis of true prosperity is the productivity potential of a nation’s economy”.<sup>8</sup> On this basis, it is hardly surprising that there are huge productivity divides between poorer and richer countries. For example, data from United Nations Conference on Trade and Development (UNCTAD) shows that it takes 94 workers in the least developed countries to produce what one worker in developed countries produce.<sup>9</sup> Thus, enhancing national competitiveness is generally seen as a fundamental determinant of wealth creation and prosperity, and productive, sustainable enterprises play a vital role in this. The World Economic Forum, for example, defines national competitiveness as “the set of factors, policies and institutions that determine the level of productivity of a country”.<sup>10</sup>

96. Enterprise competitiveness and national or country-level competitiveness are intuitively closely related concepts, but there are many cases in which the application of enterprise-level competitiveness strategies has different consequences at the national level and vice versa.<sup>11</sup> A common measure of national competitiveness is by reference to a country’s share of global markets, which mirrors a company’s competitiveness measured in terms of market share. In this sense, competitiveness is viewed as a zero sum game – one country’s exports are another country’s imports – and, in turn, this justifies policies intended to provide subsidies, hold down wages and devalue currencies in order to expand exports, hence the common argument that lower wages or weaker (devalued) currencies make a nation more competitive. However, although such policies might yield short-term gains, in the long run, their benefits are less secure. Again, Porter is erudite on this issue, “the need for low wages reveals a lack of competitiveness and holds down prosperity. Subsidies drain national income and bias choices away from the most productive use of the nation’s resources. Devaluation results in a collective national pay cut by discounting the products and services sold in world markets, while raising the

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<sup>8</sup> M. Porter: “Building the microeconomic foundations of prosperity: Findings from the business competitiveness index”, in *Global Competitiveness Report 2005–2006* (Geneva, WEF, 2005), p. 44.

<sup>9</sup> UNCTAD: *The least developed countries report 2006 – Overview by the Secretary-General of UNCTAD* (Geneva, UNCTAD, 2006), p. 16 (data refers to 2002–03).

<sup>10</sup> A. Lopez-Claros et al. (eds): *Global Competitiveness Report 2006–2007* (Geneva, WEF, 2006), p. 3.

<sup>11</sup> See P. Krugman: “A country is not a company”, in *Harvard Business Review* (Cambridge, Massachusetts, 1996), Jan.–Feb., Vol. 74, issue 1, pp. 40–51, for a seminal article on the differences between company-level and country-level competitiveness (and a discussion of why he believes great business leaders do not necessarily make great economic policy-makers).

cost of the goods and services purchased abroad. Exports based on low wages or a cheap currency, then, do not support an attractive standard of living”. Changes in the price of things, such as the cost of inputs, the value of a currency or the wage rate of labour, obviously have an impact on national competitiveness, but for this to be sustainable, it is necessary to consider the productivity of the economy measured in terms of the value of goods and services produced per unit of the country’s resources (i.e. their efficiency). “Productivity allows a nation to support high wages, a strong currency and attractive returns to capital”,<sup>12</sup> but national prosperity is also determined not just by those actually working and the capital employed, but also by those not working or underemployed and the extent to which other resources (such as natural resources) are used for productive activities. In short, prosperity is determined by both the amount of resources and the efficiency with which they are used.<sup>13</sup>

#### Box 4.2

##### Competitiveness – Adding up the real costs of cheap labour

“Absolute labour costs matter, but other factors in the equation – political risk, intellectual property loss risk, the price of materials and equipment, transportation, interest rates, the cost of energy, taxes, licences – are far more important than we ordinarily reckon. ... Even looking narrowly at labour costs, what matters are unit labour costs – how much labour is needed to produce a given value of production. ... A business that needs to employ a large semiskilled workforce will probably do better in a low wage country, all other things being equal – but they rarely are. The enormous accomplishment of successful foreign investors’ factories (and a limited number of domestic industries) in regions of China like Guangdong is their control over the negative drag weight of all other things, which makes it possible to realize the advantages of low-cost labour” (pp. 260–261).

“A country like Haiti, which is close to the United States, with at least 70 per cent unemployment and a minimum wage under US\$2 a day, might seem tempting for a labour intensive industry.” It may have been a deciding factor when an international apparel manufacturer contracted a Dominican manufacturer to set up sewing plants in a free-trade zone straddling the border between Haiti and the Dominican Republic in order to recruit Haitian workers, especially when the investment was backed by an International Finance Corporation (IFC)/World Bank loan to build the plant which came with the condition that workers’ rights be respected. However, “a union-organising campaign was followed by claims of brutality, counterclaims from the management about political militants, the intervention of the Dominican military, a lockout, international protests and picketing” of the international manufacturers’ stores in the United Kingdom. Irrespective of the rights and wrongs of this particular conflict, the example “demonstrates how setting up shop in a country with weak enforcement of the rule of law, where order depends on repression, is likely to lead to disasters like this one. No level of wages could compensate for the loss of reputation for brand integrity, to say nothing of financial losses in such an episode” (p. 119).

Source: S. Berger: *How we compete – What companies around the world are doing to make it in today’s global economy* (New York, Random House, Inc., 2006). A study based on the MIT Industrial Performance Center’s five-year study of 500 international companies.

<sup>12</sup> M. Porter: “Building the microeconomic foundations of prosperity”, in *Global Competitiveness Report 2005–2006*, op. cit., p. 44.

<sup>13</sup> There is a wealth of resource tools and studies on various aspects of productivity and competitiveness. *Productivity and competitiveness upgrading through improved labour–management relations and workplace practices*, a CD-ROM interactive training resource (Geneva, ILO, 2006) provides an excellent overview and contains a comprehensive list of references on the subject; and J. Prokopenko: *Productivity management: A practical handbook* (Geneva, ILO, 1987), although dated, provides an excellent introduction to the practical aspects of the subject.

## Measuring and evaluating competitiveness

97. Due to the depth and breadth of the concept of competitiveness, there is broad agreement that the most informed approach to assessing competitiveness is by reference to a wide range of factors, and there are two international surveys of competitiveness produced annually which attempt to present a systematic and holistic assessment of the competitiveness of nations. These are the GCR, produced annually since 1979 by the Geneva-based World Economic Forum, and the World Competitiveness Yearbook (WCY), produced annually since 1989 by IMD, the Lausanne-based business school.<sup>14</sup> Both surveys make use of secondary data from national and international sources and also conduct specific surveys of business leaders/executives. Both publications weight together a large number of variables (around 300 in the case of the WCY and about 100 in the case of the GCR) to produce overall indices of competitiveness.

98. Inevitably, these indices are, at least to some extent, biased towards the views of those whose opinions are surveyed, and an intelligent and measured interpretation of the data sets is required. For example, in the WCY, Iceland classifies overall as one of the most competitive nations but in terms of the density of roads and railways, it is at the bottom of the list. Clearly, Iceland is not going to become more competitive by building more roads and railways, but rather by maintaining its position at the top of the list on criteria like Internet usage, and on the adequacy and efficiency of its energy infrastructure. Similarly, before drawing conclusions from data in either the WCY or the GCR, it is important to be careful about the causality of some of the data; do they imply more about the cause of competitiveness or the consequence of competitiveness, for example? It could also be argued that some criteria are more related to the size of an economy than its competitiveness, and it is important to remember that the data from the opinion surveys reflects the perspective of a particular segment of the private sector – executives in mostly medium- to large-sized formal enterprises – which may not necessarily reflect the views and priorities of the informal, micro or small enterprises, which usually make up the majority of the private sector in most countries. However, both publications provide reference points for assessing the drivers of competitiveness across a very broad range of criteria, over time and across a large number of countries. They have become the first point of reference for business leaders interested in tracking national competitiveness.

99. The WCY provides data sets across four broad categories: economic performance (77 criteria), government efficiency (72 criteria), business efficiency (68 criteria) and infrastructure (95 criteria). Within the economic performance category, there are eight criteria concerned with trends in employment including labour force participation rates, unemployment rates, distribution of employment by sector and youth unemployment, with data drawn from secondary sources such as the *ILO Yearbook of Labour Statistics*. Under the government efficiency category, survey data – from the Executive Opinion Survey – is available on the extent to which business executives perceive that labour regulations hinder or do not hinder business activities and on whether unemployment legislation does or does not provide incentives to look for work. In terms of the business efficiency category, there is a wealth of information on productivity factors, working

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<sup>14</sup> There are many other sources of data on competitiveness and factors related to competitiveness, produced by organizations like UNCTAD (World Investment Report); A.T. Kearney (FDI Confidence Index); World Bank (Doing Business surveys, Investment Climate surveys, etc.); EBRD (Business Environment and Enterprise Performance data sets, with World Bank); OECD; and the EU. However, the WCY and the GCR are the two most comprehensive sources of data on a broad range of measures of competitiveness, with data collected on a regular basis across a large number of countries – 125 in the GCR and 53 plus eight regional economies in the case of the WCY.

hours, labour relations, worker motivation, employee training, competence of senior managers, ethical practices in companies, attitudes towards globalization, and even a specific question on whether or not business executives take into account the value of employees. The WCY provides country rankings of these data sets by each criterion and also presents the data by country, indicating particular country-level strengths and weaknesses. However, the WCY does not provide substantive commentary or a critique of the data sets; the information is essentially presented and the user is left to interpret it.

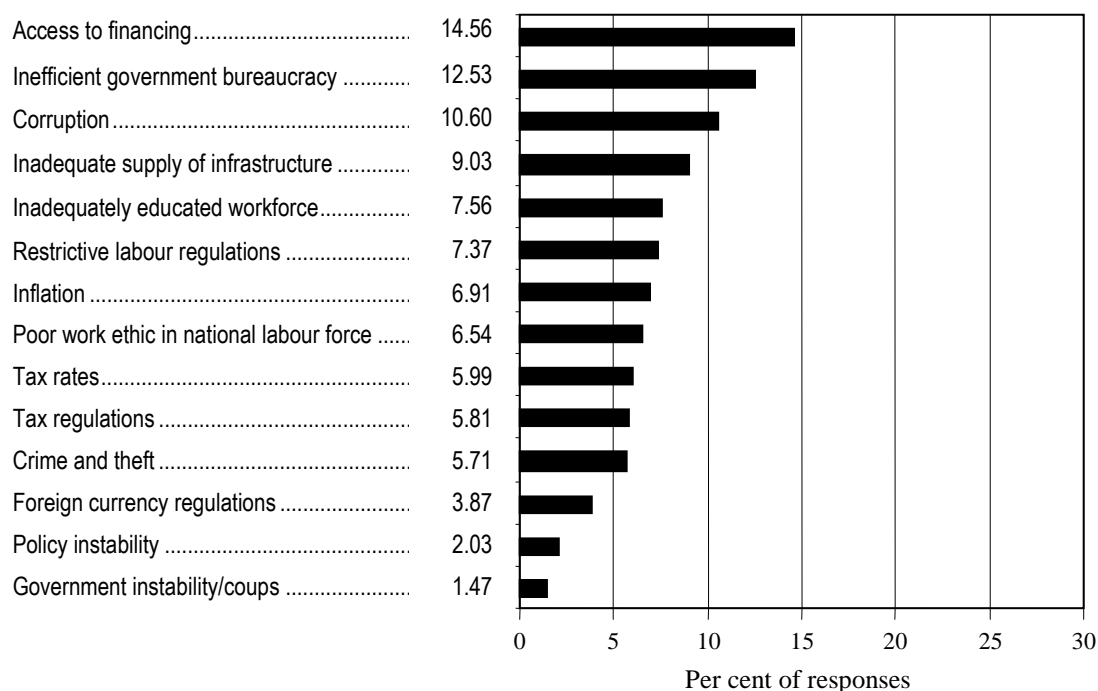
100. The GCR, by contrast, does contain extensive commentary on the data sets and includes analysis from leading thinkers on selected issues and special topics related to competitiveness. The country profiles, which include a ranking of the most problematic factors for doing business in each country, and the data tables, cover a large number of transition and developing countries. Among the many areas covered by the Executive Opinion Survey<sup>15</sup> are national perceptions of contemporary issues like the impact of the threat of terrorism on the costs of doing business, the medium-term impact of HIV/AIDS on business and perceptions surrounding the business costs of corruption. There are rankings on the ease of hiring foreign labour, the private sector employment of women, the extent of staff training, flexibility of wage determination, cooperation in labour–employer relations, opinion on the link or otherwise between pay and productivity and the perceived importance of corporate social responsibility (CSR).<sup>16</sup> In the GCR, a “national competitiveness balance” showing the relative advantages and disadvantages for each country is produced, together with a chart showing the most “problematic factors for doing business”. These factors vary quite significantly from country to country. Figures 4.2 to 4.4 illustrate the type of issues which arise from the Executive Opinion Survey, using the case of a “factor driven” low-income country (Mozambique), an “efficiency driven” middle-income country (Jamaica) and an “innovation driven” high-income country (Japan). The resulting global competitiveness index provides a holistic overview of factors that are critical to driving productivity and competitiveness and groups them into the following nine pillars: institutions; infrastructure; macroeconomy; health and primary education; higher education and training; market efficiency; technological readiness; business sophistication and innovation.

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<sup>15</sup> The Executive Opinion Survey, which yielded almost 11,000 responses to around 150 questions in 2005, ranks responses ranging from 1 to 7. For example, the question on the flexibility of wage determination is posed as “wages in your country are (1 = set by a centralized bargaining process, 7 = up to each individual company) and the question on cooperation in labour–employer relations is posed as “labour–employer relations in your country are (1 = generally confrontational, 7 = generally cooperative)”. A higher value is normally associated with greater competitiveness.

<sup>16</sup> As with other similar surveys of labour markets in the context of doing business, the precise methodology and relationship between labour market regulations and labour market outcomes/performance is an important issue which requires further research.

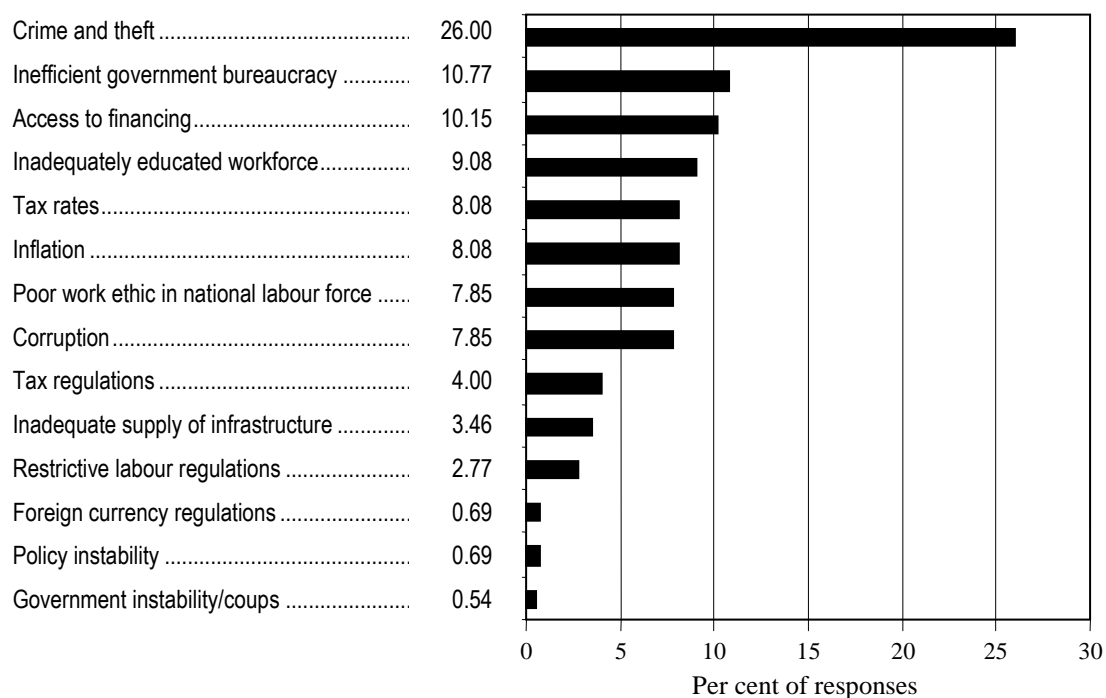
**Figure 4.2. Finance, bureaucracy, corruption and other problematic factors for doing business in Mozambique**



Note: From a list of 14 factors, respondents were asked to select the five most problematic for doing business in their country/economy and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

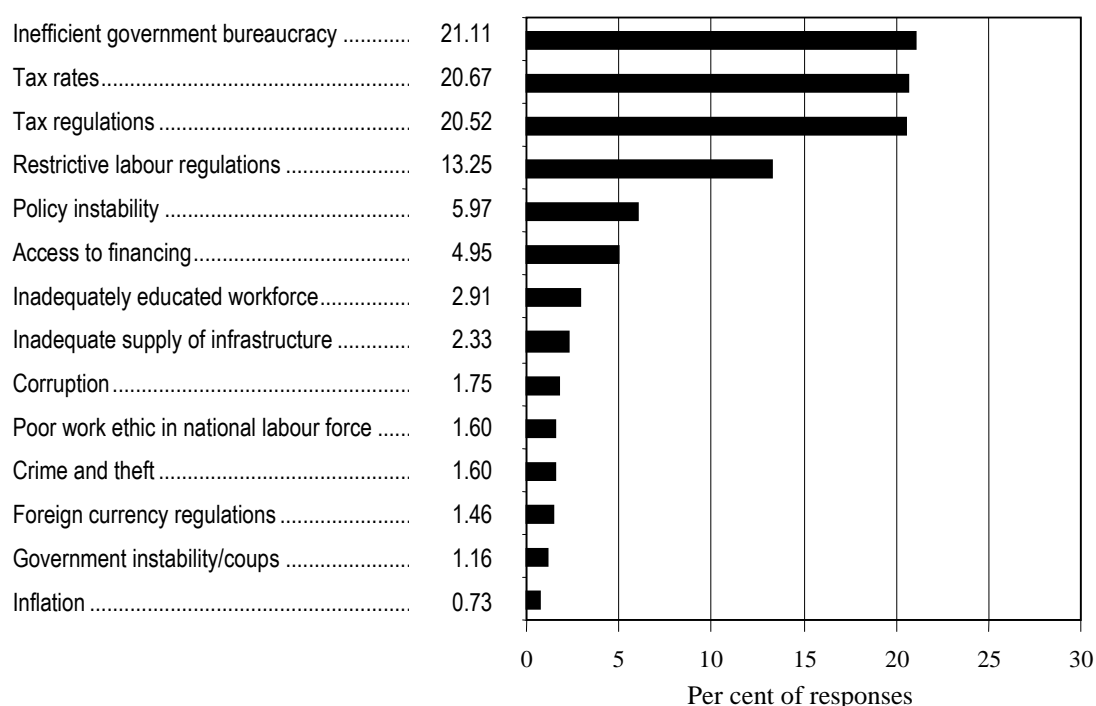
Source: *Global Competitiveness Report 2006–2007*, p. 300.

**Figure 4.3. Crime and theft in Jamaica and other problematic factors for doing business**



Note: From a list of 14 factors, respondents were asked to select the five most problematic for doing business in their country/economy and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: *Global Competitiveness Report 2006–2007*, p. 252.

**Figure 4.4. Bureaucracy, tax and other problematic factors for doing business in Japan**

Note: From a list of 14 factors, respondents were asked to select the five most problematic for doing business in their country/economy and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

Source: *Global Competitiveness Report 2006–2007*, p. 254.

101. The overall country rankings for both the WCY scoreboard and the GCR index are similar: there is a positive correlation between levels of national per capita income and overall ranking, for example, especially for countries at either end of the spectrum (for example, 19 of the 25 lowest ranked countries in the GCR index are low-income African countries). However, direct comparison is somewhat misleading, as different criteria are used to construct the two indices (the GCR puts a higher weight on results from its executive survey in computing the overall index than does the WCY, for example), the WCY covers less than half the countries covered by the GCR, and the data sets cover slightly different time periods (so a significant change in a number of criteria could be picked up in one survey but not in the other). Nevertheless, for illustrative purposes, the top ten rankings from both surveys are shown in table 4.1.

Table 4.1. The WCY and GCR overall rankings

WCY (scoreboard 2006)	GCR (index 2006)
United States (1)	Switzerland (4)
Hong Kong, China (2)	Finland (2)
Singapore (3)	Sweden (7)
Iceland (4)	Denmark (3)
Denmark (7)	Singapore (5)
Australia (9)	United States (1)
Canada (5)	Japan (10)
Switzerland (8)	Germany (6)
Luxembourg (10)	Netherlands (11)
Finland (6)	United Kingdom (9)

Source: WCY 2006 and GCR 2006–2007; previous year's ranking in brackets.

#### Box 4.3 What makes Switzerland so competitive?

According to the GCR, “Switzerland’s top ranking reflects a combination of a world-class capacity for innovation and the presence of a highly sophisticated business culture. The country has a well-developed infrastructure for scientific research, with close collaboration between the leading research centres and industry. Companies spend generously on research and development. Intellectual property protection is strong and this has helped spur high levels of technological innovation, as measured by per capita patents registration ... Business activity in the country benefits from a well developed institutional framework, characterized by respect for the rule of law, an efficiently working judicial system and high levels of transparency and accountability within public institutions. Flexible labour markets and excellent infrastructure facilities are two healthy features of the business environment. Steady efforts to improve macroeconomic fundamentals over the past few years, in particular reducing the budget deficit and stabilized public debt levels are paying off ... For Switzerland to retain its top ranking, it will have to address a number of remaining weaknesses, some of which stand at odds with developments elsewhere in the industrial world. Competition in goods markets is limited by various forms of government intervention; there is resource misallocation through agricultural support, and at a time when the EU and much of the rest of the world is quickly moving to remove barriers to international trade, Swiss borders remain zealously guarded”.<sup>17</sup>

Source: A. Lopez-Claros et al.: *Global Competitiveness Report 2006–2007* (Geneva, World Economic Forum, 2006), pp. 24–27.

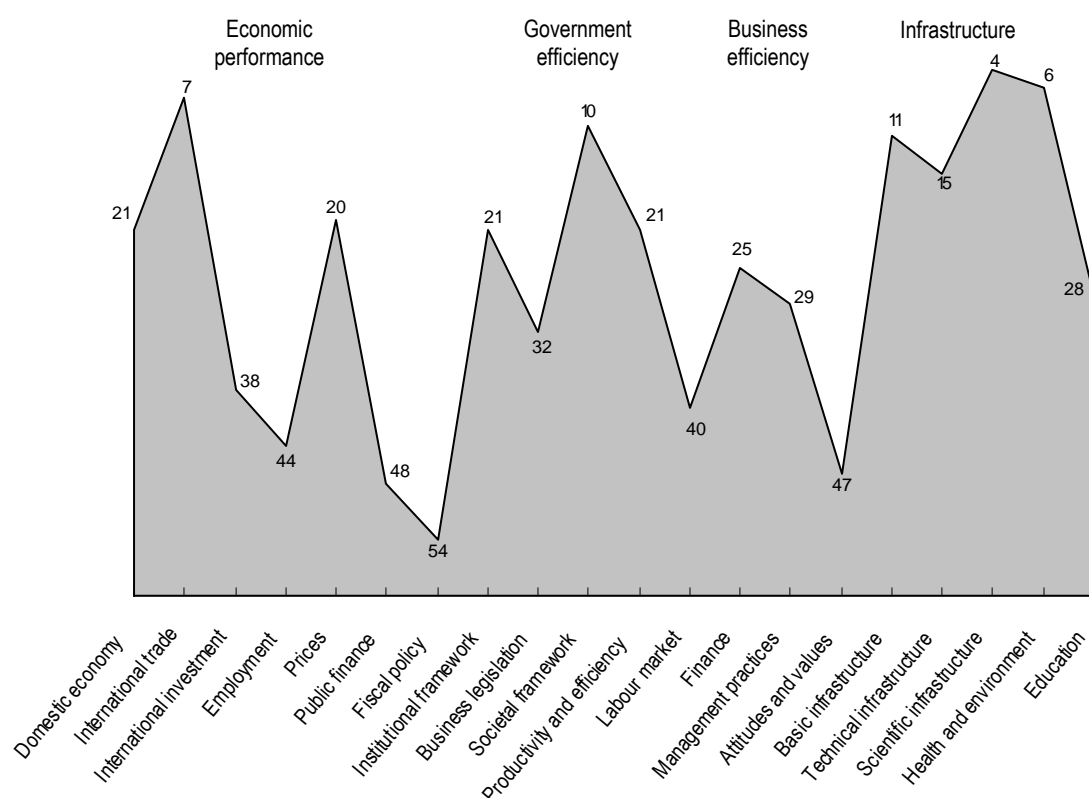
102. The surveys of competitiveness provide useful benchmarks against which individual countries can assess their relative strengths and weaknesses. These surveys do not attempt to argue the importance of one particular criterion over another for enhancing competitiveness but rather point to the holistic, systemic basis for

<sup>17</sup> Not everyone, of course, will agree that labour markets in Switzerland are quite as flexible as seems to be implied here and many will question whether the “EU and much of the rest of the world” is really moving quickly enough to remove barriers to international trade. The issue of labour market flexibility is, of course, a relative concept and within a country, different parts of the labour market will be characterized by different degrees of flexibility. Within Switzerland, for example, some sectors of the labour market are very inflexible and operate as effective monopolies whilst others are very flexible and open.



competitiveness. However, they do provide governments with insight into where actual and potential competitive advantage (and disadvantage) lies and provide the evidence base for doing something about this in terms of, for example, reforms to the regulatory environment, changes in competition, tax or investment policy, skills upgrading, supporting enhanced research and development, and so forth. These surveys also give a basis for countries to develop national competitiveness policies and strategies, which can include macroeconomic policies, strategies to promote trade and inward investment, support for infrastructure and technology development, enhancing human capital, promoting entrepreneurship, helping develop enterprise clusters, and so on.<sup>18</sup> However, as figures 4.5 and 4.6 illustrate, it is often necessary, especially for larger countries, to assess competitiveness at subnational levels, as relative competitiveness is likely to vary across regions within countries (and, of course, across sectors). In the case of Germany, for example, data from the WCY indicate that “management practices” in the state of Bavaria seem to be substantially more favourable, in terms of perceived competitiveness, than in Germany as a whole.

Figure 4.5. Competitiveness landscape for Germany

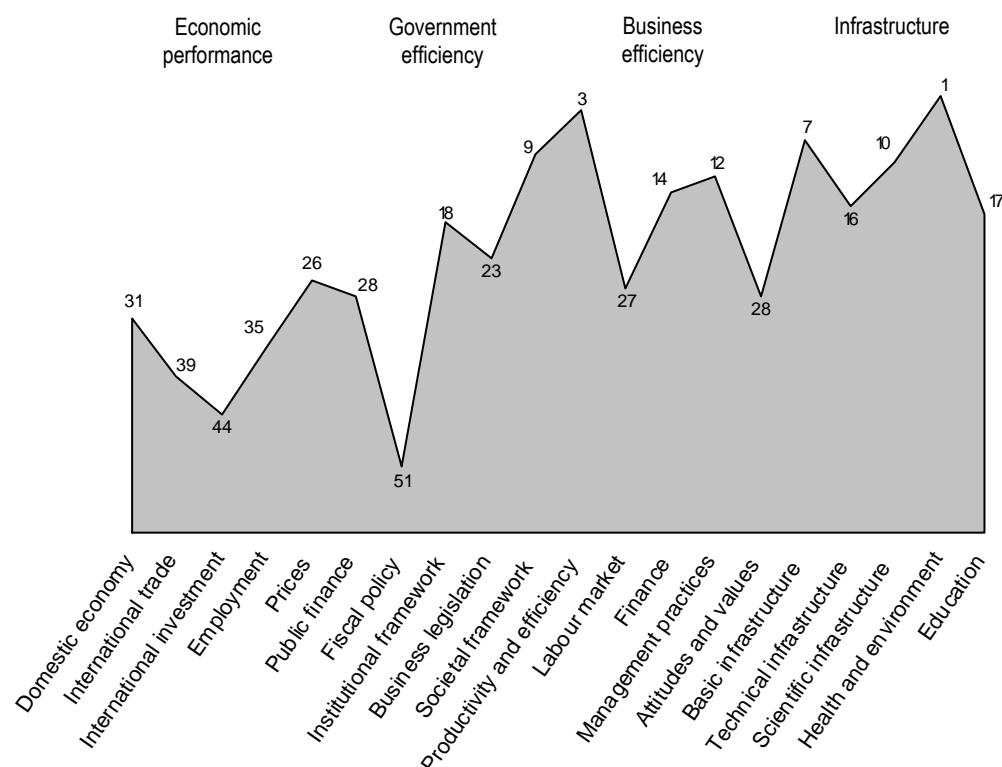


Note: Figures denote a ranking out of 61 countries and economies; the lower the number the higher the ranking.

Source: Adapted from *World Competitiveness Yearbook 2006*, p. 142.

<sup>18</sup> J. Prokopenko: *Competition: An agenda for the 21st century* (Geneva, Bureau for Employers' Activities/ILO, 2000).

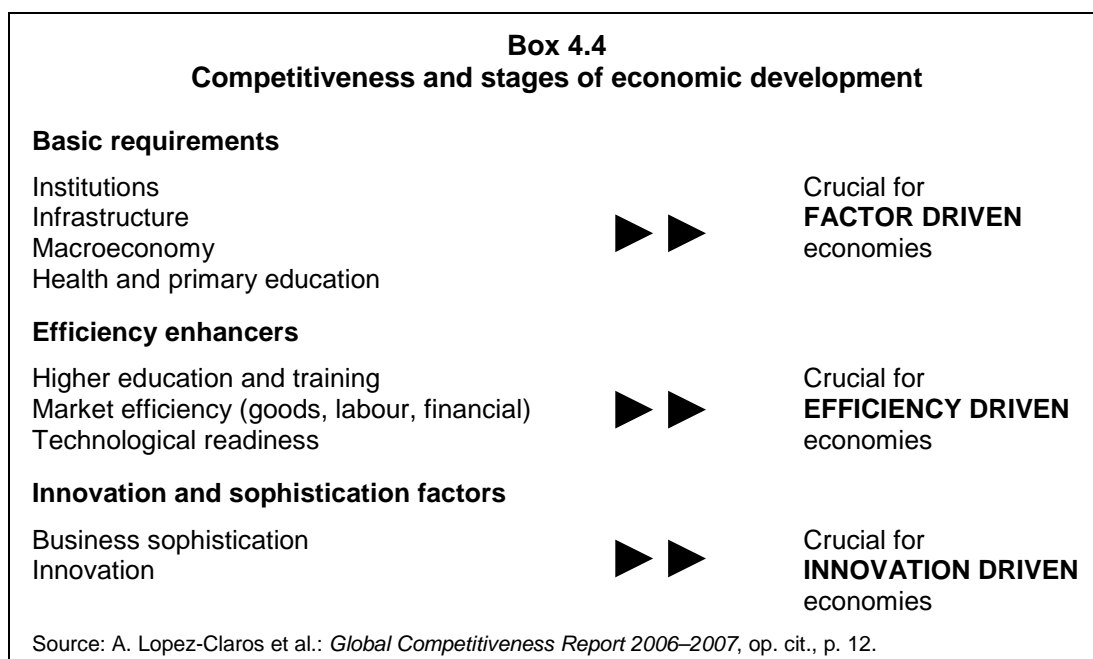
Figure 4.6. Competitiveness landscape for Bavaria, Germany



Note. Figures denote a ranking out of 61 countries and economies; the lower the number the higher the ranking.

Source: Adapted from *World Competitiveness Yearbook 2006*, p. 78.

103. There is no magic formula for enhancing national competitiveness, but trends can be discerned which indicate the relative importance of different factors according to levels of development (box 4.4). For example, among low-income countries, the challenge is often to move beyond competing on cheap labour or natural resource endowments, and this is probably best achieved by focusing on the “basic conditions” like basic education and health and addressing infrastructure weaknesses, rather than placing priority on upgrading regulatory standards for businesses. For middle-income countries, factors like improving the quality of marketing and management and of post-secondary education, expanding the export base, improving the quality of the telecommunications infrastructure and Internet usage are likely to become more significant factors favouring competitiveness. For high-income countries, increasing the capacity to innovate becomes key, and national competitiveness is significantly influenced by factors such as the quality of corporate governance, the extent of bureaucratic red tape, the quality of labour and financial markets, barriers to foreign investment and the depth of cluster development. This is obviously a fairly stylized representation of a complex and diverse process, but it illustrates that the level of development is likely to influence which are the most significant “binding constraints” and indicate the importance of different competitiveness and productivity challenges facing countries and hence the different policy options open to them. However, it does not imply a vending machine approach; country-specific challenges and solutions will vary and countries must develop their own strategies for addressing them and cannot rely on copying the policies of other countries.



## The role of governments: Policy and institutional issues

104. Overall though, it appears that, irrespective of levels of development, business environment factors as a group are a greater determinant of differences in competitiveness across countries than are enterprise-level factors. On the basis of GCR time series data, it appears that the benefits of a better business environment for prosperity increase with the sophistication of local enterprise operations and strategy, and vice versa. Countries which experience improvement in both the business environment and enterprise-level factors in tandem are likely to reap disproportionate benefits, while countries where there is an imbalance bear disproportionate costs. This is relatively intuitive and is explained, at least in part, by spillovers between enterprise-level and national-level competitiveness factors, such that an improvement in one part of the business environment has more impact if other parts of the business environment are stronger, and by the fact that countries may reap fewer benefits from a given amount of enterprise-level improvements due to weaknesses in the basic macroeconomic, political, legal and environmental and social conditions.<sup>19</sup>

105. Governments clearly have a role to play in fostering national competitiveness and in addition to the policy approaches discussed in previous chapters, one instrument for this is industrial policy. For a period during the 1980s and 1990s, industrial policy (or sectoral policies) went out of fashion, but as doubts emerged about the impact of liberalization and privatization policies, coupled with the high profile of industrial policy success stories like those of some Asian countries, some commentators have proposed a return to a new type of industrial policy.<sup>20</sup> The key point in this debate is how the concept of industrial policy is defined, and as with competitiveness, it means different

<sup>19</sup> M. Porter: "Building the Microeconomic Foundations of Prosperity", in *Global Competitiveness Report 2005–2006*, op. cit.

<sup>20</sup> D. Rodrick: *Industrial policy for the twenty-first century*, paper prepared for UNIDO (Cambridge, Harvard University, 2004).

things to different people. Taking industrial policy to refer to “any type of selective intervention or government policy that attempts to alter the sectoral structure of production toward sectors that are expected to offer better prospects for economic growth than would occur in the absence of such intervention”,<sup>21</sup> it is clear that a lot can be attributed to industrial policy, even across-the-board supply-side measures like support for research and development and the protection of intellectual property. Thus, it is not hard to find either good or bad examples of industrial policy, which might include successful or failed government attempts to protect infant industries, misused or well used grants or other special concessions or subsidies provided to establish or protect a particular firm or sector, and industrial “white elephants” which have simply failed, as well as “showcase” industrial parks which have spawned new products or industry clusters.<sup>22</sup> Similarly, it is possible to identify both broadly positive and negative country experiences of export processing zones (EPZs). Evidence tends to suggest that the capacity of EPZs to generate growth and employment depends to a large extent on the broader policy context.<sup>23</sup>

106. There are many examples where governments have played a key role in nurturing successful enterprises or industrial sectors, and there are also numerous examples of less successful attempts, which have in fact lumbered governments with costly mistakes. Among the most common arguments against industry policy, especially in developing countries, is the weak capacity of governments to render industrial policy effective. However, it is unclear what the counterfactual is; most developing countries have weak, capacity-constrained governments, so all public policy presents challenges, but it is clearly not an option for governments not to formulate public policy. Furthermore, there are a number of successful examples where capacity-challenged governments have been relatively successful – in partnership with the private sector – in supporting industrial policy and developing markets for particular sectors. Similarly, there is an argument that industrial policy is prone to political capture and corruption but, again, this is also an argument levelled against other areas of policy-making and does not, *prima facie*, provide a clear case against industrial policy.

107. On the basis of the positive stories, a new industrial policy has emerged which lays emphasis on public and private sector collaboration, the latter identifying business opportunities and constraints and the former generating policy initiatives in response. Thus, the “new” language in industrial policy is about building value chains, fostering learning, investing in people and skills and obtaining benefits from economies of scale and scope on the basis of clusters. In effect, private enterprises become responsible for the kind of learning strategies that “old” industrial policy placed firmly in the hands of the government. Furthermore, the contemporary international policy environment imposes constraints on the use of national policies that were absent 15 or more years ago, and these constraints are backed up by potent dispute settlement procedures at the World Trade Organization (WTO).<sup>24</sup> In the modern-day environment, the “policy space”

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<sup>21</sup> H. Packa and K. Saggi: *The case for industrial policy: A critical survey*, Policy Research Working Paper No. 3839 (Washington, DC, World Bank, 2006).

<sup>22</sup> A number of countries in Eastern Europe, among them the Czech Republic and Hungary, have been particularly successful in using industrial parks to foster the creation and growth of enterprises, see OSCE: *Best practice guide for a positive business and investment climate* (Vienna, OSCE, 2006), pp. 107–109.

<sup>23</sup> ILO: *Employment and social policy in respect of export processing zones (EPZs)*, Committee on Employment and Social Policy, Governing Body, 286th Session, Nov. 2003, GB.286/ESP/3.

<sup>24</sup> S. Hayter: “The Rules of the Game for Building Globally Competitive Industries”, in *New Agenda*, Third Quarter 2004, pp. 84–90.

for industrial policy is therefore quite different from what it was in the past;<sup>25</sup> the “new industrial policy” stresses systemic competitiveness and integrates reforms in the business environment, with upgrading skills, of investment in research and development and with policies encouraging trade and inward investment.

108. The rise of globalization and the information society presents a new set of challenges for policy-making at the interface between technological innovation and enterprise growth. Governments, including at the subnational level, have responded to this challenge in different ways, as illustrated by the experience of, for example, India, Singapore, Silicon Valley in the United States, and Finland. There is no one model and each of these experiences shows that there is room for different policies and values. However, the Finnish model does provide some interesting insights into how the State can most effectively play a role in guiding economic growth and building an equitable information society. It has done this by, among other things, using incentives and strategic planning to complement market mechanisms, rather than substituting for them, and facilitating the spatial clustering and organizational networking of knowledge-based industries, which has been critical in enhancing productivity and competitiveness. The Finnish model also shows that a fully fledged welfare state is not incompatible with technological innovation or with a dynamic and competitive economy. It provides an example where “the welfare state and cooperation between business and labour, mediated by government, allow the development of work flexibility within a stable system of industrial relations”.<sup>26</sup>

109. Many countries (and regions within countries) have developed investment policies to attract inward investment, and some have been very successful.<sup>27</sup> Investment policies usually include the establishment of investment promotion agencies (IPAs), which typically have responsibility for policy advocacy, image promotion, investment generation and various investor services. Many countries have some sort of IPA and some can demonstrate considerable success. For example, CzechInvest of the Czech Republic is often cited for its expertise in investment promotion, and Ireland has been particularly successful in attracting investment and transforming its economy by establishing a positive business environment (see box 4.5). Good practice suggests that IPAs should not use investment incentives (including fiscal incentives) as a substitute for a favourable business climate. Rather, these should be a complement to other policies designed to improve the climate for doing business, both for domestic and foreign investors.<sup>28</sup> Good practice also suggests that because there is often no clear dividing line between policies for improving the investment climate to attract inward investment from foreigners and policies designed to improve the investment climate for domestic investment, the two should go together.<sup>29</sup> These principles are put into practice in the OECD-supported South-East Europe Investment Compact which, on a regional basis, provides a mechanism and set of incentives for combining investment promotion with business climate reform (box 4.6). Good practice on investment promotion also cautions

<sup>25</sup> UNCTAD: *Trade and development report 2006* (New York/Geneva, United Nations, 2006).

<sup>26</sup> M. Castells and P. Himanen: *The information society and the welfare state: The Finnish model* (Oxford, Oxford University Press, 2002), p. 167.

<sup>27</sup> See, for example, J.W. Fox: *Successful integration into the global economy – Costa Rica and Mauritius*, Research Report by Nathan Associates, Arlington, Virginia for USAID, 31 Jan. 2003.

<sup>28</sup> UNCTAD: “Investment and technology, policies for competitiveness – Review of successful country experiences”, in *Technology for Development Series* (New York/Geneva, United Nations, 2003).

<sup>29</sup> See, for example, the Investment Climate Facility for Africa, <http://www.investmentclimatefacility.org> and the Foreign Investment Advisory Service (FIAS) of the World Bank, <http://www.fias.net>.

the use of certain types of incentives, especially where there is the potential that they may foster dependency, fuel corruption, lead to mismanagement or create excessive fiscal challenges for the government.

#### Box 4.5

##### The Celtic Tiger: Making Ireland a competitive place to do business

In the 1990s, Ireland underwent a remarkable transformation from being an economic laggard to becoming one of the economic trailblazers in Europe. Although many factors contributed to this, such as its strong relations with the United States, its English-speaking population and its membership of the EU, the fact that Ireland did not have an established industrial base, lacks significant natural resources and has traditionally been a source of labour out-migration, makes this transformation all the more remarkable. In particular, Ireland succeeded in establishing an outstanding business climate through intelligent policy-making. The following important factors can be distinguished:

1. **Development of human capital.** Ireland stressed the quality of its workforce with skill sets matched to investor needs (e.g. ICT skills).
2. **Cooperation between labour and industry through a social partnership.** Unions agreed to fair but moderate wages in return for the Government's support of the welfare state. Partnership commitments provided ongoing input into economic decision-making. Systematic dialogue was developed between public and private sectors.
3. **Strong policy of national investment in infrastructure.** Supported by a clear planning framework and EU structural funds.
4. **Simplified and attractive business regulations and taxes.** The principle of proportionality guided regulatory policy, with regulations being easy to understand and balancing risks, costs and benefits. Ireland established low corporate tax rates.
5. **Targeted investment promotion.** The promotion of FDI was targeted at four growth-oriented sectors: IT, pharmaceuticals and health care, international FS and international services.

Individually, none of these measures would have achieved the levels of inward investment, economic growth and employment generation that Ireland has experienced over the past decade and a half, but as a package of interdependent incentives and policies, these measures have transformed Ireland into a "Celtic Tiger".

Source: Adapted from OSCE: *Best practice guide for a positive business and investment climate* (Vienna, OSCE, 2006), p. 19.

110. IPAs seek to attract inward investment by measures which not only address the costs of doing business but also improve the quality of the business environment. Where the country's investment or political climate is particularly risky, investment might have to be underwritten by sovereign guarantees, and where investors are unwilling to accept such guarantees (which is obviously quite common in countries where the investment or political climate is particularly risky), third party sources or political risk insurance can be sought, such as through the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. In some places, such investment guarantees might be the only way of attracting investment, but there clearly is a cost attached to such guarantees, both for the investor and for the host country. This raises the overall cost of an investment, providing further confirmation of the value of a good BEE.

#### **Box 4.6** **Investment compacts**

Founded in 2000, the OECD's Investment Compact for South-East Europe has attempted to increase investment and improve the business environment by:

- **evaluation and monitoring of progress** in investment reform, including concrete case studies of how to improve, based on OECD best practice;
- **support in implementation of** investment reform through coaching and peer review;
- **support in structuring the dialogue between public and private sectors** through the Regional Network of Foreign Investors Councils and the "Regional White Book" (<http://www.regionalfic.org>); and
- **political support through an annual ministerial conference** focused on a specific theme of investment reform.

One of the products of the Investment Compact is the Investment Reform Index, a comprehensive tool used to measure a country's performance in reforming its investment climate in ten areas: investment policy, investment promotion, tax policy, anti-corruption policy, competition policy, trade policy, SME support, public administration, financial institutions and infrastructure and human capital. The foreign investor councils are all privately funded, but their success depends on a positive dialogue with governments.

The Organization for Security and Cooperation in Europe (OSCE) recommends such investment compacts as a model for regional approaches to improving the investment climate which other countries could follow.

Source: <http://www.investmentcompact.org>; and OSCE: *Best practice guide for a positive business and investment climate* (Vienna, OSCE, 2006).

111. A complement to investment policy is effective competition policy, which is generally considered an important feature of competitive economies and, by extension, necessary for creating an environment supportive of sustainable enterprises. Governments increasingly recognize that encouraging competitive markets – inclusive, flexible, dynamic markets which foster innovation – is likely to stimulate productivity, lower costs, reduce price distortions and widen consumer choice. A competitive economy is also seen as conducive to promoting greater accountability and transparency in business and thereby leading to better corporate governance.<sup>30</sup> Empirical data and experience suggest that economies with greater competition are better able to withstand economic shocks and have higher levels and rates of growth in per capita national income.<sup>31</sup> Furthermore, the OECD consistently highlights the perverse employment effect of anti-competitive product market regulations. Such practices are found to hamper the creation of new businesses in sectors where there is strong potential growth by keeping prices artificially high and therefore depressing average real wages for the economy as a whole. By restricting output, such policies tend to reduce employment levels in the affected sectors, except when a protected environment allows overstaffing to be maintained, and labour demand may be further reduced if wages in these sectors contain an element of product–market rents. Furthermore, there may be “further scope for improving labour market performance by lowering domestic barriers to market entry, notably in the services sectors, reducing restrictions on foreign trade and investment and addressing administrative hurdles and costs to business creation. In addition, addressing legal impediments and administrative hurdles to setting up new firms as well as ensuring that small firms have adequate access to credit would nurture an entrepreneurial climate”.<sup>32</sup>

<sup>30</sup> See OECD Global Forum on Competition at [http://www.oecd.org/document/60/0,2340,en\\_2649\\_34685\\_2732220\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/60/0,2340,en_2649_34685_2732220_1_1_1_1,00.html).

<sup>31</sup> W.W. Lewis: *The power of productivity – Wealth, poverty and the threat to global stability* (Chicago/London, University of Chicago Press, 2004); and <http://rru.worldbank.org/PapersLinks/Developing-Competition-Policy/>.

<sup>32</sup> OECD: *Boosting jobs and incomes – Policy lessons from the reassessment of the OECD jobs strategy*, background paper prepared by the OECD Secretariat for the Saint Petersburg G8 Summit meeting of G8 employment and labour ministers, Moscow, 9–10 Oct. 2006, p. 10.

112. Competition policies exist in most countries and consist of laws designed to regulate practices which limit or remove competition from a market such as through predatory and other types of price fixing, bid rigging, types of market segmentation or other practices associated with monopolies or cartels. Typical components of competition law include the following: general regulations; prohibitions against collusion and collusive behaviour between erstwhile competitors; a ban on abuses of monopoly power or of a dominant position in a relevant market; provisions dealing with enterprises with special or exclusive rights or natural monopolies; state aid; merger control: rules governing the conduct of government competition authorities; consequences, including fines, penalties, imprisonment or civil liability in cases of violations of competition law and a more detailed set of regulations dealing with exemptions, procedures and other complicated matters.<sup>33</sup>

113. In practice, the enactment of competition law and, more particularly, its implementation, is rather complex. For example, it is not always obvious when mergers and acquisitions serve to enhance *pareto* (or overall) efficiency and when they serve to secure monopoly power. Similarly, the effects of vertical restraints on competition – contracts and business arrangements along a value chain – are not always easy to classify as being generally positive or negative in terms of their effect on competition. Furthermore, globalization has increased the complexity of competition policy – the relevant market for judging whether market power exists or is being abused will increasingly cover far more territory than any one single economy – entailing the need to ensure coherence between trade and competition policy and raising the importance of multilateral competition policy, as is the case in the EU.<sup>34</sup> However, whether through domestic or multilateral channels, the enactment of competition law and its enforcement by specialized agencies is generally considered necessary in order to encourage equity among producers, reduce rent-seeking behaviour, complement the implementation of national economic policies, foster sustainable enterprises and lead to broad-based employment and economic benefits.

114. Governments may also promote competitiveness, sustainable enterprises and employment creation via local and regional-based approaches including, but not limited to, economic regeneration or support to particular disadvantaged areas by providing incentives for investment in these areas as part of broader development programmes. These programmes are likely to be important for nurturing inclusive economies which, it has been argued, are conducive to the creation and growth of sustainable enterprises. One particular approach to nurturing enterprise and broader participatory-based development in local communities is local economic development (LED). This refers to area-based development strategies in which endogenous and institutional factors are integrated within a comprehensive development framework, with activities typically integrated around four axes: improving the competitiveness of local enterprises; attracting inward investment; upgrading human resources; and building infrastructure (figure 4.7). The figure also illustrates the risks inherent in such strategies, centred on the capacity of local communities to capture the intended benefits of LED programmes.<sup>35</sup> Such risks include the possibility of fostering dependence, facilitating easy access to

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<sup>33</sup> For good practice guideline, see OECD: *Guiding principles for regulatory quality and performance* (Paris, OECD, 2005); and OECD/World Bank: *A framework for the design and implementation of competition law and policy* (Paris/Washington, DC, OECD/World Bank, 1999).

<sup>34</sup> J. Clarke and S. Evenett: *A multilateral framework for competition policy?* (Bern, World Trade Institute, University of Bern, 2003).

<sup>35</sup> A. Rodríguez-Pose: *The role of the ILO in implementing local economic development strategies in a globalized world* (Geneva, ILO, Policy Paper, 2002), pp. 9–11.



competitors, the danger of subsidizing non-competitive firms or of stimulating migration/a brain drain. LED is perhaps most commonly associated with rural development programmes in developing countries, but box 4.7 illustrates the relevance of local or regional-based approaches to promoting competitiveness in a developed country like the United States.

**Box 4.7**  
**Workforce Innovation in Regional Economic Development (WIRED)**

Global competition is typically seen as a national challenge. In reality, the front lines of the battlefield are not national, but rather the regional economies within a country. Regions are where companies, workers, educators, researchers, entrepreneurs and governments come together to create competitive advantage. That advantage stems from the ability to transform new ideas and new knowledge into advanced, high-quality products or services. In other words, it is in regions that innovation occurs.

While many regions in the United States have thrived as a result of globalization and made considerable progress in integrating talent and skills development into their larger economic strategies, there are regions that are struggling to compete. These regions are being forced to revitalize and reinvent themselves. The US Department of Labor recognizes the importance of supporting regions that need additional technical and financial assistance to achieve these goals.

In February 2006, the Department of Labor launched WIRED, which focuses on the role of talent development in driving regional economic competitiveness, increased job growth and new opportunities for workers. Through a competitive process, 13 economic regions from across the country were selected to participate in the WIRED initiative. Each region will receive with approximately US\$15 million in funding over a three-year period and will also be provided with on-going expertise from several of the leading organizations in the field of innovation.

Recognizing that economic regions no longer correspond to state, county, local or municipal boundaries, the WIRED initiative is focusing on labour market areas comprising multiple jurisdictions within a state or across state borders. The regions represent the diversity of the United States and range from metropolitan areas like Denver and Kansas City to rural areas like eastern Montana and the Mississippi–Alabama border, and from the transformation of traditional industries in Michigan and North Carolina, to the creation of entirely new industries in Maine and California. Each region brings a unique set of characteristics, and each offers the promise of unique solutions to the challenges posed by the global economy.

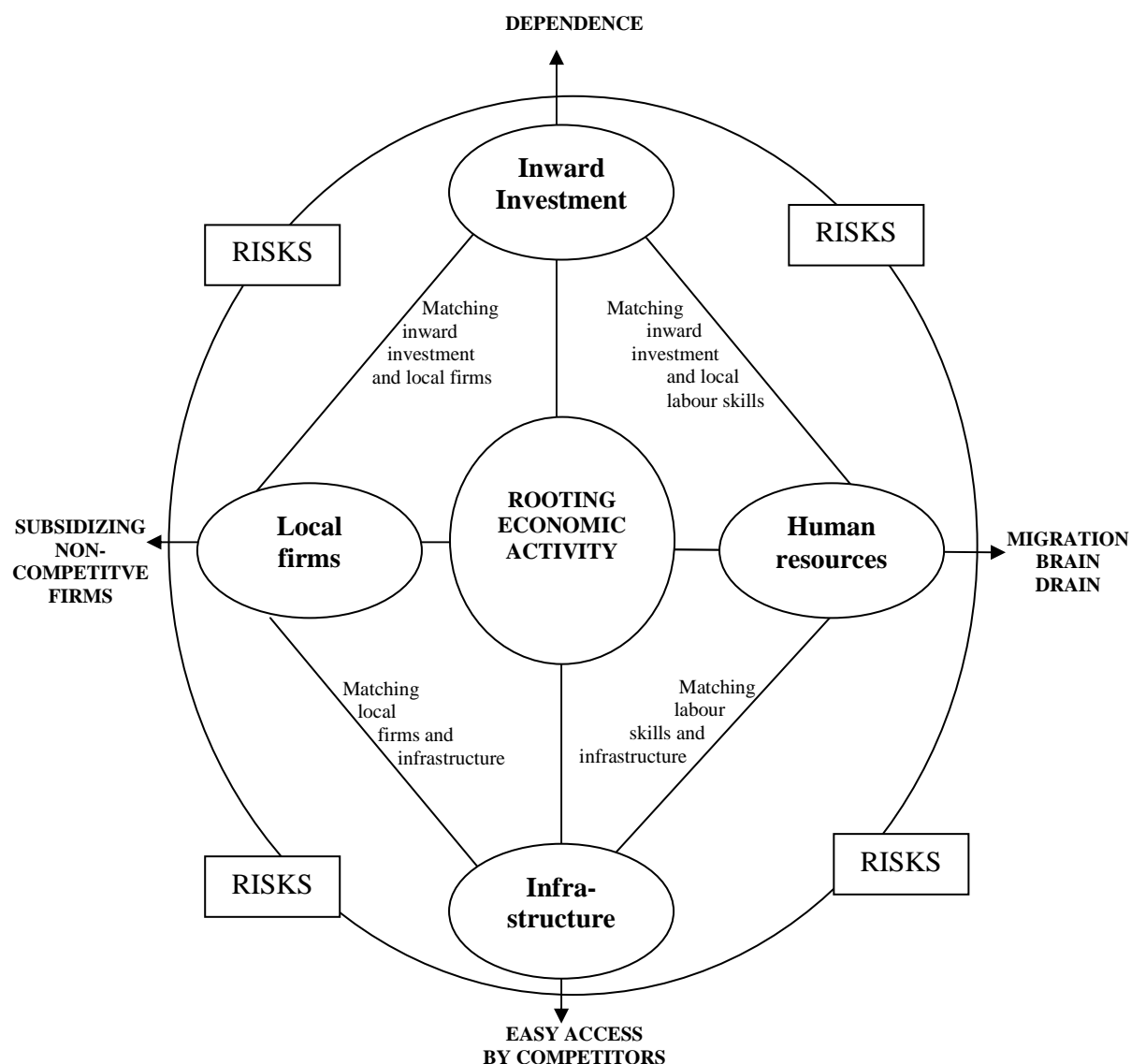
Over the past 75 years, an array of systems and structures to feed and support the economy have been built in the United States, including education, economic development and workforce development systems. As a general rule, these creations have operated independently from one another. However, in today's world, it is important to integrate and leverage all available resources to meet the challenge of global competition, or risk the irrelevance of the systems themselves.

One of the keys to integrating these disparate systems and structures is strong partnerships at the regional level. Each of the 13 WIRED regions has a partnership that is representative of the entire economic region and is comprised of civic, business, investor, academic, entrepreneurial and philanthropic leaders. The quality and strength of the regional partnerships are key to the success of WIRED.

The WIRED initiative was launched in recognition of the fact that talent drives prosperity. In other words, the bedrock of a nation's competitiveness is a well educated and skilled workforce. The initiative supports innovative approaches to education, economic development and workforce development that go beyond traditional strategies, preparing workers to compete and succeed both within the United States and around the world. It is expected that WIRED will demonstrate how talent development can drive economic transformation and enable regions to compete in the global economy.

Source: <http://www.doleta.gov/>.

Figure 4.7. Local economic development – Strategies and risks



Source: A. Rodríguez-Pose: *Local Economic Development Programme, The role of the ILO in implementing local economic development strategies in a globalized world*, op. cit., p. 11.

115. This chapter has argued the importance of nurturing competitive enterprises and nations in order to build prosperous societies based on productive employment and decent work. Competitiveness is difficult to define and measure, but it is vital for making markets work, increasing choice, stimulating innovation and creating wealth. There are many policies which can be developed to enhance the competitiveness of nations and enterprises, ranging from competition and investment policies through to focused industrial and sectoral policies and area-based initiatives like LED. Policies targeted at human resources development, including skills upgrading, are likely to be important features of all such policies. However, there are no blueprints, and policy choices will depend on many factors, not least the basic conditions described previously.

## Chapter 5

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### The regulatory and legal environment: Issues and policies

116. The “business-enabling environment”<sup>1</sup> is a broad concept which covers a range of factors, external to enterprises, that affect their formation and growth.<sup>2</sup> Of the many factors which influence the environment for doing business, aspects of the legal and regulatory environment invariably figure highly on most policy agendas. Box 5.1 provides a typical assessment of policy prescriptions related to the BEE, in this case based on surveys in ten countries in Africa and Central Europe. There are many dimensions to the legal and regulatory environment, some of which relate to the basic functions of government in market economies, including: protecting and guaranteeing investor, worker and consumer rights; maintaining the integrity and independence of the legal system; ensuring free and independent media; legislative stability; transparency in public decision-making; and measures to tackle corruption. However, the focus here is on the specific regulatory framework for business which relates to laws and regulations covering such things as business registration, licensing, taxation, employment, access to credit and other types of finance, contract enforcement, protection of property rights, and bankruptcy provision. Ultimately, improvements to the BEE are expected to strengthen the capacity for wealth, productive employment and decent work creation and in developing countries they are often seen as a mechanism for helping to address poverty reduction.<sup>3</sup>

117. The importance of different aspects of the BEE and the impact of changes in the environment affect different stakeholders – small/large enterprises, informal/formal, rural-/urban-based enterprises, workers/employers, international/domestic business, and so on – in different ways. Figure 5.1 illustrates the different views on various policy constraints from the perspective of formal and informal firms.<sup>4</sup> Cost and access to finance is more than twice as important for informal firms as formal ones, while formal firms are likely to point to policy uncertainty as a greater constraint than are informal

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<sup>1</sup> Definitions vary, with terms like “business environment”, “business climate”, “enabling environment”, “business-enabling environment”, “environment for doing business”, “policy framework for investment” and the “investment climate” used by different governments, donors, development organizations and other stakeholders to mean slightly different but often essentially similar things. For a discussion of donor approaches and definitions, see S. White: *Donor approaches to improving the business environment for small enterprises* (Washington, DC, Committee of Donor Agencies for Small Enterprise Development, July 2004).

<sup>2</sup> See ILO: *Small enterprise development: An introduction to the policy challenge*, SEED/ILO, Geneva, 2003; and the ILO/ITC–Turin training programme on *Creating an enabling environment for small enterprise development* (<http://www.itcilo.org>).

<sup>3</sup> G. Reinecke and S. White: *Policies for small enterprises: Creating the right environment for good jobs* (Geneva, ILO, 2004).

<sup>4</sup> For an influential and landmark study of the impact of regulations on the informal economy, see H. de Soto: *The other path – The invisible revolution in the Third World* (New York, Harper and Row, 1989).

firms. It is also necessary to distinguish between policies set at different levels of government to ascertain the impact of regulations which are set at the subnational level, some of which can have a major bearing on levels of LED.<sup>5</sup>

**Box 5.1**

**Some prescriptions for governments, donors and other stakeholders involved in the business-enabling environment**

**Institutional framework**

- ❑ Sound and stable macroeconomic policies are an essential basis for development, but they are not sufficient to encourage business growth.
- ❑ A lead ministry covering private sector development needs to be strong and influential, and its role clearly identified.
- ❑ An SME act is not necessary in all countries, but where policy and commitment is weak, it may help to provide a legal basis for reforming the policy environment, and monitoring the implementation of reforms.

**Policy machinery**

- ❑ Consultation with the private sector, and with all levels of government, is essential to design and monitor effective policies and regulations.
- ❑ Policies should be more concerned with helping the private sector to help itself, that is by removing obstacles, rather than in providing financial or business support measures.
- ❑ All governments need a central point for regulatory reform to monitor new and existing legislation, to promote change, and to act as an advocate both within and outside government.
- ❑ Mandatory policy/regulation impact assessment procedures are necessary.

**Policy formulation**

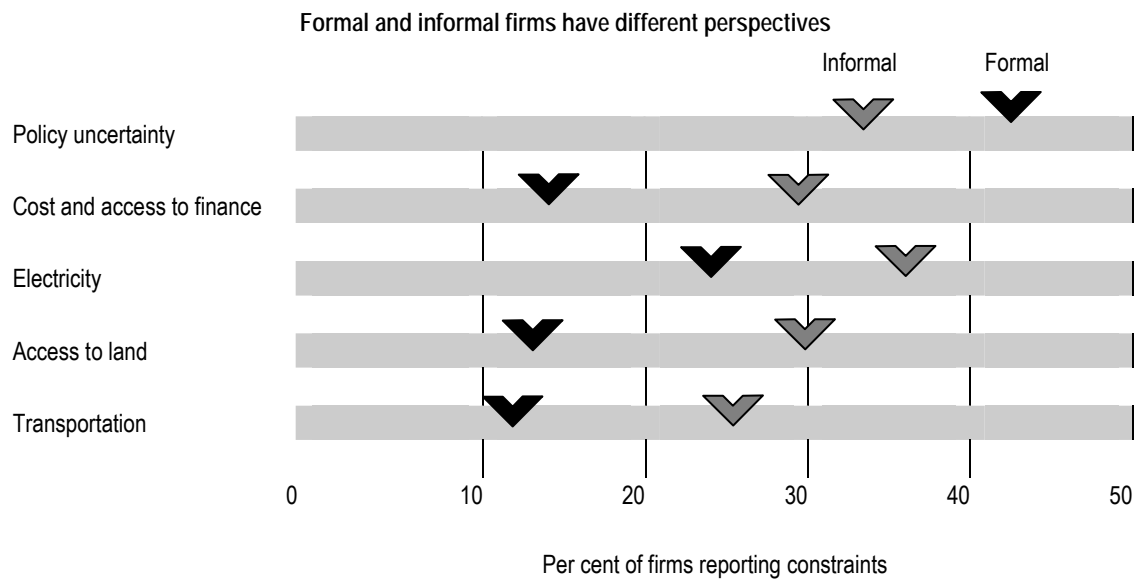
- ❑ Fiscal policies should be directed at reducing barriers to formal sector activity (thus reducing the size of the informal sector). Compliance costs of the tax system can be lowered by simplification and the adoption of user-friendly unitary tax authorities.
- ❑ The (real and informal) costs of business registration and licensing need to be brought down drastically, and uncoupled from revenue raising.
- ❑ Poor people will never be able to participate fully in opportunities to raise capital until they can obtain clear legal title to property.
- ❑ Banking and other financial institutions should be regulated in ways that minimize costs and promote competition.
- ❑ Systems for exit from business through bankruptcy or liquidation need to be modernized.
- ❑ Alternative dispute resolution mechanisms are particularly needed in Africa where relatively low cost legal services are unavailable.
- ❑ Rationalization of customs procedures is necessary so as to facilitate trade, and thereby private sector development.
- ❑ Policies on business support services need to be redirected towards facilitating private provision, and providing information and easing compliance with regulations.

Source: G. Bannock et al.: *Indigenous private sector development and regulation in Africa and Central Europe – A 10 country study*, Bannock Consulting, Aug. 2002, p. 6.

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<sup>5</sup> IFC: *Simplification of business regulations at the sub-national level – A reform implementation toolkit for project teams* (Washington, DC, World Bank/IFC, 2005); and S. Pahwa et al.: *Impact of municipal regulations on SMMEs*, Development Policy Research Unit, Working Paper No. 06/107, University of Cape Town, May 2006.

Figure 5.1. Formality affects policy priorities



Source: World Bank Investment Climate Surveys, World Development Report Surveys of micro and informal firms, quoted in *World Development Report 2005* (Washington, DC, World Bank, 2004), p. 39.

118. There is substantial evidence to indicate the importance for all stakeholders of a favourable legal and regulatory environment, which typically constitutes an essential pillar of a country's strategy to stimulate investment and economic growth and to generate opportunities for productive employment and decent work. Furthermore, there is substantial evidence that one way of increasing competitiveness is to reduce the costs, delays and risks inherent in the regulatory environment. Most obviously, risks like political upheaval, seizure of assets, some types of currency controls, constraints on repatriation of profits, and other practices which increase uncertainty, are likely to deter investment and may encourage investors to accept less attractive returns in more stable environments in order to minimize risk. Even where, for example, labour, transport or energy quality and costs are competitive, investors may be deterred if other costs like taxes, fees, fines and corruption – or the time taken in dealing with them – are deemed to be particularly burdensome or prevalent. Overall, although many factors are important in fostering an attractive BEE, there is growing evidence that the quality of business regulations and the institutions that enforce them are major determinants of growth and prosperity, even in terms of making optimal use of such locationally-specific factors as market size and the availability of natural resources.

119. Regulations may be defined as any government measure that seeks to change the behaviour of individuals or groups. In this context, the focus is obviously on regulations that affect businesses. They can both give people rights (such as the right to freedom of association) or restrict their behaviour (such as banning the use of child labour). But regulatory policy-making often presents a conundrum. On the one hand, there are constant demands for more regulation to protect (for example) the environment, workers or consumers, but where regulation is poorly designed or overly complicated it can impose excessive costs and constrain productivity. There is substantial evidence indicating that excessive red tape imposes real costs on business – costs which typically have a particularly pernicious effect on the “transfer, capture and protection of property rights”.<sup>6</sup> Governments, therefore, face the difficult challenge of getting the balance

<sup>6</sup> Y. Barzel: *Economic analysis of property rights* (Cambridge, Cambridge University Press, 1989), p. 2.

right, providing proper protection to different groups and making sure that the impact on those being regulated is proportionate. This is a vital challenge because “the efficient functioning of markets and enterprises is in the interest of public authorities, businesses, citizens and the social partners [and] it is increasingly determined by the regulatory frameworks in which they operate”.<sup>7</sup> There is obviously a political dimension to regulatory policy but there are also principles which can guide policy-making to ensure that regulations are affordable, necessary, fair and effective and enjoy a broad-based degree of public support and confidence (box 5.1).

120. Unfortunately, in many countries, there is a “regulatory thicket” comprising multiple or inadequate regulations, lack of clarity concerning regulations, duplication, high costs of compliance, frequent changes to regulations, a lack of awareness about regulations or regional disparities or inconsistencies between regulations and the different bodies responsible for implementing them (an example is described in box 5.2). Such regulatory thickets impede dynamism and growth and often have their roots in attempts to respond to various types of market failures and in attempts on the part of capacity-constrained governments to achieve multiple objectives simultaneously. Frequently, this regulatory thicket is most severe and burdensome in those very countries which most need entrepreneurs to create jobs and boost growth, namely the poorest countries (as shown with respect to business registration in figure 5.2) and some regulations may have a disproportionately negative impact on smaller enterprises, which calls for innovative approaches to balance protection and safeguards without excessively or unnecessarily burdening smaller enterprises.<sup>8</sup> It is also ironic that some regulations designed to tackle market failure (some types of licensing regimes, for example) end up exacerbating the same or other types of market failure by creating barriers to market entry or exit: a process which typically ends up conferring benefits on one group (typically the richer and better connected) at the expense of others (most often the poor).

**Box 5.2**  
**Regulatory firewalls**

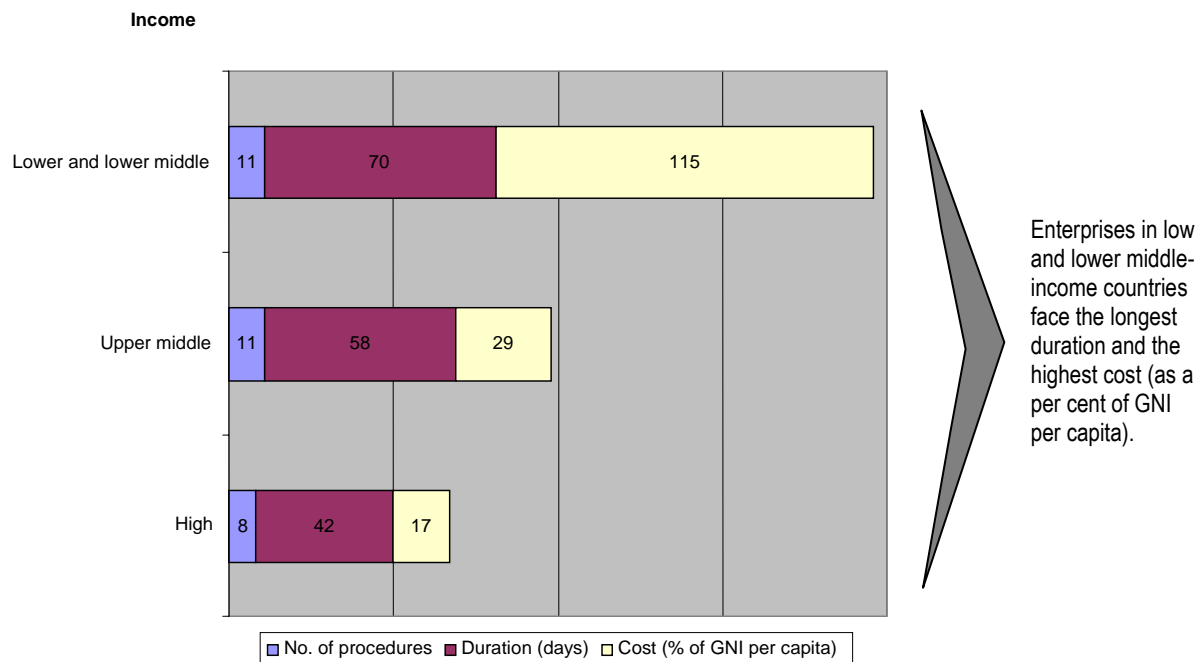
Both federal and local regulations govern the installation of fire extinguishers which must be installed in roadside canteens. Unfortunately, the two sets of regulations disagree about the height at which the extinguisher should be hung. An enterprising owner of one canteen had two hooks placed on the wall, one corresponding to the rules of each code. She moved the extinguisher to the relevant hook for each visiting inspector. She was thwarted, however, when the inspectors conspired to arrive together, discovered the violation and elicited a payment. Not to be beaten, the owner of the canteen insisted on paying the fine at the offices of the local inspectorate. The next day, she turned up outside these offices and knowing that the inspector she had dealt with was away, paid an informal “expediter” to arrange for a “discounted” payment receipt from another inspector (who shared the proceeds of the fine with the “expediter”). Thereafter, the intrepid entrepreneur proceeded to the business registration office and reregistered her enterprise as a “temporary food stall” which does not require any fire extinguishers.

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<sup>7</sup> European Commission: *Better regulation for growth and jobs in the European Union*, communication from the Commission to the Council and the European Parliament, Brussels, 16 Mar. 2005, COM (2005) 97 final, p. 12.

<sup>8</sup> C. Fenwick et al.: *Labour and labour related laws in micro and small enterprises – Innovative regulatory approaches*, a report prepared for the ILO (SEED) by the Centre for Employment and Labour Relations Law, University of Melbourne, Mar. 2006.

Figure 5.2. Enterprises in low-income countries face more burdens when registering



Source: UNDP: *Unleashing entrepreneurship: Making business work for the poor*, Commission on the Private Sector and Development, report to the Secretary-General of the United Nations (New York, UNDP, 2004), p. 17.

## Good and bad regulations

121. It follows from the principles set out in table 5.1, that regulatory reform is not simply deregulation, nor is it only a matter of costs: it is about appropriate, smart, effective and efficient regulation. Regulations and administrative procedures are needed to implement public policies, and private enterprises depend on adequate regulatory frameworks for ensuring fair competition (“level playing fields”), for making markets work better (such as regulations on contract enforcement and protection of intellectual property rights) and for ensuring the sustainability of markets (such as regulations on waste management, fuels and energy use). Regulations are essential to the fair and sustainable working of market economies but all regulations have costs as well as benefits; the important point is to distinguish between such costs and benefits. For example, most people would agree that occupational safety and health (OSH) regulations are essential but this does not mean that all OSH regulations are appropriate irrespective of the associated regulatory costs of implementing them. It may be possible, for example, to reduce the costs of complying with regulations without reducing their benefits.

122. The same applies to taxes and customs regulations. Clearly, taxes are indispensable for raising public revenue, and the setting of tax rates and the application of tax burdens are both highly politicized processes. However, businesses are often burdened with ineffective, discriminatory and overly complex taxation policies and practices (which may encourage tax evasion) and so the regulatory challenge is typically about seeking to simplify tax regimes, reducing the compliance burden and increasing the predictability and transparency of tax administration. This calls for an analysis of the costs and benefits of tax administration and of regulations relating to tax policy which are likely to be particularly important for encouraging the growth of small enterprises and attracting inward investment, although evidence cautions governments that “tax incentives are a

poor instrument for compensating for negative factors in a country's investment climate".<sup>9</sup>

**Table 5.1. Making and maintaining good regulatory policy**

Principle	What it means	What needs to be considered
Proportionality	Regulators should only intervene when necessary. Remedies should be appropriate to the risk posed and costs identified and minimized.	<p>Policy solutions must be proportionate to the perceived risk, avoiding "knee-jerk" reactions and justifying the compliance costs imposed ("don't use a sledgehammer to crack a nut").</p> <p>All the options – not just prescriptive regulation – for achieving policy objectives should be considered.</p> <p>Regulations can have a disproportionate impact on small business ("think small first").</p> <p>Enforcement regimes should be proportionate to the risk posed and enforcers should, where possible, consider an educational rather than punitive approach.</p>
Accountability	Regulators must be able to justify decisions and be subject to public scrutiny.	<p>Proposals should be published and all those affected consulted before decisions are taken.</p> <p>Regulators should clearly explain how and why final decisions have been reached.</p> <p>Regulators and enforcers should establish clear standards, lines of responsibility and criteria against which they can be judged.</p> <p>There should be well publicized, accessible, fair and effective complaints and appeals procedures.</p>
Consistency	Government rules and standards must be joined up and implemented fairly and consistently.	<p>Regulators should be consistent with each other and work together in a coherent and consistent way. Avoid unintended consequences ("fixing one thing but causing problems elsewhere").</p> <p>New regulations should take account of other existing or proposed regulations.</p> <p>Regulations should be predictable in order to give stability and certainty to those being regulated.</p>
Transparency	Regulators should be open and keep regulations simple and user-friendly.	<p>Policy objectives should be clearly defined and effectively communicated to all interested parties.</p> <p>Effective consultation must take place before proposals are developed to ensure that stakeholders' views and expertise are properly taken into account. This will also help to reconcile contradictory objectives.</p> <p>Those being regulated should be made aware of their obligations, with law and best practice clearly distinguished.</p> <p>Those being regulated should be given the time and support to comply, perhaps by supplying examples of methods of compliance.</p>

<sup>9</sup> OSCE: *Best-practice guide for a positive business and investment climate* (Vienna, OSCE, 2006), p. 46.



Principle	What it means	What needs to be considered
Targeting	Regulation should be focused on the problem and minimize side effects.	<p>The consequences of non-compliance should be made clear.</p> <p>Regulations should focus on the problem and avoid a “scattergun approach”.</p> <p>Where possible, regulators should establish goals.</p> <p>Guidance and support should be adapted to the needs of different groups.</p> <p>Enforcers should focus primarily on those whose activities give rise to the most serious risks.</p> <p>Regulations should be systematically reviewed to test whether they are still necessary and effective, especially in rapidly changing markets (“sunset clauses” might be useful in some cases).</p>

Source: Adapted from United Kingdom Government: *Regulation – Less is more: Reducing burdens, improving outcomes* (London, United Kingdom Government Cabinet Office Better Regulation Task Force, 2005), p. 51.

123. In addition to the costs incurred by the public sector bodies actually responsible for administering regulations, regulatory costs come in various forms. For the private sector, some regulations may: increase the transaction costs of regular operations; make it difficult to define and put into effect their property rights; increase capital costs because of higher levels of uncertainty, risk and corruption; and weaken competition by deterring market entry and exit. Some regulations may encourage enterprises to operate informally, and there is evidence to suggest that countries with heavy regulatory burdens also have large informal economies.<sup>10</sup> This does not, however, imply a simple causality between the quantity of regulations and the size of the informal economy.<sup>11</sup> Given that a disproportionate amount of women-owned enterprises are small, this also implies that there are gender-based factors which need to be addressed when undertaking regulatory reforms. Many costs associated with administrative procedures are often hidden and never accounted for, and there is often a lack of coordination across multiple jurisdictions (between different inspection procedures, for example) which may lead to excessive and/or overlapping demands on business. A recent OECD report on red tape in industrialized countries found that “governments seldom have a detailed understanding of the extent of the total administrative burdens imposed on businesses, citizens, and government itself, nor of the cost efficiency of many of the administrative simplification tools applied”.<sup>12</sup> Such conclusions are likely to be even more pertinent to developing countries. A major obstacle to reform in some countries is political interference and the fact that administrative formalities generate rents; each administrative barrier or regulatory obstacle is likely to be fiercely guarded by vested interests including lawyers who sell services to help businesses, civil servants who sell favours such as faster processing, and existing businesses that want to protect their position by reducing market entry and limiting competition.

<sup>10</sup> UNDP: *Unleashing entrepreneurship: Making business work for the poor*, op. cit.; and World Bank: *Doing business in 2004 – Understanding regulations* (Washington, DC, World Bank, 2004), p. xii. See also ILO: *Decent work and the informal economy – Abstracts of working papers*, Employment Sector Working Paper (Geneva, ILO, 2002).

<sup>11</sup> Causality is also dependent on the quality of regulations and the degree to which they are implemented or enforced.

<sup>12</sup> OECD: *From red tape to smart tape – Administrative simplification in OECD countries* (Paris, OECD, 2003), p. 9.

124. There are two broad categories of regulatory costs: those which relate to compliance and those which relate to efficiency. Compliance costs are the basic “red tape” costs which enterprises incur in complying with regulations. That includes time spent understanding the regulations and actually applying them; time spent with authorities on clarifying issues to do with the regulations; and the costs of obtaining advice on the regulations. Thus, for example, the costs of preparing tax returns or other paperwork associated with taxation are compliance costs but the tax payments themselves are not. Efficiency costs are somewhat more complex and can be more difficult to calculate, as they refer to the market outcome costs associated with regulations. Efficiency costs arise, for example, if employment is discouraged by discrimination in the labour market, if businesses restrict output to keep sales below a VAT or sales tax threshold, or if regulations push up the costs of products, making them too expensive to compete in export markets. Reducing the compliance costs of regulations does not usually pose the same kinds of political challenges or socio-economic trade-offs as reducing efficiency costs and so are usually easier to put into effect. Simplifying procedures, making processes available online, reducing multiple requests for information, and so forth, are likely to make a significant difference to compliance costs while potentially avoiding adverse affects on important interest groups.

## Measuring and evaluating the cost of doing business and interpreting results

125. The legal and regulatory framework obviously affects all aspects of business operations, from supplier markets to customer markets, implying that operating a business will require knowledge of the regulatory environment along the supply chain, sometimes involving multiple national jurisdictions. Clearly, there is great variation in the regulatory regimes in different countries and this has been put into focus by the World Bank’s influential Doing Business surveys. These annual surveys focus on the costs of the regulatory environment and not the wider competitiveness and business environment as covered in, for example, the competitiveness surveys undertaken for the WCY and the GCR (see Chapter 3).

126. Now in its fourth year, the Doing Business report covers the regulatory environment as it affects the costs of doing business for limited liability companies in 175 countries. It uses indicators corresponding to ten categories of regulations to benchmark comparative performance, analyse economic outcomes and identify which reforms have worked, where and why. The Doing Business report is widely cited and has made an important contribution to the international debate with respect to important features of the business environment and the need to reduce certain regulatory burdens and costs, especially as they pertain to “red tape”.

127. The very fact that the data sets are relatively simple constructs, and easy to compare between countries and over time, attracts the attention of business leaders and policy-makers and encourages governments to undertake reforms and to compare, if not compete, on their rankings (Mauritius has set a goal of reaching the top ten on the ease of doing business by 2009, for example). Furthermore, donors to the International Development Association (the World Bank’s highly concessional lending arm) have set targets for reducing the time and cost of starting a business – as measured by the surveys – as a condition for obtaining grant money. Thus, the surveys have a high profile and have become the most widely cited global benchmark against which the ease of doing business is measured. However, the methodology employed by the Doing Business

survey has some limitations which are particularly serious with respect to the “employing workers” category (see box 5.3).

128. The *Doing business in 2007* report identified Singapore as the best place to do business, with OECD countries dominating the high rankings which also featured Hong Kong, China (fifth), Thailand, Puerto Rico (United States), Malaysia and the Baltic States in the top 25. The report focused on “how to reform” and highlighted the fact that African countries were active reformers, reporting that two-thirds of African countries made at least one reform and that Ghana and the United Republic of Tanzania ranked among the top ten reformers. For example, the survey reveals that in Côte d’Ivoire, registering a property in 2005 took the equivalent of 397 days but after reforms this average dropped to only 32 days. Obviously, some reforms are easier to enact than others; the report notes that the most popular reforms in 2005–06 were on easing regulations on starting a business and that “in the top reforming economies in the past three years, nearly 85 per cent of reforms took place in the first 15 months of a new government”.

129. The Doing Business reports acknowledge different approaches to successful reform but suggest the following steps, which adhere to the principles of tackling costs (compliance and efficiency costs and the costs of things like infrastructure services and finance), risks (through policy predictability, property rights and contract enforcement), and barriers to competition (regulations concerning start up and bankruptcy, competition policy and access to finance and infrastructure services):

- ❑ Start simple and consider administrative reforms that do not need legislative changes.
- ❑ Focus on enhancing property rights.
- ❑ Cut unnecessary procedures, reducing the number of bureaucrats entrepreneurs interact with.
- ❑ Introduce standard application forms and publish as much regulatory information as possible.
- ❑ Consider how regulations are administered. Expand the use of technology. The Internet alleviates many frustrations without changing the spirit of the regulation.
- ❑ Make reform a continuous process.<sup>13</sup>

### Box 5.3

#### Doing business – Understanding what it really means

The widely cited Doing Business initiative of the World Bank has made an important contribution to the international debate with respect to key components of the enabling business environment. Its assessment of 175 countries and territories covers ten categories: starting a business; dealing with licences; employing workers; registering property; getting credit; protecting investors; paying taxes; trading across borders; enforcing contracts; and closing a business.

<sup>13</sup> World Bank: *Doing business in 2007: How to reform* (Washington, DC, World Bank, 2006), p. 5; and *Doing business in 2004*, op. cit., p. 92.

Other elements of the business environment, like levels of corruption, quality of physical infrastructure, size of market, levels of demand and security factors, are not covered.<sup>1</sup> The surveys are national-level surveys, so the data does not identify potentially considerable variation in the ease of doing business within countries and across particular sectors or areas of business, which may be particularly significant in large countries and/or those with decentralized laws, regulations and policies.

To properly understand the Doing Business rankings, it is important to appreciate the survey methodology, its assumptions and weaknesses.

To ensure comparability and consistency, the actual survey methodology implies some very restrictive assumptions about the type of business in question. For instance, for the “employing workers” category, the business should have (among other assumptions) 201 employees and be a limited liability company operating in the country’s most populous city. Furthermore, the worker is assumed to be a full-time male employee who has worked for the same company for 20 years, has a wife and two children, earns a salary plus benefits equal to the country’s average wage during the entire period of his employment and is not a member of a labour union unless membership is mandatory. Therefore, the scope is limited in terms of the businesses and workers covered and the assessment criteria used.

The employing workers category uses a difficulty of hiring index; a rigidity of hours index; and a difficulty of firing index to produce an overall rigidity of employment index and adds to this non-wage labour costs (as a percentage of salary) and firing costs (in terms of weeks of salary). The scoring system assigns a higher ranking to countries with a lower level of regulation which can easily lead users to conclude that fewer regulations mean a better environment for doing business, e.g. countries which have zero non-wage labour costs, zero firing costs, that do not have a minimum wage or do not restrict the number of hours an employee can work are rated high. This linear and selective view of the costs of labour market regulations gives rise to misleading conclusions and is the most serious flaw in the Doing Business methodology.

In addition, unlike the other nine categories, the employing workers category relates directly to the livelihoods and well-being of workers and it implies – by assigning a higher value to the ease of hiring and firing workers – that workers can be treated as a commodity. This approach appears to discourage countries from full respect for fundamental workers’ rights and international labour standards. It tends to weaken employment protection without a sense of balance between the needed flexibility and the necessary security for workers and their families.

Although the Doing Business reports do not make explicit assertions as to what is deemed an appropriate level of labour regulation, by publishing a ranking which implicitly does this and which, in turn, feeds into an overall ease of Doing Business index, the report implies a premium on policies which deregulate labour markets. However, the actual evidence on the link between deregulation of labour markets and its effect on the growth of business investment, competitiveness or employment is limited, mixed and inconclusive, especially as it relates to developing countries. Therefore, ranking countries in a way which can lead users and policy-makers to believe that making it easier to do business can be achieved by compromising fundamental principles of decent work is misleading and may induce countries into spurious debate and serious policy mistakes in this area.

While there are serious limitations affecting the employing workers category, other categories have arguably a more appropriate approach to assessing relevant dimensions of the cost of doing business.

In reality, most of the high-ranking countries have a comprehensive regulatory framework for employment and it is not that they regulate too little but rather that they regulate intelligently, with regulations which provide necessary safeguards and protections but in ways which minimize burdens and costs. The ranking just for the “employing workers” category, however, produces some perverse results.

<sup>1</sup> The 2008 Doing Business report “will expand the scope of the indicators to cover the quality of business infrastructure and possible transparency in government procurement” (*Doing business in 2007*, p. 7).

130. On the subject of reform, the 2007 report builds on the theme of the 2006 report (“creating jobs”) by stressing how regulatory reforms can make it easier for formal businesses to create more jobs and by suggesting that women and young workers may benefit the most from reforms. It is also asserted that “reform expands the reach of regulation by bringing businesses and workers into the formal sector” and that this brings associated benefits in terms of the quality of employment.<sup>14</sup> There is a body of evidence to indicate that many – but certainly not all – reforms to the business environment have a positive impact on growth and the formalization of enterprises.<sup>15</sup> One study even suggests that countries which improve their regulation to correspond to good practice standards can increase growth by as much as 2.3 per cent a year.<sup>16</sup> Better performance on the ease of doing business is usually associated with more jobs and, conversely, where regulations are costly and burdensome, businesses are more likely to operate in the informal economy, remaining very small and creating few decent jobs.<sup>17</sup> Reforms which make it easier to do business by reducing the regulatory burden without compromising necessary protections and safeguards are likely to have a positive effect on employment. However, as argued in box 5.3, reforms to the labour market should not undermine international labour standards.

131. There are examples where, in aggregate, successful regulatory reforms demonstrate significant payoffs for job creation. For example, one study suggests that if the investment climate for firms in Dhaka matched that of Shanghai, Dhaka would hypothetically reduce its productivity gap by 40 per cent and wages could rise by 18 per cent, whilst for Kolkata the effect would be twice as strong, with wages rising by 38 per cent.<sup>18</sup> A study in Slovakia suggests that reforms have helped cut the number of unemployed by 43,000 since 2002.<sup>19</sup> Another study suggests that, with secure property titles, the urban poor in Peru have been better able to find jobs rather than staying at home to protect their property. This has also enabled them to send their children to school which, in turn, has helped reduce the incidence of child labour.<sup>20</sup> A 2004 study of the quality of labour regulations and unemployment concluded that in OECD countries with “flexible laws”, the employment rate is 2–2.5 percentage points higher (the same study also concluded that those countries with worse labour relations have experienced higher unemployment).<sup>21</sup> Pioneering work on labour market “flexicurity” by the ILO has shed light on the complex relationship between employment stability and flexibility.<sup>22</sup> Furthermore, the OECD *Employment outlook 2006* asserts that:

<sup>14</sup> World Bank: *Doing business in 2007*, op. cit., p. 1.

<sup>15</sup> OECD: *From red tape to smart tape – Administrative simplification in OECD countries*, op. cit.

<sup>16</sup> S. Djankov, C. Macliesh and R. Ramalho: *Regulation and growth* (Washington, DC, World Bank, 2005).

<sup>17</sup> J. Dyring Christensen and M. Goedhuys: *Impact of national policy and legal environments on employment growth in micro and small enterprises*, SEED Working Paper No. 63 (Geneva, ILO, 2004).

<sup>18</sup> World Bank: *World Development Report 2005*, op. cit., p. 31.

<sup>19</sup> World Bank: *Doing business in 2006 – Creating jobs* (Washington, DC, World Bank, 2006), p. 6 (based on data from the Slovak Statistical Office but with no details on the nature or type of reforms to which this change is attributed).

<sup>20</sup> E. Field: *Entitled to work: Urban property rights and labor supply in Peru*, Princeton Law and Public Affairs Working Paper 02-1, Princeton University, Princeton, United States, 2002.

<sup>21</sup> O. Blanchard and T. Philippon: *The quality of labor relations and unemployment*, Working Paper No. 04-25, (?), MIT, Department of Economics, Cambridge, MA, 2004.

<sup>22</sup> P. Auer and S. Cazes: *Employment stability in an age of flexibility – Evidence from industrialized countries* (Geneva, ILO, 2003); and A. Nesporova and S. Cazes: *Flexicurity – A relevant approach for Central and Eastern Europe* (Geneva, ILO, 2006).

... it is time to grasp the nettle of employment security *versus* flexibility. Too often, countries have opted to ease the conditions governing temporary jobs while leaving those governing permanent jobs unchanged. While this may deliver some short-term job gains, it leads to growing duality in labour markets and hinders investment in training, and thereby productivity growth. Fortunately, there are better alternatives to hand. One such is so-called “flexicurity”, but there are others such as the Austrian individual savings accounts. These have the merit of guaranteeing much greater predictability to employers concerning the costs of hiring and firing while providing essential income security to workers who are laid off.<sup>23</sup>

Notwithstanding this evidence, it is clear, however, that further research is required on the relationship between reforms to the business environment and the growth and nature of employment.<sup>24</sup>

132. Some evidence suggests that excessive or stringent employment protection regulations may forestall job destruction but at the same time, they are likely to discourage job creation.<sup>25</sup> Notwithstanding the important quality dimension to job destruction or creation and the inevitable discussion about what is judged “excessive” or “stringent”, it appears that labour regulations as such may not be perceived by business leaders as a major obstacle (as suggested by the example of Eastern Europe and the former Soviet Union shown in figure 5.3). This might be because they are not enforced (which is hardly an ideal situation because although this might yield flexibility, which might be perceived as good from a business owners’ perspective, it serves effectively to undermine the rule of law and consequently contributes to the uncertainty faced by both employers and workers). It could also be because other constraints are so much more burdensome, like macroeconomic instability and corruption. One study of regulatory regimes in Eastern Europe even notes that, “in Croatia employment protection legislation is very strict, yet employers hardly complain about it. In contrast, in Poland, employment protection legislation is significantly more liberal; nonetheless, it ranks high among key business concerns”. It attributes this to different awareness levels due to enterprise restructuring measures in Poland. However, it is probably safe to conclude that in this region (and perhaps in others as well) “the main constraints to job creation ... currently lie outside the labour market. It could also mean that labour market regulations are just a part of a broader institutional and policy framework that constrains firms’ ability to grow and create new jobs”. This implies that policies to foster employment growth “cannot be limited to improving the workings of the labour market; instead they should aim at improving the overall investment climate and focus on the most severe obstacles to firm growth”.<sup>26</sup>

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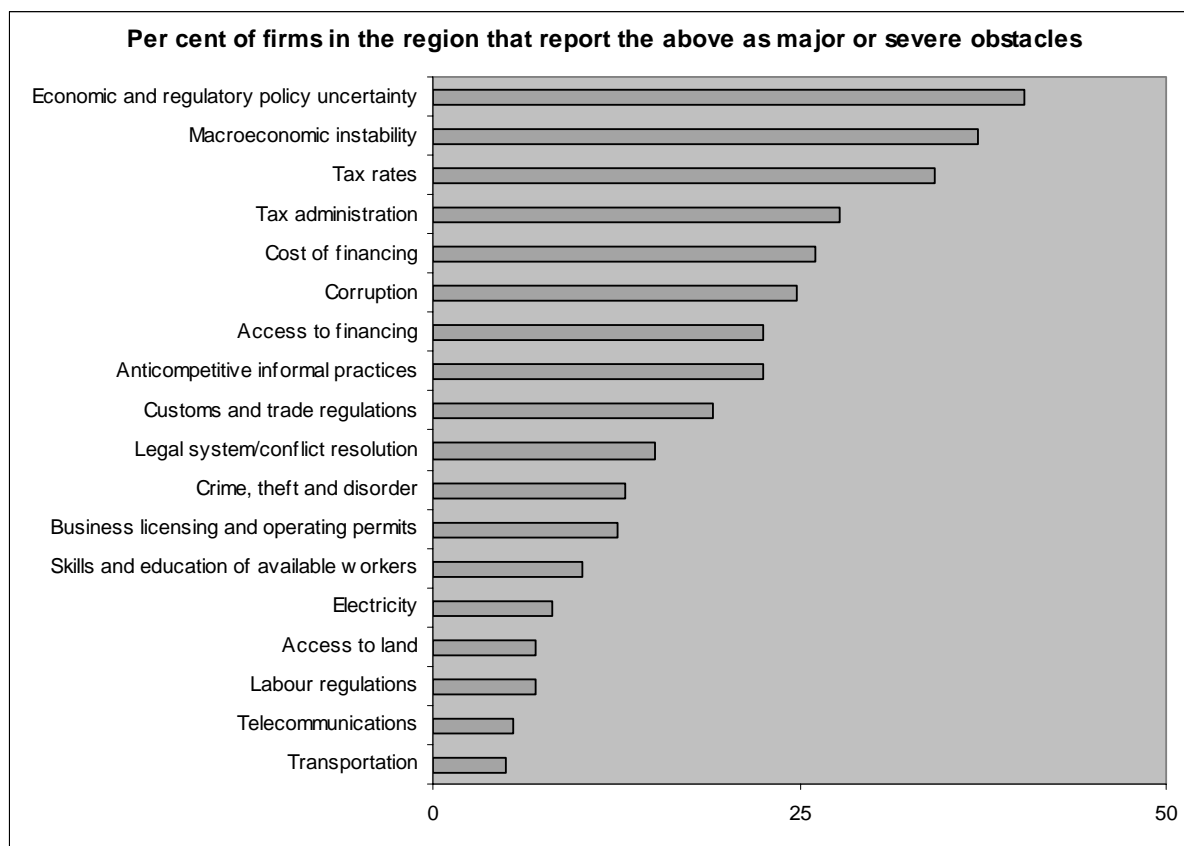
<sup>23</sup> OECD: *Employment outlook 2006: Boosting jobs and incomes* (Paris, OECD, 2006), p. 12. The concept of “flexicurity” is an evolving one and – as with the Austrian individual savings accounts and similar products – opinions vary on good practices, appropriateness and efficacy for particular economies.

<sup>24</sup> J. Berg and D. Kucera (eds): *Labour institutions in the developing world – Cultivating justice through laws and policies* (London, 2007, ILO and Palgrave Macmillan); and P. Auer and R. Islam: “Economic growth, employment, competitiveness and labour market institutions”, in A. Lopez-Claros et al.: *Global Competitiveness Report 2006–2007* (Geneva, WEF, 2006), pp. 105–115, both provide excellent insights into this issue.

<sup>25</sup> J. Rutkowski and S. Scarpetta: “Enhancing job opportunities – Eastern Europe and the former Soviet Union” (Washington, DC, World Bank, 2005), Ch. 5; World Bank: *Doing business reports for the years 2004–07*; and G. Bannock et al.: *Indigenous private sector development and regulation in Africa and Central Europe – A 10 country study*, op. cit.

<sup>26</sup> J. Rutkowski and S. Scarpetta: *Enhancing job opportunities*, *ibid.*, pp. 165–166.

Figure 5.3. Most frequently reported major obstacles in the business environment for firms in Eastern Europe and the former Soviet Union



Source: EBRD–World Bank Business Environment and Enterprise Performance Surveys, 2002, quoted in J. Rutkowski and S. Scarpetta: *Enhancing job opportunities – Eastern Europe and the former Soviet Union* (Washington, DC, World Bank, 2005), p. 159.

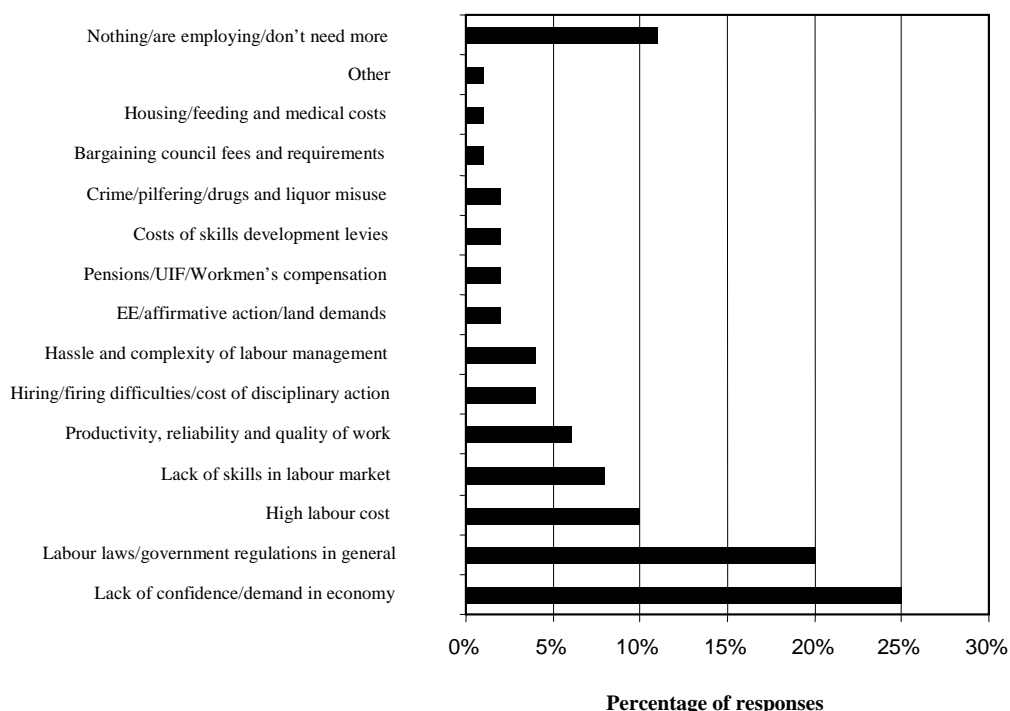
133. It is undoubtedly informative to understand how business respondents perceive the effect of business environment issues on growth but it is also useful to focus specifically on the impact of business environmental factors (and specific regulatory reforms) on employment. Evidence on the impact of different regulations on employment is still quite limited and there is clearly a need for greater analysis of the impact on the quantity and quality of employment of particular regulatory reforms, an issue which was raised in a recent ILO report.<sup>27</sup> Among the relatively few studies that have taken a closer look the relationship between regulatory structures and employment is a comprehensive regulatory cost survey of the South African private sector covering large corporations, SMEs, through to the informal economy.<sup>28</sup> The findings relating to a specific question on the constraints on increasing employment produced the findings shown in figure 5.4. A lack of confidence or demand in the economy attracted the most mentions, followed by “labour laws and government regulations in general” (which is, admittedly, a rather unhelpful catch-all category which would be more informative if further disaggregated). Although specific to the case of South Africa, the responses gave the general impression that regulatory costs are an important reason why South African businesses are not

<sup>27</sup> ILO: *Business environment, labour law and micro and small enterprise*, Committee on Employment and Social Policy, Governing Body, 297th Session, Geneva, Nov. 2006, GB.297/ESP/1.

<sup>28</sup> C. Darroll: *Counting the cost of red tape for business in South Africa*, Headline Report, SBP, Johannesburg, South Africa, Nov. 2004, pp. 6–7.

hiring more staff. The same study also produced findings on the ways in which businesses seek to avoid regulatory compliance (see figure 5.5)<sup>29</sup> and apart from those who thought it was not possible to avoid regulations, the main mechanisms suggested were reducing employment and limiting business size, both of which imply very significant efficiency costs. Overall, the study estimated that the aggregate recurring compliance costs for the formal sector amounted to the equivalent of 6.5 per cent of GDP.

Figure 5.4. Business environment and constraints on increasing employment in South Africa

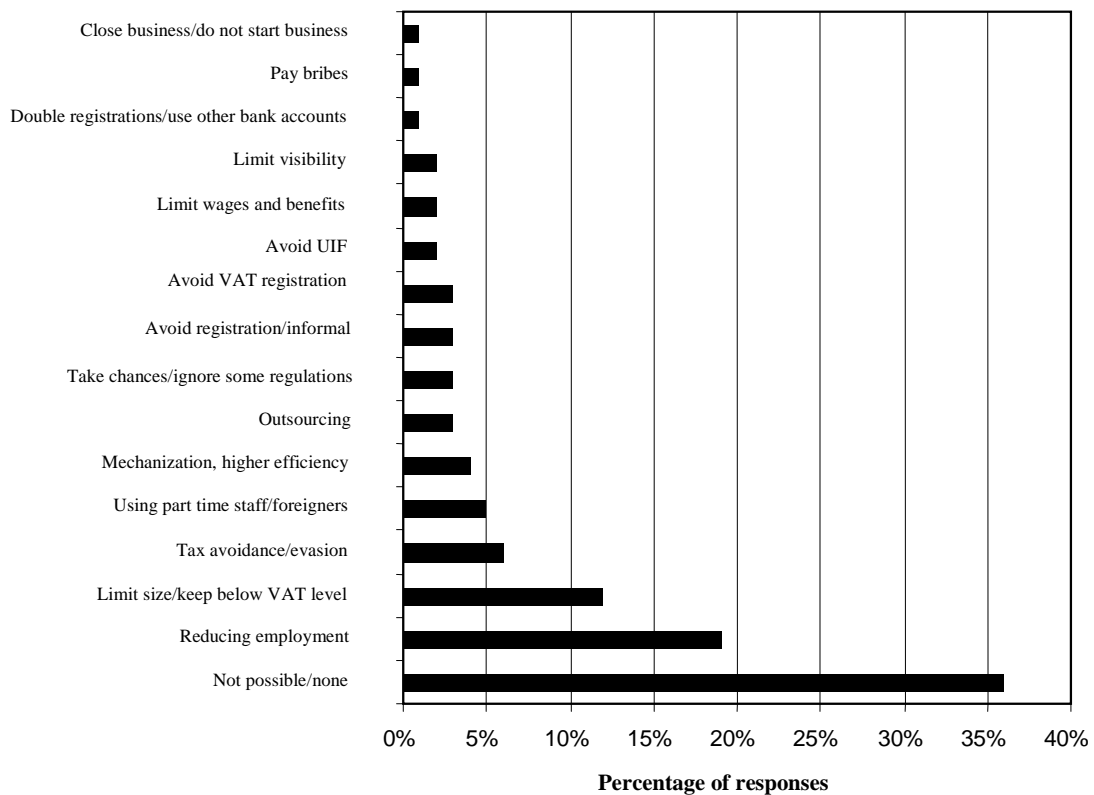


Source: C. Darroll: *Counting the cost of red tape for business in South Africa*, op. cit., p. 6.

<sup>29</sup> The question was posed tactfully, requesting respondents to suggest things done by other businesses to avoid the costs of regulation, so as to avoid putting pressure on respondents to admit to avoidance in their own businesses.



Figure 5.5. Ways of avoiding regulatory compliance in South Africa



Source: C. Darroll: Counting the cost of red tape for business in South Africa, op. cit., p. 6.

## Regulatory impact assessment (RIA) tools

134. There is no shortage of diagnostic tools, guides and assessments for regulatory reform, and many countries – especially among OECD countries – have developed a sophisticated and systematic approach to reducing regulatory burdens.<sup>30</sup> A common approach and a key part of the policy-making toolkit are regulatory impact assessments (RIAs) which weigh the costs and benefits of proposed as well as existing regulations and which sometimes include specific “small business litmus tests” to ensure that smaller enterprises will not be disproportionately affected. Depending on the particular type of regulations under investigation, approaches can involve establishing “one stop shops” for dealing with multiple regulatory and administrative procedures in one place; regulatory “bulldozers” (bulldozing away the roadblocks to a good business climate); “sunset clauses” under which a law or regulation will exist only for a fixed period of time after which a specific case must be made to re-introduce it, rather than allowing the law or regulation to continue by default; and regulatory “guillotines” (establishing

<sup>30</sup> S. White: *Assessing the influence of the business environment on small enterprise employment – An assessment guide* (Geneva, SEED/ILO, 2005); S. Kikeri et al.: *Reforming the investment climate – Lessons for practitioners* (Washington, DC, IFC/World Bank, 2006); S. Jacobs et al.: *Good practices for regulatory inspections – Guidelines for reformers* (Jacobs & Associates, 2005) (<http://www.regulatoryreform.com>); United Kingdom Government: *The tools to deliver better regulation – Revising the regulatory impact assessment* (Better Regulation Executive, Cabinet Office, United Kingdom Government, 2006) (<http://www.cabinetoffice.gov.uk/regulation/ria/>); and OECD: *From red tape to smart tape*, op. cit.

centralized regulatory registries and determining that any regulation not on the list by a fixed deadline is cancelled without further legal action, i.e. the guillotine drops).

135. Whatever methodology is identified, good practice extols the virtue of establishing and upholding quality regulations which provide safeguards and protections and, by establishing standards and facilitating level playing fields, provide a basis for the efficient and effective operation of markets. Good practice also extols the virtue of social dialogue as a means for identifying priorities and for designing, implementing and monitoring the impact of regulatory reform. A vital channel for identifying the obstacles to job creation is ongoing government consultations and dialogue with workers' representative bodies, employers' organizations and, where relevant, with other stakeholders like small businesses, financial institutions or consumers' groups. The intensity and institutionalization of government – private sector dialogue throughout the reform process affects the depth of reform because such dialogue empowers allies of reform and enlarges the “reform space” by increasing the scope and depth of the review of the regulatory regime.<sup>31</sup>

## The special challenges facing the micro- and small enterprise (MSE)

136. While most of the discussion so far has not focused specifically on small enterprises, this group warrants special treatment, given its significance in terms of employment. The challenges facing policy-makers who want to reduce the regulatory burden on these enterprises while addressing the fact that many MSE workers are not adequately protected by labour and labour-related laws merit special attention.<sup>32</sup> Figure 5.6 illustrates the labour law-related compliance gap between MSE on the one hand, and larger enterprises on the other, for the case of Peru. While in large enterprises, more than 70 per cent of salaried workers are protected by the health insurance and pension scheme they are legally entitled to, this share drops to less than 40 per cent in small enterprises and less than 20 per cent in micro-enterprises. Compliance with the legally binding minimum wage also varies with enterprise size. In micro-enterprises, more than half of salaried workers earn less than the hourly minimum wage. Indications are that figures similar to Peru are applicable to many other developing countries. Some measures to better address the special needs of MSEs are given in this section.

137. General measures to improve the business environment along the lines discussed can all help reduce the precariousness of MSEs and thus enhance their ability to comply with laws and regulations. Reducing the time and cost of registering a new business and ensuring adequate property rights have been shown to be important measures to facilitate the formalization of MSEs,<sup>33</sup> particularly if complemented by positive incentives such as access to credit, government contracts, training, low-cost health insurance and other services. Some countries have successfully supported such measures through special MSE departments and one-stop shops for information, paperwork, and so on (Peru and the Philippines are examples). Other examples of such incentives include the training, insurance and credit opportunities provided by the Shanghai municipal government to

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<sup>31</sup> B. Herzberg and A. Wright: *International Workshop on Public–Private Dialogue*, proceedings of an event held in Paris, 1–2 Feb., 2006, including the “Charter of good practice in using public-private dialogue for private sector development”, published May 2006.

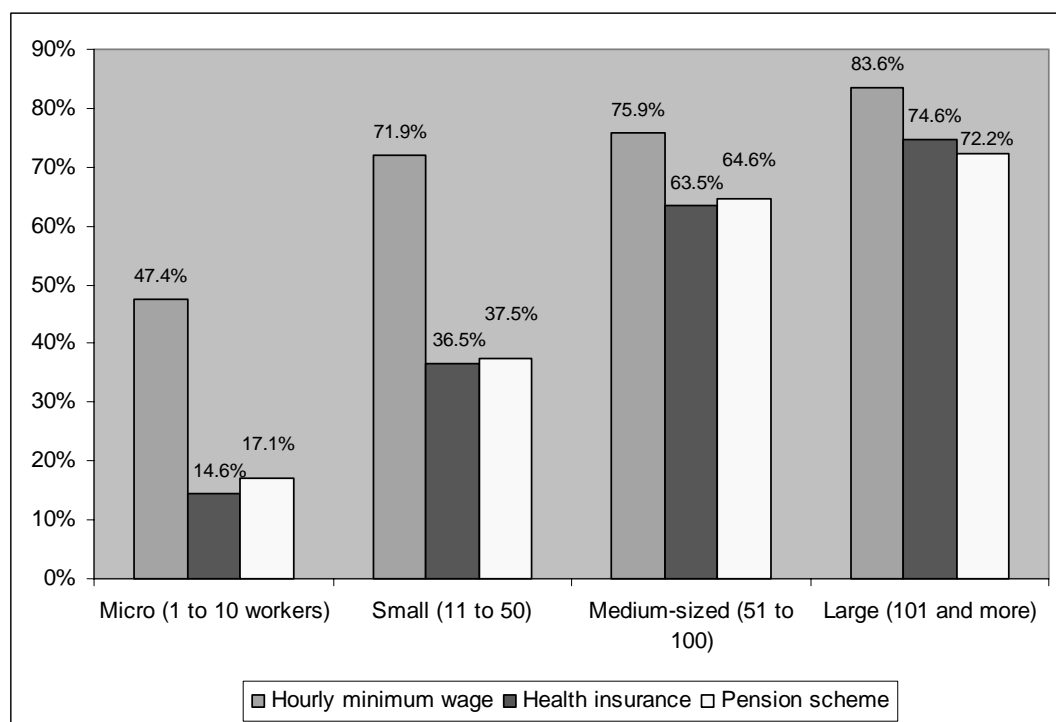
<sup>32</sup> W.M. Crain: *The impact of regulatory costs on small firms*, report prepared for the United States Small Business Administration Office of Advocacy, Sep. 2005.

<sup>33</sup> H. de Soto: *The other path: The invisible revolution in the Third World* (New York, Harper & Row, 1989).

the self-employed in exchange for increased levels of formalization, or the tax allowances offered to MSEs in Hungary and Viet Nam for a certain period after registration. Research from Peru also indicates that incentives, such as access to credit or to markets, are essential in inducing enterprises to join the formal sector.<sup>34</sup> Specific measures may be required to enable women entrepreneurs to start, expand, and formalize their businesses. Lack of legal title to land and discrimination in access to formal credit mechanisms often work specifically against women entrepreneurs. Legal mechanisms need to be introduced and/or made more robust in order to eliminate such discrimination.

138. Employers' organizations can play a key role in improving the competitiveness of MSEs and promoting their formalization. They are uniquely positioned to support small enterprises since they enjoy privileged access to policy-makers and can provide or facilitate access to services and markets.<sup>35</sup> To tap this potential the ILO, in collaboration with the IOE, has developed a capacity-building tool known as "Reaching out to SMEs" which is being used in South Asia, Eastern Europe, Central America and southern Africa.

Figure 5.6. Peru – Compliance with labour and social security law by enterprise size, salaried private sector workers, urban areas, 2005



Source: J. Chacaltana (2006): *Economic implications of labor and labor-related laws for SMEs: A quick review*. A paper prepared for the ILO, Geneva.

139. The design of legislation in many cases does not appear well adapted to its application to MSEs, resulting in particularly high compliance costs for this group.

<sup>34</sup> V. Zuin: *Business strategies of informal micro-entrepreneurs in Lima, Peru*, Decent Work Research Programme, International Institute for Labour Studies, Geneva, 2004; and J. Chacaltana: *Economic implications of labour and labor-related law on SMEs – A quick review of the Latin American experience*, a paper prepared for the ILO, Sep. 2006.

<sup>35</sup> ILO: *Employers' organizations and the promotion of small and medium-sized enterprises – Practical experiences from seven countries* (Geneva, ILO, 2004).

Given that transaction costs usually have a strong element of fixed costs that hardly vary with the size of the enterprise, the cost of compliance per employee or as a share of turnover is much higher for MSEs than is the case for larger enterprises. The costs for OECD countries illustrate the disproportionate burden of such costs borne by smaller enterprises.<sup>36</sup> Reducing the costs of complying with labour law is thus an important task, especially where the costs incurred do not contribute to workers' welfare.

140. The degree to which legal requirements are adapted to the situation of MSEs should be reviewed, preferably with the involvement of the concerned employers and workers, leading to, among other things, differentiations in application by enterprise size in specific cases. In this respect, a particular challenge is to bridge the "representational gap" for MSEs (box 5.4). An important objective of both employers' and workers' organizations is therefore to extend their outreach among the smallest enterprises and the informal economy. The Confederation of Mexican Workers (CTM) in Mexico, for example, incorporates a broad range of organizations, including agrarian communities and small enterprises. In El Salvador, the national employers' organization helped women market vendors in micro-enterprises in their dealings with the authorities, and some of these women became members as a result.<sup>37</sup>

141. On their side, governments should establish mechanisms to involve representatives of the MSE sector in the design of new legislation, and to carry out regular monitoring of the effectiveness and impact of, and problems with, legislation and regulations. Australia, Canada, Ireland and the United Kingdom, for example, have established various participatory mechanisms to review the impact of new and existing legislation on small businesses in order to make it better suited to the conditions of these enterprises and to promote successful compliance.

#### **Box 5.4<sup>38</sup>**

##### **Insufficient representation of micro- and small enterprises (MSEs)**

A way of ensuring that labour and labour-related laws are adapted to the requirements of the MSEs is their involvement in the process of designing the law. While government has the primary responsibility for the design of the policy and legal framework, the role of improving and reforming this environment should not be left to government alone. The ILO's methodology of participatory labour law reform exemplifies that common sense approach.<sup>1</sup>

Research by the ILO<sup>2</sup> and others<sup>3</sup> clearly indicates that there is generally insufficient representation of the MSE sector in policy-making processes, and that this is one reason for the large enterprise bias in the policy environment in many countries. MSEs are seldom organized in such a way as to have much involvement or influence on public policy-making. Both MSE employers and workers often face difficulties in representation. On average, MSE employers are less prone to affiliate to employers' organizations. MSE workers are less likely to affiliate to trade unions than their counterparts in larger enterprises, partly as a result of legal restrictions which establish a minimum number of workers to form a trade union and partly because of the precarious situation of enterprises.

<sup>36</sup> OECD: *Businesses' views on red tape: Administrative and regulatory burdens on small and medium-sized enterprises* (Paris, OECD, 2001).

<sup>37</sup> ILO: Report of the Director-General: *Organizing for social justice* – Global Report under the Follow-up to the ILO Declaration on Fundamental Principles and Rights at Work, International Labour Conference, 92nd Session, Report I(B), Geneva, 2004.

<sup>38</sup> Based on information in ILO: *Business environment, labour law and micro- and small enterprises*, Committee of Employment and Social Policy, GB.297/ESP/1, paras 24–27, Nov. 2006.

In virtually all countries with available data, unionization rates are much lower in MSEs than is the case for larger enterprises. For example, in the United Republic of Tanzania the percentage of unionized enterprises jumps from 12 per cent for micro-enterprises and 33 per cent for small enterprises to 96 per cent for large enterprises. A similar tendency is reflected in the data for South Africa and several Latin American countries.<sup>4</sup>

In many countries, unionization and collective bargaining are legally linked to a certain minimum size of the enterprise, such as in several Latin American countries with labour relations systems based on enterprise unions, excluding workers in the smallest enterprises from the possibility of organizing themselves into unions. Uruguay, however, does not establish any restriction or minimum size for the establishment of a trade union.<sup>5</sup> Workers in enterprises below this minimum size can only be covered by virtue of sectoral or national unions and collective agreements. This limitation on unionization is clearly at odds with the Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87).<sup>6</sup> For example, in Ecuador, the establishment of worker organizations requires a minimum of 30 workers.<sup>7</sup>

<sup>1</sup> See ILO DIALOGUE's labour law web site, which stresses participatory labour law reform: <http://www.ilo.org/public/english/dialogue/ifpdial/areas/legislation/index.htm>.

<sup>2</sup> G. Reinecke and S. White: *Policies for small enterprises: Creating the right environment for good jobs* (Geneva, ILO, 2004).

<sup>3</sup> A. Berry: *Creating an enabling policy environment for promotion of small enterprises: Traditional and innovative approaches*. Focal/CIS Working Paper No. FC1995-10. Toronto, Centre for International Studies, 1995, p. 1.

<sup>4</sup> G. Reinecke and S. White: *Policies for small enterprises: Creating the right environment for good jobs* (Geneva, ILO, 2004).

<sup>5</sup> J. Dieste: *La aplicación de la legislación en las micro y pequeñas empresas. El caso de Uruguay* (Santiago, ILO, 2005).

<sup>6</sup> C. Schlyter: *International labour standards and the informal sector: Developments and dilemmas*. Working Paper on the Informal Economy, No. 3 (Geneva, ILO, 2002).

<sup>7</sup> ILO: Report of the Director-General: *Organizing for social justice* – Global Report under the Follow-up to the ILO Declaration on Fundamental Principles and Rights at Work, International Labour Conference, 92nd Session, Report I(B), Geneva, 2004.

142. While the content of the law may be problematic for MSEs in some cases, it is very common for complicated administrative procedures for compliance to be more of a burden than the law itself. It is therefore important to simplify the application of labour and labour-related laws by eliminating unnecessary fees, reducing the number and complexity or simplifying the content of forms, removing the need for legal verifications and advice, reviewing the periodicity of cyclical reporting and data collection and strengthening the capacities and transparency of law enforcement agencies, including the elimination of corrupt practices.

143. A high tax wedge on labour<sup>39</sup> may negatively impact formal employment and stimulate informality. For instance, a 10 per cent rise in payroll taxes in Colombia reduced manufacturing wages by between 1.4 and 2.3 per cent and formal employment by between 4 and 5 per cent.<sup>40</sup> Also in the EU-8 (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia), each percentage point difference in the tax wedge is associated with a decrease in employment growth by 0.5–0.8 percentage points.<sup>41</sup> Where the informal economy is large, and the revenue base is too small, alternatives to labour taxation could be considered in order to advance the twin

<sup>39</sup> The tax wedge is a measure of the difference between the total labour cost to an employer and the corresponding disposable income of an employee. It is the sum of personal income tax, social security contributions and payroll taxes minus any cash benefits.

<sup>40</sup> A. Kugler and M. Kugler: *The labor market effects of payroll taxes in a middle-income country: Evidence from Colombia*, IZA Discussion Paper No. 852, Institute for the Study of Labour, Bonn, 2003.

<sup>41</sup> World Bank: *Quarterly Economic Report*, Special Topic – “Labor taxes and employment in the EU 8” (Washington, DC, World Bank, Apr. 2005).

objectives of social progress and economic development. For instance, social security spending could be partially financed from general taxes as in the case of several countries in Europe and other parts of the world, reducing the burden for employers and workers.<sup>42</sup>

144. Yet another issue that affects compliance is the frequent lack of information about legislation among MSE employers and workers. According to studies in various countries, such as China, Nepal and the United Republic of Tanzania, many employers are simply not aware of their legal obligations.<sup>43</sup> Likewise, many MSEs are not aware of the benefits they are entitled to under small enterprise promotion policies or similar schemes.<sup>44</sup> In many cases, this is aggravated by frequent changes in regulations, causing additional stress for enterprise owners and managers.<sup>45</sup> It can be addressed through information campaigns by governments, constituents and other groups (box 5.5). Wide dissemination of the rules in force can also help.<sup>46</sup> Award schemes and other initiatives can also be effective at raising awareness. The language used in legal documents is often difficult for lay persons to understand. The “plain language movement” in South Africa, for example, tries to ensure that all laws are understandable by involving non-legal specialists in the drafting of texts. Such measures can be particularly effective for MSEs where literacy levels are often low.

**Box 5.5**  
**Awareness campaign by the ILO**

Several ILO technical cooperation projects have run public awareness programmes about labour laws and their application through its constituents. Principal media providers, like radio, TV and print, even street theatre entertainers – in project countries (Indonesia, Kenya, Uganda, United Republic of Tanzania) were trained for the production of programmes, responding to call-in messages and drafting articles focused on the labour laws and related services. The projects have also organized a number of high visibility thematic events and encounters with select organizations as part of the media campaigns.

Source: ILO project documents.

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<sup>42</sup> For an in-depth analysis on the implications of alternative sources of financing social protection, see: M. Cichon et al.: “Financing social protection”, in the *Quantitative Methods in Social Protection Series*, ILO/ISSA, Geneva, 2004.

<sup>43</sup> P. Tibandebage et al.: *Creating a conducive policy environment for employment creation in micro- and small enterprises in Tanzania*, SEED Working Paper No. 55 (Geneva, ILO, 2003); P.M. Shakya: *Labour law reforms and growth trap among micro- and small enterprises (MSEs) in Nepal*, a paper prepared for ILO Kathmandu, 2004; and F. Cooke: “Employment relations in small commercial businesses in China”, in *Industrial Relations Journal*, Vol. 36, No. 1, pp. 19-37, 2005.

<sup>44</sup> R. Meier and M. Pilgrim: “Policy-induced constraints on small enterprise development in Asian developing countries”, in *Small Enterprise Development* Vol. 5, No. 2, Jun 1994, pp. 32–38; and A.K. Singh et al.: “Review of policy and regulatory environment for micro- and small enterprises in Uttar Pradesh”, a paper prepared for ILO SRO New Delhi, ILO, 2005.

<sup>45</sup> T. Fashoyin, E. Sims and A. Tolentino: *Labour-management cooperation in SMEs – Forms and factors* (Geneva, ILO, 2006).

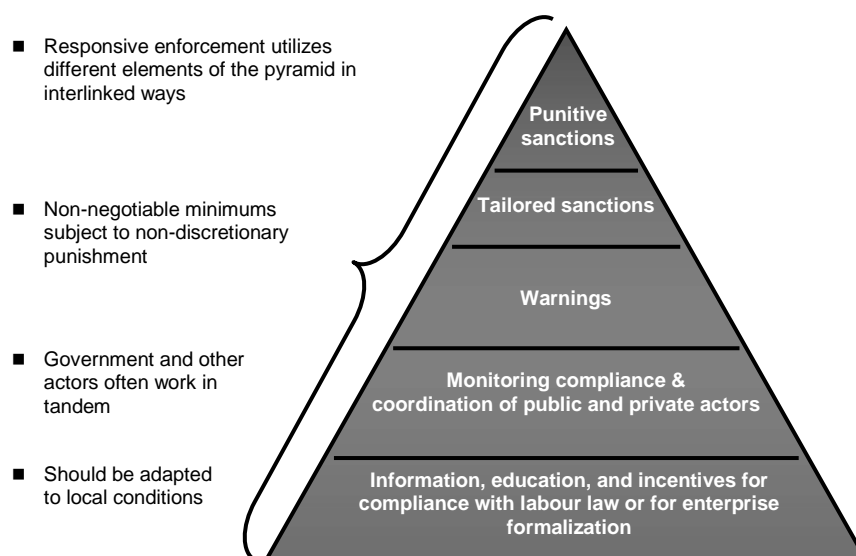
<sup>46</sup> For some examples of the ILO’s efforts to share simple descriptions see: “Labour law profiles” at <http://www.ilo.org/public/english/dialogue/ifpdial/info/national/index.htm>; and “Termination of employment digest” (English only) at <http://www.ilo.org/public/english/dialogue/ifpdial/info/termination/>.

## Strategies for labour law enforcement in micro- and small enterprises (MSEs)

145. Many labour law regimes depend mainly on a traditional enforcement approach relying largely on sanctions. In other words, they establish mandatory labour rights and standards, empower one or more regulatory agencies at the national and subnational levels to oversee the monitoring and enforcement of the standards, and provide for sanctions in the event of failure to comply. However, a growing body of evidence indicates that a more holistic and innovative strategy is likely to lead to higher levels of compliance in MSEs.<sup>47</sup>

146. Figure 5.7 presents such a more holistic approach in the form of a “pyramid of enforcement strategies”. A key aspect of the pyramid is that it assumes that regulation is likely to be more effective when regulators have a number of different options available to them in strengthening compliance with labour laws. The existence of legal rules and norms enshrining labour rights and standards as non-negotiable behavioural minimums, with non-compliance subject to non-discretionary punishment, are at the apex of the pyramid. However, sanctions and fines are only one of several means to ensure compliance. Other regulatory strategies may be used, often in collaboration with other regulatory actors, to achieve the desired change in a manner that is responsive to the circumstances of MSEs.

Figure 5.7. Pyramid of enforcement strategies



Source: C. Fenwick, J. Howe et al.: “Labour and labour-related laws in micro- and small enterprises: Innovative regulatory approaches”, a paper prepared for the ILO, Geneva, 2006, based on I. Ayres and J. Braithwaite: *Responsive regulation. Transcending the deregulation debate*, New York, Oxford University Press, 1992.

147. Providing advice or education to MSEs about labour rights and standards, together with incentives for MSEs to formalize and recognize their obligations under labour law, can form the first stage in an overall enforcement strategy, or the base of the pyramid. Other strategies at this level include information campaigns, training courses, and “small employer of the year” awards. Employers’ organizations are important players in this

<sup>47</sup> C. Fenwick et al.: *Labour and labour-related laws in micro- and small enterprises*, op. cit.

regard; many of them already provide industrial relations-related services to assist entrepreneurs in observing labour law and improving employee–management practices.

148. The pyramid recognizes the need for regulatory authorities to monitor the extent to which MSEs comply with labour laws. This level of the enforcement pyramid can incorporate cooperation between state labour administrations and representative organizations such as trade unions' organizations in monitoring and inspection. An example of such cooperation is the Regional Safety Representative Scheme in Sweden, under which trade unions play a prominent role in monitoring and promoting compliance with OSH standards in small businesses.

149. Another stage in moving towards the imposition of formal sanctions for non-compliance might be warnings of non-compliance with labour laws, indicating that further non-compliance would lead to the imposition of tailored punitive sanctions. Such an approach is adopted by the Philippines in relation to small enterprises. This strategy would be used in situations where education and monitoring had failed to bring about behavioural change. Such warnings may be linked to assistance to employers to enable them to comply.

150. Tailored sanctions allow state labour administrations to impose sanctions on MSEs for non-compliance with labour law, but to do so in a manner that provides incentive and capability for the enterprises to comply with the legal requirements. An interesting approach to remediation strategies to enforce the law in micro-enterprises was introduced in Chile with the 2001 reform of labour law. An enterprise with fewer than ten workers that has been found guilty of infringing the labour law for the first time in a year can exchange the monetary fine for participation in a compulsory training course. This approach is based on the hypothesis that, in many cases, non-compliance among MSEs is due to lack of knowledge and information rather than bad faith. A first impact assessment study suggests slightly higher levels of compliance among training participants than among a control group that paid their fine.<sup>48</sup>

151. Finally, punitive sanctions would most likely involve legal action taken by a state labour administration invoking and seeking the application of sanctions available under labour laws to a non-complying MSE. Although punitive sanctions form the peak of the enforcement pyramid, the fact that they are available to regulators contributes to the effectiveness of other strategies in the pyramid.

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<sup>48</sup> This probably reflects the fact that the impact assessment included many sample enterprises which underwent the training during the very first months of the programme, when training content was still less consolidated than is the case now. See L. Montero et al.: *Sustitución de multas por capacitación: Evaluación de una experiencia innovadora de aplicación de la legislación laboral en micro empresas*, ILO, Santiago, 2006.



## Chapter 6

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### Sustainable integration of markets through trade and value chains

152. One of the oldest insights in economics is that the size of the market is a key determinant of the potential for enterprises to grow and take advantage of economies of scale. The opportunities for countries to have a more diversified, more competitive, and higher productivity economy, and therefore achieve higher standards of living are also strongly influenced by the size of the market to which they have access. This is the main economic reason why, since the nineteenth century, many countries have explicitly sought to enlarge their markets and expand demand by promoting integration into larger markets. During the early stages of development, many countries pursued policies of protectionism, or tried to promote industrialization and diversification via so-called import-substitution industrialization, with different degrees of success. However, in the last decades there has been a growing trend for countries to pursue deeper integration of their national economies into the world economy as a key strategic objective of their growth and development policies. Countries have used multiple paths for market enlargement, depending on initial conditions and stage of development: unilateral trade liberalization; multilateral engagement in the General Agreement on Tariffs and Trade (GATT) or the WTO since its foundation in 1994; regional integration; and more recently there has been a proliferation of bilateral trade agreements.<sup>1</sup> Indeed, multilateral and regional trade negotiations have been one of the main driving forces behind globalization. The paths above have been combined to various degrees with export promotion and investment attraction efforts, as well as with policies on the supply side to promote competitiveness.

153. The purpose of this chapter is to highlight ways in which trade, market integration and global value chains can be harnessed to support the growth of sustainable enterprises and, by implication, of productive employment and decent work. The focus is on three main issues: (1) trade and integration trends and policies and the opportunities and risks they pose for sustainable enterprise development and decent job creation; (2) the challenges of integrating micro-, small and medium-sized enterprises into global supply chains; and (3) trends regarding ethical and fair trade initiatives and policies to promote more equitable supply chains.

154. The importance of extending good governance to the international level was articulated in the United Nations ECOSOC ministerial declaration on generating full and productive employment and decent work for all:

We emphasize that good governance at the international level is fundamental for achieving sustainable development. In order to ensure a dynamic and enabling international

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<sup>1</sup> J.M. Salazar-Xirinachs: "Proliferation of subregional trade agreements in the Americas: An assessment of key analytical and policy issues", in *Journal of Asian Economics*, Vol. 13, issue 2 (Mar.–Apr. 2002).

economic environment, it is important to promote global economic governance through addressing the international finance, trade, technology and investment patterns that have an impact on the development prospects of developing countries. To this effect the international community should take all necessary and appropriate measures, including ensuring support for structural and macroeconomic reform, a comprehensive solution to the external debt problem and increasing the market access of developing countries.<sup>2</sup>

## Trade and sustainable economic integration

155. Due to a combination of technological factors and increased trade opening, global trade expansion over the last decade (1995–2005) was nearly 6 per cent per annum, almost two times stronger than global GDP growth. Over the longer term, the ratio of world exports of goods and services to GDP rose from 13.5 per cent in 1970, to 32 per cent in 2005, and all major regions recorded an excess of trade over output growth. FDI flows have also risen strongly since the 1980s: in the early 1980s, global annual FDI flows hovered around US\$55 billion; they reached US\$200 billion in 1990–94, peaked at US\$1,300 billion in 2000, and were US\$900 billion in 2004–05.<sup>3</sup> Significant export and investment expansion has also followed the implementation of a number of regional and bilateral trade agreements but, as will be seen below, the existence of positive trade effects and their magnitude depends on specific country conditions, and there are valid questions about the necessary conditions for export and investment expansion to have broad-based developmental impacts, and about what countries must do to maximize the benefits and minimize the costs. A major feature of recent global trade developments is of course the emergence of China and India as major traders, both as exporters of manufactures and services, respectively, and also, increasingly, as importers of raw materials, commodities and other goods and services.

156. At a general level, economic theory and practice identify a number of channels by which trade and economic openness has the potential to promote growth of incomes, employment and standards of living: increased specialization according to comparative advantage; greater exploitation of economies of scale and increasing returns; importing of ideas, knowledge and technological capacities, including benefits from the acceleration of learning and a larger variety of technological inputs; positive effects of increased competition on productivity; and even improving economic performance through strengthening institutions and regulatory frameworks. However, the processes of economic transformation induced by economic integration with larger markets can also have negative effects, such as: job dislocation and accelerated job churning; accelerated mortality of non-competitive enterprises; lower job quality; increased poverty and informality; as well as increased income and wage inequality. In addition, since modern trade negotiations go beyond measures at the border, and into a series of areas of domestic regulation, there are also valid issues around how to make these regulations “development friendly”, how “intrusive” trade agreements should be in these new areas and their impacts on domestic policy space.

157. Therefore, what balance of positive and negative effects may result in practice from increased trade and openness is an empirical question that depends on a series of country-specific (and agreement-specific) key elements: (1) the pace and sequence of trade liberalization; (2) the basic supply side or competitive conditions of the economy

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<sup>2</sup> ILO: United Nations ECOSOC: *Draft ministerial declaration of the High-level Segment, on “Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all, and its impact on sustainable development”*, E/2006/L.8, para. 15.

<sup>3</sup> UNCTAD: *World investment report 2005* (New York, United Nations, 2005).

that influence the extent to which the enterprises in the economy can take advantage of the new market access opportunities opened by trade, and the extent to which investment may increase in response to increased trade openness; (3) the quality of social dialogue and economic and social governance so that countries may put in place the necessary complementary policies to benefit from freer trade and mitigate adjustment costs; and (4) in low-income countries in particular, the availability of aid and other resource transfers to facilitate not only trade adjustment but also the costs of developing international competitiveness.

158. Given this variety of factors that influence outcomes in reality, as well as the diverse country experience and uneven distribution of the costs of benefits of trade between and within countries, there are diverging views about how best to harness the potential benefits and minimize the costs associated with trade integration.<sup>4</sup> It is not easy to disentangle the range of quite complex relationships that exist between trade policy, growth, employment, job quality, wages, poverty, inequality, and adjustment policies. There is a vast literature covering these subjects which has recently been reviewed in a very useful joint ILO–WTO paper.<sup>5</sup>

159. For instance, with regard to the trade–growth relationship, a number of researchers using different approaches have found positive correlations between growth and trade, or economic openness or trade liberalization.<sup>6</sup> However, there is an ongoing scholarly debate about the methodology and interpretation of this cross-country empirical research.<sup>7</sup> Some economists are sceptical of both the results and the progress that can be made from further cross-country empirical research without a better theoretical understanding of how trade and trade policy affects total factor productivity, income levels and growth.<sup>8</sup> This scepticism does not stem so much from disagreement over the basic proposition that economic openness enhances growth, but rather from the

<sup>4</sup> World Commission on the Social Dimension of Globalization: *A fair globalization – Creating opportunities for all* (Geneva, ILO, 2004); J. Stiglitz: *Making globalization work* (New York, W.W. Norton, 2006); and M. Wolf: *Why globalization works* (New Haven, Yale University Press, 2004).

<sup>5</sup> ILO–WTO: *Trade and employment: Challenges for policy research*, a joint ILO–WTO study (forthcoming, 2007).

<sup>6</sup> See R. Levine and D. Renault: “A sensitivity analysis of cross-country growth regressions”, in *American Economic Review*, Vol. 82, issue 4, Sep. 1992, pp. 942–963; J. Sachs and A. Warner: “Economic reform and the process of global integration”, in *Brookings Papers on Economic Activity*, 1, 1995, pp. 1–118; X. Sala-i-Martin: “I just ran two million regressions”, in *American Economic Review*, Vol. 87, issue 2, May 1997, pp. 178–183; J. Frankel and D. Romer: “Does trade cause growth?”, in *American Economic Review*, Vol. 89, issue 3, pp. 379–400, June 1999; and D. Irwin and M. Tervio: *Does trade raise income? Evidence from the twentieth century*, National Bureau of Economic Research Working Paper Series No. 7745, June 2000, (<http://www.nber.org/papers/w7745>).

<sup>7</sup> F. Rodríguez and D. Rodrik: *Trade policy and economic growth – A skeptic’s guide to the cross-national evidence*, 1999 (<http://ksghome.harvard.edu/drodrik.academic.ksg/skeptic1299.pdf>); and D. Rodrik: *Development strategies for the next century* (Cambridge, Harvard University Press, 2000) are sceptical about the robustness of some of these results regarding the relationship between trade openness and growth. C. Jones: “Comment on Rodríguez and Rodrik: *Trade policy and economic growth – A skeptic’s guide to the cross-national evidence*”, in *Macroeconomics Annual*, National Bureau of Economic Research, Cambridge, MIT, 2000, however, focusing on trade policy variables, concludes that trade restrictions are almost invariably harmful to long-run growth, although the magnitude of the effect is uncertain. For Rodrik, “The appropriate conclusion to draw ... is not that trade protection should be preferred to trade liberalization as a rule. The point is simply that the benefits of trade openness should not be oversold.” Rodrik, 2001, p. 39.

<sup>8</sup> See R.N. Cooper: “Growth and inequality – The role of foreign trade and investment”, in *Annual World Bank Conference on Development Economics 2001/2002*, edited by B. Pleskovic and N. Stern (Oxford, World Bank/Oxford University Press, 2002); P. Klenow and A. Rodríguez-Clare: “Economic growth – A review essay”, in *Journal of Monetary Economics*, Vol. 40, No. 3, 1997, pp. 597–618; A. Rodríguez-Clare: “Comment”, in *Annual World Bank Conference on Development Economics 2001/2002*, edited by B. Pleskovic and N. Stern (Oxford, World Bank/Oxford University Press, 2002).

limitations presented by cross-country research methods that lack a better understanding and specification of causalities and mechanisms.<sup>9</sup>

160. In terms of the issue of sustainable enterprises and the associated employment, trade integration can accelerate the process of “creative destruction”. In fact, it is precisely the process of “creative destruction” that lies at the heart of the potential benefits, but also the costs of trade. The attention here should be not only at the level of the individual enterprise or even sector but in terms of the net aggregate effects in the economy. For instance, as regards the trade–employment impacts, the ILO–WTO joint study concludes that so far no clear message appears to emerge from the large number of empirical studies analysing the issue. The only general conclusion that may be justified is that employment effects depend on a large number of country-specific factors. For instance, one study finds that temporary increases in unemployment following trade reform have been observed in many developing countries; however, it also finds that unemployment rates do not appear to be systematically higher in more open economies.<sup>10</sup> Studies of the employment effects in Canadian manufacturing following the Free Trade Agreement (FTA) between Canada and the United States have found that, in the first five years, Canada lost a staggering 390,600 jobs; however, the studies show that those job losses were mainly due to economic recession in both the United States and Canada.<sup>11</sup> After controlling for the recession, it appears that the FTA-mandated tariff cuts accounted for between 15 and 30 per cent of the jobs lost over the period. The adjustment process lasted seven years. During this period, many workers moved to high-end manufacturing jobs, while at the same time there were dramatic productivity increases in low-end manufactures. Both aspects reflect important long-run efficiency gains from trade.

161. Despite significant trade opening in the last decades, including that brought about by the Uruguay Round, there remain high levels of protection in many countries. For instance, average agricultural tariffs in industrial countries are two to four times higher than manufacturing tariffs. Tariff rate quotas, tariff peaks and tariffs that increase by degree of processing (tariff escalation) also seriously limit the possibility of expanding exports in key products where a number of countries have comparative advantage. The impacts of agricultural subsidies, particularly by some OECD countries, are also well documented. Protection levels in many developing countries are also high, in both manufacturing and agriculture, and significant gains for other developing countries have been estimated to come from lower developing country protection. The World Bank estimated that “A serious agreement to reduce border protections would produce benefits for the world’s poor that far exceed those that can be anticipated from present levels of development assistance.”<sup>12</sup> A more recent World Bank evaluation report cautions

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<sup>9</sup> J.M. Salazar-Xirinachs: “Economic integration and trade negotiations in Latin America and the Caribbean at the turn of the century”, in A. Margheritis (ed.): *Latin American democracies in the new global economy* (Miami, North-South Center Press, University of Miami, 2003).

<sup>10</sup> M. Rama: *Globalization and workers in developing countries*, Policy Research Working Paper No. 2958 (Washington, DC, World Bank, 2003).

<sup>11</sup> N. Gaston and D. Trefler: “The labour market consequences of the Canada–US Free Trade Agreement”, in *Canadian Journal of Economics*, Vol. 30, issue 1, pp. 18–41, Feb. 1997; G. Trefler: *The long and short of the Canada–US Free Trade Agreement*, NBER Working Paper No. 8293, 2001.

<sup>12</sup> World Bank: *Global economic prospects 2004 – Realizing the development promise of the Doha agenda*, (Washington, DC, World Bank, 2004), p. 105.

against over-optimistic estimates of the poverty reduction impact of trade liberalization.<sup>13</sup>

162. All of this means that the Doha Round can make an important contribution to the growth of sustainable enterprises and poverty reduction worldwide. A number of institutions and researchers have produced estimates of the benefits of a successful round in terms of trade expansion and poverty reduction.<sup>14</sup> It is beyond the scope of this chapter to enter into details in this respect; suffice it to point out that a failure of the Doha Round would involve serious costs and risks for the world economy, partly because the levels of protection and subsidization in certain sectors, such as agriculture, are quite high and a failure of the Doha Round would mean foregone benefits in this respect, particularly for many developing countries; and partly because of the risks of a relapse into higher levels of protectionism.

163. Beyond tariffs, other obstacles hindering trade are also well documented. For instance, removing non-tariff barriers, reviewing procedures to apply product and process standards and implementing trade facilitation and customs reform programmes are important means for promoting higher trade integration, and might be particularly important to allow SMEs to engage in trade. This is especially important in light of a number of trends: the proliferation of trade agreements that has the risk of complicating border formalities due to proliferation of different procedural requirements (e.g. rules of origin); different product and process standards that, although necessary for public safety and health reasons, can also create non-tariff barriers to trade which can be particularly onerous for developing countries or SMEs; additional border formalities, imposed due to heightened security threats since the terrorist attacks of 11 September 2001, represent further serious constraints on the free flow of goods across borders.<sup>15</sup> All these and similar obstacles make the international trade facilitation agenda an important element of improving the international environment for sustainable enterprise development. Enterprises faced with fewer obstacles are more likely to break into overseas markets.

164. Many of the obstacles to and the benefits from trading across international borders also apply to trading across borders within countries, especially within larger countries where infrastructure impediments and those obstacles relating to the paperwork and regulations involved in moving goods, money and people across regional frontiers can sometimes be as severe and constraining on business and employment as barriers to trade between countries. As with improvements to the environment for doing business domestically, the concrete measures which governments can take to improve the environment for doing business across borders centre on reducing costs and risks without undermining the social and environmental protections necessarily afforded to employers, workers, consumers and communities.

165. As stated above, one recent trend in trade is the proliferation of bilateral and subregional trade agreements, and the fact that many of these are not, like in the past, between countries at similar level of development but between developed and developing countries. For instance, the United States has negotiated agreements with numerous countries, and the EU is beginning a process of turning unilateral trade preferences granted to Asia, Caribbean and Pacific (ACP) countries into reciprocal

<sup>13</sup> Independent Evaluation Group: *Assessing World Bank Support for Trade 1987–2004: An IEG evaluation*, World Bank, 2006.

<sup>14</sup> W. Cline: *Trade policy and global poverty* (Washington, DC, Center for Global Development, Institute for International Economics, 2004); op.cit.

<sup>15</sup> World Bank: *Global economic prospects 2004*, op. cit., Ch. 5, “Reducing trading costs in a new era of security”.

agreements. This new generation of agreements tends to include not only market-expanding trade liberalization measures at the border, but also areas of domestic regulation including labour and environmental provisions. Thus, these agreements affect the investment climate and the environment for enterprises operating in partner countries in multiple ways.

166. The inclusion of labour provisions in many of these bilateral agreements of recent vintage means that they include an important element of the social dimension of trade: respect for fundamental workers' rights and international labour standards. However, as the paragraphs above suggest, the challenge for sustainable enterprise development and for job creation includes both this qualitative dimension and a very important quantitative dimension: what is the net impact of "creative destruction" that trade agreements induce, in terms of companies that go out of business (destruction) versus new investments and start-ups (creative), and in terms of the underlying job churning?

167. Sustainable trade integration is therefore related to the capacity of the labour market, flexibly to allow companies and the economy as a whole to adjust to the new trade-induced conditions of competition, while at the same time providing adequate protection for workers. The implications and possibilities take on quite different dimensions in developed and developing countries. Consider the following stylized representation. In developed countries, social protection and safety nets tend to be more developed than in the latter. Thus, increased import competition can be seen as having similar effects to those of productivity growth: it makes workers available to work somewhere else in the economy. If social protection and safety nets are available, workers are protected and more willing to accept mobility between jobs. If there is an enabling environment for investment, entrepreneurs can match workers made redundant with new business ideas and investment capital and thus increase the total amount of business and wealth. The production of goods and services can thus increase, along with productivity, and employment levels do not have to decrease. This is the virtuous circle that trade, growth and employment strategies must try to achieve. In a "typical" developing country, however, this virtuous circle does not work so well, or is broken. Social protection and safety nets are less developed, so workers' security tends to be more linked to the present job. There is surplus labour relative to existing productive capital, so rates of unemployment, underemployment and informal activity are higher. The business environment is not as enabling, so it is more difficult for entrepreneurs to match workers made redundant by trade with new investments. And these difficulties are exacerbated by skills deficiencies and mismatches. Therefore, reaping the full benefits of trade requires, in many cases, a "big push" in terms of infrastructure, education and skills investments, as well as measures to facilitate adjustment, minimize its costs, which may include job churning and deindustrialization on the one hand and, on the other, ensuring that economic opportunities are created for enterprise, including for lower income groups, so that growth and opportunities for trade are based on equitable development.<sup>16</sup> The promotion of sustainable enterprises becomes even more crucial in this context.

168. As in other areas, the goals of sustainable development and sustainable enterprise promotion overlap strongly in the context of economic integration. There are many concrete steps that governments can take to promote sustainable enterprise in the context of trade integration along the lines of paradigm 3 described in Chapter 3: improve the

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<sup>16</sup> ECOSOC: *Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all and its impact on sustainable development*, Report of the Secretary-General, Substantive Session of 2006, High-level Segment, 24 Apr. 2006, E/2006/55, paras 15–24.

business environment and investment climate; improve competitiveness; support value chain upgrading (see next section of this chapter); strengthen business services, particularly for SMEs; improve infrastructure; and improve education and training systems. In addition, active labour market policies and increased social protection complete a basic set of policies complementary to trade opening that are essential if trade integration is to be made more socially and economically sustainable.

169. Finally, a number of economists think that for economic convergence (in income levels) to occur, trade agreements themselves or parallel efforts must incorporate substantial transfers of resources from the richer countries and regions to the poorer ones, in order to close the gaps in infrastructure, education and skills, institutions and elsewhere. This is one of the lessons of the EU and this is also one of the reasons why discussions on trade capacity building or “aid for trade” have assumed such a prominent place in trade talks.<sup>17</sup> Of course, aid and international resource transfers will not do much good if the internal distributive mechanisms (tax policy, social policy) are not working well and if no social safety nets are in place.

170. The enormity of these challenges implies a key role for social dialogue and the importance for governments and social partners of participating in multilateral organizations, compacts and forums in order to ensure balance between trade and development concerns.

## Opening up opportunities for micro-, small and medium-sized enterprises via value chain upgrading

171. The integration of micro-, small and medium-sized enterprises into global supply chains is facilitated by a more open trade regime but this is not enough. Specific promotional measures are also important. A value chain is a set of businesses and their interactions that bring a product (or service) from raw material to final consumer.<sup>18</sup> Vibrant value chain systems grow and continuously incorporate new businesses, generating ever-increasing jobs, income and assets. In this manner, value chain systems have significant potential to integrate micro-, small and medium enterprises into national and global production systems. Value chain development forms a core part of a range of private sector development strategies, from export promotion to LED and clustering strategies. At the heart of value chain development is the effort to strengthen mutually beneficial linkages among enterprises so that they work together to take advantage of market opportunities.

172. Most value chain initiatives work with a range of business types to strengthen both vertical linkages – among enterprises that buy from and sell to one another – and horizontal linkages – among enterprises that serve the same functions in the value chain (see box 6.3 and subsequent paragraphs on fair-traded coffee, for example). Positive

<sup>17</sup> L. Lopez Calva and N. Lustig: “Social protection and inclusive trade: Strengthening the sources of convergence in the FTAA”, in A. Estevadeordal, D. Rodrik, A. Taylor and A. Velasco (eds): *Integrating the Americas – FTAA and beyond* (Boston, David Rockefeller Centre for Latin America Studies, Harvard University Press, 2004); J.M. Salazar-Xirinachs and J. Granados: “The US-Central America free trade agreement: Opportunities and challenges”, in J. Schott (ed.): *Free trade agreements – US strategies and priorities* (Washington, DC, Institute for International Economics, 2004).

<sup>18</sup> The ILO and UNIDO have been particularly active in developing resource tools and guides on value chain analysis. See, for example, ILO: *A guide for value chain analysis and upgrading* (Geneva, ILO, 2006); H. Schmitz: *Value chain analysis for policy-makers and practitioners* (Geneva, ILO, 2005); and UNIDO: *Integrating SMEs in global value chains – Towards partnership for development* (Vienna, UNIDO, 2001).

outcomes occur when there is strong market drive for linkages, strong investment from many enterprises in the chain and a market system in place to replicate improved models and practices. Clearly, a chain cannot be moved by pushing it; in order to move a chain, it has to be pulled. In this sense, a value chain system will only develop if linked to strong consumer demand. Furthermore, value chains thrive when businesses in the chain come together to market themselves using a common competitiveness strategy.

173. Value chains may be organized through different mechanisms. Increasingly, intermediate forms of industrial organization emerge which enable firms to combine the advantages of specialization with a minimum level of production control. The term “value chain governance” refers to these intermediate forms. It implies that some firms in the chain set and enforce the parameters under which others in the chain operate. Those firms that set the parameters are termed “lead firms”.

174. New patterns of value chain organization create significant threats for developing countries, but also new opportunities for some of the more adaptable economic agents. Empirical evidence suggests that threats are much greater and opportunities more limited where the competitiveness of the domestic business sectors lags far behind international standards.

175. Threats. A first threat results from the fact that lead firms are almost exclusively based and embedded in OECD countries. If lead firms become more important as innovators and governors of global production networks, and subordinated companies become standard-takers which are excluded from important processes involved in creating intangible values, this process will shift power, and probably value added, away from developing countries. On the other hand, there is an increasing trend for lead firms to come from a number of emerging economies. Second, the growing importance of knowledge-intensive factors (e.g. design and branding) may enlarge imbalances between developing and developed countries, as well as within these countries. Successful product innovations and branding strategies tend to shift rents and bargaining power to the innovator or brand owner. In poor countries, only very few differentiated industrial clusters exist that are able to provide strategic support for knowledge-intensive production. Third, increasing scale requirements and market consolidation raise entry barriers for smaller firms and reduce the number of markets where they can sell their products. Small, less efficient firms will often be crowded out. Local market alternatives, where compliance challenges and costs are still low, will probably shrink and be characterized by excess supply and low margins. Fourth, as lead firms (but also governments and consumer organizations) impose more rigid standards, barriers to entry tend to rise. Suppliers have to bear the costs of compliance with social, environmental, hygiene and other standards, plus the necessary certification procedures and customer audits. Crowding out of smaller, less competitive suppliers and locations is likely to occur.

176. Opportunities. As lead firms systematically subdivide their functions, reorganize their internal corporate structures, concentrate on core competencies, and outsource marginal tasks and functions, new opportunities present themselves to developing countries. The spatial dislocation of production processes according to the specific requirements of each stage of production principally benefits developing countries, if they are able to find a specialization in which they can compete and to create the necessary links with the world economy. New information and communication technologies, for example, enable developing country firms to acquire contracts in new areas such as back office services. Moreover, since lead firms are ever more interested in assuring reliable supply in compliance with all sorts of standards, more knowledge transfer is required. Empirical evidence shows a variety of relevant learning processes



among developing country suppliers in global production networks. Successful adoption of standards is an important means of industrial upgrading, one that, in part, protects firms from lower-cost competitors who are not able to comply.

177. Value chain development recognizes ongoing structural change and adapts supporting policies accordingly. The behaviour of economic actors, e.g. their make-or-buy decisions, their willingness to source locally or abroad, their decision to sell through anonymous markets or to regular buyers, etc. is always affected by a great number of general policies. Therefore, it is useful to distinguish between *general private sector development policies with an impact on value chains* and *specific value chain support activities*. However, it is important to acknowledge that general and specific policies interact in a number of ways, calling for an integrated policy approach. The following general policies are relevant to domestic inter-firm linkages, although they do not specifically address linkage building directly.

178. Policy interventions aimed at making the business environment more reliable, more transparent and less bureaucratic contribute to value chain integration. If, for example, property rights are not guaranteed or contracts cannot be enforced due to deficiencies in the legal system, entrepreneurs will reduce inter-firm transactions as far as possible. Likewise, unnecessary bureaucratic procedures and high administrative costs for the registration of small enterprises may exclude the poor from doing business or induce them to stay informal, which makes it difficult to take up business linkages with the formal sector.

179. Trade and investment policies largely determine to what extent developing countries benefit from offshoring. Any location interested in attracting international offshoring investment needs to keep the cost of trading low. On the other hand, cheap imports, especially of light manufactures, have ruined local industries in many developing countries around the world. Likewise, the global expansion of large retail chains impacts severely on local chains. Although protectionist trade policies tend to hold back innovations and productivity growth, there is a strong case for careful timing and sequencing of liberalization. Especially in very disadvantaged, least developed countries, safeguards may be required to protect economic activities which are highly important for the livelihood of the poor.

180. Tax policy also matters. In most developing countries, a huge proportion of SMEs evade taxation. Firms that are not registered with the revenue authorities usually do not qualify for regular supply chain relations. Broadening the tax base while keeping taxes for micro and small firms low is therefore an important step with regard to legalizing informal firms and making them eligible as supply chain partners. Moreover, sales taxes act as a disadvantage to inter-firm specialization if they do not allow for deduction of taxes which had already been paid at the previous stage of the value chain. Value-added taxes are thus more conducive to inter-firm specialization.

181. Other general policies which affect the propensity to create inter-firm linkages are skills development and innovation policies, financial and non-financial business services, cluster policies, etc. Integrated value chain approaches, therefore, need to take these policies into account. Specific activities for pro-MSME value chains, in contrast, include all those measures that intervene directly at one or more stages of the value chain and affect the modes of interaction within the respective chain. These include:

- (i) Awareness raising and matching. Lack of market transparency hampers the formation of business linkages. This applies in particular to SMEs, which are often not familiar with the requirements of regular supplier relationships and may not have a good overview of potential buyers. Three instruments can promote matching

between potential customers and suppliers: Information and motivation events for suppliers; subcontracting exchange schemes and supplier fairs and exhibitions.

- (ii) Supporting spillovers from lead firms. Lead firms contribute to local enterprise development in many ways, both deliberately and unintentionally, including through the facilitation of market access, coaching and mentoring, funding of supplier development projects, the introduction of standards or brands which enhance the competitiveness of its supply chain as a whole, or the creation of new enterprises by former employees.
- (iii) Some countries use tax and financial incentives to encourage investors to develop local linkages or enhance technology transfer. In some countries, expenditure incurred in the training of employees, product development and testing, and factory auditing to ensure the quality of vendors' products, is allowed as a deduction in the computation of income tax. Donors and international organizations may help to benchmark such policies, identify the most beneficial tax and financial incentive schemes for value chain development and assist in their implementation.
- (iv) Value chain finance. Value chain integration often facilitates a supplier's access to credit. This may happen directly, by receiving credit from business partners in the value chain, such as buyers or input providers or, indirectly, by making the firm creditworthy to financial institutions, for example, because secure sales channels are accepted as collateral. Public programmes can help to improve both direct and indirect value chain finance. Support agencies may provide soft credit lines and credit guarantees to development banks in order to stimulate linkages, and they may contribute to developing financial products which support value chain integration, such as factoring. Donor agencies may also promote outgrower schemes as a form of improved value chain coordination, thereby facilitating direct credit supply from buyers.
- (v) Promotion of inclusive standards. Recently a great number of standards have been created and implemented worldwide. Standards address a range of issues, including quality management procedures and product properties, as well as social, environmental, safety and health concerns. More and more often they are enforced through value chain relations, given that the final producer or distributor of the respective product is held accountable for compliance and thus takes a strong interest in assuring compliance at previous stages of the value adding process. Public programmes have a role in promoting standards as a means of adding value to the production of the poor.

## Fair trade and more equitable value chains

182. Global attention on the importance of trade as a means of generating growth and development, coupled with the pervasive inequities in the global trading system, has spawned the growth of niche markets for fair-traded goods and an allied fair trade movement which combines an advocacy platform for trade justice with direct interventions to develop products and markets for fairly traded goods.<sup>19</sup> There is a wide

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<sup>19</sup> See, for example, the International Fair Trade Association at <http://www.ifat.org>, and the European Fair Trade Association at <http://www.eftafairtrade.org>. There are, of course, many enterprises with a social – as well as commercial – cause that produce and/or market goods internationally with the aim of benefiting disadvantaged groups in developing countries. An example is Aarong, the marketing arm of the Bangladeshi mega NGO BRAC – <http://www.brac-aarong.com>. These enterprises may operate independently of any affiliation to a fair trade association and may not necessarily label themselves as fair trade organizations.

range of fair trade organizations and associated certification standards and labelling schemes but the basic principles of fair trade are outlined in box 6.1. Most fair trade organizations subscribe to these principles and seek to support commercially sound but ethically-based relationships with small producers at the base of the value chain. In some cases, this is largely a marketing relationship but, in other cases, fair trade organizations build up closer partnerships with suppliers and work to strengthen producer organizations through tailor-made business development programmes aimed at improving their capacity to access market opportunities. Such programmes typically provide information, training, advice and support in many different areas, such as market information, financial systems, cooperative management, product development, quality control systems, accessing markets and funding. In particular, fair trade organizations typically seek to help clusters of small producers gain better access to markets through the identification of new market opportunities and the development of new fair trade brands and sometimes they also provide export finance to producers. In essence, such approaches, characterized as fair trade, provide insights into how trade in general can be made more sustainable, especially when complemented by policy coherence in, for example, competition, investment and industrial policies. However, fair trade can only be a complement to, and not a substitute for, freer trade.

183. Fair trade organizations have achieved particular success in marketing retail food products like coffee, tea, nuts and fruit. Coffee – one of the world’s most traded commodities, with notoriously volatile global prices – has been a particular success story for a number of fair trade organizations and has become a testing ground for what it means to be an ethical consumer. For example, *Cafédirect* has become the fourth largest roast and ground coffee brand in the United Kingdom and has a rapidly expanding retail and wholesale customer base. As with many markets with a global supply chain, producers at the beginning of the chain typically receive only a small fraction of the retail value of the final product (less than 1 per cent, compared to five times more for fair-traded coffee, according to *Cafédirect*). Most fair trade organizations in Europe, such as *Max Havelaar* in Switzerland or *Solidarmonde* in France, have seen coffee sales rise dramatically, with products now typically available in retail markets through leading supermarkets and at points of sale in many leading companies and international organizations including, for example, cafeterias at the European Parliament, World Bank and the ILO. Some fair trade organizations have a wide network of clients. For example, the UK-based Twin trading company sources coffee from producer organizations on behalf of *Cafédirect* and others in the United Kingdom, Europe and Japan and is responsible for the importation, logistics, blending and quality control of products from 26 producer organizations employing over 230,000 producers in nine countries.<sup>20</sup>

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<sup>20</sup> <http://www.twin.org.uk> and <http://www.cafedirect.co.uk>.

**Box 6.1**  
**The principles of fair trade**

Fair trade is a trading partnership based on dialogue, transparency and respect that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to and securing the rights of, marginalized producers and workers – especially in the global South.

❑ **Creating opportunities for economically disadvantaged producers**

Fair trade is a strategy for poverty alleviation and sustainable development. Its purpose is to create opportunities for producers who have been economically disadvantaged or marginalized by the conventional trading system.

❑ **Transparency and accountability**

Fair trade involves transparent management and commercial relations to deal fairly and respectfully with trading partners.

❑ **Capacity building**

Fair trade is a means to develop producers' independence. Fair trade relationships provide continuity, during which producers and their marketing organizations can improve their management skills and their access to new markets.

❑ **Promoting fair trade**

Fair trade organizations raise awareness of fair trade and the possibility of greater justice in world trade. They provide their customers with information about the organization, the products, and in what conditions they are made. They use honest advertising and marketing techniques and aim for the highest standards in product quality and packing.

❑ **Payment of a fair price**

A fair price in the regional or local context is one that has been agreed through dialogue and participation. It covers not only the costs of production but enables production which is socially just and environmentally sound. It provides fair pay to the producers and takes into account the principle of equal pay for equal work by women and men. Fair Traders ensure prompt payment to their partners and, whenever possible, help producers with access to pre-harvest or pre-production financing.

❑ **Gender equity**

Fair trade means that women's work is properly valued and rewarded. Women are always paid for their contribution to the production process and are empowered in their organizations.

❑ **Working conditions**

Fair trade means a safe and healthy working environment for producers. The participation of children (if any) does not adversely affect their well-being, security, educational requirements and need for play and conforms to the UN Convention on the Rights of the Child as well as the law and norms in the local context.

❑ **Child labour**

Fair trade organizations respect the UN Convention on the Rights of the Child, as well as local laws and social norms in order to ensure that the participation of children in production processes of fairly traded articles (if any) does not adversely affect their well-being, security, educational requirements and need for play. Organizations working directly with informally organized producers disclose the involvement of children in production.

❑ **The environment**

Fair trade actively encourages better environmental practices and the application of responsible methods of production.

Source: <http://www.ifat.org>.

184. Although all fair trade organizations will normally work to promote sustainable enterprises and, as part of that, will usually advocate good workplace practices, the

Ethical Trading Initiative (ETI) specifically comprises a detailed voluntary base code (box 6.2) which addresses a broad range of workplace practices. The ETI is not a fair trade organization but rather an alliance of global brands and retailers, trade unions and civil society organizations, established in 1998, and working to improve the lives of workers and their families in global supply chains. All companies which join the ETI are required to adopt the Base Code and to work with their supplier companies to ensure that they promote responsible corporate practices and observe national labour laws and international standards. In late 2006, the ETI comprised 29 member companies, over 20,000 suppliers and more than 3 million workers.<sup>21</sup>

**Box 6.2**  
**The Ethical Trading Initiative – Base code**

**Employment is freely chosen**

- 1.1. There is no forced, bonded or involuntary prison labour.
- 1.2. Workers are not required to lodge “deposits” or their identity papers with their employer and are free to leave their employer after reasonable notice.

**Freedom of association and the right to collective bargaining are respected**

- 2.1. Workers, without distinction, have the right to join or form trade unions of their own choosing and to bargain collectively.
- 2.2. The employer adopts an open attitude towards the activities of trade unions and their organizational activities.
- 2.3. Workers representatives are not discriminated against and have access to carry out their representative functions in the workplace.
- 2.4. Where the right to freedom of association and collective bargaining is restricted under law, the employer facilitates, and does not hinder, the development of parallel means for independent and free association and bargaining.

**Working conditions are safe and hygienic**

- 3.1. A safe and hygienic working environment shall be provided, bearing in mind the prevailing knowledge of the industry and of any specific hazards. Adequate steps shall be taken to prevent accidents and injury to health arising out of, associated with, or occurring in the course of work, by minimizing, so far as is reasonably practicable, the causes of hazards inherent in the working environment.
- 3.2. Workers shall receive regular and recorded health and safety training, and such training shall be repeated for new or reassigned workers.
- 3.3. Access to clean toilet facilities and to potable water, and, if appropriate, sanitary facilities for food storage shall be provided.
- 3.4. Accommodation, where provided, shall be clean, safe, and meet the basic needs of the workers.
- 3.5. The company observing the code shall assign responsibility for health and safety to a senior management representative.

**Child labour shall not be used**

- 4.1. There shall be no new recruitment of child labour.
- 4.2. Companies shall develop or participate in and contribute to policies and programmes which provide for the transition of any child found to be performing child labour to enable her or him to attend and remain in quality education until no longer a child; “child” and “child labour” being defined in the appendices.
- 4.3. Children and young persons under 18 shall not be employed at night or in hazardous conditions.

<sup>21</sup> <http://www.ethicaltrade.org>; *ETI Workbook* (second edition): *Ethical trade – A comprehensive guide for companies*. Ethical trade can, of course, be subject to different interpretations – to include organic farming, environmental sustainability, fair trade and so forth – but in the ETI context, it is used to refer to the assumption of responsibility by a company for the labour and human rights practices within its supply chain.

<p>4.4. These policies and procedures shall conform to the provisions of the relevant ILO standards.</p> <p><b>Living wages are paid</b></p> <p>5.1. Wages and benefits paid for a standard working week meet, at a minimum, national legal standards or industry benchmark standards, whichever is higher. In any event wages should always be enough to meet basic needs and to provide some discretionary income.</p> <p>5.2. All workers shall be provided with written and understandable information about their employment conditions in respect to wages before they enter employment and about the particulars of their wages for the pay period concerned each time that they are paid.</p> <p>5.3. Deductions from wages as a disciplinary measure shall not be permitted nor shall any deductions from wages not provided for by national law be permitted without the expressed permission of the worker concerned. All disciplinary measures should be recorded.</p> <p><b>Working hours are not excessive</b></p> <p>6.1. Working hours comply with national laws and benchmark industry standards, whichever affords greater protection.</p> <p>6.2. In any event, workers shall not on a regular basis be required to work in excess of 48 hours per week and shall be provided with at least one day off for every seven-day period on average. Overtime shall be voluntary, shall not exceed 12 hours per week, shall not be demanded on a regular basis and shall always be compensated at a premium rate.</p> <p><b>No discrimination is practised</b></p> <p>7.1. There is no discrimination in hiring, compensation, access to training, promotion, termination or retirement based on race, caste, national origin, religion, age, disability, gender, marital status, sexual orientation, union membership or political affiliation.</p> <p><b>Regular employment is provided</b></p> <p>8.1. To every extent possible work performed must be on the basis of recognized employment relationship established through national law and practice.</p> <p>8.2. Obligations to employees under labour or social security laws and regulations arising from the regular employment relationship shall not be avoided through the use of labour-only contracting, subcontracting, or homeworking arrangements, or through apprenticeship schemes where there is no real intent to impart skills or provide regular employment, nor shall any such obligations be avoided through the excessive use of fixed-term contracts of employment.</p> <p><b>No harsh or inhumane treatment is allowed</b></p> <p>9.1. Physical abuse or discipline, the threat of physical abuse, sexual or other harassment and verbal abuse or other forms of intimidation shall be prohibited.</p> <p>Source: <a href="http://www.ethicaltrade.org">http://www.ethicaltrade.org</a>.</p>
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185. A major independent review of the ETI base code, begun in 2003 but completed late 2006, which the ETI sees as “the most comprehensive independent study to date of the impact of codes of labour practice” provided mixed messages on progress to date. Based on a mix of qualitative and quantitative information, including over 400 worker interviews from 23 supply sites, the study found improvements in safety and health (such as fire safety, or safer use of chemicals); in working hours (reduced regular and overtime hours); wages (on-time payment, compliance with minimum wage legislation and provision of state insurance and pensions); and on child labour (less of it). In contrast, the report observed less impact in relation to freedom of association, discrimination and “harsh treatment”. In general, permanent and regular workers benefited most and migrant and contract workers least from codes of labour practice. Some practical improvements for women workers were noted, but, overall, codes had done little to address basic inequalities such as unequal access to employment, promotion and training.

However, the report also highlighted the fact that, at many sites, codes had increased management awareness and/or compliance with national labour legislation and that this might be significant in terms of ensuring the sustainability of improvements over time.<sup>22</sup>

186. The ETI and similar, sometimes sector or specific cause-based, initiatives highlight the importance of value chains as both a challenge and an opportunity for promoting sustainable enterprises. Increasing liberalization of trade and decreasing costs of transport and communication have made it possible for enterprises to split up production processes into ever more complex parts spread to an increasing degree across national borders. The result is that each enterprise typically specializes in a core area of production, while other activities are outsourced to suppliers. This leads to a fragmentation of the production process which is counterbalanced by closer integration between the enterprise and its trading partners.<sup>23</sup> It is estimated that two-thirds of global trade takes place between and within major MNCs.<sup>24</sup> The supply chains of these companies clearly offer a major potential window of opportunity for leveraging better employment conditions and fairer prices for developing country suppliers and larger companies can play an important role in providing long-term opportunities for smaller enterprises as suppliers or distributors. In this sense, the hope is that value chains can function not only to foster domestic competitiveness, enterprise and employment growth, but also as global “conveyor belts” for good practices in social and environmental sustainability.

187. However, although global value chains do have the potential to generate quality employment, they can also be vehicles for passing on the costs and risks to the weakest links in the chain. Sometimes, under pressure from investors, among others, governments in poorer countries have allowed labour standards to be defined by the demands of supply chain flexibility, including easier hiring and firing, more short-term contracts, fewer benefits and longer periods of overtime which may bring short-term advantage for trade but at the risk of a long-term cost to society.<sup>25</sup> Thus, distinguishing the costs and benefits of value chains, and identifying how best to promote value chains which have the potential to nurture sustainable enterprises, requires careful analysis and a conducive policy framework. As described previously, the analysis of value chains can take various forms. On the one hand, companies are motivated to identify how best to integrate, collaborate and adapt supply chains in order best to manage complex relations and change processes and ultimately to shape their competitive advantage.<sup>26</sup> On the other hand, value chain analysis can take a broader perspective to identify how the sustainability of enterprises from the point of view of all stakeholders along the value chain can be enhanced.<sup>27</sup> One particular approach, which explores the linkages between

<sup>22</sup> S. Barrientos and S. Smith: *The ETI code of labour practice – Do workers really benefit?*, report on the ETI Impact Assessment, Institute of Development Studies, University of Sussex, 19 Oct. 2006, available at <http://www.ethicaltrade.org>.

<sup>23</sup> Copenhagen Centre for Corporate Responsibility: *Managing social and environmental requirements in global value chains – Perspectives for Danish small and medium-sized enterprises*, 2006, <http://www.copenhagencentre.org>.

<sup>24</sup> United Kingdom Government: *Private sector development*, Fourth report of session 2005–06, House of Commons International Development Committee, Vol. 1 (London, United Kingdom Government, 2006), p. 59; and *DFID trade matters in the fight against world poverty*, DFID (London, United Kingdom Government, 2005).

<sup>25</sup> K. Raworth: *Trading away our rights – Women working in global supply chains* (Oxford, Oxfam, 2004).

<sup>26</sup> A.T. Kearney (business consultants): “Managing supply chains in the twenty-first century” and other chapters in *Executive Agenda – Ideas and Insights for Business Leaders*, Vol. 6, No. 3, Third Quarter, 2003.

<sup>27</sup> Interesting examples of this approach include Consumers International: *From bean to cup – How consumer choice impacts upon coffee producers and the environment* (London, Consumers International and IIED, 2005);

business and poverty reduction along value chains in Indonesia, was undertaken between Oxfam, a development non-governmental organization (NGO) and Unilever, an MNC. This collaborative exercise (box 6.3) assessed corporate behaviour from the point of view of identifying “base of the pyramid” impacts on growth and poverty reduction.

### Box 6.3

#### Value chains – Linking international business with poverty reduction

Oxfam GB, Novib (Oxfam Netherlands), Unilever and Unilever Indonesia (UI), collaborated on a research project to increase their understanding of the impacts of business on the lives of poor people.

The report also focuses on the potential links between international business and poverty reduction. It explores how, and to what extent, the operations of UI have an impact on poverty – both positive and negative – in Indonesia. It looks at the impact of UI’s entire value chain, from its interactions with small-scale producers in the supply chain to those with low-income consumers.

#### Key findings

Key findings from this data-rich study include the following:

UI’s core workforce includes approximately 5,000 people, of whom 60 per cent are direct employees, and 40 per cent are contract workers. Indirectly, the full-time equivalent (FTE) of about 300,000 people make their livelihoods in UI’s value chain.

More than half of this employment is found in the distribution and retail chain. This includes an estimated 1.8 million small stores and street vendors.

The closer and more formally workers in the value chain are linked with UI’s operations, the more they benefit from the company. Contracting out employment may reduce a company’s ability to monitor the situation of contract workers or suppliers’ employees, and thus result in gaps between corporate policy and practice.

Two-thirds of the value generated along the chain is distributed to participants other than UI (producers, suppliers, distributors and retailers). Taxes paid by UI to the Indonesian Government account for 26 per cent of the value generated in the chain.

The value created by poorer people working at either end of the value chain is much lower than the value captured by those who are in direct interaction with UI.

Participation in value chains such as UI’s does not automatically guarantee improvements in the lives of people living in poverty.

The collaboration was prompted by calls from the United Nations to businesses, governments and NGOs to work together to develop solutions to global poverty – the first of the MDGs. This report does not have all the answers, but it provides a contribution to the debate and provides insights into the links along global value chains between business and poverty reduction.

Source: [http://www.oxfam.org.uk/what\\_we\\_do/issues/livelihoods/downloads/unilever.pdf](http://www.oxfam.org.uk/what_we_do/issues/livelihoods/downloads/unilever.pdf).

188. There is a growing body of evidence to indicate that an equitable relationship along the value chain is vital for all enterprises and that those at the top of the value chain have an inherent interest in nurturing sustainable, long-term relationships with suppliers.<sup>28</sup> The ability of purchasers to deliver for their company depends on the continued viability and efficiency of their suppliers. However, some purchasing practices may, in fact, jeopardize those foundations by undermining suppliers’ efficiency to provide for workers’ welfare. This can result in high worker turnover and lower productivity, which in turn can lead to poor quality products, delayed delivery and additional costs for the

K.N. Harilal et al.: *Power in global value chains – Implications for employment and livelihoods in the cashew nut industry in India* (London, IIED, 2006); and T. Reardon: *Retail companies as integrators of value chains in developing countries – Diffusion, procurement system change and trade and developmental effects* (Eschborn, GTZ, 2005).

<sup>28</sup> See WBCSD (<http://www.wbcsd.org>).



buyers themselves. It also puts at risk the long-term supply of quality products from the same source in the future. There are many practical measures which more powerful buyers can implement to enhance the sustainability of their operations and, at the same time, safeguard the interests of weaker suppliers further down the value chain, such as entering into longer term contracts, paying deposits at the time of ordering, avoiding predatory pricing practices and other restrictive trading practices, as well as supporting buyer codes<sup>29</sup> and promoting and using international labour standards.

189. In addition to the role of trade and FDI in both creating and potentially displacing jobs (through, for example, offshoring of production processes),<sup>30</sup> there is also a labour migration element to the sustainable integration of markets.<sup>31</sup> Globalization is characterized by increasing labour migration across borders. This movement of workers and the remittances they generate are vectors of economic growth. They help to sustain economic activity and growth in higher income countries, where labour forces may contract as a result of ageing, where there may be a shortage of high-technology skills, or where national workers may shun certain sectors and occupations. Therefore, international migration “could play a critical role in stabilizing the labour markets of both labour importing and exporting countries if balanced, for example, against the adverse effects of the brain drain of skilled personnel from developing to developed countries. Emphasis should be given to policies that maximize the development benefits of migration”.<sup>32</sup>

190. Overall, there are many dimensions to the sustainable integration of markets through trade and value chains. Globalization heightens the importance of trade and policies which encourage open economies. However, although this has the potential to yield significant long-run welfare gains, in the short-term, safeguards are required to minimize the costs of adjustment, and appropriate policies need to be put in place to assist developing countries to overcome supply-side production constraints and to enable exporters to meet the requirements of international markets, diversify exports and increase added value before exporting them. Making it easier to trade through increasing market access, improving trade rules, encouraging the growth of sustainable value chains and strengthening ethical and fair trade principles and practices in trading relationships are all important trade-related dimensions of promoting sustainable enterprises.

<sup>29</sup> *Buying matters – Consultation on sourcing fairly from developing countries*, Feb. 2006, <http://www.responsible-purchasing.org>.

<sup>30</sup> P. Auer et al.: *Offshoring and the internationalization of employment – A challenge for a fair globalization?*, Proceedings of the France–ILO Symposium, Annecy, 2005 (Geneva, ILO/IILS, 2006).

<sup>31</sup> ILO: *ILO multilateral framework on labour migration – Non-binding principles and guidelines for a rights-based approach to labour migration* (Geneva, ILO, 2006).

<sup>32</sup> ECOSOC: *Creating an environment at the national and international levels conducive to generating full and productive employment and decent work for all and its impact on sustainable development*, E/2006/55, op. cit., para. 24.

## Chapter 7

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### The role of enterprise in society

191. To maximize their contribution to sustainable development and its three pillars (economic, social and environmental) as well as to productive employment and decent work, enterprises need from the state and society enabling conditions for investing, doing business and creating wealth. They will give consideration to the impact of their operations on society and the environment and will act in a socially responsible manner. This presents many opportunities but also challenges because enterprises operate in ever more complex social and economic systems, where they are subject not only to commercial and economic pressures but also to social and environmental pressures from governments, civil society groups, consumers and suppliers, and from their owners, managers and workers.

### The economic and social importance of enterprises

192. The importance of enterprise as the principal source of growth and employment cannot be overstated. They are at the heart of economic activity and the development process in nearly all countries. Growth is fuelled first and foremost by the creativity and hard work of entrepreneurs and workers. Driven by the quest for profits, enterprises innovate, invest and generate employment and wage income. Their contribution to the generation of employment varies from country to country but, overall, private enterprises generate the majority of jobs, creating opportunities for people to apply their skills and talents and to improve their well-being. Enterprises provide the goods and services needed by everyone, from consumer goods through to health care, food and shelter. Enterprises are a major – often the main – source of tax revenues and therefore typically constitute the foundation on which the public provision of health, education and other services rests. Enterprises are important to all societies whether they are seeking to develop from low-income status, in transition or seeking to compete as diversified modern economies in highly innovative globalized markets. Everywhere, entrepreneurship and enterprise is a vital stimulant that brings about change and progress by ensuring that economies remain dynamic and competitive. The principal way in which enterprises contribute to society and the economy is, therefore, through their core function.

193. Beyond this core function, enterprises often assume a broader role in society. The issue of the social responsibility of business is not new – there is a long tradition to business philanthropy and antecedents to CSR dating back to the European social reformers of the eighteenth and nineteenth centuries, such as Robert Owen and his “model factory” at New Lanark – and some enterprises have a long history of supporting social or community centred activities without calling them by the modern terminology of CSR or necessarily reporting on them. However, the ILO Tripartite Declaration of

Principles concerning Multinational Enterprises and Social Policy, dating from 1977, updated several times, most recently in 2006, is one of the earliest international instruments covering the social dimension of business. In recent times, the role of business in society has gained increased attention and this has spawned a whole CSR industry and a rich and diverse body of analysis and comment on the subject.<sup>1</sup>

194. Conceptually, the increased attention given to the role of business in society is grounded in the basic message of sustainable development, namely that in the long term, economic growth, social cohesion and environmental protection go hand in hand. Globalization serves to focus attention on this. In particular, the media and modern information and communication technologies have heightened the transparency of business activities; increased concern about the damage caused by economic activity to the environment; and helped raise concerns and expectations among citizens, consumers, public authorities and investors. Multinational companies are now obliged to conduct their operations under constant public scrutiny and to come to terms with levels of risk exposure and demands for degrees of transparency that simply did not exist a generation ago. Progressive enterprises now realize the value of being ahead of the curve on corporate responsibility, not least because social and environmental criteria are increasingly influencing consumer decision-making and the investment decisions of individuals and institutions.

195. For enterprises to effectively integrate into their operations such social, ethical and environmental dimensions, they need a set of “basic conditions” (Chapter 3). The rule of law – embracing, but not limited to, contract and commercial law – including respect for property rights and international labour standards, together with effective state institutions and public policies for implementing them, are essential for enterprises to better integrate into their operations ethical values and social and environmental requirements as expressed by international standards and national laws and practices.

## Corporate social responsibility (CSR)

196. Although CSR is a concept now in common usage, it is evolving and takes on different meanings over time and place and is often interpreted differently by different stakeholders (see box 7.1 for some definitions). For example, the perceived or prioritized social and environmental responsibilities of a small furniture-making enterprise in Central America are likely to be somewhat different to that of a large transport company in Europe. Generally, in labour-intensive industries, attention tends to focus more on labour or social issues whereas, for example, in extractive industries and forestry, the focus tends to be on environmental issues and the impact of company operations on local communities. Further, the social and environmental responsibilities of enterprises are likely to reflect society’s expectations, which are far from static, so, for example, what companies see as desirable practices today might become essential at some time in the future. And, most obviously, the different stakeholders of a particular enterprise are likely to prioritize different and sometimes competing or contradictory demands with respect to social and environmental dimensions of enterprise behaviour. Thus, CSR

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<sup>1</sup> See, for example, IOE (<http://www.ioe-emp.org/>); Global Unions (<http://www.global-unions.org/>); United Nations Global Compact (<http://www.unglobalcompact.org/>); the International Business Leaders Forum (<http://www.iblf.org/>); Business for Social Responsibility (<http://www.bsr.org/>); Business in the Community (<http://www.bitc.org.uk/>); the Global Reporting Initiative (<http://www.globalreporting.org/>); and CSR Europe (<http://www.csreurope.org/>). For an overview of the different instruments of CSR, see R. Goel and W. Cragg: *Guide to instruments of corporate responsibility – An overview of 16 key tools for labour fund trustees* (Toronto, Schulich/York University, 2005); or D. Abrahams: *Regulating corporations – A resource guide* (Geneva, UNRISD, 2004).

presents many challenges for businesses, such as delineating responsibilities vis-à-vis the public sector, identifying how far along the supply chain a company's responsibility extends and determining how far into the future a company should plan for the impact of its operations, a factor which is particularly important vis-à-vis the use of natural resources in business operations. It is important, therefore, to be realistic about what can be achieved through CSR and to recognize that the range of issues that can be addressed by CSR, while important, is limited and cannot be a substitute for the primary responsibilities of governments to uphold laws and standards.

### Box 7.1

#### Corporate governance, citizenship and social responsibility

##### Corporate social responsibility (CSR)

"CSR is a way in which enterprises give consideration to the impact of their operations on society and affirm their principles and values both in their own internal methods and processes and in their interaction with other actors. CSR is a voluntary, enterprise-driven initiative and refers to activities that are considered to exceed compliance with the law."

Source: ILO: *InFocus Initiative on Corporate Social Responsibility (CSR)*, Subcommittee on Multinational Enterprises, Governing Body, 295th Session, Mar. 2006, GB.295/MNE/2/1.

##### Corporate citizenship

"Being a good corporate citizen means going beyond responding to the financial concerns of shareholders and responding to the concerns of all stakeholders ... it must be embedded in a company's culture ... as it can ultimately make a difference between commercial success and failure ... What does corporate citizenship mean for corporations?"

- ☐ Operating with ethical business practices.
- ☐ Treating employees well.
- ☐ Making a profit, paying taxes, providing jobs.
- ☐ Providing safe and reliable products/services.
- ☐ Having a good environmental record.
- ☐ Working to improve conditions in the community."

Source: The Centre for Corporate Citizenship at Boston College, United States and CIPE: *The business case for corporate citizenship*, Economic Reform Issue Paper No. 0410, 27 Dec. 2004 (Washington, DC, Centre for International Private Enterprise, 2004), p. 3.

##### Corporate governance

"Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital."

"Corporate governance is a focal point in creating safeguards against corruption and mismanagement, limiting insider dealing and cronyism while promoting the values of a market economy in a democratic society. The values include accountability, transparency and the rule of law – as well as fairness, responsibility and ownership and protection for minority shareholders."

Source: (first quote) World Bank Reports on the Observance of Standards and Codes, for example, *Corporate governance country assessment – Ghana* (Washington, DC, World Bank, 2005); (second quote) UNDP: *Unleashing entrepreneurship – Making business work for the poor*, Commission on the Private Sector and Development, report to the Secretary-General of the United Nations (New York, UNDP, 2004), p. 34.

197. While most codes and instruments recognize CSR as "voluntary and varied by nature", it has become increasingly important for businesses, and especially large MNCs, to address the impact of their operations on society, whilst not diverting such enterprises from their "vital role in providing the primary means for wealth creation within society

through profitable activity”.<sup>2</sup> In this regard, table 7.1 shows the “business case” arguments for enterprises to take action on the environmental and social impact of their operations. Failure to take action can damage their reputation and corporate image, impose additional costs of doing business and reduce their competitiveness. Indeed, there is now substantial evidence to indicate that CSR boosts acceptance of a company’s operations and enhances its international reputation, and can also help it to open up fresh market opportunities, strengthen its innovative and competitive edge and create new jobs.<sup>3</sup> In fact, “numerous studies show that responsible business practices – attention to factors other than just maximizing short-term profits – help companies’ bottom line and that responsible firms outperform their competitors”.<sup>4</sup> However, it can be argued, of course, that these differences in financial performance may not necessarily reflect the benefits of social responsibility per se but rather the probability that businesses which are managed in a socially responsible fashion are also likely to be well run: “doing good and doing well” are mutually reinforcing.

**Table 7.1. The business case for addressing environmental and social factors in enterprise operations**

	Environment	Workers	Communities
Cost savings	Reduce energy costs, cut waste disposal costs, save from recycling	Employees stay longer, reducing recruitment and training costs and other costs associated with staff turnover	Constructive engagement may yield positive externalities from good community relations like lower insurance and security costs
Improving productivity and/or sales	Reduced input and costs increase productivity. Potential to target eco-consumers and benefit from procurement policies which embody environmental principles	Better motivated employees and lower absenteeism. Greater continuity in staffing feeds into better customer service and satisfaction	Possibility of tapping into local knowledge. Community engagement feeds through into improving morale and motivation of staff and may help achieve greater diversity at the workplace. Potential for raising business profile, enhancing brand and reputation and ultimately improving scope for new business opportunities

198. Even though there is a strong ethical or normative case for enterprises to integrate ethical values and social and environmental requirements, as expressed by international standards and national laws and practices, into their operations and often a sound business case for doing so, this does not imply that all enterprises will necessarily integrate it into their operations, nor does it negate the important role that government has in supporting laws and standards, including as they relate to the international labour standards.<sup>5</sup> Promoting CSR is, of course, not the primary purpose of enterprises and,

<sup>2</sup> IOE: *The role of business within society* – Position Paper (Geneva, IOE, 2005), p. 1.

<sup>3</sup> S. Gabriel, German Federal Minister quoted in *Corporate social responsibility – An introduction from the environmental perspective* (Berlin, Federal Ministry for the Environment, Nature Conservation and Nuclear Safety, 2006), p. 3.

<sup>4</sup> CIPE: *The business case for corporate citizenship*, op. cit., p. 2.

<sup>5</sup> D.W. Justice: “Corporate social responsibility – Challenges and opportunities for trade unionists”, in *Labour Education* (Geneva, ILO, 2003), 2003/1, No. 130, pp. 1–13 (and other articles in the same volume).

given that it is voluntary and varied by nature, this implies that governments have a crucial role in promoting it.<sup>6</sup> One of the most effective and fundamental ways in which governments can do this is by fostering a favourable climate for doing business (such as by upholding the rule of law and property rights) and setting standards of good governance (such as by enhancing transparency and eliminating corruption). Strengthening and supporting the business climate does not imply mandating or managing CSR initiatives but rather encouraging an atmosphere where companies are provided with incentives to develop sustainably and act responsibly.<sup>7</sup> Governments can also provide direct incentives to encourage aspects of CSR through, for example, “green” fiscal instruments and by ensuring that their procurement policies include safeguards for compliance with codes of conduct. Indeed, a number of European governments have been very active advocates of CSR. For example, in 2000, the United Kingdom Government appointed a Minister for Corporate Social Responsibility; in 2001, with the adoption of the law on the new economic regulations, France became the first country to mandate triple bottom line reporting for publicly listed companies; and in 2002, the Belgian Parliament approved a law aimed at promoting socially accountable production by introducing a voluntary social label. However, such initiatives and the basic conditions for effective CSR, such as responsive businesses interested in their social and environmental impacts, an active civil society with the capacity to partner with business and government and a strong state able to provide a suitable BEE, are conditions which are not always present in the majority of the world.

199. Gaining and maintaining the public’s goodwill, especially but not exclusively in OECD countries, has become an important challenge for many businesses. Without such goodwill, companies may become increasingly vulnerable in today’s globalized world, with consumers ready to punish companies through market mechanisms for practices they deem unfair. Indeed, there are now many national consumer groups which take an active interest in aspects of CSR and in the age of globalization, international bodies like Consumers’ International<sup>8</sup> play a key role in safeguarding consumers’ interests, particularly on issues which transcend national borders. Consumers thus play an influential role in fostering the demand conditions for sustainable enterprises. The United Nations recognizes this and in 1985, the United Nations Guidelines for Consumer Protection were adopted (and expanded in 1999). They embody specific “essential rights” for consumers and provide guidance on sustainable consumption. Consumers, of course, want quality products at a price they can afford. Globalization has made it easier for consumers to differentiate products based on factors other than price, so consumers are increasingly likely to make their consumption decisions based, at least in part, on non-price aspects – such as product safety and quality, the environmental impact of a product or its production and the human rights record of the company producing the goods.

200. This has given rise to ethical consumerism, which takes on many forms, from advocating support for fair trade or organic products through to increasing consumer awareness of company behaviour with respect to workers’ rights or responsible

<sup>6</sup> Many governments, especially in Europe, have produced guidelines on CSR. The European Commission prepared a CSR Green Paper in 2001 which has given rise to (among many other initiatives) a communication from the Commission advocating that Europe should become a “pole of excellence” on CSR ([http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006\\_0136en01.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/com/2006/com2006_0136en01.pdf)). The Commission has also produced a compendium of national public policies on CSR in the EU ([http://ec.europa.eu/employment\\_social/social/csr/national\\_csr\\_policies\\_en.pdf](http://ec.europa.eu/employment_social/social/csr/national_csr_policies_en.pdf)) and a new initiative to promote CSR in SMEs.

<sup>7</sup> H. Ward: *Public sector roles in strengthening corporate social responsibility – Taking stock* (Washington, DC, World Bank, 2004).

<sup>8</sup> <http://www.consumersinternational.org>.

marketing practices. Studies show that, although consumers are often unaware of the ethical features of products they buy, when provided with that information they will lean toward more responsible companies that provide products and services which appeal to the consumers' ethical values. Furthermore, the negative publicity that civil society groups can generate compels companies to take action to enhance their reputation and build their brand image. Sustainable enterprises recognize that reputation is a value creating mechanism and that stakeholders pay close attention to it. A World Economic Forum "Voice of the Leaders Survey", conducted in late 2003, showed that almost 60 per cent of those surveyed estimated that good reputation can contribute as much as 40 per cent to the market capitalization of companies.<sup>9</sup> Furthermore, economic theory makes a good case that, in markets with asymmetric information, a good corporate reputation allows firms to both attract new customers and retain existing ones because, in markets where consumers are only partially aware of the quality or other features of a product, they can rely on a company's past reputation and brand quality.

201. The importance of a good reputation for sustained corporate performance leads to a further benefit of responsible business practices, namely the potential to attract more capital and to borrow at lower costs. There is substantial evidence to indicate that a "commitment to good corporate governance – well-defined shareholder rights, a solid control environment, high levels of transparency and disclosure and an empowered board of directors – make a company both more attractive to investors and lenders and more profitable".<sup>10</sup> Going beyond good corporate governance, there is also a broad body of evidence showing a strong link between environmental and social issues and company value.<sup>11</sup> This has given rise to a rapid growth in SRI<sup>12</sup> which was originally confined to the negative screening of investment funds managed on behalf of specific groups or targeted at a narrow range of specific issues (such as armaments or apartheid-era South Africa) but has grown into a major industry, "investing in a manner that takes into account the impact of investment on wider society and the natural environment both today and in the future".<sup>13</sup> Generally, in most countries, the single largest portion of invested funds is associated with pension liabilities and this source has been a major driver in the growth of SRI in a number of OECD countries. In the United Kingdom, for example, SRI assets increased tenfold over four years, from £22.7 billion in 1997 to £224.5 billion in 2001.<sup>14</sup> Laws requiring disclosure of the SRI policies of investment funds can help responsible investors – including pension fund beneficiaries – to choose their investment portfolios or to put pressure on trustees to incorporate social, environmental and governance issues into investment policy. For example, the occupational pension law introduced in Belgium in 2003 requires pension fund managers to disclose in their annual reports to what extent they take into account ethical, social and/or environmental criteria in their investment policies. Similar laws exist in other OECD countries.<sup>15</sup>

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<sup>9</sup> <http://www.weforum.org/en/media/Latest%20Press%20Releases/PRESSRELEASES233>.

<sup>10</sup> IFC/World Bank: *The irresistible case for corporate governance* (Washington, DC, World Bank/IFC, 2006), p. 1.

<sup>11</sup> UNEP: *Show me the money: Linking environmental, social and governance issues to company value* (Geneva, UNEP Finance Initiative, 2006). Empirical evidence to support this can be found at the Dow Jones Sustainability Index (<http://www.sustainability-index.com/>), a global index tracking the financial performance of "the leading sustainability driven companies worldwide" which has for the past ten years consistently outperformed the MSCI World Index (a benchmark for global stock funds).

<sup>12</sup> See the United Nations Principles for Responsible Investment, launched in 2006, <http://www.unpri.org/>.

<sup>13</sup> WEF/AccountAbility: *Mainstreaming responsible investment* (Geneva, WEF, 2005), p. 17.

<sup>14</sup> UK Social Investment Forum, <http://www.uksif.org/Z/Z/Z/sri/data/index.shtml>.

<sup>15</sup> See also <http://www.workerscapital.org>.

202. The onus is, therefore, on companies to incorporate in their competitive strategies ethical values and social and environmental requirements as expressed by international standards and national laws and practices, as well as to use CSR as an effective tool to enhance community relations, help mitigate risk, improve reputation and more effectively market, sell and define their brand with consumers.<sup>16</sup> Important drivers of this are the leaders of companies (senior managers and/or board members) who are responsible for designing, promoting and monitoring such policies, including codes of conduct. Leaders of sustainable enterprises will assess the environmental record of their business operations on a consistent basis before crises occur, introduce codes of conduct as a responsive and preventative measure and set higher than minimum safety and health standards and encourage other good workplace practices. They will ensure that mechanisms and procedures exist for consultation with stakeholders, both internal and external to the enterprise, and will promote social dialogue as the vehicle for constructive dialogue between government, employers' and workers' organizations.<sup>17</sup> Moreover, such policies are likely to be most effective when connected to national and international policies and targets on sustainable development.

## Systems of social auditing, monitoring and certification

203. In addition to the ILO Declaration on Fundamental Principles and Rights at Work (1998), which highlighted the universally applicable core labour standards, there are a number of intergovernmental instruments negotiated with multilateral organizations, such as the OECD guidelines on multinationals<sup>18</sup> signed up to by OECD governments and covering competition, financing, taxation, employment, industrial relations, environment, science and technology. Adopted in 1977, the ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (dating from 1977) was groundbreaking. In the 1960s and 1970s, the activities of multinational enterprises (MNEs) provoked intense discussions that resulted in efforts to draw up international instruments for regulating their conduct and defining the terms of their relations with host countries, mostly in the developing world. Labour-related and social policy issues were among those concerns to which the activities of MNEs gave rise. The ILO's search for international guidelines in its sphere of competence resulted, in 1977, in the adoption by the ILO Governing Body of the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (MNE Declaration). The principles laid down in this universal instrument offer guidelines to MNEs, governments, and employers' and workers' organizations in such areas as employment, training, conditions of work and life, and industrial relations.<sup>19</sup>

204. The MNE Declaration has proved a valuable instrument. In March 2000 the text of the MNE Declaration was revised to incorporate the fundamental principles and rights at

<sup>16</sup> See "Beyond the Green Corporation", in *Business Week Online*, 29 Jan. 2007, available at <http://www.businessweek.com>.

<sup>17</sup> See, for example, R. Jones and P. Hubbard: *Workers' voice in corporate governance – A trade union perspective*, Global Unions Discussion Paper, published under the auspices of the Trade Union Advisory Committee to the OECD and the Committee on Workers' Capital, Sep. 2005.

<sup>18</sup> [http://www.oecd.org/document/28/0,2340,en\\_2649\\_34889\\_2397532\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/28/0,2340,en_2649_34889_2397532_1_1_1_1,00.html).

<sup>19</sup> <http://www.ilo.org/public/english/employment/multi/download/english.pdf> and <http://www.ilo.org/dyn/declaris/DECLARATIONWEB.INDEXPAGE>. Also ILO: *Proposals for reporting on the effect given to the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy*, Subcommittee on Multinational Enterprises, Governing Body, 297th Session, Geneva, Nov. 2006, GB.297/MNE/3.



work. All the parties to which the Declaration is commended were thus encouraged to contribute to the realization of the ILO Declaration on Fundamental Principles and Rights at Work. During the last update of the MNE Declaration, which was approved in March 2006, the list of ILO Conventions that member States are invited to ratify was extended to all the fundamental Conventions. Furthermore, a specific recommendation was added to encourage enterprises, both multinational and national, to take immediate and effective measures within their own competence to secure the prohibition and elimination of the worst forms of child labour, as a matter of urgency. References to further ILO instruments were also added, including: the GEA; the Employment Policy (Supplementary Provisions) Recommendation, 1984 (No. 169), and the Job Creation in Small and Medium-Sized Enterprises Recommendation, 1998 (No. 189); and ILO codes of practice on HIV/AIDS and the world of work (2001) and on managing disability in the workplace (2002).

205. In addition to the intergovernmental instruments, there is a plethora of codes of conduct (or codes of ethics) to guide the socially responsible business, ranging from relatively general aspirational principles<sup>20</sup> to more specific company codes<sup>21</sup> and trade association codes which are adopted by trade bodies within a sector or geographical area, such as the Kenya Flower Council Code,<sup>22</sup> the Common Code for the Coffee Community (4C)<sup>23</sup> or the Electronic Industry Code of Conduct,<sup>24</sup> and third party, sector-based codes such as the World Health Organization (WHO) Ethical Criteria for Medicinal Drug Promotion. Bridging these two types of codes are supply chain codes, which are particularly common in supply chains involving consumer goods produced in developing country or emerging markets with relatively weak regulatory environments and destined for consumers in developed country markets. Supply chain codes include buyer codes, which are sometimes augmented by factory certification schemes. Typically, buyer codes involve the buyer paying for internal monitors and independent auditors to review supplier factories. Suppliers then pay for any infrastructure upgrades or other improvements necessary to meet the code standards. Once suppliers are selected they are monitored to make sure that they are maintaining the standard. For buyers, the benefits of these codes are that they protect their brand from bad publicity and other civil attacks, whilst consumers stand to get higher quality goods from the upgrades to the quality of the infrastructure and the labour force. In countries where labour laws are less stringent or weakly enforced compared to international standards, the codes may have the effect of creating higher labour standards and serve as a self-governing mechanism for the enforcement of laws governing working conditions and production standards.<sup>25</sup>

206. With such a depth and diversity to codes of conduct, it is not surprising that a number of initiatives have sought to streamline the codes into consistent and coherent frameworks or guidelines. Indeed, the International Organization for Standardization (ISO) plans to launch an international standard (ISO 26000) providing guidelines (but, because of its voluntary nature, not a certification standard) for social responsibility.<sup>26</sup> Multi-stakeholder codes

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<sup>20</sup> Such as the Caux Roundtable Principles for Business, <http://www.cauxroundtable.org/principles.html>.

<sup>21</sup> For example, [http://www.statoil.com/we\\_in\\_statoil](http://www.statoil.com/we_in_statoil) and [http://www.angloamerican.co.uk/static/uploads/Bus\\_Principles.pdf](http://www.angloamerican.co.uk/static/uploads/Bus_Principles.pdf).

<sup>22</sup> <http://www.kenyaflowers.co.ke>.

<sup>23</sup> <http://www.sustainable-coffee.net>.

<sup>24</sup> <http://www.eicc.info/index.html>.

<sup>25</sup> See also the ILO Better Factories Cambodia Programme, <http://www.betterfactories.org>.

<sup>26</sup> <http://www.iso.org/sr>.

currently in operation include the ETI,<sup>27</sup> a UK-based alliance of companies, NGOs and trade unions which seek to promote and improve the implementation of corporate codes of practice which cover supply chain working conditions; AccountAbility 1000 (AA1000),<sup>28</sup> a foundation and process standard which seeks to define what constitutes best practice in social auditing, accounting and reporting; and Social Accountability 8000 (SA 8000),<sup>29</sup> a global, auditable standard on working conditions based on the ILO Conventions.

207. Such codes provide guidelines, and in some cases benchmarks, for assessing companies' record against social and/or environmental criteria. Some companies have integrated requirements relating to codes of conduct into their standard supplier quality audits; others have set up separate audit teams for this purpose or engage external auditors. Some initiatives have more rigorous promotional or monitoring functions than others, some issues are accorded little attention (such as the rights of indigenous people or of home workers, and, in some cases, gender issues) and, of course, there is great variation in the levels of commitment shown by companies in terms of implementing the codes of conduct to which they aspire.<sup>30</sup> However, such codes have served to focus attention on the desirability for enterprises to integrate ethical values and social and environmental requirements, as expressed by international standards and national laws, into their operations. Furthermore, they provide principles and standards against which companies and the public can judge performance.<sup>31</sup>

208. One particularly prominent reporting mechanism is the Global Reporting Initiative (GRI) – a collaborating centre of the United Nations Environment Programme – which seeks to promote reporting on economic, environmental, and social performance by organizations (not just businesses) with the goal that this becomes as routine and comparable as financial reporting.<sup>32</sup> The GRI has developed and promoted the use of a sustainability reporting framework, the core of which are the Sustainability Reporting Guidelines.<sup>33</sup> In addition, there are a number of sector-based codes or standards, such as the Equator Principles based on IFC performance standards, which provide benchmarks for the financial industry to manage social and environmental issues in project financing. Revised in 2006 and covering over 40 financial institutions that together represent more than 80 per cent of global project financing, the principles apply to all project finance above US\$10 million.<sup>34</sup> The World Bank Group is a particularly strong advocate of the Equator Principles and has developed a range of other environmental and social safeguards for guiding its private sector operations.<sup>35</sup>

<sup>27</sup> <http://www.ethicaltrade.org/>.

<sup>28</sup> <http://www.accountability.org.uk/>.

<sup>29</sup> <http://www.cepaa.org/>.

<sup>30</sup> B. Lang: *Experiences with voluntary standards initiatives and related multi-stakeholder dialogues*, a GTZ report commissioned by the German Federal Ministry for Economic Cooperation and Development, Mar. 2006.

<sup>31</sup> KPMG/UNEP: *Carrots and sticks for starters*, a joint United Nations Environment Programme/KPMG South Africa publication, 2006 (available at <http://www.kpmg.co.za>) provides a good overview of current trends and approaches in voluntary and mandatory standards for sustainability reporting.

<sup>32</sup> The GRI has its origins in the Ceres/Valdez Principles, put together by the US-based Coalition for Environmentally Responsible Economies (Ceres) in response to the 1989 Exxon Valdez disaster.

<sup>33</sup> See <http://www.globalreporting.org/> for coverage of labour practices and decent work indicators.

<sup>34</sup> <http://www.equator-principles.com>.

<sup>35</sup> Such as the IFC: *Addressing the social dimensions of private sector projects – Good practice note No. 3* (Washington, DC, IFC, 2003); and IFC: *Policy on social and environmental sustainability* (Washington, DC, IFC, 30 Apr. 2006).

209. Today, there is a wealth of CSR experience covering businesses of all sizes,<sup>36</sup> throughout the world and across a very broad range of sectors, illustrating how companies have responded to these codes of conduct and the many programmes and vehicles which exist to promote CSR, such as the UN-backed Global Compact (see box 7.2). Many of these initiatives can be found on the ILO's business and social initiatives database (BASI).<sup>37</sup> In addition to various high-profile international initiatives, national organizations of employers, chambers of commerce, trade unions and consumers groups, as well as NGOs, are all very active in promoting aspects of social and environmental responsibility in their respective countries.<sup>38</sup>

### **Box 7.2** **The Global Compact**

The ten principles of the Global Compact are derived from the Universal Declaration of Human Rights; the ILO Declaration on Fundamental Principles and Rights at Work; the Rio Declaration on Environment and Development; and the United Nations Convention against Corruption.

The Global Compact asks companies of all sizes – the majority of signatories are SMEs – to embrace, support and enact, within their sphere of influence, a set of core principles in the areas of human rights, labour standards, the environment and anti-corruption. Today, more than 2,500 companies from over 70 countries have engaged in the Global Compact.

#### **Human rights**

1. Businesses should support and respect the protection of internationally proclaimed human rights; and
2. make sure that they are not complicit in human rights abuses.

#### **Labour standards**

3. Businesses should uphold freedom of association and the effective recognition of the right to collective bargaining;
4. the elimination of all forms of forced and compulsory labour;
5. the effective abolition of child labour; and
6. the elimination of discrimination in respect of employment and occupation.

#### **Environment**

7. Businesses should support a precautionary approach to environmental challenges;
8. undertake initiatives to promote environmental responsibility; and
9. encourage the development and diffusion of environmentally friendly technologies.

#### **Anti-corruption**

10. Businesses should work against corruption in all its forms, including extortion and bribery.

Source: The Global Compact (<http://www.unglobalcompact.org>).

<sup>36</sup> Attention tends to focus on multinational companies, or at least large companies, but CSR and corporate citizenship are just as applicable to small and medium enterprises. See, for example, P. Raynard and M. Forstater: *Corporate social responsibility – Implications for small and medium enterprises in developing countries* (Vienna, United Nations Industrial Development Organization (UNIDO), 2002); UNIDO: *Survey of small and medium enterprises in the Global Compact* (Vienna, UNIDO, 2004); D. Grayson: *Inspiration – Successfully engaging Europe's smaller businesses in environmental and social issues* (Copenhagen, Copenhagen Centre, 2003); and L. Princic: *Engaging small business in corporate social responsibility*, Canadian Business for Social Responsibility, Oct. 2003.

<sup>37</sup> Accessible from <http://www.ilo.org/public/english/employment/multi/>.

<sup>38</sup> See, for example, the CSR-related activities of the Consumers' Association of Austria (<http://www.konsument.at/konsument/default.asp>); the Confederation of Swedish Enterprise (<http://www.svensktnaringsliv.se/english>); and the CFDT trade union in France ([http://www.cfdt.fr/actualite/economie/developpement\\_durable/developpement\\_durable\\_0005.htm](http://www.cfdt.fr/actualite/economie/developpement_durable/developpement_durable_0005.htm)).

210. Given the myriad corporate citizenship initiatives and codes of conduct, it is often difficult for enterprises to prioritize their approach to CSR and, inevitably, they often take a selective approach that may emphasize, for example, charitable activities or working conditions in the supply chain. However, “the ultimate purpose of a CSR policy is to develop innovative, economically viable and precautionary solutions within core business processes to improve environmental protection and working conditions”<sup>39</sup> which implies the advantages of a holistic, integrated approach. Table 7.2 illustrates how companies can map a comprehensive CSR strategy into their business operations, focused on core CSR functions like operational environmental protection; taking account of employee interests; addressing environmental protection and working conditions along the supply chain; an integrated product or service policy; and consumer protection. Companies can assess what is essential, expected and desirable and then work out a strategy for integrating actions throughout their operations. This will then improve the prospects for establishing a strategic approach to CSR: one that respects the voluntary nature of CSR but which avoids an arbitrary and aimless approach by incorporating social and environmental actions into a systematic management regime – including through social dialogue<sup>40</sup> – so that opportunities can best be exploited and risks avoided.

**Table 7.2. Action and prioritization in CSR**

<b>Vision and strategy</b>		
<b>Guiding questions</b>		
What is ESSENTIAL – actions that must be taken by the company to observe relevant legal standards such as international human rights law, international labour standards, national laws and regulations, including in situations where a government is unwilling or unable to fulfil its obligations.		
What is EXPECTED – actions which should be taken by the company to meet the expectations of, and accept its shared responsibilities to, relevant stakeholders, which may vary according to the business sector.		
What is DESIRABLE – actions through which the business could demonstrate real leadership, which could include partnerships with other stakeholders, charitable donations, donation of expertise, etc.		
↓		
<b>Governance and management systems</b>	Communication with internal and external stakeholders	
↓		
<b>Areas of CSR activity in central business processes</b>	Environmental management	Management of social areas of CSR action
	Operational environmental protection	Interests of employees
	Environmental protection in the supply chain	Working conditions and human rights in the supply chain
↓		
<b>Areas of CSR activity outside central business processes</b>	Environmental product responsibility	Consumer protection and customer interests
	Involvement in shaping the regulatory framework (including lobbying), combating bribery and corruption	Commitment to the community including charitable giving, sponsorship, employee release for volunteering, etc.
Source: Adapted from United Nations Global Compact/UNHCHR/Business Leaders Initiative on Human Rights: <i>A guide for integrating human rights into business management</i> ; and German Federal Government: <i>Corporate social responsibility – An introduction from the environmental perspective</i> , op. cit.		

<sup>39</sup> German Federal Government: *Corporate social responsibility – An introduction from the environmental perspective*, op. cit., p. 8.

<sup>40</sup> See J. Baker: *Freedom of association and CSR*, remarks of Jim Baker, ICFTU, to OECD Conference on Corporate Social Responsibility, 19 June 2001.

## The role that enterprises can play in improving governance, promoting human rights and reducing poverty

211. One particularly challenging aspect of CSR which confronts many enterprises, both large and small, is the issue of poor governance giving rise to corruption. This phenomenon in one form or another blights most countries, but is perceived as being particularly problematic for attracting investment and encouraging enterprise growth in lower-income countries.<sup>41</sup> Corruption is a problem in both the public and private sectors, as it has both demand-side elements (for example, public officials willing to accept bribes) and supply-side elements (for example, private sector business people willing to pay bribes). And, for obvious reasons, it is a politically sensitive and complex topic. Definitions of corruption vary and what is perceived to be corruption in some societies could be a socially acceptable behaviour in others, such as attitudes towards gift giving, using privileged information for personal gain, certain types of nepotism and conceptions about conflicts of interest. Corruption is also sometimes legitimized as a means of avoiding inefficient or obstructive regulations or simply because it is perceived as being ubiquitous, embedded in society and therefore unavoidable. Some types of corruption such as bribery are quite common simply because they expedite the favourable resolution of difficulties and can be effective in obtaining contracts and business.

212. However, corruption feeds inefficient and uncompetitive economic systems. Surveys of business opinion repeatedly point to corruption as a major constraint on doing business because it deters investment and creates extra costs, barriers and unfair competition. Eliminating corruption from business would create a better business environment and ultimately open markets, creating more wealth and business opportunities. There are many measures which can be taken to minimize corruption, such as instituting sound corporate governance, improving accounting standards, implanting codes of conduct and anti-bribery laws, streamlining legal and regulatory frameworks, lowering barriers to starting and running a formal business and so forth.<sup>42</sup> However, reform is often difficult to achieve, especially in those societies where corruption appears to be ingrained, where those with influence and vested interests feel threatened and where it is difficult to get serious political commitment to bring about change. Addressing corruption also requires the creation and enforcement of appropriate incentives to reward good practices and transparency and appropriate sanctions to discourage behaviour and practices which threaten ethical behaviour in business.<sup>43</sup>

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<sup>41</sup> The Transparency International Corruption Perceptions Index (2005) shows a very strong correlation between income levels and perceived levels of corruption – [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi](http://www.transparency.org/policy_research/surveys_indices/cpi).

<sup>42</sup> CIPE: *Combating corruption – Private sector perspectives and solutions*, Economic Reform Issues Paper No. 0409 (Washington, DC, Center for International Private Enterprise, 2004); and see <http://www.cipe.org> for a policy toolkit on combating corruption.

<sup>43</sup> Actions to combat corruption can often resemble the classic prisoners' dilemma, a common example used in game theory to show the probability of suboptimal outcomes due to conflicting incentives under conditions of asymmetric information.

### Box 7.3 The paradox of plenty

It is possible for natural resource revenue to be used to help promote peaceful and sustainable development, rather than being, as is too often the case, a driving force for conflict and state looting. The widespread abuse of human rights, environmental destruction, poverty and economic insecurity that are part of the landscape of modern-day conflict are, in many cases, intricately linked to resource extraction. Natural resources-based industries – like oil, diamond and timber – have highlighted a much wider problem, where political and economic disorder brought about by conflict have provided the cover for the wholesale looting of state assets by combatants and their political and economic allies. Natural resources that should be promoting equitable development and the growth of sustainable enterprises, which in turn, help eradicate poverty, are misappropriated and mismanaged.

Rising revenues from resource extraction have generally gone hand in hand with declining indicators of human development. Recent analyses identify a clear statistical relationship between states with dependency on primary extractive industries and unaccountable state institutions that are linked to poverty and civil conflict. This “paradox of plenty” indicates, for example, that states dependent on primary resource exports are over 20 times more likely to suffer a civil war than non-dependent countries.

At the moment, natural resources can be accessed and traded with almost no reference to their link with instability and conflict. International businesses are often unable and unwilling to make a stand. Political leadership has also been lacking as northern governments have sought to appease the ruling elite to avoid harming national business interests. Although there is no single solution to these problems, it is clear that a more joined-up international approach to the way that companies access and manage the extraction of resources worldwide is necessary. This calls for global dialogue and advocacy to address issues like the link between the exploitation of natural resources and the exploitation of human rights. Representative organizations of workers and employers, together with international organizations like the ILO, have a vital role to play in this dialogue. They can help develop and use toolkits, comprising inter alia smart sanctions, chain-of-custody monitoring, appropriate disclosure regulations and registers of interests as well as a series of strategic legal actions to identify and sanction mafeasants and to enshrine the rule of law and good governance in the resource sector.

At a time when it is increasingly apparent that dysfunctional states can become havens for terrorists and money laundering, this approach is an important and long overdue first step in addressing these global problems, as well as strengthening governance and combating poverty in many of the world's poorest and least developed countries.

Source: <http://www.globalwitness.org>; and <http://www.business-humanrights.org>.

213. There are a number of initiatives aimed at addressing corruption and, in particular, the effect of corruption on doing business, including a United Nations Convention against Corruption,<sup>44</sup> adopted by the General Assembly in 2003, and the United Nations Global Compact which added the 10th principle on anti-corruption in 2004. Over the last ten years the World Bank has taken a more proactive position on corruption by strengthening its engagement on governance and anti-corruption.<sup>45</sup> There is also a set of Business Principles for Countering Bribery, published by Transparency International and Social Accountability International in collaboration with key stakeholders including business associations, civil society organizations and trade unions, which constitutes a practical tool for companies to use when developing good internal control procedures.<sup>46</sup> In addition to these broad-based

<sup>44</sup> [http://www.unodc.org/unodc/crime\\_convention\\_corruption.html](http://www.unodc.org/unodc/crime_convention_corruption.html).

<sup>45</sup> This was not always the case but over the past ten years much greater attention has been given to addressing governance and corruption both in World Bank Group lending operations and in its policy advice. See, for example, World Bank/IMF: *Strengthening Bank Group engagement on governance and anti-corruption* – World Bank/IMF Development Committee, 8 Sep. 2006, DC2006-0017, paper for discussion at the World Bank and IMF Annual Meeting in Singapore, 17–18 Sep. 2006.

<sup>46</sup> [http://www.transparency.org/global\\_priorities/private\\_sector/business\\_principles](http://www.transparency.org/global_priorities/private_sector/business_principles).

instruments, there is a wide range of national anti-corruption processes and industry or sector-specific initiatives targeted at making it easier to do business on a level playing field. One example is the Kimberley Process<sup>47</sup> which is a joint government, international diamond industry and civil society initiative to stem the flow of conflict diamonds – those used by rebel movements to finance wars against legitimate governments – which account for over 99 per cent of the global production of rough diamonds.<sup>48</sup> Similarly, the Extractive Industries Transparency Initiative (EITI) (box 7.4) brings together oil, gas and mining countries and companies along with civil society to create greater transparency around the flow of money from companies to governments – “publish what you pay” principles<sup>49</sup> – which, since its launch in 2002, has been signed up to by more than 20 countries, of which a few, including Azerbaijan and Nigeria, are now reporting regularly according to the criteria and principles of the EITI.

**Box 7.4**  
**The Extractive Industries Transparency Initiative (EITI)**

The EITI aims to ensure that the revenues from extractive industries contribute to sustainable development and poverty reduction. At the core of the initiative is a set of principles and criteria that establish how EITI should be implemented.

**Criteria**

- ❑ Regular publication of all material oil, gas and mining payments by companies to governments (“payments”) and all material revenues received by governments from oil, gas and mining companies (“revenues”) to a wide audience in a publicly accessible, comprehensive and comprehensible manner.
- ❑ Where such audits do not already exist, payments and revenues are the subject of a credible, independent audit, applying international auditing standards.
- ❑ Payments and revenues are reconciled by a credible, independent administrator, applying international auditing standards and with publication of the administrator’s opinion regarding that reconciliation, including discrepancies, should any be identified.
- ❑ This approach is extended to all companies including state-owned enterprises.
- ❑ Civil society is actively engaged as a participant in the design, monitoring and evaluation of this process and contributes towards public debate.
- ❑ A public, financially sustainable workplan for all the above is developed by the host government, with assistance from the international financial institutions, where required, including measurable targets, a timetable for implementation, and an assessment of potential capacity constraints.

Source: <http://www.eitransparency.org/>.

214. Sustainable development is about meeting the needs of both present and future generations. A stable and sustainable society cannot be achieved when there are high levels of extreme poverty. Similarly, sustainable enterprises benefit from operating in stable and secure societies, so there is a symbiotic relationship between international development and enterprise. The mutually reinforcing synergy is clear: business is good for development and development is good for business. This relationship has now been well documented, including in the report of the United Nations Commission on the Private Sector and Development<sup>50</sup> which maps out a series of actions in the public

<sup>47</sup> <http://www.kimberleyprocess.com:8080/site/>.

<sup>48</sup> For a critique centred on the effectiveness of the Kimberley Process, see: *Killing Kimberley? Conflict diamonds and paper tigers*, Occasional Paper No. 15 by Partnership Africa Canada, Ontario, Nov. 2006 (<http://www.pacweb.org>).

<sup>49</sup> <http://www.publishwhatyoupay.org>.

<sup>50</sup> UNDP: *Unleashing entrepreneurship – Making business work for the poor*, op. cit. The Commission was established by Secretary-General Kofi Annan and included ILO Director-General Juan Somavia among its

sphere to create an enabling environment for doing business, actions in the private sphere to mobilize capabilities and resources, and actions in the public–private sphere centred on partnership and innovation. There is now broad consensus that the private sector has a vital, indeed, essential role in helping to achieve the Millennium Development Goals,<sup>51</sup> from micro-enterprises, which provide the main source of employment for the majority of the world's poor people, through to large companies, which contribute not only through CSR, embedded in compliance, risk management and philanthropy, but also as drivers of growth, embedded in innovation, value creation and competitiveness. Most bilateral and multilateral development organizations are now strong advocates of partnering with business, not just as a complement to conventional approaches to development but as a necessity to confront the many interdependent challenges associated with the global commitment to poverty reduction.<sup>52</sup> The United Nations has been particularly active in identifying opportunities to work in partnership with the private sector, including as a means of facilitating United Nations reform, and has noted four types or functions of partnerships: advocacy; developing norms and standards; sharing and coordinating resources and expertise; and harnessing markets for development.<sup>53</sup>

215. Although there is a clear business case for addressing poverty reduction, this does not imply, of course, that all businesses will recognize this and act accordingly. A major impediment to the greater involvement of the formal private sector in addressing poverty challenges, both directly through generating employment and incomes and indirectly through their contribution to social and environmental progress, is the business environment, which in some developing countries is clearly not as conducive to equitable and sustainable private sector investment and growth as it could be. It is also the case that some businesses, especially those that wield significant economic power and can turn this into significant political leverage, may practice less scrupulous behaviour, for example, by extracting highly favourable fiscal incentives which may provide anti-competitive advantages, or by undertaking operations in a manner which compromises workers' rights or has an adverse impact on the natural environment.<sup>54</sup> In general, enterprises – in this sense, meaning mainly larger, formal businesses – adopt different approaches to the challenge of reducing poverty. These include “doing nothing” apart from seeking profits, at one end of the scale; “denying and defending” by denying negative impacts and defending the narrow commercial case; “paying penance” through donations and philanthropy; “risk mitigation”, focusing on managing and addressing the negative impacts of their operations; and the “creative business model” at the other end of the scale, where poverty reduction is mainstreamed into core business practices.

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members. The Commission addressed two fundamental questions: how can the potential of the private sector and entrepreneurship be unleashed in developing countries and how can the existing private sector be engaged to meet this challenge.

<sup>51</sup> J. Nelson and D. Prescott: *Business and the Millennium Development Goals – A framework for action* (New York, UNDP/IBLF, 2003).

<sup>52</sup> T. Fox and D. Prescott: *Exploring the role of development cooperation agencies in corporate responsibility*, paper based on discussions at an international donor conference on the same topic held in Stockholm, 22–23 Mar. 2004.

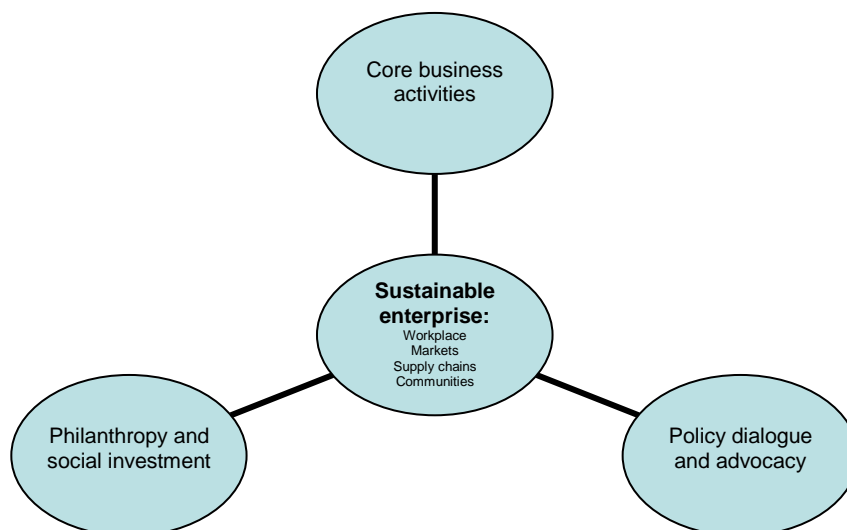
<sup>53</sup> J.M. Witte and W. Reinicke: *Business unusual – Facilitating United Nations reform through partnerships* (New York, United Nations Global Compact/Global Public Policy Institute, 2005).

<sup>54</sup> S. Dhanarajan: “Managing ethical standards – when rhetoric meets reality”, in *Development in Practice*, Vol. 15, Nos. 3 and 4, June 2005, pp. 529–538.



216. As mentioned previously, there are likely to be significant benefits, both for enterprises themselves and for poverty reduction, from an integrated approach whereby enterprises develop a strategy to take action in each of the spheres outlined in figure 7.1. A good example of this is the global partnership for hand washing with soap.<sup>55</sup> Despite the fact that soap is readily available in most places, regular hand washing is not always a norm and so contributes to illnesses such as diarrhoeal disease and respiratory tract infections, which are the two greatest killers of children in developing countries. The global partnership is a response to this challenge, involving the World Bank, United Nations Children’s Fund (UNICEF) and soap-making companies. Since its inception in 2001, the “health in your hands” initiative has grown into a global programme combining the expertise of the soap industry with the resources of the World Bank and UNICEF, which enables all partners to advance their respective interests. Governments and their development partners are in a better position to combat disease and poverty, while the private sector finds opportunities to expand markets. There are many other such examples of harnessing private sector capabilities to meet public needs. Box 7.5 illustrates this in the context of applying core business competencies to help achieve the MDG target of halving the number of people affected by hunger.<sup>56</sup>

Figure 7.1. Spheres of impact and influence for sustainable enterprises in international development



<sup>55</sup> <http://www.globalhandwashing.org>.

<sup>56</sup> WEF: *Harnessing private sector capabilities to meet public needs – The potential of partnerships to advance progress on hunger, malaria and basic education* (Geneva, WEF, 2006).

**Box 7.5****Sustainable enterprises creating sustainable societies through applying core business competencies to halve the number of people affected by hunger**

Hunger affects more than 850 million people. Chronic malnourishment causes 6.5 million child deaths per year, retards the lifelong health and cognitive capacities of tens of millions of people and has a significant negative impact on national economic productivity in many poor countries.

Eliminating hunger requires an integrated approach that addresses poverty, builds markets and infrastructure, boosts agricultural production and nutrition, focuses on health and enables the empowerment of women. Collaborative private sector efforts to reduce hunger have tremendous potential to help address this challenge. Key opportunities for applying core business competencies to the fight against hunger include:

**1. Increasing food production and strengthening market systems in hungry regions**

- ❑ Sourcing from small-scale producers, e.g. food and beverage manufacturers and retailers.
- ❑ Developing SMEs for producing, processing and distributing food and agricultural products.
- ❑ Expanding farmers' access to new and existing products and technologies, e.g. agricultural input, food and beverage, engineering and energy companies.
- ❑ Extending essential services and infrastructure to hungry areas, e.g. telecommunications, water, energy, transportation and FS companies.
- ❑ Acting to reduce the spread of HIV/AIDS, e.g. transport, mining, agricultural, media and pharmaceutical companies.

**2. Improving nutrition through fortified products and consumer education, particularly for mothers and young children**

- ❑ Fortifying food and beverage products for the bottom of the pyramid, e.g. food, beverage, retail, consumer goods, biotechnology and seed companies.
- ❑ Empowering and educating women and girls, e.g. retail, food, beverage, agribusiness, IT, financial service and media companies.

**3. Strengthening governments' commitment and capacity to act against hunger**

- ❑ Building public and political support for increased investment in hunger education, e.g. media, public relations, retail and consumer companies.
- ❑ Partnering with public agencies and NGOs to strengthen their capacity, e.g. professional and financial service companies, law firms and others with technical skills.

Source: WEF: *Harnessing private sector capabilities to meet public needs – The potential of partnerships to advance progress on hunger, malaria and basic education*, op. cit.

217. The main contribution of business in helping to address the multiple challenges of sustainable development, productive employment and decent work rests on the creation and growth of viable enterprises. This comprises core business activities, such as producing safe and affordable products and services, generating income and investment, and creating decent jobs. It calls for an appropriate enabling environment for doing business, and individual enterprises and the organized business lobby have a vital advocacy role to play in this regard. However, such advocacy extends beyond the enabling environment for doing business. Businesses, either individually or through their representative organizations, can add great value to relevant public policy dialogues, including national poverty reduction strategy planning and donor-based forums, trade and environmental policy, and global dialogues on issues such as climate change, biodiversity, money laundering, national security and so on. Such dialogues, of course, serve to underscore the importance of productive employment and decent work as a global goal. At the same time, forward-thinking, progressive enterprises will adopt and implement

responsible business practices and standards to set a positive example for sustainable private sector development. This will be grounded in the type of social, ethical and environmental instruments and codes of conduct discussed above.

## Chapter 8

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### Financial and physical infrastructure and services

218. Sustainable enterprises of all sizes and types need access to financial and physical infrastructure and services. Financial infrastructure refers to the legal and regulatory framework for the financial sector and the institutions and systems which enable the effective operation of financial sector intermediaries. FS refer to a range of financial products or instruments including credit, savings, insurance, leases, equity investments, payment services and remittances.<sup>1</sup> The state of physical infrastructure, such as roads, energy, water, ports and telecommunications is vital, both for the well-being of people in general and also for enabling the growth of enterprises. Enterprises need access to reliable sources of, for example, water and electricity, telephone and distribution services, and they need appropriate premises and places to do business.

### Making financial markets work better

219. Sustainable enterprises need access to FS and financial instruments can be used to promote sustainable enterprises. The focus of this section, therefore, is twofold. Firstly, there is a discussion of how to make financial markets work better by making them more inclusive, with an emphasis on improving access to credit for SMEs. Secondly, there is a discussion of aspects of ethical or socially responsible investment and the ways in which FS can be harnessed to support sustainable enterprises.<sup>2</sup> When financial markets work well they give enterprises of all types and sizes the ability to exploit investment opportunities, to manage risk and to increase growth in productivity and output. With respect to credit, evidence suggests that better functioning credit markets lead to more job creation.<sup>3</sup> There is also substantial evidence indicating the importance of inclusive

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<sup>1</sup> Increased migration has lead to increased remittance flows, and financial transactions related to remittances are likely to become ever more significant. For example, recorded remittance flows to developing countries have doubled over the past five years, with an estimated US\$167 billion of the total US\$233 billion of worldwide remittances going to these countries (inclusion of unofficial flows will, of course, increase these figures very significantly, perhaps by as much as 100 per cent). See World Bank: *Global development finance 2006* (Washington, DC, World Bank, 2006).

<sup>2</sup> The financial sector – comprising infrastructure and services – is an extremely broad canvas and, in the context of this report, the discussion needs to be delineated in order to make it manageable and meaningful. Although very relevant to a discussion of sustainable enterprises, microfinance, at one end of the spectrum, and capital markets for the trading of stocks and shares, bonds, commodities, etc., at the other end of the spectrum, are not covered in any great detail.

<sup>3</sup> D. Acemoglu: “Credit market imperfections and persistent unemployment”, in *European Economic Review*, Vol. 45, issue 4–6, May 2001, pp. 665–79.

financial markets for poverty reduction <sup>4</sup> and of the importance and relevance of microfinance and other types of FS to decent work. <sup>5</sup> The ability of poor people to reduce their vulnerability, improve their incomes, pay for health care and so forth is all directly hampered by their lack of access to FS.

220. A well-functioning financial system provides the lubricant for a growing and dynamic private sector. Many countries, especially in the developing world, have underdeveloped or poorly performing domestic financial sectors which are not particularly efficient, equitable or inclusive. Reforms are typically needed and made challenging because of market failures arising largely from information asymmetries (Chapter 2) and from problems associated with political economy. The importance of such reforms is underscored by a number of studies which highlight the relative significance of financing constraints among business environment obstacles reported by firms. For example, on the basis of survey data of SMEs and large firms, one study found that obstacles related to finance, crime and political stability had the most direct effect on the growth rate of firms, with finance being the most “robust” variable, implying that priority needs to be given to the sequencing of business environment policy reforms and that maintaining political stability, keeping crime under control and undertaking financial sector reforms to relax financing constraints are likely to be the most effective routes to a firm level of growth. <sup>6</sup>

221. Providers of debt (credit) have imperfect information about what the recipients are going to do with the finance they provide so this means that lenders will allocate finance according to factors which minimize their risks (by taking collateral or charging high interest rates, for example). In practice, this implies that credit will be rationed and that some groups (such as the poor or small-scale businesses) may not get access to loans. Partly as a result of such market failures, financial markets are also subject to problems associated with political economy, whereby lending policies are unduly influenced by the vested interests of powerful groups, including politicians. The record of state-dominated or directed financial sectors, where governments directed credit to favoured groups and used loan guarantees and other policies to restrict competition in the financial sector (such as unrealistic interest rate caps or severe entry restrictions on foreign banks), is rather mixed. <sup>7</sup> This gave rise to reforms, such as the market determination of interest rates, the opening of capital markets and the development of more inclusive and innovative financial institutions and services for disadvantaged groups. Among the most

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<sup>4</sup> E. Kempson: *Policy level response to financial exclusion in developed economies – Lessons for developing countries*, report by the Personal Finance Research Centre, University of Bristol, United Kingdom, Mar. 2004. See also <http://www.firstinitiative.org/> and <http://www.cgap.org>.

<sup>5</sup> For a thorough discussion of the importance and relevance of microfinance to decent work, see ILO: *Microfinance for employment creation and enterprise development*, Committee on Employment and Social Policy, Governing Body, 285th Session, Nov. 2002, GB.285/ESP/3; and ILO: *ILO policy statement – Microfinance for decent work*, Committee on Employment and Social Policy, Governing Body, 294th Session, Nov. 2005, GB.294/ESP/3. See also the ILO’s Social Finance web site at <http://www.ilo.org/public/english/employment/finance/index.htm> for more details on a number of the issues alluded to in this chapter, including microfinance, insurance, leasing, remittances, guarantee funds, collateral and property rights and other aspects of knowledge management undertaken by the Social Finance Programme, such as on the effectiveness and distributional consequences of financial sector reform in Africa.

<sup>6</sup> M. Ayyagari et al.: *How important are financing constraints? – The role of finance in the business environment*, World Bank Policy Research Working Paper 3820, Jan. 2006.

<sup>7</sup> F. Mishkin: *Prudential regulation and supervision – What works and what doesn’t* (Chicago, University of Chicago Press, 2001); C. Gonzalez-Vega and D.H. Graham: *State-owned agricultural development banks – Lessons and opportunities for microfinance*, Occasional Paper 2245, Ohio State University, Department of Agricultural Economics, Columbus, Ohio, June 1995; and J. Ledgerwood: *Microfinance handbook* (Washington, DC, World Bank, 1999).

successful and high-profile initiatives in many countries has been the enormous growth in microfinance (see box 8.1 and Chapter 2). Generally, less progress has been made in opening financial markets to address the needs of SMEs:<sup>8</sup> in some countries this is referred to as the “missing middle”.<sup>9</sup>

**Box 8.1**  
**The Nobel Prize – Microfinance for peace**

Geneva (ILO News) – The Director-General of the International Labour Office (ILO), Juan Somavia, issued the following statement on the awarding of the Nobel Peace Prize for 2006 to Muhammad Yunus and the Grameen Bank:

Professor Muhammad Yunus has spent a lifetime giving credit where it is due – to millions of women and men striving for opportunity and decent work.

He and the Grameen Bank have long recognized the entrepreneurship of the working poor, and that access to credit is a basic right. They have shown that, with a small amount of capital, the poor can truly work their way out of poverty.

The millions of people, who, as shareholders in the Grameen Bank, have become economic citizens, show the power of people to better their lives through organization.

The recognition of the pioneering work of Professor Yunus is also a call to scale up the microfinance movement globally so that women and men everywhere have the chance to use their talents and overcome poverty through work, dignity, organization, and voice.

Source: <http://www.ilo.org>, 13 Oct. 2006 (ILO/06/45).

222. There are a number of major dimensions important to the functioning of financial markets for the creation and growth of sustainable enterprises. These include: sound and stable macroeconomic policies; competitive financial markets; the broadening and deepening of financial markets including through the provision of customized products for SMEs; improving information flows and transparency; and improving and securing the rights of borrowers, lenders and investors. The following paragraphs elaborate on these dimensions.

223. A fundamental condition for the efficient functioning of financial markets (and for effective financial sector reform) is macroeconomic stability, particularly low rates of inflation, sustainable levels of debt and realistic exchange rates. High inflation erodes and discourages savings, high fiscal deficits increase interest rates, and high levels of government debt have the potential to crowd out credit to the private sector. Monetary policies, in particular interest rate regimes, can do a lot to induce financial sector deepening by underpinning deposit rates that are positive in real terms even for small deposits, and credit interest rates that reflect the real cost of intermediation.

224. Another powerful policy tool that brings about deepening is to open access to the financial market to more competition, thus driving borrowing costs down and inducing households and firms to save and use credit. Greater competition in the banking sector, including from non-bank financial intermediaries such as leasing companies, is also likely to be a fundamental driver of financial sector reform and of increasing access to financing. Ultimately, increasing competition is likely to encourage both the broadening and the deepening of the financial sector, but overall this needs to be balanced with sound regulatory and supervisory institutions and processes.

<sup>8</sup> T. Beck and A. Demircuc-Kunt: “Small and medium-sized enterprises: Access to finance as a growth constraint”, in *Journal of Banking and Finance*, Vol. 30, issue 11, Nov. 2006, and other articles in this volume.

<sup>9</sup> The “missing middle” refers both to those enterprises missing out on access to credit by virtue of their size and, more generally, to the fact that some economies are characterized by large, often informal, economies of micro-enterprises and a small group of large enterprises. The comparatively small number of enterprises in the middle (SMEs) is thus referred to as the “missing middle”.

225. Broadening refers to increasing access among a wider group of potential clients to providers of FS. Broadening the financial sector is often constrained by relatively high minimum capital requirements for getting a bank licence. Lowering the norm makes it easier for operators to set up smaller financial service providers with more modest assets which, in principle, should encourage a more diversified range of financial service providers and broader outreach. An example is the attempt to bring down the minimum liability for remittance-handling transfer agents in France, accompanying this with stricter supervision and monitoring by the financial service authority. In the microfinance field, regulation is an issue only for deposit-taking intermediaries and here the debate is about the degree to which such regulations should differentiate from bank supervision rules. Support for the savings and credit cooperative movement also helps broaden the financial sector, without requiring specific rules and regulations as this sub-sector usually has a distinct, tried and tested legal framework centred on self-regulation. Governments can intervene more directly to foster outreach of FS, but care has to be taken to ensure that such policies support rather than supplant the market. A good example might be the last-resort liability of public authorities (municipalities and *Länder*) to public savings banks in Germany, which is, in part, a deliberate move to ensure their presence in remote and otherwise under-served regions.

226. The depth of a financial sector is typically measured by the ratio of national income to some monetary measure (such as M2, i.e. currency in circulation, demand deposits, savings and time deposits) and this signals to what extent households and firms use the financial sector for their savings, investment and borrowing transactions. Competition usually encourages financial deepening (so there is an obvious interrelation with broadening the financial sector). Whilst regulation can, for example, sanction informal transactions, thus lifting informal finance into visibility, the main thrust for policy to deepen the financial sector is by way of a responsive and diversified range of financial products or instruments which lower information asymmetries in the market, speed up transactions and thus lower transaction costs and reduce uncertainty and risk, especially for hitherto disadvantaged or neglected groups. Examples, with respect to credit, might include using more simplified loan application procedures for standardized products, automatically escalating loan ceiling eligibilities subject to borrower repayment performance, introducing longer maturities for certain types of loans, basing lending decisions on business cash flow projections rather than collateral, establishing guarantee funds,<sup>10</sup> and so forth.

227. Given that information asymmetries are a major obstacle to more inclusive financial systems, one way in which access to credit can be increased is through better collection and dissemination of information. Businesses have greater access to credit in countries where credit registries or information bureaux collect and make available both positive and negative information on loan payment histories. This allows lenders to assess risk profiles better and improves borrowers' incentives to repay loans promptly because late payments with one lender can result in sanctions by many institutions. Governments can support credit registries/bureaux by enacting and enforcing data protection and credit reporting laws (obviously, there is a moral hazard problem if not all lenders share information) and establishing safeguards and appropriate standards concerning the type and quality of information gathered and the rules concerning its use and dissemination. In some cases – perhaps where lending markets are highly concentrated or where financial markets are very underdeveloped – public registries,

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<sup>10</sup> L. Deelen and K. Molenaar: *Guarantee funds for small enterprises – A manual for guarantee fund managers* (Geneva, ILO, 2004).

typically under central bank regulation, can help to increase the flow of credit to SMEs.<sup>11</sup>

228. There are many specific measures which can be taken to make it easier for SMEs to access financing, including the development of specialist financing instruments or products, typically offered through the establishment of dedicated small business lending windows in existing financial institutions or through specialist intermediaries focused on the needs of SMEs. Examples include venture capital funds for SMEs, which might be particularly useful in more dynamic innovation-driven product and service markets where access to finance can make the difference between an idea that is fully implemented and exploited commercially and an idea which remains precisely that. Another relatively undeveloped instrument for financing SME growth is the use of remittance income. Given the increase in labour mobility across borders and an increase in worker remittances, there is great potential in harnessing such flows by making it easier and cheaper for workers to remit money through formal channels by, for example, making it easier to open foreign currency accounts or relaxing certain restrictions on the exchange of foreign currencies.<sup>12</sup> Finally, leasing instruments can also make it easier for SMEs to access financing, largely by sidestepping the need for collateral (ownership of a lease resides with the lessor) and establishing the viability of the lease in terms of projected cash flows.<sup>13</sup> However, as with all financial instruments, the efficacy of leasing rests substantially on having in place a suitable legal and regulatory framework on, for example, the use of insurance and other guarantees in leasing contracts.

229. Improving and securing the rights of borrowers, lenders and shareholders is important. Perhaps the first and most fundamental criteria for securing these rights is for governments to establish and maintain an effective and efficient legal environment, including property rights protection (for using assets as collateral) and creditor rights (providing secured creditors with clear legal rights in bankruptcy procedures, for example). In countries with weak property rights, the use of assets as collateral becomes rather difficult (even when people can actually furnish assets as security for loans; if they cannot provide proof of title, then this asset will not have value as collateral).<sup>14</sup> Furthermore, even in the case where property rights are well defined, the enforcement of contracts might be extremely difficult for judicial as well as political reasons (slow and inefficient legal systems hamper enforcement in many countries and the spectre of political interference often looms when lenders try to foreclose on assets). In addition, if bankruptcy laws are weak, this will further increase the risk to creditors and deter them from investing in SMEs.

230. Making financial markets work better (for equity investments as well as loans) is also about making improvements in corporate governance through greater transparency, the preparation of financial reports according to international accounting standards and transparency in social and environmental reporting. “Stricter regulation (in the form of

<sup>11</sup> S. Djankov et al.: *Private credit in 129 countries*, NBER Working Paper 11078, Cambridge, Massachusetts, National Bureau of Economic Research, 2005.

<sup>12</sup> C. Sander: *Migrant remittances and the investment climate – Exploring the nexus*, Bannock Consulting Ltd, a case study commissioned by the Department for International Development, United Kingdom, Jan. 2004; and <http://www.sendmoneyhome.org>.

<sup>13</sup> L. Deelen et al.: *Leasing for small and microenterprises – A guide for designing and managing leasing schemes in developing countries* (Geneva, ILO, 2003).

<sup>14</sup> Microfinance lending often addresses this collateral problem by using solidarity or peer-based lending methodologies but this is less feasible for most types of SME lending. However, SMEs could benefit from collateral rules that allow them to pledge a changing pool of assets such as inventory or receivables or even future assets (such as crops), intangibles (such as patent rights) or credit histories.



high disclosure requirements set by the stock exchange or government) and strong enforcement are associated with greater market liquidity, lower costs of capital and higher valuations of firms”.<sup>15</sup> Although it is important to make it easier for financial institutions to provide FS to businesses, it is also important to ensure that regulations provide safeguards controlling risk taking. Individual lenders with portfolios in areas vulnerable to natural disasters or other shocks or with relatively homogenous client markets are vulnerable to covariant risk. Financial systems can be very vulnerable to excessive risk-taking. If an individual bank fails, due to a major default or run on its assets, this can provoke a systemic crisis by putting pressure on the payments and credit system more generally. To mitigate these risks, a number of measures can be taken, including deposit insurance, the enforcement of prudential regulation limits on the financial risks that banks can take and the creation and effective implementation of supervisory bodies or ratings agencies.

**Box 8.2**  
**What is social finance?**

“Decent employment and incomes depend critically on the financial market, its competitiveness, accessibility, equity, fairness and efficiency. Strategies that open up access to finance on fair terms have an obvious social significance. Microfinance is the provision of FS to the poor on a sustainable basis. FS that the working poor need and demand include different types of credit, savings, guarantees, insurance, transfer payments, remittances and other transactions. Microfinance is addressed to the poor and those excluded from market transactions. It seeks to broaden and deepen the market by emphasizing that ultimately microfinance institutions have to be sustainable, i.e. self-financing ...

The rationale for ILO interest in and commitment to microfinance is decent work, i.e. the net social outcome in terms of employment, incomes and social dialogue. Microfinance that is oriented towards decent work is ‘social’ finance. This emphasizes the finality and unique angle of the ILO’s interest and involvement. Social finance is the ILO’s accepted and recognized brand in this field, signalling its distinctive position and identity, and communicating to donors and the outside world in general the ultimate purpose of the ILO’s conceptual and policy work on microfinance.”

Source: ILO: *ILO policy statement – Microfinance for decent work*, Committee on Employment and Social Policy, Governing Body, 294th Session, Nov. 2005, GB.294/ESP/3.

## Socially responsible investment (SRI)

231. In addition to making financial markets more inclusive as a basis for laying the foundations for an environment conducive to the growth of enterprises, and most particularly SMEs, there is also the matter of harnessing financial infrastructure and services to support SRI. This is a complex subject which, in addition to SRI per se, can be understood to embrace broader issues of sustainable finance, such as the use of credit to encourage “eco-efficiency” or “green” investments or the use of consumer credit to provide, in parallel with financing purchases, benefits to charities or other causes (through sponsored credit cards, for example). It can also extend to ethical or socially responsible codes in other types of financial transactions, such as through codes of conduct in underwriting, insurance and the provision of money transmission services. Sustainable finance can even cover tax administration and tax policy and macro policies,

<sup>15</sup> World Bank: *World Development Report 2005 – A better investment climate for everyone* (Washington, DC, World Bank, 2004), Chapter 6, p. 122.

such as the equitable management of developing country debt. However, the focus here is on socially responsible investment as a tool for promoting sustainable enterprises.

232. Definitions of socially responsible investment vary but by most measures it is a rapidly growing sector in many developed country markets.<sup>16</sup> According to the European Social Investment Forum (Eurosif), SRI “is investing that is mindful of the impact those investments have on society. SRI traditionally combines investors’ financial objectives with their concerns about social, environmental, ethical and governance issues. SRI is an evolving movement, whose most recent development is based on a growing awareness by the population, investors, companies and governments of the impact of social, environmental and ethical risks on long-term issues ranging from sustainable development to long-term corporate performance”.<sup>17</sup> Until relatively recently, most major financial intermediaries did not consider environmental and social concerns to be particularly relevant to their operations.<sup>18</sup> However, attitudes and approaches are beginning to change and, at least among some leading financial institutions, there is a heightened awareness that they bear responsibility for the social and environmental impacts of the operations they finance. A number of leading banks now consider that addressing social and environmental issues is critical to the proper management of transaction, portfolio and reputational risks. The question is no longer whether commercial banks should address the sustainable development aspects of the activities they support but how they should do it, what standards they should apply, how they should implement them and how they should assure compliance. However, perhaps not surprisingly given such high ideals, commercial pressures and the scope and complexity of non-financial due diligence, there is generally a divergence between promises and performance in the field of socially responsible investment.<sup>19</sup>

233. Given the definitional complexity, SRI in practice will also mean different things to different people. Broadly, SRI can serve to endorse or otherwise an enterprise’s activities or as a means of encouraging enterprises to change their behaviour. In both senses SRI is, of course, a subset of broader social and environmental issues and responsibilities which enterprises typically face.<sup>20</sup> For the purposes of identifying how SRI can be harnessed to support sustainable enterprises, the focus is on SRI as a tool for investors to put social and environmental accountability into practice. In this sense, investors have three main but interlinked approaches. Firstly, there is community investment, such as investment that supports development in disadvantaged communities or sponsors non-workplace related activities like local sports teams or community groups. Secondly, there are positive or negative screening investments, such as investments which “screen in” businesses which demonstrate good workplace practices or protect the

<sup>16</sup> For example, by Nov. 2006 and just six months after its launch, the United Nations Principles for Responsible Investment had attracted signatories representing US\$5 trillion in assets under management.

<sup>17</sup> <http://www.eurosif.org>, FAQ. The European Social Investment Forum (Eurosif) is a pan-European group whose mission is to address sustainability through financial markets. Current member affiliates of Eurosif include pension funds, financial service providers, academic institutes, research associations and NGOs. The association is a not-for-profit entity that represents assets totalling over €600 billion through its affiliate membership.

<sup>18</sup> Most recently, investors have been particularly attracted to “clean technology”, especially “clean energy”, and private equity firms and venture capitalists, among others, have invested heavily in response to high oil prices, fears over energy security and a growing concern about global warming.

<sup>19</sup> BankTrack/WWF: *Shaping the future of sustainable finance – Moving from paper promises to performance* (Surrey, WWF-UK, 2006); and BankTrack: *Equator principles II – NGO comments on the proposed revision of the equator principles* (Utrecht, BankTrack, Apr. 2006). See <http://www.banktrack.org>.

<sup>20</sup> ILO: *Information note on corporate social responsibility and international labour standards*, Working Party on the Social Dimension of Globalization, Governing Body, 288th Session, Nov. 2003, GB.288/WP/SDG/3.

environment and investments which “screen out” investments in armaments or tobacco businesses or those which violate human rights (so-called “sin stocks”). Thirdly, there is active engagement. This is the most integrated or holistic approach which can take a variety of forms but typically begins with investors entering into a dialogue with companies with a view to understanding and changing their behaviour and improving their social or environmental performance. Most visibly, this type of active engagement involves investors making use of shareholder resolutions to engage with the company’s board,<sup>21</sup> but it can also be directed at other points along the investment fund decision-making chain, such as at the analysts who provide information to fund managers and others on the value and strategies of individual companies or at the fund managers themselves or the trustees or consultants who advise them.

234. Included under the rubric of direct engagement in the stewardship of investment funds is the subject of workers’ capital, which refers to the assets accumulated in collectively funded schemes in order to provide workers with financial security in their retirement.<sup>22</sup> In many countries, such as Denmark, the Netherlands, the United Kingdom and the United States, the largest shareholder bodies are employee pension schemes and, in principle, this presents an opportunity and challenge for employees to use their power as indirect shareholders to leverage influence in capital markets and to promote, for example, sustainable enterprises (by lobbying for the inclusion of good employment practices in investment analysis, for instance).<sup>23</sup> Such direct engagement can complement but does not replace the fundamental responsibility of governments to ensure the protection of rights and the upholding of the rule of law and the promotion of internationally accepted standards, such as the Declaration on Fundamental Principles and Rights at Work and the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy.<sup>24</sup>

235. One particular flagship initiative in the field of socially responsible investment is that of the Equator Principles.<sup>25</sup> The original Equator Principles were established in 2003 with ten signatories and revised and relaunched in July 2006. With over 40 signatory banks and other financial institutions, the Equator Principles now cover around 85 per cent of the world’s cross-border project finance. The Equator Principles are a voluntary framework for addressing social and environmental risks associated with all project financing with capital costs above US\$10 million (in most cases, this effectively means finance for infrastructure projects). The signatory institutions are required to follow the IFC’s performance standards, which were updated in April 2006 and require borrowers to comply with various social and environmental policies and practices.<sup>26</sup> These standards are process-based rather than compliance-based, meaning that their provisions relate to the measures clients must take in order to meet good practice. They cover eight broad areas: social and environmental assessment and management systems; pollution prevention and abatement; community safety and health; land acquisition and involuntary settlement; conservation of biodiversity and sustainable

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<sup>21</sup> *Accountability primer – Socially responsible investment*, at <http://www.accountability.org.uk>.

<sup>22</sup> <http://www.workerscapital.org>; <http://www.justpensions.org.uk>; and <http://www.share.ca>.

<sup>23</sup> Trades Union Congress: *Working capital – Institutional investment strategy* (London, TUC, 2003).

<sup>24</sup> A. Sturm and M. Badde: *Socially responsible investment by pension funds – A state of the knowledge report*, prepared for the ILO Social Finance Programme, by Ellipson Ltd, Basel, Switzerland, 2000.

<sup>25</sup> <http://www.equator-principles.com>.

<sup>26</sup> <http://www.ifc.org>.

natural resource management; indigenous peoples; cultural heritage; and labour and working conditions.

236. In terms of labour and working conditions, under the revised Equator Principles borrowers will be expected to follow standards on issues such as the application of terms and conditions, determination of wages, non-discrimination and equal opportunity, freedom of association and collective bargaining, retrenchment, grievance mechanisms, child labour, forced labour and safety and health, as well as the new requirements pertaining to the protection of subcontracted workers and those in supply chains. In practice, for the purposes of conforming with the Equator Principles, lenders and borrowers must have policies and procedures that: identify issues of potential labour risk; determine how serious these may be; set out appropriate measures to mitigate risk; enable the setting and assessment of key performance indicators; and enable periodic public reporting on labour issues.<sup>27</sup> There remain questions concerning the degree to which signatory banks implement the Equator Principles, the transparency with which decisions are made and reported on by the signatories and the degree to which this mechanism will actually help decide, investment-by-investment, where the bar on social and environmental performance should lie.<sup>28</sup> However, perhaps the biggest limitations or challenges rest in the fact that most signatory banks are OECD-based, meaning that major financial institutions in other parts of the world – such as banks in China or the Middle East – are not covered by the Equator Principles; even among the signatory banks, project finance is typically less than 10 per cent of most banks' lending activities. However, it may well be the case that the Equator Principles provide, directly or indirectly, read-over to other aspects of bank operations, such that the experience of applying the Equator Principles may provide useful lessons and guidance for other aspects of a bank's portfolio.

237. To conclude, it has been argued that inclusive financial markets are necessary for fostering sustainable enterprises because all enterprises require FS. It was suggested that SMEs are often under-served by financial intermediaries – especially in developing countries – and that addressing this “missing middle” should be a major objective of policies to strengthen the inclusivity of financial infrastructure and services for sustainable enterprises. As the example of social finance illustrates, FS can be used to promote productive and decent work outcomes, and one powerful tool for this is the use of investment instruments that specifically identify social and environmentally responsible outcomes. For many reasons, the challenges are great and the road full of pitfalls, but it is a path which is worth travelling down if the ideals of sustainable development are to be realized.<sup>29</sup>

## Physical infrastructure in support of sustainable enterprises

238. Infrastructure investment policies support enterprises in their effort to meet the challenge of job creation by ensuring their viability, their profitability and their sustainability. Because of the strong role which enterprises play in employment creation,

<sup>27</sup> Ergon: *Labour issues and the Equator principles*, Ergon Special Briefing, Ergon Associates Ltd, London, July 2006.

<sup>28</sup> M. Warner: “The new international benchmark standard for environmental and social performance of the private sector in developing countries – Will it raise or lower the bar?”, in ODI *Opinions*, London, Feb. 2006, <http://www.odi.org.uk/publications/opinions>.

<sup>29</sup> See United Nations *Principles for responsible investment*, <http://www.unpri.org/>.

infrastructure also has a major impact on opportunities for job creation. The GEA, including its core elements relating to trade and investment, to technological change, to active labour market policies and to productive employment for poverty reduction and development, sets out the importance of infrastructure for the ILO. The GEA states that economic growth and employment creation require modern, functioning, physical and social infrastructure. The investment in the setting up of such infrastructure itself has a direct and immediate employment impact. Policies of labour-based production and employment criteria in public procurement systems can all improve the employment dividend of such activities.<sup>30</sup> In its discussion of “Employment strategies for decent work country programmes: Concepts, approaches and tools for implementing the Global Employment Agenda”,<sup>31</sup> the ILO Governing Body endorsed the Office’s work in investment policies and a sound investment climate, including infrastructure, under the key policy area of economic policies for employment expansion.

239. Infrastructure development is back on the international agenda in a major way and therefore a discussion on how infrastructure investment plans can be designed, so as to facilitate sustainable enterprises and employment creation, is timely. The World Bank, the OECD, the UNDP and the Asian Development Bank have all issued recent reports highlighting the importance of infrastructure,<sup>32</sup> not only in the light of a “back to basics” focus on economic growth, but also in terms of its social impacts, particularly on poverty reduction. These reports argue that the reduced emphasis on infrastructure within the international development agenda over the past decade or so was misguided.

240. The report of the Commission for Africa, *Our common interest*, asserts that infrastructure is a key component of the investment climate, reducing the costs of doing business and enabling people to access markets, and that it is crucial to advances in agriculture, a key enabler of trade and integration, important for offsetting the impact of geographical dislocation and sovereign fragmentation, and critical for enabling Africa to break into world markets, as well as being fundamental to human development, including the delivery of health and education services to poor people. It argues that infrastructure investments constitute an enormous untapped potential for the creation of productive employment. It asserts that, despite its clear benefits, African governments and development partners over the 1990s sharply reduced the share of resources allocated to infrastructure, a move which reflected its lower priority in policy discussions. In retrospect, this was a serious policy mistake, driven by the international community, which undermined growth prospects and generated a substantial backlog of investment that will require strong action over an extended period to overcome, a mistake founded on the dogma of the 1980s and 1990s, asserting that infrastructure would be financed by the private sector, and underestimating the crucial role of public policy in this area. However, the Commission for Africa report argues that throughout the developing world,

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<sup>30</sup> ILO: *Review of the core elements of the Global Employment Agenda*, Committee on Employment and Social Policy, Governing Body, 286th Session, Mar. 2003, GB.286/ESP/1(Rev.). See also, ILO Convention No. 94 on labour clauses (public contracts).

<sup>31</sup> ILO: *Employment strategies for Decent Work Country Programmes – Concepts, approaches and tools for implementing the Global Employment Agenda*, vision document on operationalizing the employment component of DWCPs, Committee on Employment and Social Policy, Governing Body, 295th Session, Mar. 2006, GB.295/ESP/1/1.

<sup>32</sup> See, for example, *Infrastructure at the crossroads: Lessons from 20 years of World Bank experience*, World Bank, 2006; *Making infrastructure work for the poor*, UNDP, 2005; *Promoting pro-poor growth: Infrastructure*, OECD, 2006; *Connecting East Asia: A new framework for infrastructure*, Asian Development Bank, Japan Bank for International Cooperation and the World Bank, 2005.

and particularly in Africa, the private sector is unlikely to finance more than a quarter of the major infrastructure investment needs.<sup>33</sup>

241. The World Bank, in a recent review of its infrastructure lending over the past 20 years, also recognizes that the role of the public sector has been underestimated in recent times:

The events of the past decade have demonstrated that involving the private sector in infrastructure provision is not a universal cure. The Bank learned that the role of government institutions has remained a central one, as no other actors can compensate for government weaknesses in sector strategy, investment and expenditure prioritization, regulation, and risk management. The Bank also learned the importance of understanding the political economy of private participation, adapting regulatory approaches to country circumstances, and properly allocating risks between public and private sectors. The public sector will remain a key source of infrastructure investments in developing countries, and the Bank should be engaged along the entire spectrum of public–private solutions.<sup>34</sup>

242. Governments, then, have the responsibility to provide a sound investment climate for both domestic and foreign enterprises. Communications infrastructure provides better information on local business conditions and costs and therefore helps inform sound investment decisions. Transportation infrastructure ensures better access to markets and to investment opportunities. Infrastructure does not only help enterprises lower the cost of doing business, it provides new opportunities for creating and expanding enterprises in new and growing sectors, such as environmental protection and restoration, green technologies, modernizing and increasing productivity of agriculture and creating opportunities for rural non-farm employment.

243. Among the key issues relating to infrastructure and to improving its impact on sustainable enterprises and employment creation are the following:

- ❑ What kinds and scale of infrastructure development investments are most supportive of sustainable enterprises and employment creation?
- ❑ How can different sizes of enterprises best cooperate and interconnect in order to ensure overall sustainability, and what role can infrastructure play in this process?
- ❑ What new and emerging sectors are most propitious for sustainable enterprise development?
- ❑ What kinds of financing mechanisms can support sustainable enterprises to provide high-quality employment opportunities?
- ❑ What is the comparative advantage which the ILO and its constituents can bring to bear to increase the impact of infrastructure investments on sustainable enterprise development?

## Types and scale of infrastructure

244. A number of major initiatives, for example the Infrastructure Project Preparation Facility of the New Partnership for Africa's Development (NEPAD), which is hosted and managed by the African Development Bank supported by NEPAD, are pushing for greater regional and cross-border integration as a strategy for encouraging the autonomous development and expansion of regional markets. Such infrastructure-based

<sup>33</sup> Commission for Africa: *Our common interest*, report of the Commission for Africa, Mar. 2005.

<sup>34</sup> World Bank: *Infrastructure at the crossroads: Lessons from 20 years of World Bank experience* (Washington, DC, World Bank, 2006), pp. xv–xvi.

initiatives will help support development of internal markets and provide new opportunities for enterprises. A major challenge, however, is linking large infrastructure projects with LED.

245. There can be major lost opportunities – for example, high-tension power lines, pipelines or highways that stretch over thousands of kilometres across countries linking only large industries or cities where the technical design has permitted only a limited amount of subsidiary investments. If designed differently, such projects could have contributed not only to heavy industry but also to rural electrification and LED in vast areas. There are many examples of such large-scale infrastructure projects, both positive and negative, that demonstrate the potential, both realized or wasted, to use major infrastructure projects as a foundation for diversified and sustainable enterprise development.

246. Likewise, in planning major highways and cross-border transportation, it is important to realize the full economic potential of these investments by balancing the investments with the development of agricultural feeder roads which can help local agricultural production and rural employment processing industries. Furthermore, systematic linking of large-scale investments with LED can help provide the local markets necessary for the investments to be profitable. Public procurement processes can be put in place which support the creation of small-scale, labour-based contracting enterprises which can bid on public tenders for secondary infrastructure development linked to large-scale projects. These enterprises, which require support in both financial and technical management, can also be contracted for ongoing maintenance operations, thus improving their sustainability.

247. ILO constituents can have a particular added value by ensuring that large-scale infrastructure development projects facilitate rather than crowd out LED and employment opportunities. One area in which the ILO's tripartite partners have already agreed to work together is in promoting the systematic employment impact assessment of public and private investment programmes.<sup>35</sup> By working with private sector investors, government officials and development finance institutions responsible for infrastructure investment programmes, the ILO seeks to optimize their employment impacts and to support the sustainability of enterprises – both those working in the construction and building sectors and those whose productivity and profitability will be enhanced by the infrastructure.

## The size, scale and interconnectedness of enterprises

248. Infrastructure can help realize positive externalities for enterprise development and sustainability. Just as large and small-scale infrastructure projects should be interconnected and mutually reinforcing, it is important to examine different models, based on both competitiveness and interconnectedness, whereby different sizes of enterprises can address their own sustainability issues. “Fordist models” of mass production and consumption can be contrasted with models where large and small enterprises occupy different market niches and act in symbiosis, with one group ensuring the sustainability of the other rather than one seeking to occupy the market space of the other.

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<sup>35</sup> ILO: *Evaluations – Independent evaluation of the ILO's strategy for employment-intensive investment*, Programme, Financial and Administrative Committee, Governing Body, 297th Session, Nov. 2006, GB.297/PFA/2/2.

249. The ILO's experience in labour-based contracting enterprises has demonstrated how small enterprises specializing in certain categories of infrastructure, which also tend to have high labour requirements, can be the preferred executing agent, not only from the point of view of cost but also from that of technical standards and economic impact. Knowledge of local markets, mobilization cost and time and the ability to manage the local workforce are areas of comparative advantage for small-scale labour-based contractors as compared with larger ones. For example, in the case of hill irrigation schemes in Nepal, use of heavy equipment can destroy the fragile ecosystem and provoke landslides. In many slum upgrading schemes, large equipment is not an option since the narrow maze-like configuration of streets does not allow access. In both cases, small-scale labour-based contractors would be the preferred option.

250. Since labour contracting enterprises have at times been used by larger contractors in this sector to circumvent labour standards and to lower labour costs, it would be preferable to encourage the development of an indigenous, independent and well-organized small-scale contracting industry. Public procurement policies and practices will have to be redesigned to facilitate bidding and tendering by such enterprises, which typically will not pre-qualify for public contracts because they do not possess the required equipment park or could manage only a small portion of the total works normally included in public tenders.

251. In Madagascar, ILO-assisted labour-based investment programmes in basic infrastructure for local governments, including water and land development, road rehabilitation and school construction, provide the resources and the human capacities required to support the Government's new policies for decentralization. The projects were designed with three aims: to improve transport for sustainable agricultural enterprises in the Vakinankaratra region, to improve school enrolment and quality of education and, finally, to create jobs through the promotion of SMEs. The approach involves business and technology training of small labour-based contractors and engineering consulting firms, leadership and management training for enterprises, local governments and communities and, finally, introducing good governance, transparency and improved working conditions and standards into public procurement at the local level. An ILO-supported labour-based training and resource centre, developed through a public-private partnership and staffed with a core group of professional trainers, has played a central role in countrywide dissemination and implementation of an employment-intensive infrastructure investment approach. This centre trains national and local government technical departments, emerging enterprises, consulting engineers and technical staff, as well as community groups, resulting in improved performance of many national investment programmes and donor-funded projects. In this way, the centre has reinforced good governance through improved procurement systems and procedures and management capacities, and has supported the sustainability of the enterprises created.

## New and emerging sectors favourable to enterprise development

252. Strategies to strengthen the sustainability of enterprises will stand a greater chance for success if based on a careful analysis of trends in growing and emerging economic sectors. A few sectors bear mentioning, with particular respect to their employment-generating potential and to their links to creation and management of infrastructure. These include building and construction, rural industry and so-called "green" industries in environmental protection and restoration.



253. The building and construction industry is relatively labour intensive. In many developing countries, there is a growing need to fill the vacuum which exists between large-scale and often foreign and multinational construction enterprises and small-scale artisans who would at best be able to construct individual housing or minor infrastructure works. In fact, the lack of a small- and medium-scale indigenous contracting industry is responsible for one of the main bottlenecks in expanding the use of labour-based technologies in the construction industry. The ILO, often in association with World Bank infrastructure loans, has implemented small contractor-training programmes which provide small enterprises with learning worksites so that they can master labour-based technologies and learn good management, technical and business processes and better organize themselves, so they are able to bid successfully on public construction contracts. At the same time, an effort is made among government technical departments and municipalities to modify tendering procedures, in order to allow such small-scale enterprises to participate in construction projects.

254. The renewed emphasis within the ILO on questions of rural development <sup>36</sup> is illustrative of a belief that future development strategies should give greater attention not only to agriculture, but also to rural non-farm industries. New advances in ICTs can help rural agricultural-based and non-farm enterprises respond in a more timely fashion to changing market opportunities and to market niches resulting from their isolation, thereby turning disadvantage into advantage. Growing recognition of the need to safeguard biodiversity also points to new market opportunities for enterprise development in the kind of infrastructure which can safeguard biodiversity.

255. Of great importance are opportunities for “green” enterprise development, which also have strong and positive linkages to infrastructure. This kind of labour-intensive infrastructure often goes hand in hand with infrastructure projects for restoring or protecting the environment (including soil and water conservation and land restoration, reforestation, and erosion control). Here, as in the traditional building and construction industry, there is a need for enterprises to bridge the gap between small-scale community groups involved in environmental restoration in their own communities and on their agricultural lands, and the larger enterprises which may not have a comparative advantage in terms of local knowledge and labour-based and management-based technologies.

## Infrastructure financing mechanisms that support sustainable enterprises

256. Infrastructure financing mechanisms can have a major influence on the ability of enterprises to create sustainable employment opportunities. As has been learned from experience over the past decade, the private sector cannot be expected to bear the main burden in financing of infrastructure. Therefore, the allocation and design of public investment budgets will play a major and ever increasing role in providing the kind of infrastructure that is necessary for ensuring the sustainability, profitability and productivity of enterprises. The ILO’s constituents have called upon the Office to develop “methodologies and approaches, such as impact assessments for integrated environmental and employment outcomes of investment plans and programmes”. <sup>37</sup>

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<sup>36</sup> The promotion of rural employment for poverty reduction (general discussion based on an integrated approach) is on the agenda of the 2008 session of the International Labour Conference.

<sup>37</sup> ILO: *Promoting sustainable development for sustainable livelihoods*, Committee on Employment and Social Policy, Governing Body, 294th Session, Geneva, Nov. 2005, GB.294/ESP/2, para. 34(a) (an account of how the ILO’s Decent Work Agenda supports the promotion of sustainable development).

Therefore, strategic development in the area of infrastructure and enterprise development should, as a first step, address the design and allocation of public investment resources. From this starting point, the public sector can help the private sector, including in the area of FDI, to assess the impact of investment plans on the sustainability of enterprises. In fact, employment impact assessments can be one area in which to anchor and assess public–private partnerships.

257. A number of modalities of financing infrastructure development can be analysed through their impact on the creation of decent work and the strong role which enterprises play in delivering high-quality jobs. These include various types of public–private partnerships, concessions, area-based development funds and municipal bonds, as well as the reality in many countries of foreign aid and debt relief mechanisms. All of these mechanisms can be open to tripartite participation to ensure that funding mechanisms result in sustainable enterprises and in sustainable quality jobs.

## Leveraging infrastructure investments to promote sustainable enterprises and development: The ILO's comparative advantage

258. On the basis of an evaluation of the ILO's employment-intensive investment work, the ILO constituents endorsed three major substantive areas of focus which are relevant to linking infrastructure services with sustainable enterprises and quality job creation.<sup>38</sup> This mandate points to possible ways in which the ILO's constituents could contribute to a greater impact of infrastructure investments and services in support of sustainable enterprises, employment and decent work. The three substantive areas are:

- promoting the systematic employment impact assessment of public and private investment programmes and policies;
- strengthening the Office's integrated policy advice and tools in the fields of employment creation and social protection through support to high-quality and cost-effective public and community investment programmes as a social transfer mechanism; and
- strengthening the private sector's role in employment creation, through both small-scale domestic enterprise development and improved contracting and procurement policies and practices, and by integrating employment creation into the economic and financial strategies of enterprises offering and receiving FDI.

<sup>38</sup> ILO: *Independent evaluation of the ILO's strategy for employment creation through employment-intensive investment*, ILO Evaluation Report, Sep. 2006; and ILO: *Evaluations – Independent evaluation of the ILO's strategy for employment-intensive investment*, Programme, Financial and Administrative Committee, Governing Body, 297th Session, Nov. 2006, GB.297/PFA/2/2.

## Chapter 9

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### Human resources: Investing in people

259. Sustainable enterprises recognize people as a source of competitive advantage and treat their employees both as assets and as agents for change.<sup>1</sup> Therefore, sustainable enterprises need to win their employees' support not only for determining the success of their operations in the commercial sense but also in terms of the enterprise's engagement with social and environmental issues in pursuit of the three pillars of sustainability. This will come from promoting enterprise values aligned with the economic, social and environmental dimensions of sustainability and from investing in the quality of working life through appropriate workplace organization, workplace practices, conditions of employment and human resource development and management.

260. In turning economic, social and environmental challenges into opportunities, enterprises need to tap into the creativity and innovation of employees at all levels, from the plant floor or service centre to the boardroom, by investing in the quality of working life. This chapter draws on some of the elements alluded to in earlier sections of the report (notably Chapter 4 on competitiveness) and overlaps to some extent with issues elaborated upon in the next chapter, namely, the role of the social partners, social dialogue and tripartism. It also presupposes the type of basic conditions outlined in Chapter 3, especially as they relate to the need for societies characterized by broad-based levels of, and access to, basic health and education as articulated in, for example, the MDGs and the Education for All movement.<sup>2</sup>

261. This chapter brings together a number of key issues pertaining to human resources – investing in people – in order to map out what this implies with respect to the promotion of sustainable enterprises. Although various approaches to good workplace practice, issues related to conditions of work and aspects of skills and employability are covered, there is no attempt to unpack or analyse the pros and cons of the vast array of methods and types of programmes and activities which fall under the rubric of investing in people.<sup>3</sup> Rather, and in the context of promoting sustainable enterprises, the objective is to illustrate the interrelationship between enterprise-level investment in the quality of

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<sup>1</sup> T.A. Kochan and P. Osterman: *The mutual gains enterprise – Forging a winning partnership among labour, management and government* (Boston, Harvard Business School Press, 1994); and J. Pfeffer: *The human equation – Building profits by putting people first* (Boston, Harvard Business School Press, 1998).

<sup>2</sup> UNDP: *Human Development Report 2003* (New York, UNDP/Oxford University Press, 2003); and World Bank: *World Development Report 2006* (Washington, DC, World Bank/Oxford University Press, 2005); and UNESCO at [http://portal.unesco.org/education/en/ev.php-URL\\_ID=50558&URL\\_DO=DO\\_TOPIC&URL\\_SECTION=201.html](http://portal.unesco.org/education/en/ev.php-URL_ID=50558&URL_DO=DO_TOPIC&URL_SECTION=201.html).

<sup>3</sup> For details on specific education, training and skills programmes, see ILO: Human Resources Development Recommendation, 2004 (No. 195). Education, training and lifelong learning, database web site <http://www.ilo.org/public/english/employment/skills/hrdr/index.htm>; and the ILO SKILLS programme at <http://www.ilo.org/public/english/employment/skills/index.htm>. For further information on conditions of work and employment, see the ILO TRAVAIL programme at <http://www.ilo.org/travail>.

working life and outcomes both in terms of enterprise performance and in terms of decent work.

## The growing importance of investing in people

262. In a rapidly globalizing world, enterprises face a dynamic business environment that requires them to be adaptive and competitive in order to survive and grow in the “24-hour economy”. In the light of new and evolving structures of production and work, enterprise success is likely to rest increasingly on human and social resources. The competitiveness and viability – even survival – of enterprises increasingly depends on the ability to ensure that employees are motivated, skilled and committed. This is best achieved in a progressive workplace environment characterized by a spirit of mutual trust and respect, non-discrimination and good labour–management relations.<sup>4</sup>

263. Indeed, at no time in history has the quality of the workforce assumed such widespread importance as at the present conjuncture. Globalization has brought about an intensification of international competition centred on the use of modern forms of technology which are primarily knowledge based, i.e. intensive in the use of conceptual skills. The forces of global integration and technical change have rendered education and training of paramount importance in terms of enterprise (and national) competitiveness.<sup>5</sup> Governments have a vital and essential role to play in ensuring that education systems equip young people with the basic skills which are necessary to ensure that training can actually enhance people’s employability. The importance of this is recognized in numerous policy documents, including the ILO’s GEA (box 9.1), the Lisbon Agenda of the EU<sup>6</sup> which seeks to forge European competitiveness around balanced policies targeting technological innovation and enhanced labour productivity, and the restated OECD Jobs Strategy.

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<sup>4</sup> T. Fashoyin, E. Sims and A. Tolentino: *Labour–management cooperation in SMEs – Forms and factors* (Geneva, ILO, 2006).

<sup>5</sup> ILO: *Learning and training for work in the knowledge society*, Report IV(I), International Labour Conference, 91st Session, Geneva, 2003.

<sup>6</sup> See, for example: *Jobs, jobs, jobs – Creating more employment in Europe*, report of the EU Employment Taskforce chaired by Wim Kok, Nov. 2003, p. 49; [http://ec.europa.eu/employment\\_social/employment\\_strategy/task\\_en.htm](http://ec.europa.eu/employment_social/employment_strategy/task_en.htm); and *Facing the challenge – The Lisbon strategy for growth and employment*, report from the High-level Group chaired by Wim Kok, Nov. 2004 (Kok report), p. 16, [http://ec.europa.eu/growthandjobs/pdf/kok\\_report\\_en.pdf](http://ec.europa.eu/growthandjobs/pdf/kok_report_en.pdf).

**Box 9.1****The ILO's GEA: policy challenges in skills development**

**Investment in education and training.** There is a critical need for a greater overall investment in education and training, particularly in developing countries, for all people (including women and groups with special needs, such as people with disabilities). Education and training investments should be closely linked to economic and employment growth strategies and programmes. Responsibility should be shared between the government (primary responsibility), enterprises, the social partners, and the individual.

**Basic education, literacy and core skills.** Literacy and basic education cannot be "leapfrogged". Urgent reforms are needed to improve basic education and the literacy of people in the poorest countries. The development of "core work skills" (such as communication, problem solving, etc.) is an important part of the reform to prepare individuals for the knowledge and skills-based society.

**Reforming vocational education and training (VET) systems.** To make lifelong learning for all a reality, countries will need to make major reforms of their vocational and education and training systems. School-to-work schemes for young people should integrate education with workplace learning. Training systems need to become more flexible and responsive to rapidly changing skill requirements. Reforms should also focus on how learning can be facilitated, not just on training for specific occupational categories.

**Recognizing an individual's skills.** Many people have acquired skills from a wide range of non-traditional sources, but these go largely unrecognized. It is critical that people should be able to have their skills recognized as part of a national qualifications framework, irrespective of where the skills were obtained.

**Promoting social dialogue on training.** There is an urgent need to involve the social partners more closely in discussions on training policy and skills development, if the desired reforms and increased investment are to become a reality. It is clear that governments can no longer be the sole voices on education and training. The more successful training systems are underpinned by a strong social dialogue process.

**Advocating labour market programmes for disadvantaged people.** Promote active labour market programmes, including effective approaches to skills acquisition and development, in formal and informal settings, for people who are disadvantaged in the labour market – including people with disabilities.

**Reforming employment services and promoting cooperative efforts between public and private employment agencies.** Public employment services are usually the dominant government institution responsible for providing a variety of active labour market programmes, but their capacity often needs strengthening. In addition, recent international trends in the growth of private employment agencies and the outsourcing of public services provide new ways for public and private agencies to work together.

Source: ILO GEA, <http://www.ilo.org/public/english/employment/skills/policy.htm>.

264. The policy lessons from the reassessment of the OECD Jobs Strategy stress the contribution that lifelong learning can make to support high economic growth whilst also helping to reduce poverty and mitigate inequality. The restated Jobs Strategy asserts the employment benefits of workplace training not just in terms of trained workers having better job prospects than those who have not received training but also because training makes it easier to move from temporary work arrangements into more stable employment. Under pillar 4, it notes that:

... the OECD has found that well-designed systems of recognition of skills, career guidance, information on the content and outcomes of the courses on offer and performance monitoring of training providers may help ensure that the training market works well. In addition, public support has been found to be more efficient when it is matched with a contribution from the recipient firm or individual ... Where this is consistent with national

practice, the active involvement of social partners in designing and implementing lifelong learning policies can help make the programmes successful.<sup>7</sup>

265. The policies outlined in these three overarching frameworks – of the ILO, the EU and the OECD – go beyond the simple logic that more and better skills will make enterprises and nations become more competitive, more productive and more prosperous. They do not assume a simple linear and automatic connection between skill formation and economic performance. Rather, skills and human resources development – investing in people – is placed in the broader socio-economic and political context. This context both influences the strength of the link and helps to determine the most important variables in the link. Thus, implicit in this treatment is the idea that Say's Law<sup>8</sup> does not apply to education and skills, that is, the supply of educated and skilled people does not automatically create the demand needed to employ it.<sup>9</sup> Context – levels of development, forms of workplace organization, and so forth – is vitally important.

266. Investing in people is, therefore, about improving education but also about promoting decent and productive workplaces by addressing the human dimension of productivity and competitiveness. Furthermore, it is focused on the enterprise level and issues to do with human resources and skills development and the integrated involvement of workers in enterprises. Thus, national laws and practices, guided where appropriate by international labour standards, are the instruments for shaping policy and practice. They usually cover, for example, remuneration (including regular payment of wages, the fixing of minimum wage levels, the settlement of unpaid wages in case of enterprise insolvency, overtime and leave) and work-time arrangements, including as they relate to flexible work patterns and the need for workers to reconcile work and personal/family life (parental leave, work sharing, job sharing, compressed work weeks, flexitime, shift work, leave periods, etc.). Flexibility on work-time arrangements can have benefits for both employees and employers, such as enhanced employee commitment, reduced absenteeism and ultimately higher productivity and enterprise performance.<sup>10</sup>

267. Sustainable enterprises will enable women to combine successfully their reproductive and productive roles and will actively prevent unequal treatment in employment due to their reproductive role, among other things by providing appropriate maternity protection for women workers and paternity provision for men. Family structures and patterns are evolving in many places around the world. In economic terms, as women continue to participate in ever greater numbers in the paid labour market, families are becoming increasingly reliant on more than one wage earner, and traditional solutions to reconciling work and family life are under great strain. At the same time, enterprises in many societies have become dependent on the greater availability of women. One result is that increased local and global competition among enterprises has meant increased demands on the workforce, particularly in the form of more flexible work patterns.

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<sup>7</sup> OECD: *Boosting jobs and incomes – Policy lessons from the reassessment of the OECD jobs strategy*, background paper prepared by the OECD secretariat for the Saint Petersburg G8 Summit meeting of G8 employment and labour ministers, Moscow, 9–10 Oct. 2006, pp. 10–11.

<sup>8</sup> Jean-Baptiste Say (1767–1832), a French classical economist, argued that supply creates its own demand.

<sup>9</sup> D. Ashton and F. Green: *Education, training and the global economy* (Cheltenham, Edward Elgar, 1996).

<sup>10</sup> S. Dex and C. Smith: *The nature and pattern of family friendly employment policies in Britain* (Bristol, Polity Press/Joseph Rowntree Foundation, 2002); P. Yasbeck: *The business case for firm-level work-life balance policies – A review of literature*, Labour Market Policy Group, Department of Labour, New Zealand, Jan. 2004.

268. Sustainable enterprises will promote equity and non-discrimination at the workplace. Managing a diverse workforce, for example, is increasingly recognized as a key factor in improving efficiency, productivity and overall business success. Globalization has accelerated and reinforced the need to embrace diversity. Similarly, there is increasing evidence to indicate not only the benefits of a diverse workforce but also the increased economic drag of discrimination at the workplace, both for enterprises themselves and for economies and societies more generally.<sup>11</sup>

## The importance of good workplace practices

269. There is an essential relationship between conditions of work and productivity. Studies repeatedly highlight that enterprise success, in increasingly competitive environments, can no longer be measured purely in terms of figures. Instead, sustainable enterprises will be those which also pursue factors such as customer satisfaction, optimizing working relationships within the enterprise, innovation and flexible organizational structures. The quality of work has a significant effect on productivity and profitability. The concept of good workplace practices is broad and embraces several features. However, among the key work environment and organizational factors that can contribute to the creation of an effective and productive workplace are:

- ❑ decent standards of living and economic security;
- ❑ leadership which values employees;
- ❑ safe and healthy working environment;
- ❑ mutual trust among employers and employees;
- ❑ participation in decision-making;
- ❑ culture of openness regarding decision-making;
- ❑ encouragement of initiative and creativity;
- ❑ supportive supervision at all levels;
- ❑ opportunities to use and develop skills;
- ❑ work–life balance.

The actual implementation of these features will often be quite context specific, depending on how particular societies define or put into practice, in a broader sense, concepts like a culture of openness, trust, initiative and creativity (see box 9.2 for an example from the United Kingdom).

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<sup>11</sup> *Success at work – Protecting vulnerable workers, supporting good employers*, United Kingdom Department of Trade and Industry, London, Mar. 2006.

**Box 9.2**  
**Introducing change through trust and cooperation**  
**in the United Kingdom**

Thorn Lighting, based in the United Kingdom, is one of the world's leading suppliers and manufacturers of lighting systems and products, with operations in around 30 countries and over 4,000 employees. Since 1989 Thorn Lighting has undergone major organizational and cultural changes enabling its market share to approximately double. Much of this success has been attributed to more effective performance management and teamwork, based around the need to introduce new technologies and working practices in order to improve its productivity and market position.

The UK-based employees all had to acquire new skills and adjust to new relationships as they moved toward more flexible working practices and self-managed teams. The building of trust was, from the outset, seen as a crucial basis for the free flow of information within the organization. To this end the company set out to transform its relationship with the trade union. To start this process, senior management opened the books to the unions and introduced a "Partners in Change" programme. This involved holding regular meetings and union workshops. In addition, the union and senior management met annually for a business review and planning workshop. The company provided the trade unions with details of performance, market conditions and the forthcoming strategy for the year, which provided the basis for the development of a joint action plan to enable the trade unions to play a positive role in business.

Source: D. Ashton and J. Sung: *Supporting workplace learning for high performance working* (Geneva, ILO, 2002).

270. A study of EU Member States identified the following workplace factors for enterprise success:

- ❑ combining business targets with human resource activities so as to achieve better results;
- ❑ a holistic approach to health promotion that not only looks at immediate working conditions but also includes job motivation and corporate culture;
- ❑ health promotion programmes that are aimed at avoiding health risks;
- ❑ improving working practices and the organization of work in connection with technical innovation.<sup>12</sup>

On the basis of case studies in various member States and different sectors, the same study found the following factors for improving productivity:

- ❑ High quality of work, including good conditions for reconciling work and family life is very important.
- ❑ Cooperative behaviour by management contributes to higher productivity.
- ❑ Forms of work organization that give employees more autonomy and responsibility in their work have a positive effect.
- ❑ Improving working methods and workplace equipment helps to reduce the burden of physically demanding work and facilitates higher productivity, making such investment worthwhile.
- ❑ Certain types of heavy duties need creative solutions for the avoidance of occupational accidents.
- ❑ Cutting absence due to sickness has a direct, positive effect on productivity.

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<sup>12</sup> European Agency for Safety and Health at Work: *Quality of the working environment and productivity*, Working Paper (2004), [http://osha.eu/publications/reports/211/quality\\_productivity\\_en.pdf](http://osha.eu/publications/reports/211/quality_productivity_en.pdf).



271. The significance of supporting employees so that they can be effective in their jobs and in their working environments, in ways that promote, rather than compromise their health and well-being, is widely realized, and not just in industrialized countries. For example, studies carried out in manufacturing firms in Sri Lanka have shown that developing human resources and creating a committed workforce can yield greater benefits for productivity improvement than developing the “technical system”.<sup>13</sup> The creation of such commitment among employers can be achieved through a variety of employee involvement strategies such as team briefings, job enrichment programmes, self-directed work teams and joint consultative committees. Many enterprises can point to the benefits of employee involvement programmes – often combined with other aspects of a positive work environment – which have not only resulted in an improved quality of work life but have also contributed to improved efficiency and productivity within the organization (see box 9.3 for an example from Mozambique).

**Box 9.3**  
**Successful industrial development and a positive work environment in Mozambique**

Launched in 1998, Mozal, an aluminium smelter, was Mozambique's largest ever industrial project. By 2003, Mozal was credited with contributing to 5 per cent of the country's economic growth and a 3.2 per cent share of GDP. It also employed 2,750 people directly and created an estimated 10,000 indirect jobs.

Mozal's commercial success is mirrored by a commitment to a positive work environment and engagement with the local community which is reflected in the company's mission statement. Mozal adheres to the BHP Billiton Guide to Business Conduct, fostering integrity, respect, trust and openness in the workplace (<http://www.bhpbilliton.com/bb/peopleEmployment/globalBusinessConductGuide.jsp>). In keeping with these values, Mozal instituted employee-focused programmes and policies, including an employee medical plan, the first of its kind in Mozambique. Building on a solid framework for employee development, Mozal provided financial assistance to some 150 employees for the pursuit of career-related qualifications. Employee training and career-development programmes include the Capacity Building Programme, Graduate Development Programme and Operator and Maintainer Career Path. Mozal also recognizes the dedication of its employees by granting long-service awards for five or more years of employment with the company.

Through its supply chain programmes and Community Development Trust, Mozal extends a culture of learning to local SMEs and communities. The company recognizes the power of education as a support for the community and, in turn, a means of strengthening its own success. Mozal embodies the philosophy that the accumulation and application of expertise not only encourages employee and community development but also enhances the smelter's performance in an increasingly competitive global marketplace.

Source: IFC: *Making a difference* (Washington, DC, IFC, 2006), pp. 10–11.

## Occupational safety and health (OSH)

272. The safety and health of workers is fundamental to the concept of sustainable enterprises and is determined by factors at the national and international levels as well as at the enterprise level.<sup>14</sup> The ILO recently estimated that, globally, about 2.2 million people die every year from occupational accidents and diseases, while some 270 million

<sup>13</sup> K.L. Chandratilleke: “Social dialogue as a means of enhancing productivity and quality of work life”, in A. Sivananthiran and C.S. Venkata Ratnam: *Social dialogue at enterprise level, successful experiences* (New Delhi, ILO, 2004), pp. 79–100.

<sup>14</sup> ILO: *Occupational safety and health – Synergies between security and productivity*, Committee on Employment and Social Policy, Governing Body, 295th Session, Mar. 2006, GB.295/ESP/3.

suffer serious non-fatal injuries and another 160 million fall ill, for shorter or longer periods, from work-related causes.<sup>15</sup> This entails an enormous toll of suffering for workers and their families. Furthermore, the ILO has estimated that the total cost of such accidents and ill health amounts to approximately 4 per cent of the world's GDP – a colossal figure that is over 20 times greater than official development assistance.

273. It is necessary to consider the contribution that good working conditions and OSH can make towards increased productivity, as well as the normative case for maintaining safety and health at the workplace and the impact that good safety and health standards have on how enterprises are perceived. Sustainable enterprises cannot afford to have injuries and diseases at work, which would not only interrupt operations but may have strong economic and reputational consequences. Globalization has put increased pressure on employers to improve business efficiency and productivity, but there is clear evidence to indicate the fallacy of trying to cut costs while compromising on OSH. There is substantial evidence that promoting workers' health and well-being at work can lead to sustainable enterprise development.<sup>16</sup> For example, enterprises that have taken voluntary measures to improve health and reduce accidents have at the same time improved employee motivation, morale and productivity and a reduction in absenteeism and medical costs. In order to foster a safe and relatively stress-free working environment that will motivate workers and contribute to sustainable economic development and increased productivity, social dialogue plays a key role in identifying and implementing good workplace practices that will help ensure safety and health at work.

274. The competitiveness reports referred to in Chapter 4 – the GCR and the World Competitiveness Yearbook – indicate that the most competitive countries are generally also the safest and that there is no evidence that any country or enterprise would have benefited in the long run from a low level of safety and health.<sup>17</sup> Even the most simple measures taken to reduce risks in the workplace, such as good lighting or safe electrical installations, minimize accidents and health-related problems and allow workers to concentrate on their work, becoming more effective and productive.<sup>18</sup> A low-safety, low-health and low-income survival strategy does not lead to increased competitiveness or sustainability.

275. Moreover, the impact of work-related accidents and ill health on national economies is much greater in countries with less developed social protection and healthcare systems, and the effects on economic development are likely to be very significant.<sup>19</sup> Therefore, the argument often heard that lower-income countries cannot afford safety and health measures is not tenable (see box 9.4 for a practical example from India). Safety and health at work also affects the employability of the workforce, given that the working capacity of many unemployed workers has been weakened as a result of injury or disease. This impairment may however not be severe enough to entitle workers to compensation or a disability pension, although the loss of working ability

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<sup>15</sup> ILO: *Decent work – Safe work*, Introductory report to the XVIIth World Congress on Safety and Health at Work, 2005, <http://www.ilo.org/public/english/protection/safework/wdcongrs17/intrep.pdf>.

<sup>16</sup> G.S. Lowe: *Healthy workplaces and productivity: A discussion paper*, Minister of Public Works and Government Services Canada, 2003, <http://www.grahamlowe.ca>.

<sup>17</sup> ILO: *Decent work – Safe work*, Introductory report to the XVIIth World Congress on Safety and Health at Work, Orlando, Sep. 2005, p. 14.

<sup>18</sup> ILO: *Occupational safety and health – Synergies between security and productivity*, Committee on Employment and Social Policy, Governing Body, 295th Session, Mar. 2006, GB.295/ESP/3.

<sup>19</sup> *Decent work – Safe work*, op. cit., p. 11.

might severely worsen their chances of re-employability. For instance, construction workers with back problems, or painters who develop an allergy to solvent-based paints, are difficult to employ in the job for which they have been trained. The actively employed are generally healthier than the unemployed, a third of whom are estimated to have to deal with such complications. Therefore, the protection of workers in their working environment not only improves general health and well-being, but also directly contributes to the realization of decent work and both social development and poverty alleviation.

**Box 9.4**  
**Better enterprise performance and better occupational safety and health – The brassware industry clusters in Moradabad, India**

Shafique operates a brassware micro-foundry with his sons in Moradabad. The city is well known for its brassware, producing 80 per cent of India's output and accounting for 33 per cent of all Indian handicraft exports. The foundry is one of about 25,000 small and 20 medium enterprises engaged in the city's brassware sector, which employs as many as 200,000 people. Shafique enrolled in a training course which forms part of the ILO's Moradabad Brassware Programme for Enterprise Development and Productivity Improvement. He learned that if he installed simple chimneys he could easily channel smoke and heat from the casting out of his workplace. This would improve productivity and reduce the health hazards of this type of work. In addition, he learned to organize his work space better, and painted his cooling pans different colours to separate hot from cooled castings. This was designed to reduce the incidence of burns. After making the changes, Shafique and his sons noticed a distinct improvement in air quality and temperature, which contributed to improved productivity. His son, Mohammed Yamin, had formerly produced about 40 castings per hour but could not produce more because of the smoke and the heat. With the new chimneys, he was able to produce 60 castings per hour.

The Programme on Boosting Employment through Small Enterprise Development (SEED) has a diverse and integrated programme in Moradabad, which not only includes training in the basics of improving working conditions but also involves links with government training institutions, with the Entrepreneurship Development Institute of India and with exporters. SEED is working to improve productivity through better working conditions and to reorient the industry to produce for domestic niche markets so as to avoid direct competition with cheaper production sites. The Moradabad brassware case highlights the fact that introducing OSH measures can add substantial improvements in productivity to micro-enterprises in a low-income country. In this case a safer and better workplace environment directly and positively correlates with the economic performance of the enterprise.

Source: ILO project documents.

## A skills- and knowledge-based approach to employability <sup>20</sup>

276. Technological change and globalization is increasing the demand for a more educated and skilled workforce, which in some countries is leading to increased demand for skilled jobs relative to unskilled jobs and also to increased wage differentials between these categories. Both government and the private sector will need to respond to improve education and to train and upgrade the skills of the workforce through training policy options tailored to particular country conditions. However, in a knowledge-based global economy and society, production and services systems are continually upgraded through the use of ICT technologies and innovative products and production processes.

<sup>20</sup> ILO: *Employability by improving knowledge and skills*, Committee on Employment and Social Policy, Governing Body, 295th Session, Geneva, Mar. 2006, GB.295/ESP/2(Rev.).

This is accompanied by changes in the organization of work, including technical and organizational structural change in production and management systems. Such changes require appropriate responses in terms of what skills development and learning opportunities are available and accessible at the workplace and outside the workplace. However, the school-to-work transition is obviously a key bridge on the road to enhanced employability, so the development of such key skills as ICT literacy, communication and team skills must invariably be given consideration in all branches of the education system, including school-based education.

277. The term employability has attracted high-profile attention in the recent policy debate. The ILO's GEA provides a framework for developing a skills and knowledge-based concept of employability. This framework was further developed and refined in ILO Recommendation No. 195 on human resources development that was adopted subsequently. The knowledge-based concept of employability connects the core elements of the GEA with the Recommendation by distinguishing between the capabilities of workers, entrepreneurs, managers and policy-makers as determinants of employability. This is the main value added of the knowledge-based employability approach.

278. At the individual level, skills and competencies define the capacity to make use of job and income opportunities and to adapt to changes in the labour market brought about by technological progress and globalization. Skills and knowledge for improved performance in internal and external labour markets and adaptability are key to employability. In addition, education in workers' rights and other citizenship skills empowers women and men who might otherwise be discriminated against in labour markets in terms of access to education, training, decent jobs, opportunities to start a business and, if needed, the judicial system.

279. At the enterprise and organizational level, entrepreneurs' and managers' business and leadership skills significantly determine an enterprises' capacity to create and use opportunities and to invest in the skills of the workforce. These business skills, and the capacity to promote a learning culture, to encourage workplace learning and to facilitate knowledge sharing between workers, determine the employability of workers within the enterprise. Enterprise-specific skills and organizational knowledge are essential for the enterprise's capacity to absorb technology, to innovate and to grow.

280. The capacity to make effective policy choices in training and labour markets is critical for employability. It is also important that policy be coherent and integrated across all levels from the individual to the enterprise to the national (see box 9.5 for an example of this from Singapore). Discriminatory recruitment practices limit the employability of men and women, regardless of their occupational skills endowment. The skill of decision-makers in designing and applying legal institutions and governance tools that support equal opportunities and workers' rights, together with the skill of the social partners in engaging in a meaningful social dialogue, enhances employability and sustainable economic and social development. Social dialogue can be used as a vehicle for developing a new organization culture that promotes labour-management cooperation rather than confrontation. It can be argued that the implementation of productivity programmes is most effective and sustainable in a safe and healthy work environment, with good labour-management relations based on social dialogue between managers and workers.<sup>21</sup>

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<sup>21</sup> K.L. Chandratilleke: "Social dialogue as a means of enhancing productivity and quality of work life", in A. Sivananthiran and C.S. Venkata Ratnam: *Social dialogue at enterprise level, successful experiences* (India, ILO publications), pp. 79–100.

281. Employability, for example, can be an important aspect in collective bargaining strategies. In some OECD countries, for example, there is an increasing trend towards social dialogue and collective bargaining on continuous training.<sup>22</sup> Agreements deal with the joint determination of training needs in an enterprise or sector, the set-up of training plans, and so forth. In France, for example, vocational training was the second most important bargaining issue in 2001. In countries with training levies and training funds, these have usually been given a framework through bipartite or tripartite agreements at the sectoral or even national level. In this context, collective bargaining can contribute to investment in training even in countries in which trade union density or collective coverage (in the traditional sense) is not high.

282. The capacity of governments to design and implement coherent economic policies which address the demand side of the economy is central to ensuring that the potential of an employable workforce is maximized. Competent policy choices in trade, investment, finance, technology and migration determine economic growth, job creation and the demand for labour. Coherent macroeconomic policies reduce the level of uncertainty in the economy and, in combination with economic growth and the redistributive effects of “pro-poor” growth, increase incentives for workers and enterprises to invest in training and skills.

**Box 9.5**  
**Integrating workplace learning into national qualifications systems in Singapore**

In Singapore, the workforce skills qualifications system is an adult training initiative for those already in work, who may or may not already have undertaken pre-employment training. The aim has been to develop appropriate training focused on the specific needs of individual industry sectors (such as retailing, tourism and engineering), and to promote worker employability by establishing sector-specific qualifications based on the ability to carry out predefined sets of activities. Workers are also taught certain key foundation or soft skills, which are transferable beyond specific sectors to industry at large.

Key industry players, including the social partners, actively participate through industry skills and training councils in identifying and developing the type of skills required, competency standards, curricula and qualifications.

Workers completing specific training modules receive appropriate certificates and nationally recognized qualifications. Significantly, the new qualifications system takes into account both knowledge acquired through formal training routes and that acquired in other contexts, including informal learning activities in the workplace. Workers with no academic or technical qualifications may apply to have the knowledge and skills they have acquired through work experience assessed and, if successful, will receive appropriate certificates and recognized qualifications without needing to undergo training. By such means “unofficial” training and learning carried out in the workplace is being integrated into a system of transferable skills, to the benefit of all enterprises and workers in a sector, and beyond.

Source: Singapore Workforce Development Agency (<http://app.wda.gov.sg/index.asp>); F. Pyke: *A guide to improving workplace learning in the Asia and Pacific region*, draft paper prepared for the Regional Skills and Employability Programme, ILO Regional Office, Bangkok, Oct. 2006.

283. Although the benefits to enterprise-based training can be significant, it appears that enterprises typically under-invest in training their workers. This may often be due to a poor investment or BEE, which reduces incentives to invest not only in plant and equipment but also in the workforce. There may also be a number of enterprise-level reasons as well, such as a perceived low level of workforce education, that suggests a

<sup>22</sup> W. Ok and P. Tergeist, 2003: *Improving workers' skills: Analytical evidence and the role of the social partners*, OECD, Social Employment and Migration Working Papers No. 10.

limited capacity to benefit from training, limited financial resources to fund training, imperfect knowledge about what training is needed or how to train, a high labour turnover that leads to the poaching of trained workers (and the loss of training investment) and, sometimes, the use of technologies which might be perceived as requiring relatively little need for training.

284. However, given the potentially large productivity gains from investing in training, – and the associated positive externalities – public policy in most countries addresses these information failures, training externalities and underdeveloped markets for financing training. Policies could include reducing the school dropout rate, raising educational attainment levels in formal education, increasing incentives for in-service training (an example from Australia is given in box 9.6), reforming national training programmes and systems so as to improve their quality and relevance, encouraging private training providers and, through proactive policies, targeting small enterprises which are often particularly weak in their provision of and capacity to make use of training.

#### **Box 9.6**

##### **Australian Structured Workplace Learning Programme**

The Australian Government Structured Workplace Learning Programme provides school students with structured learning opportunities in the workplace. This structured workplace learning placement is usually a component of a vocational education and training (VET) in school courses undertaken by senior secondary students. The placement provides on-the-job training and mentoring that develops the students' technical and generic employability skills. The skills are assessed, usually following the work placement, by a registered training organization (RTO) and the VET qualifications are recognized nationally by industry and education systems. The Structured Workplace Learning Programme is administered through a national network of local community partnerships.

Source: Australian Government, Department of Education, Science and Training, 2005; F. Pyke: *A guide to improving workplace learning in the Asia and Pacific region*, draft paper prepared for the Regional Skills and Employability Programme, ILO Regional Office, Bangkok, Oct. 2006.

285. A large range of factors affect productivity and competitiveness, both internal and external to the enterprise. This chapter has drawn attention to factors internal to the enterprise and the importance of investing in people – the most fundamental resource of an enterprise and a key determinant of sustainability. Implicit in addressing these internal conditions or factors is the understanding that the way people are treated, taught skills and managed is of central importance to productivity. Globalization makes investing in people more important than ever. Evidence suggests that employees are motivated by many different things. However, most would agree that people tend to be more motivated in the workplace if they feel appreciated and respected. Creating a positive work environment boosts not only morale but also productivity and competitiveness. The benefits of investing in people are likely to be greater if they take place in parallel with broader improvements to the basic conditions (outlined in Chapter 3), the investment climate (Chapter 2, among others) and an appropriate framework for effective social dialogue. However, appropriate workplace practices, including conditions of work and labour–management relations as well as human resource development in its broadest sense, are vitally important for the promotion of sustainable enterprises.

## Chapter 10

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### Social partners, social dialogue and tripartism

286. Institutions and organizations matter for sustainable enterprise development. Weak institutions and dysfunctional organizations can become insurmountable obstacles to the creation and growth of sustainable entrepreneurial initiatives. Hence, a conducive institutional and organizational environment ought to be regarded as a fundamental component of any strategy aimed at fostering entrepreneurship and private sector development. Drawing from the “new institutional economics” literature,<sup>1</sup> institutions are defined here as “the formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behaviour, and self-imposed codes of conduct), and the enforcement characteristics of both”. Organizations on the other hand are the “groups of individuals bound by a common purpose to achieve objectives”. They include different types of bodies: political (e.g. political parties); economic (e.g. business associations and trade unions); social (e.g. religious groupings); and educational (e.g. vocational training centres).

287. The role of institutions in promoting sustainable enterprises has been discussed thoroughly in previous sections of the report. This chapter focuses on the role of the organizations, with a strong emphasis on two types: business associations (including employers’ organizations), and trade unions. These two are the most important actors, along with the State, in determining labour market outcomes, and their actions beyond the labour sphere have important implications in creating the conditions for sustainable development.

288. The developmental potential of organizations like business associations and trade unions has often been the object of intense controversy. In the 1970s and 1980s a relatively pessimistic view prevailed in some quarters, with both organized business and trade unions perceived by some (but not all) as “special interest groups” which negatively influenced the political system and the economy. This view, while still pervasive in the academic world, slowly began to change in the 1990s. Strong empirical evidence suggests that, under certain circumstances, business associations and trade unions can make significant contributions to development.<sup>2</sup> A positive wave is gaining

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<sup>1</sup> D. North: “Institutions and economic theory”, in *American Economist* (Los Angeles, California), Spring 1992, Vol. 36, No. 1, p. 3.

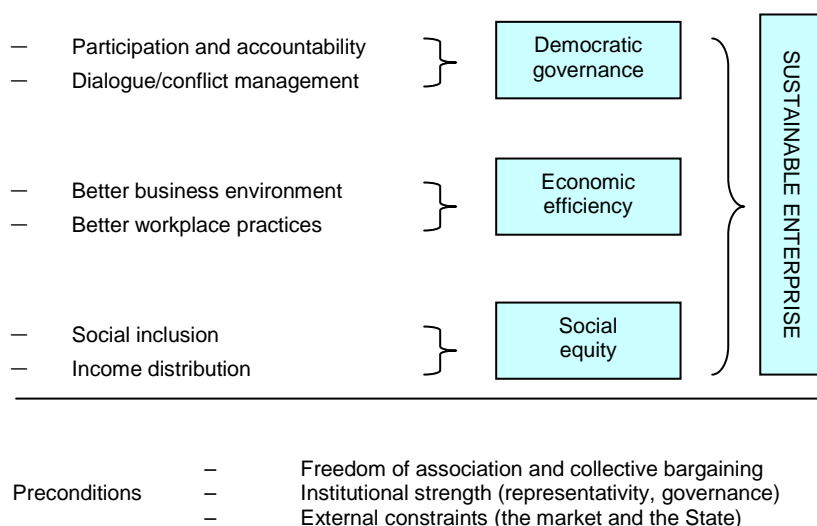
<sup>2</sup> See, for example, R. Doner and B. Schneider: “Business associations and economic development: Why some associations contribute more than others”, in *Business and Politics* (The Berkeley Electronic Press), Dec. 2000, Vol. 2, No. 3; R. Doner and B. Schneider: *The new institutional economics, business associations and development* (Geneva, ILS/ILO, 2000); A.V. Jose (ed.): *Organized labour in the twenty-first century* (Geneva, ILS/ILO, 2002); D. Kucera and R. Sarna: “Trade union rights, democracy and exports, a gravity model approach”, in *Review of International Economics* (Oxford, Blackwell Publishing Ltd), Nov. 2006, Vol. 14, No. 5, pp. 859–882.

momentum amongst the international development community. Most donors and international agencies are now seeking, with renewed interest, to tap the developmental potential of civil society organizations, including the representative associations of employers and workers. Participatory policy-making (e.g. Poverty Reduction Strategy Papers), public–private dialogue (e.g. competitiveness councils) and other forms of interaction between the State and key social actors, are now shared goals in most cooperation agencies.

## The potential contribution of workers' and employers' organizations

289. Workers' and employers' organizations can potentially contribute to the creation of three basic conditions that are indispensable for the emergence and growth of sustainable enterprises. These conditions are: democratic governance, economic efficiency and social equity (figure 10.1). The channels and conditions that enable the realization of these potential benefits are analysed in the sections ahead.

Figure 10.1. Potential contributions of workers' and employers' organizations to sustainable enterprise development



## Democratic governance

290. As stated in the International Labour Conference's resolution concerning tripartism and social dialogue adopted in 2002, "legitimate, independent and democratic organizations of workers and employers, engaging in dialogue and collective bargaining, bring a tradition of social peace based on free negotiations and accommodation of conflicting interests, therefore making social dialogue a central element of democratic societies".<sup>3</sup> Democracy and good governance are central elements for economic growth and sustainable development. Cross-country empirical evidence suggests that democracies perform better on a number of counts, particularly when institutional

<sup>3</sup> ILO: *Effect to be given to resolution adopted by the International Labour Conference at its 90th Session (2002): (a) Resolution concerning tripartism and social dialogue*, Governing Body, 285th Session, Nov. 2002, GB/285/7/1, p. 11.



quality is improving: “they produce less randomness and volatility, they are better at managing shocks, and they yield distributional outcomes that are more desirable”.<sup>4</sup> This positive correlation between political liberty and economic performance is a result of a number of factors, including greater transparency and accountability (lower risk of making the wrong policy choices) and better systems of conflict management and interest representation (lower risk of social disruption and civil strife).

291. Political freedom and participation are not just means to economic progress but development goals in their own right. As stated in the UNDP Human Development Report in 2002:

Political freedom and the ability to participate in the life of one’s community are capabilities that are as important for human development as being able to read and write and being in good health. People without political freedom – such as being able to join associations and to form and express opinions – have far fewer choices in life. And being able to participate in the life of one’s community – commanding the respect of others and having a say in communal decisions – is fundamental to human existence.<sup>5</sup>

292. There are at least two main channels through which workers’ and employers’ organizations contribute to the development and consolidation of democratic governance: (a) promoting participation, representation and empowerment of their members through legitimate and effective organizations, enabling them to influence policies and to demand greater accountability and transparency from decision-making bodies and political leaders; and (b) making politics less divisive through a process of interest aggregation, social dialogue and conflict management that facilitates the formation of broad-based social consensus on development and policy directions, thereby reducing the sources of friction in the political system.

293. Political participation has been instrumental in restoring democracy and building democratic institutions around the world. Trade unions, for example, have played an important role in the transition to democracy in a number of countries (including Chile, Poland, South Africa and the Republic of Korea); they converted the economic space of the industrial workforce into a political space, campaigning against authoritarian regimes and broadening their social base beyond organized labour, leading a sustained struggle to establish or restore democracy.<sup>6</sup> Examples of business associations engaged in governance-enhancing activities are also frequent. A common function of organized business, for instance, is to exert pressure on policy-makers in order to strengthen the rule of law, fight corruption and increase government accountability, all basic conditions for well-functioning democracies and good governance.

294. Social dialogue is another means through which employers’ and workers’ organizations contribute directly to enhancing democratic governance. Numerous country examples show that social dialogue at all levels can be used effectively to cultivate sustainable enterprises through increased enterprise productivity and improved workplace practices (see box 10.1).

<sup>4</sup> D. Rodrik: *Democracy and economic performance*, mimeo, John F. Kennedy School of Government, Harvard University (Cambridge, Massachusetts, Dec. 1997).

<sup>5</sup> UNDP: *Human Development Report 2002* (New York, UNDP, 2002), Ch. 2, p. 52.

<sup>6</sup> A.V. Jose (ed.): *Organized labour in the twenty-first century* (Geneva, ILS/ILO, 2002); D. Kucera and R. Sarna: “Trade union rights, democracy and exports, a gravity model approach”, in *Review of International Economics* (Oxford, Blackwell Publishing Ltd), 2006, Vol. 14, No. 5, pp. 859–882.

### Box 10.1 Examples of social dialogue fostering sustainable enterprises

**Social dialogue at enterprise level as a means of enhancing productivity and quality of work life in Sri Lanka:** At the Maha Oya Group of the Bogawantalawa Plantations Company, the enterprise level social dialogue was initially triggered by comparatively low productivity in the Sri Lankan plantation sector which has been attributed to high absenteeism, strikes, poor health and reluctance towards estate employment. Among other participatory management activities, the ILO helped set up the social dialogue project to enhance overall productivity and economic well-being of the plantation workers. After a couple of orientation meetings, workers and employers instituted monthly meetings as a forum to review work progress through labour–management dialogue. This resulted in numerous improvements of workplace practices, including introduction of rain guards (productivity enhancement), opening bank accounts for workers (social security), introduction of an incentive scheme linked to latex intake per rubber tapper (compensation practices) and reconstruction and rehabilitation of estate roads (infrastructure development). After the project 91.1 per cent of workers expressed confidence in resolving workplace issues through dialogue, while the study supported growing evidence of the positive impact of participatory management practices on labour productivity improvements.

**Regional social dialogue brings local employment pacts in Ireland:** Local employment pacts in Europe utilize social dialogue at local level to create new jobs and fight unemployment. They involve social partners and various public actors: banks, research institutes, universities, professional associations, third-sector associations, etc. at territorial rather than company level. After bargaining, partners finally make certain commitments, often in a solemn, written form.

In 1997, young people (under 24 years) accounted for 24.5 per cent of the total unemployed in the Dublin region. Furthermore, 52 per cent of the unemployed were classified as long-term unemployed. Through social dialogue at local level it was diagnosed that, in order to decrease long-term and youth unemployment, it was necessary to provide training in information and communication technologies, and particularly in skills needed to meet the demands of local businesses. Accordingly, three programmes were implemented to meet these objectives: “Whole Time Jobs Initiative Programme”, “Core Skills Programme” and “Organized Labour Streams”. In addition, the “Train and Build Project” offered educational support to young people from disadvantaged communities and built skills to the third-level initiative.

Local employment pacts are successful examples of social dialogue at the local level working to reconcile entrepreneurial competitiveness with employment-friendly policies, most notably by fighting social exclusion and other social barriers to increasing employment and improving living and working conditions. The comparative analysis of the local employment pacts in different countries in the European Union reveals that, in terms of achieving flexibility while ensuring workers’ security, social dialogue has proved to be much more fruitful and its results much more satisfactory than those obtained through simple deregulation policies.

Source: M. Biagi: *Job creation policies at local level and the role of the social partners in Europe* (IFP/Dialogue Working Paper No. 9, Geneva, International Labour Office, 2002); and K.L. Chandratilleke: “Social dialogue as a means of enhancing productivity and quality of work life: Case study of Bogawantalawa Plantations Company” in A. Sivananthiran and C.S. Venkata Ratnam (eds.): *Social dialogue at enterprise level – Successful experiences* (IIRA, New Delhi, ILO, 2005).

## Economic efficiency

295. Employers’ and workers’ organizations play an important economic role in society. They can influence, directly or indirectly, the working conditions at the enterprise level as well as the policy and regulatory environment in which companies operate. For these reasons they can potentially make a substantive contribution to enhancing productivity and competitiveness, thus creating the appropriate conditions for sustainable enterprise development.

296. Business associations' contributions to economic performance can be divided into market-supporting and market-complementing activities.<sup>7</sup> Within the first category, business associations support the provision of basic public goods that are indispensable for the operation of market economies, such as the rule of law (including strong property rights), transparent and effective public administration, and infrastructure. The rule of law and an efficient public administration are two crucial pillars for enterprise development. As stated in the UNDP Unleashing Entrepreneurship Report, an important factor in allowing entrepreneurship and the private sector to blossom is a "level playing field" for firms which can be created only by "a system of rules and enforcement that inspires trust and reasonably limits the cost and burden on enterprises".<sup>8</sup> Business associations can play an important role in this regard, organizing the voice of businesses to advocate for a more coherent, stable and enterprise-sensitive regulatory environment. Business associations have also played an important role in lobbying for and, in some cases, directly providing various types of infrastructure. In Colombia, for instance, the Government granted the coffee association, *Federacafé*, the right to collect an export tax that was then used to deliver value-added services to the producers, especially transportation infrastructure, port facilities and warehouses.<sup>9</sup>

297. Market-complementing activities, the second category of business associations' contributions to enhance economic efficiency, are defined by Doner and Schneider<sup>10</sup> as those involving "direct coordination among firms to reconcile interdependent production and investment decisions". Table 10.1 lists market-complementing functions and offers numerous examples documented by these authors of associations that provided them.

Table 10.1. Market-complementing functions of business associations

Functions	Cases
1. Macroeconomic stabilization and reform	Business Coordinating Council (CCE, Mexico); Confederation for Production and Commerce (CPC, Chile); Federation of Thai Industries (FTI); Kuwait Chamber of Commerce and Industry (KCCI)
2. Horizontal coordination (quota allocation, capacity reduction)	Turkish Clothing Manufacturers' Association (TGSD); Thai Rice Exporters' Association (TREA); Thai Garment Manufacturers' Association (TGMA); Korean Federation of Textile Industries (KOFOTI)
3. Vertical coordination (upstream–downstream)	Thai Sugar Associations; Sindipeças (auto parts, Brazil); Nigerian groundnuts; Business Coordinator for International Trade (COECE, Mexico); Commercial Farmers' Union (CFU, Zimbabwe)
4. Lowering the cost of information	Chinese Chamber of Commerce (Penang); Korean Trade Promotion Association; <i>Federacafé</i> (coffee, Colombia); TGMA (textiles, Thailand); Peruvian footwear; Colombian bankers; KOFOTI (textiles, Republic of Korea); Mexican footwear; Brazilian footwear

<sup>7</sup> R. Doner and B. Schneider: "Business associations and economic development: Why some associations contribute more than others", op. cit.

<sup>8</sup> UNDP: *Unleashing entrepreneurship: Making business work for the poor*, Commission on the Private Sector and Development, report to the Secretary-General of the United Nations (New York, UNDP, 2004), p. 24.

<sup>9</sup> R. Doner and B. Schneider: "Business associations and economic development: Why some associations contribute more than others", op. cit.

<sup>10</sup> R. Doner and B. Schneider: "Business associations and economic development: Why some associations contribute more than others", op. cit.

Functions	Cases
5. Setting standards	Thailand Board of Trade (rice); <i>Federacafé</i> (coffee, Colombia); Aruaru Association of Furniture Makers (AAFM, Brazil)
6. Quality upgrading	All Japan Cotton Spinners' Association (Boren); AAFM (furniture, Brazil); Colombian Rice Association; footwear manufacturers (Mexico, Peru and Brazil); KOFOTI (textiles, Republic of Korea); SIMA (surgical instruments, Pakistan)

Source: (adapted from) R. Doner and B. Schneider: "Business associations and economic development: Why some associations contribute more than others", in *Business and Politics* (The Berkeley Electronic Press), 2000, Vol. 2, No. 3, p. 265.

298. *Macroeconomic stabilization.* In the area of macroeconomic policy, coordination between business, labour and government can reduce the social costs of stabilization efforts. However, this requires strong trade unions and business associations capable of enforcing commitments. Success stories of this type of coordination are common in Europe, but positive developments have also occurred in developing countries where the abovementioned conditions are met. In Mexico, for example, during the 1987 crisis, representatives of business, government and labour signed the first of a series of agreements on wages, prices (public and private), exchange rates, and government spending that brought inflation down from over 100 per cent to manageable levels within a year. Two specific associational activities were especially important to stabilization: coordination of intra-sectoral or intra-industry price differences, and monitoring and enforcement by the retailers' association of the prices of member firms.<sup>11</sup>

299. *Horizontal coordination.* Market coordination and capacity rationalization are functions that some business associations, operating under specific circumstances, have been able to perform. Market coordination has arisen in cases where a quota system exists. Capacity reduction or rationalization in cases of market downturns is another positive function that some business organizations have managed to perform. This function has the potential to alleviate the inefficiencies resulting from the underutilization of capacity and can also foster more efficient patterns of specialization.<sup>12</sup>

300. *Vertical coordination.* Associations can potentially facilitate supply, price and quality coordination between upstream and downstream producers. This type of activity is helpful in assisting particularly developing countries to promote business linkages and to increase the local value added of exports. By solving short-term distributional differences between upstream and downstream producers, business associations can also facilitate liberalization programmes that accommodate the concerns of industries along the value chain, thereby facilitating adaptation to more open trade regimes. Vertical coordination mechanisms can also be used to upgrade labour standards. Building on this potential, the IFC and the ILO recently agreed to collaborate in developing a global programme for better labour standards in global supply chains.<sup>13</sup> The Better Work Programme will look at various industries, including garments and footwear, plantations, electronic equipment and light manufacturing, with the focus on improving labour standards and promoting the business case for better working conditions.

<sup>11</sup> R. Doner and B. Schneider: *The new institutional economics, business associations and development*, op. cit., p. 12.

<sup>12</sup> R. Doner and B. Scheneider: "Business associations and economic development: Why some associations contribute more than others", op. cit.

<sup>13</sup> Agreement reached on Monday, 21 Aug. 2006.

301. Multi-stakeholders' initiatives could also be seen as a variant of this type of vertical or value-chain coordination. For instance, the World Cocoa Foundation (WCF), established in 2002, involves all the respective stakeholders in world cocoa production (the global chocolate and cocoa industry, trade unions, NGOs and the ILO) in ensuring respect for international labour standards in the cocoa-growing industry. By connecting the expertise of NGOs, donor organizations, research institutions and independent experts with representative organizations of employers and workers, they seek to address the growing challenges facing cocoa farmers, their employees, families and communities.<sup>14</sup>

302. *Lowering the cost of information.* Facilitating members' access to information is a critical and common function of business associations. Employers' organizations, for instance, tend to concentrate on the provision of information related to industrial relations and the world of work. In Ireland, the Occupational Health and Safety (OHS) Service of the Irish Business and Employers' Confederation (IBEC) assists members in creating and maintaining high standards of health and safety in the working environment. The Service provides information and advice on all aspects of safety legislation, occupational hazards and best standards for safety and health at work. Advice and information is given on such issues as accident prevention, claims for personal injury, preparation of safety statements, training needs and information sources. The Employers' Confederation of the Philippines (ECOP) runs surveys on a variety of issues, including collective bargaining agreements and corporate compensation practices. SMEs in Singapore can access, by phone or email, information on business start-up regulations, human resource and industrial relations from the Singapore National Employers' Federation (SNEF). Business associations provide a wider range of information services, including valuable data on new markets, both domestic and export.

303. *Setting standards.* When it comes to accessing international markets, reputation matters. The failure of some suppliers to deliver good quality products into the market may damage the reputation of all the country's producers in a specific sector. This is particularly true in export markets for basic commodities. In these circumstances, the role of business associations in setting and enforcing quality standards can make a significant contribution to the international competitiveness of particular economic sectors or industries. The case of the Colombian coffee producers is a good example. By granting *Federacafé* the power to monitor and sanction miscreants, the Government enhanced the capacity of the private sector to implement effectively the existing labelling protocols that distinguish the diverse types of coffees being exported.<sup>15</sup> This service greatly contributed to the marketing strategies of Colombian coffee producers at the international level.

304. *Upgrading quality and productivity.* One of the main functions of business associations is to deliver value-added services to their members in order to strengthen their productivity and competitiveness. They can assist their members in improving their technology, managerial practices and the skills of their workforces. The range of potential services is extremely wide. Some are simple and inexpensive (e.g. quick advice over the telephone, opportunities for networking), while others are more complex and costly (e.g. training, consulting). Employers' organizations often focus on successful management of employer–employee relations as a critical factor for the productivity, growth and profitability of enterprises. Some key areas where advice and assistance are

<sup>14</sup> See <http://www.worldcocoafoundation.org>.

<sup>15</sup> R. Bates: *Open-economy politics: The political economy of the world coffee trade* (Princeton, Princeton University Press, 1997).

provided include handling problems that remain within the enterprise, handling disputes that are brought before an external body such as a labour court or arbitration panel (includes representing the enterprise), negotiating collective agreements and improving industrial relations not arising from a dispute. An interesting case study from Brazil, highlighting the developmental potential of business associations in upgrading the productivity and sustainability of enterprises, is shown in box 10.2.

**Box 10.2**  
**Clothing cluster upgrading in Brazil**

The clothing cluster in the State of Pernambuco, north-east Brazil, employs 80,000 people. Most of the establishments are small, informal businesses that produce at low quality and pollute the local water supply. The active efforts of a local cluster association (SINDIVEST), in partnership with organizations in Germany, have helped to reduce environmental problems, initiate policy change, formalize the sector and raise quality.

**(a) Environment efforts**

Denim production requires the use of large quantities of water, which become polluted with toxic chemicals. Pernambuco produces 1 million pairs of jeans per month and the untreated waste water was polluting the local water supply and affecting a reservoir that supplied 80 towns and villages in the area. Public authorities were reluctant to enforce pollution control regulations for fear of damaging an industry that was the lifeblood of the local economy. The project tackled this problem through a joint effort involving public authorities in Pernambuco and Bavaria (Germany) and by engaging with private washing businesses. An entrepreneur in Toritama, the main washing area, agreed to establish a pilot plant using water cleaning technology. The entrepreneur was able to reduce pollution levels by half and recycle 60 per cent of the waste water. This has resulted in substantial savings and allowed the new plant to pay for itself in six months. The 19 largest washing plants in the region, accounting for 70 per cent of production (and pollution), have now adopted the new technology and comply with all environmental regulations. SINDIVEST has been a catalyst for these activities.

**(b) Training and design upgrading**

Few seamstresses had any formal training. The result was low-quality work and low innovation in design. SINDIVEST, with its partners, organized study visits to training colleges in Germany, short missions to Brazil for textile engineering staff of a German college to train trainers for courses offered by SENAI and the University of Recife, training courses for textile engineering and other issues, visits to international trade fairs to learn about quality; and three new training schools for technicians set up by SENAI. By 2002 about 1,000 workers had been trained in a variety of areas, including not only garment production but also general management issues, human resources, logistics, fashion and design. A variety of courses are now offered from one-day seminars and courses lasting a few days to more in-depth programmes of 18 months. In addition, a Fashion Committee of Pernambuco has been established to provide leadership on design issues, and efforts are being made to develop a local brand.

**(c) Lobbying to reduce tax and increase formalization**

One of the key problems faced by the business association was the fact that 90 per cent of the enterprises in the clothing sector were informal. These informal businesses were not interested in entering the formal sector, however, because of the 17 per cent sales tax that is imposed on the sector. Together with the Association of Clothing Wholesalers, SINDIVEST opened discussions with the state and local authorities to highlight the problem. The authorities agreed to reduce the sales tax to 4 per cent. The business association conducted a successful public awareness campaign to encourage informal businesses to "formalize". Over 1,000 firms formalized in the first four weeks of the campaign and others did the same at a later time. By mid-2005 the informality rate had dropped from 90 per cent to 81 per cent of businesses.

Source: M. Wahl and R. Meier: *How a business membership organization can contribute to improving the business environment (Case study: North-East Brazil)*, paper presented to the International Conference on Reforming the Business Environment, Cairo, Nov.–Dec. 2005.

305. Trade unions also play a vital role in advancing the goals of competitiveness and productivity, as well as promoting decent work. The impact of unions in economic performance has been the object of intense controversy:

The general neo-liberal view of trade unions is that they are the root cause of labour market distortions from which many negative economic consequences flow, such as the raising of labour costs above market clearing levels, thereby reducing both competitiveness and employment; the creation of obstacles to flexible adjustment within enterprises that would raise productivity and lower costs; the undermining of macroeconomic stability through excessive (inflationary) wage settlements; and the disruption of industrial peace.<sup>16</sup>

306. There is, however, no clear-cut empirical evidence to support this view. On the contrary, under certain circumstances the evidence suggests a positive correlation between trade unions and workers' rights, on the one hand, and economic performance on the other. The rest of this section reviews the evidence related to the impact of trade unions on economic efficiency in three significant areas: macroeconomic stability, trade competitiveness and productivity.

307. *Macroeconomic performance.* Although it is difficult to isolate the economic impact of trade unions and labour market institutions (including collective bargaining) from other variables, a fair amount of evidence supports the argument that, given the right mix of policies and institutions, trade unions can have a positive economic effect at the macroeconomic level. They can contribute to reducing the possible trade-off between inflation and employment and facilitate smoother, more balanced adjustment to economic reform.<sup>17</sup>

308. Comparative studies of OECD countries covering the period from 1960 to 1998 looked at the effects of the framework of collective bargaining on a large number of macroeconomic performance indicators such as unemployment and inflation. The research concluded that different institutional arrangements can lead to very different macroeconomic outcomes; in particular, it found that bargaining coordination<sup>18</sup> did have a beneficial impact on macroeconomic performance in the 1970s and 1980s, though not so much in the 1990s. According to a World Bank analysis of these studies:

Countries with highly coordinated collective bargaining tend to be associated with lower and less persistent unemployment, less earnings inequality and wage dispersion, and fewer and shorter strikes compared to countries with semi-coordinated (for example, industry-level bargaining) or uncoordinated (for example, firm-level bargaining or individual contracting) collective bargaining.<sup>19</sup>

These findings highlight the fact that the economic, legal and political environment in which collective bargaining takes place, and in which trade unions operate, has a significant impact on their capacity to influence economic performance positively.

309. *Trade competitiveness.* There is very robust evidence that trade union members and other workers covered by collective agreements in both industrial and developing countries get higher wages than their non-unionized (or uncovered) counterparts, even

<sup>16</sup> E. Lee: "Trade union rights: An economic perspective", in *International Labour Review* (Geneva, ILO), 1998, Vol. 137, No. 3, pp. 313–319.

<sup>17</sup> ILO: *Collective bargaining and the Decent Work Agenda*, Committee on Employment and Social Policy, Governing Body, 297th Session, Nov. 2006, GB.297/ESP/2.

<sup>18</sup> *Bargaining coordination* is defined as the extent of coordination between unions and employers' organizations in wage setting and other aspects of industrial relations (for example, working conditions, holidays and leave provisions, etc.).

<sup>19</sup> T. Aidt and Z. Tzannatos: *Unions and collective bargaining: Economic effects in a global environment* (Washington, DC, World Bank, 2002), p. 12.

after accounting for other productivity-related determinants of wages.<sup>20</sup> The size of the wage mark-up often depends on a number of factors, including the type of worker and workplace characteristics, the economic environment (product market competition) and the collective bargaining framework. For this reason it is often assumed that by raising labour costs trade unions adversely affect trade competitiveness, especially for trade in labour-intensive goods. A recent study on this issue,<sup>21</sup> containing data for 162 countries between 1993 and 1999, shows that stronger trade union rights are associated with higher total manufacturing exports, although no significant relationship was found between these rights and labour-intensive manufacturing exports. Trade union rights, therefore, are not incompatible with trade competitiveness. Indeed, the positive relationship identified demonstrates that the possible negative effects of higher labour costs due to stronger trade union rights can be offset by other positive effects (e.g. social stability, increased productivity, good labour–management relations).

310. *Productivity.* Trade unions can have a positive impact on productivity. They can contribute to create an enabling work environment by reducing labour turnover and by promoting worker training. Through collective bargaining they can also provide firms with a mechanism for encouraging participation in the workplace and fostering trust and commitment in employment relations. Indeed, there is a large body of evidence showing that workplace participation can enhance firm performance and that firms with higher degrees of worker participation outperform other firms.<sup>22</sup> In addition, greater employee participation in the workplace reduces monitoring costs, with benefits in terms of efficiency. Empirical evidence appears to suggest that the positive contribution of trade unions in this field depends largely on market conditions and industrial relations. Trade unions are most effective at improving conditions for workers, without substantive efficiency costs, when the following conditions are met: product markets are competitive; collective bargaining arrangements are flexible; and trade unions are capable of internalizing the cost of their actions.<sup>23</sup>

311. The active role of unions in training, an important productivity-enhancing function, is well documented. The Trade Union Congress of the Philippines, for instance, has a special educational department that provides continuous training to enable workers to improve their working conditions and to become active participants in promoting social justice and environmentally sustainable development. The department institutionalizes all trade union-affiliated educators and trainers to create non-formal education at the workplace and union level. It has so far provided extensive training on labour–management relations, social safety nets, youth leadership, organizing the informal sector and relevant subject matters.<sup>24</sup> The training can also be successfully combined with training on environmental standards and methods of environmental protection. The Trades Union Congress in the United Kingdom launched a Green Workplaces project in 2006 in order to provide training on how to tackle energy and climate change issues at work. The course aims at educating workplace representatives on how to increase efficiently and reuse resources.<sup>25</sup>

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<sup>20</sup> T. Aidt and Z. Tzannatos: *Unions and collective bargaining*, op cit., p. 7.

<sup>21</sup> D. Kucera and R. Sarna: “Trade union rights, democracy and exports, a gravity model approach”, op. cit.

<sup>22</sup> ILO: *Collective bargaining and the Decent Work Agenda*, GB.297/ESP/2, op. cit., para. 23.

<sup>23</sup> World Bank: *World Development Report 2006* (Washington, DC, World Bank, 2005), p. 189.

<sup>24</sup> See <http://www.tucp.org.ph/departments/education/index.htm>.

<sup>25</sup> See <http://www.tuc.org.uk/sustainableworkplace>.



312. Evidence suggests that countries with a high level of unionization and strong collective bargaining traditions have been able to achieve successful economic and productivity growth. According to the *World Development Report 2006*, different labour market institutional setups can yield equally good productivity growth paths. For example, the Nordic countries and the United States, with very different labour market institutions, share a good track record of solid productivity growth. The active role of trade unions and the central role of collective bargaining in the Nordic countries have not hindered the achievement of comparable productivity levels, which is even higher in some cases than in the United States. They have done so with less wage inequality and wider protection of workers.<sup>26</sup>

## Social equity

313. Organizations of employers and workers can potentially play an important role in the realm of social equity. Two main channels through which this may occur are income distribution and social inclusion. Trade unions can effectively contribute to decreasing income inequalities. They can support this objective by obtaining a fairer share of total product for labour, reducing wage dispersion, advocating a wage floor (minimum wages), and ensuring that skill acquisition becomes affordable for a larger number of workers. Unions can also influence state policies fostering the expansion of social and labour protection systems. Empirical evidence confirms the positive contribution of trade unions to building more equitable societies. World Bank research shows that unions reduce inequality and wage discrimination in countries as diverse as Ghana, the Republic of Korea, Mexico and Spain.<sup>27</sup> There is also growing evidence of a favourable conjuncture in many countries between the presence of collective bargaining institutions, more equal distribution and smoother adjustment as countries integrate into the global economy.<sup>28</sup>

314. When the bargaining power of organized labour diminishes, income inequality tends to increase. In the United States, for instance, productivity gains are no longer keeping pace with pay increases, a significant deviation from the experience of past decades. Worker productivity rose 16.6 per cent from 2000 to 2005, while total compensation for the median worker rose 7.2 per cent.<sup>29</sup> As a consequence of this, wages now make up the lowest share of the nation's gross domestic product since the Government began recording the data in 1947.

315. Under certain circumstances nonetheless, where unionized workers are a small minority and trade unions adopt restrictive practices, there can be adverse effects on equity and on the employment prospects of non-unionized workers. This effect however "is often mitigated by tripartite institutions which provide incentives for unions to take into account overall economic and social interests; by trade union concern for, and advocacy of, the interests of low-income and disadvantaged groups; and by trade unions' achievement of social gains, such as national systems of social and labour protection which, in principle, benefit all workers".<sup>30</sup> Increased product market competition, which

<sup>26</sup> World Bank: *World Development Report 2006* (Washington, DC, World Bank, 2005), p. 188.

<sup>27</sup> *ibid.*, p. 189.

<sup>28</sup> ILO: *Collective bargaining and the Decent Work Agenda*, GB.297/ESP/2, para. 7, *op. cit.*, p. 3.

<sup>29</sup> See S. Greenhouse and D. Leonhardt: "Wages fail to match a rise in productivity", in *The New York Times* (New York), 28 Aug. 2006.

<sup>30</sup> E. Lee: "Trade union rights: An economic perspective", in *International Labour Review* (Geneva, ILO), 1998, Vol. 137, No. 3, p. 316.

limits the ability of firms to pass on the cost of this type of undesirable practice to customers, becomes an additional restraining element.

316. Another important contribution of unions to equity is its social inclusion orientation. A means to achieve social justice and equity is empowerment, participation and representation of the most vulnerable and discriminated against. A positive example in this respect is the growing interest of trade unions in organizing the informal economy (see box 10.3). Two clear trends are emerging; on the one hand, there is an increasing number of formal trade unions that extend their coverage to informal workers; on the other, unions of informal workers are also multiplying.<sup>31</sup>

Studies of informal worker associations in India, South Africa and Thailand suggest that organizing informal workers decreases the workers' invisibility to policy-makers and legislators, helps them gain access to information, gives them voice and self-identity, and in some cases helps to provide them with a range of social protection services.<sup>32</sup>

**Box 10.3**  
**Trade unions reaching out to the informal economy**

The informal economy has been steadily growing to become the major component of the national economy in most developing countries. With this in mind, it is understandable that numerous institutions are reaching out to create programmes to effectively integrate this vibrant sector into the formal economy. It is important to note that informal economy interventions should satisfy two, at times diverging, but equally necessary and important goals: promoting the application of core labour standards, while also promoting the income-generating capacity of this vital sector. Trade unions in different parts of the world have been reaching out to help organize informal workers in at least three different modes:

- (a) Textile Clothing and Footwear Union of Australia and UNITE (a new, organizing union for textile, hotel, restaurant, hospitality, food service, apparel and retail workers) in Canada are successfully organizing workers in the garment industry, while homeworkers in the timber industry in Ghana are organized by its Timber and Woodworkers' Union.
- (b) Trade unions – instead of organizing informal workers themselves – might help organize special organizations for informal workers, as has been the case in Senegal and Hong Kong, China.
- (c) SEWA is a completely independent association of self-employed women in India, which has been part of an influential movement to get poor informal workers' interests recognized in national and international legislation and policy.

Source: ILO: *Promoting gender equality – A resource kit for trade unions* (Geneva, ILO, 2001); and J. Birchall: *Organizing workers in the informal sector: A strategy for trade union-cooperative action* (ILO, Geneva, 2001).

317. Employers and business associations can also contribute to social inclusion. They can play an important role, for instance, in empowering women and young entrepreneurs, as well as in fighting discrimination in the workplace. A recent ILO publication documents ten case studies of employers' organizations from across the world taking an active stance on issues of gender equality and non-discrimination.<sup>33</sup> An interesting example is that of New Zealand, where a joint voluntary initiative between the Government and New Zealand employers led to the creation of the Equal Employment Opportunities Trust "to help workplaces adapt to and embrace the diversity of the workforce through the use of equal employment opportunity principles and best practice.

<sup>31</sup> World Bank: *World Development Report 2006* (Washington, DC, World Bank, 2005), p. 190.

<sup>32</sup> *ibid.*

<sup>33</sup> ILO: *Employers' organizations taking the lead on gender equality: Case studies from ten countries*, ACT/EMP No. 43 (ILO, Geneva, 2005).

Valuing diversity in the workplace benefits both employers and workers by making workplaces more effective, efficient and competitive – and great places to work”.<sup>34</sup>

318. Women around the world are also setting up their own business associations. The National Association of Business Women (NABW) in Malawi, for instance, has designed a specific advocacy programme to provide a voice for women entrepreneurs and improve the overall economic status of Malawian women.<sup>35</sup> The NABW held regional meetings throughout Malawi and conducted independent studies to identify the most pressing needs of women entrepreneurs. As a next step, it invited key government officials and agencies to participate in its membership meetings to discuss and finalize sectoral development plans and recommendations. As a result of active participation by a large number of policy-makers, several laws and policies that negatively affected Malawi’s businesswomen were changed and the Government increased the funding for several ministries to carry out programmes which benefit women entrepreneurs.<sup>36</sup>

## Conditions for strengthening organizations

319. Not all employers’ and workers’ organizations are equally capable of making the type of positive contributions described above. In reality, some are weak, divided and generally ineffective. What then are the conditions that enhance an organization’s developmental potential? Three key possible explanatory variables are analysed here: freedom (right to organize and collective bargaining), strength (institutional capacity) and external constraints (the market and the state).

320. *Freedom of association and collective bargaining.* The right of employers and workers “to establish and ... to join organizations of their own choosing without previous authorization”<sup>37</sup> and the freedom to bargain collectively are fundamental labour rights and indispensable conditions for employers’ and workers’ organizations to flourish and develop. The promotion of these rights is not only instrumental in strengthening the contribution of employers’ and workers’ organizations to development, but a cornerstone in building inclusive and democratic societies.

321. *Institutional strength.* Academic research into business associations has found three conditions that seem necessary for high institutional capacity,<sup>38</sup> (these interrelated factors can be easily adapted to trade unions as well), valuable selective benefits,<sup>39</sup> high membership density and effective mediation among members’ interests (including appropriate rules for good governance). Experience demonstrates that it is mainly the synergy between all three factors that builds real capacity. Obviously, human resources and material assets are also important; nevertheless, they tend to be a function of the other factors. A common weakness in many organizations is the under-representation of employers and workers from micro- and small enterprises. Closing this “representational

<sup>34</sup> *ibid.*, p. 10.

<sup>35</sup> S.E. Jalbert: *Women entrepreneurs in the global economy* (Washington, DC, Center for International Private Enterprise, 2000).

<sup>36</sup> CIPE: *How to advocate effectively: A guidebook for business associations* (Washington, DC, CIPE, 2003), p. 24.

<sup>37</sup> ILO: Freedom of Association and Protection of the Right to Organise Convention, 1948 (No. 87), Article 2.

<sup>38</sup> R. Doner and B. Schneider: “Business associations and economic development: Why some associations contribute more than others”, *op. cit.*

<sup>39</sup> Selective benefits are those that the organization can offer to members only and that make membership valuable and exit costly. An example, in the case of business associations, is export quotas.

gap” and increasing the role of MSE owners and workers in social dialogue is a shared goal amongst ILO constituents and a key ingredient in fostering the creation of an enabling environment for enterprise development.<sup>40</sup> It should, therefore, be a key component of any strategy aimed at increasing the formalization of businesses and the creation of decent work.

322. *External constraints.* Institutional strength is not enough; it is typically a neutral resource that can be used for good or ill. The research mentioned above (Doner and Schmidt) has found that workers’ and employers’ organizations are generally subject to two key external constraints: competitive markets and state discipline. Competitive markets reduce the risk of rent-seeking activities and therefore create incentives for organizations of workers and employers to focus on welfare-enhancing functions. State discipline refers to arrangements in which governments grant organizations selective benefits in return for enhanced economic performance by their members. This mechanism appears to have played an important role in some countries in East Asia.<sup>41</sup>

323. In conclusion, employers’ and workers’ organizations are capable, under certain circumstances, of creating enabling and basic conditions for sustainable enterprise development (Chapter 3) in three areas: democratic governance, economic efficiency, and social equity. In terms of governance they can promote greater political accountability and provide an effective means for dialogue and conflict management, making politics more transparent and less divisive. Employers’ and workers’ organizations also play an important economic role. They influence, directly or indirectly, the working conditions at the enterprise level, as well as the policy and regulatory environment in which companies operate. Evidence indicates that their impact on competitiveness and productivity can be very positive. Finally, concerning social equity, both types of organizations can perform an important function in enhancing social inclusion and combating all forms of discrimination. Their interaction, along with the state, also has important consequences for income distribution. It is clear, however, that not all employers’ and workers’ organizations are equally capable of making the type of positive contribution described here. Three key factors condition their development potential: freedom (right to organize and collective bargaining), strength (institutional capacity) and external constraints (the market and the state).

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<sup>40</sup> ILO: *Business environment, labour law and micro- and small enterprises*, Committee on Employment and Social Policy, Governing Body, 297th Session, Nov. 2006, GB.297/ESP/1, para. 42.

<sup>41</sup> World Bank: *The East Asian miracle* (Washington, DC, World Bank, 1993), p. 181.

## Suggested points for discussion

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1. What are the key elements of an environment that is conducive to sustainable enterprises?
2. What are the key elements for enterprises to operate successfully on a sustainable economic and social basis?
3. How can governments strengthen their role in implementing policies and programmes to promote sustainable enterprises? Are there useful examples of “best practice” approaches by governments?
4. What can and should the social partners do to promote sustainable enterprises?
5. What should be the role of governments and the social partners in promoting the contribution of enterprises to social and economic development?
6. What can the Office do to support constituents in their efforts to promote sustainable enterprises?
7. What should be the ILO’s priorities within its Decent Work Agenda in terms of supporting the promotion of sustainable enterprises, in the following areas:
  - ❑ Promoting an enabling business and regulatory environment?
  - ❑ Value-chain upgrading and clustering?
  - ❑ Local economic development?
  - ❑ Promoting good workplace practices?
  - ❑ Targeted programmes: microenterprises, SMEs, MNEs, entrepreneurship development (including for women), the informal economy and cooperatives?
8. Which external partners should the ILO work with to promote sustainable enterprises?