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Task Force 04

TRADE AND INVESTMENT FOR SUSTAINABLE AND INCLUSIVE GROWTH

A G20 Compact to Enable a Just and Green Transition of MSMEs in Emerging Economies

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Abstract

The G20 have long recognised the vital role played by MSMEs in employment generation, technology innovation and sustainable economic development. Further, it is well established that integration into Global Value Chains can help MSMEs access global markets and improve competitiveness. Recognizing the challenges faced by MSMEs, the G20 has pledged to improve access to information, ease trade barriers, promote inclusive trade policies, support capacity building, enable access to finance and facilitate innovation and digitisation amongst others.

However, as MSMEs aspire to increase participation in global trade, they increasingly encounter challenges in aligning to the rapidly evolving climate targets (the most recent being net zero), disclosures, sustainability standards, and exclusionary trade policies and inclusivity landscape. Several international regulations such as the EU Corporate Sustainability Due Diligence directive, EU Carbon Border Adjustment mechanism and several others developed by buyer countries require that global value chains are designed to recognise and address environmental and social risks. MSMEs in emerging economies are ill equipped to match the pace of this transition and face a real risk of being excluded from global trade. Though research indicates that digitisation and sustainability are indispensable areas for MSMEs to future-proof themselves, the fact is that MSMEs cannot make this transition without an adequate enabling environment.

This policy brief aims to present approaches to engage MSMEs into a sustainable transition of the global economy vis-a-vis the role of G20 nations in enabling green and just transition of MSMEs through capacity enhancement, common sustainability reporting standards, technology and learning exchange, and a forum at G20 for increased and active representation of MSMEs from emerging economies.

Diagnosis of the Issue

Micro, small, and medium enterprises (MSMEs) are the backbone of economies worldwide, accounting for over 90% of all firms and 60-70% of total employment (Coke-Hamilton, 2023). In emerging economies, MSMEs drive inclusive economic growth, generate jobs, foster innovation, and enable social mobility. Evidence shows that MSMEs receive a great impetus when they are integrated into international trade and Global Value Chains (ADB, 2021). However, as the world grapples with the urgent need to transition to a low-carbon, climate-resilient and inclusive future, MSMEs face significant challenges in aligning with evolving climate targets, sustainability standards and exclusionary trade policies.

Due to their size and scale, MSMEs often don't meet the participation threshold for market-based policies such as carbon-pricing and consequently, are unable to participate in sector-wide targeted carbon reductions. Also, most corporate net-zero commitments exclude scope 3 emissions - 60-90% of these can be attributed to the MSMEs in their supply chain (WEF, BCG, 2021). This transition challenge is exemplified by the emergence of mandatory regulations, such as the EU Corporate Sustainability Due Diligence Directive and the EU Carbon Border Adjustment Mechanism, which require global value chains to recognise and address environmental and social risks. These regulations place additional burdens on MSMEs in emerging economies and they face a real risk of being excluded from global trade, exacerbating inequalities within and between countries.

The G20 has long recognised the vital importance of MSMEs. It has pledged support through various initiatives to improve their access to information, markets, capacity building, finance, and technology. However, MSMEs still encounter major barriers as they seek to integrate into global value chains and embrace sustainable business practices. Some key challenges include:

1. **Low technical knowledge and limited information access to fulfill sustainability and inclusion criteria.** MSMEs lack awareness and technical capacity to meet complex, varying and multiple sustainability standards, climate targets and regulations imposed by developed countries especially due to:
   a) Multiplicity of voluntary sustainability standards making it costly, time consuming and unproductive for MSMEs which are anyway finance and skill constrained. MSMEs
   b) Immediate requirements to measure and report on social and environmental hotspots. There are new reporting requirements that necessitate both human resource and financial investments by MSMEs (Hanley et al. 2023). A case in point is the Environmental Product Declaration (EPD), a document that measures the environmental impact of a product through its entire lifecycle.
   c) Limited awareness amongst local MSMEs about global initiatives addressing information asymmetry. In many instances, market and global trade related information does not percolate to MSMEs at all levels thus restricting their ability to enhance their knowledge.

2. **Inadequate access to green finance** to fund the costs of transitioning to low-carbon operations, upgrading to cleaner technologies, and investing in climate resilience measures (OECD, 2019). A BCG and WEF report highlights that SMEs will need USD 25-50 trillion to achieve net zero supply chains (WEF, BCG, 2021).

3. **The digital divide and poor access to technology** hampers MSMEs' competitiveness and the ability to leverage digital solutions for measurement, efficiency, traceability, and transparency in their operations and value chains (G, Santosh, 2024). AI presents significant opportunities for MSMEs, particularly in decision-making and customer engagement. However, it is essential to ensure a just and fair transition, as the rapid adoption of AI could make many MSMEs, especially in the services sector, redundant.

4. **Policy incoherence** and unintended consequences of certain green trade policies that may disadvantage MSMEs in emerging economies, such as carbon border taxes. In fact, an UNCTAD report estimates that developing countries could face an export decline of 1.4% - 2.4% if CBAM is implemented (UNCTAD, 2021).

There is a growing concern that MSMEs in emerging economies may be left behind in the transition towards a greener future, more so for MSMEs led by women and youth, who are more vulnerable to such economic shifts. This has significant implications for achieving the Sustainable Development Goals. Supporting MSME resilience and sustainability is thus critical for a just transition.

The G20 is uniquely positioned to enable MSMEs to become catalysts for a green and inclusive future and help them access the information, tools and resources needed to thrive in a net-zero world. The Brazil G20 2024 agenda, with its focus on sustainable development and supporting the Global South, provides an opportune platform to galvanize ambitious action.

By developing a G20 Compact for MSMEs, member countries can spur transformative partnerships, policies, and investments to build MSME capacity, connect them to green finance and technologies and foster their participation in fair and inclusive global value chains.

Recommendations

The G20's unique combination of influence over global trade, resource allocation capabilities, and their reach on a vast network of MSMEs creates an unparalleled opportunity to drive a just and green transition that is inclusive and leaves no one behind. A dedicated G20 Compact to enable Green Transition of MSMEs is the need of the hour - a common framework for member countries to cooperate on policy, capacity, finance, and technology needs of the MSMEs.

A few key recommendations for G20 to enable this transition include:

1. Enhanced cooperation for capacity building of MSMEs: The emerging climate policies and trade regulations announced by the developed countries are already posing challenges for greater participation of MSMEs in global value chains (GVCs). The MSMEs in the developing economies lack capacity on many fronts including sustainable finance, low-emission technologies, and tools for emissions measurement and reporting. A G20 cooperation on MSME Capacity Building Program to share existing best practices, tools, and knowledge products can result in multiple benefits for the G20 economies. The G20 can also look at programs that enable greater access to market information for MSMEs to leverage both national and international business opportunities. This will build on The Jaipur Call to Action under India's G20 Presidency that aims to address the information asymmetry faced by MSMEs. ITC Geneva has been tasked with the updating of the Global Trade helpdesk pursuant to the Jaipur call to action. G20 member countries can play a crucial role in informing and connecting MSMEs in their countries to the helpdesk through awareness programs and creation of local/multilingual information centres to enable easy access for MSMEs to the Helpdesk. National governments could leverage on Trade and Investment Support Institutions, e-modules, social media, roadshows etc. to promote awareness and utilization of the Global Helpdesk and ensure that information flows through all tiers of supply chains.

2. Benchmarking and reporting Emissions and Sustainability Performance and Common Reporting Standards: Increasingly complex trade policies demand life cycle emissions, Environmental Product Declarations (EPDs), and sustainability performance reporting, necessitating the benchmarking of industry-specific and product-level emissions against common metrics. Adjustments to weightage based on technology readiness levels and emission factors are crucial for fairness, enabling greater participation of MSMEs in Global Value Chains (GVCs).

MSMEs need support through digital tools like SME Climate Hub, GHG Protocol, which aid compliance and pinpoint industry-specific sustainability metrics such as water consumption or waste generation. These tools, often free and high-quality, build MSMEs' capacity and confidence in net-zero practices.

Additionally, with 29 countries globally mandating ESG (Environmental, Social, and Governance) disclosure compliances by 2026, it becomes important for all tiers of supply chains in emerging economies to be brought more actively into the sustainability and climate discourse. The G20 should consider adopting a globally recognized framework that is adjusted to accommodate MSMEs and prevent redundancy in reporting requirements. While the framework could have standardized outcomes, member countries should define input parameters per country regulations and local conditions. Existing frameworks and guidelines such as those provided by the UN, Global Reporting Initiative (GRI) Standards and the Sustainability Accounting Standards Board (SASB) offer guidelines. Still, they may be complex or costly for resource constrained MSMEs to implement. An adapted business framework for such reporting would balance comprehensiveness with ease of implementation, ensuring MSMEs can meet industry-specific compliances and effectively participate in global trade while promoting sustainable practices. This would foster transparency, facilitate due diligence, and enhance MSMEs' competitiveness in global trade, addressing the unique needs of the Global South and ensuring a balanced dialogue in framework development.

3. Enabling MSME access to green finance: Access to affordable green finance remains a significant challenge for MSMEs to adopt low-carbon technologies, highlighting the need for policies that address credit market imperfections and broaden the range of financing instruments available to them for adopting low-carbon measures, in accordance with the G20/OECD High-level Principles on SME Financing (OECD, 2022). To achieve this, G20 nations may consider implementing the following measures:

a) **Enhancing financial support for low-carbon trade:** (i) Develop sustainability-linked export credit guarantees and trade finance solutions to incentivize the adoption of low-carbon technologies and practices across industries as demonstrated by companies like Tesla, Volkswagen, Patagonia, Levi's, ArcelorMittal, and Starbucks. Such financial instruments will boost efforts of the private sector to adopt low carbon measures in their operations and across their value chains. This will help MSMEs mitigate risks, reduce the cost of capital, and improve access to financing for their low-carbon transition. (ii) Strengthen the capacity of local development finance institutes/ financial systems to channel ESG/sustainability focussed funds available globally into tailor-made programs for local MSMEs. For e.g. SIDBI in India has received funding from WB, ADB, KfW etc. to finance clean energy/energy efficiency initiatives for MSMEs in India. These local financing avenues are more accessible to MSMEs and will support them in implementing low-carbon measures in line with GVC requirements.

b) **Scaling sustainable supply chain finance models and digital platforms:** Governments should foster public-private collaboration to scale up successful sustainable supply chain finance models and digital platforms, as demonstrated by initiatives like Puma's partnership with IFC, Walmart's collaboration with HSBC, and Taulia's cooperation with IFC. Offering incentives to encourage private sector participation and promoting knowledge sharing among nations can accelerate the adoption of sustainable practices by MSMEs globally. The proven success of these programs highlights the potential for replication and expansion, driving a more sustainable future for MSMEs worldwide.

4. Promoting low-carbon technology transfer: Implement targeted subsidies, such as R&D tax credits and technology transfer grants, to incentivize low-carbon technology transfer among G20 nations. Facilitate knowledge sharing through relaxed IP licensing terms and joint ownership models. Disseminate process-based technologies through technical assistance programs and South-South cooperation initiatives. Address export challenges for developing economies by improving the investment climate through streamlined regulations and infrastructure development.

Scenario of Outcomes

While the recommendations have the potential to drive a just and green transition for MSMEs, they also present the complexities and trade-offs involved in implementing such policies on a global scale. Different scenarios, contradictions, and trade-offs that may result if suggested recommendations are adopted by the G20 are listed here:

- **Implementation challenges:** If the G20 adopts the recommendations, they may face challenges in implementing them effectively and consistently across the member nations. For instance, enhancing cooperation for capacity building of MSMEs requires significant resources and coordination among member countries. While the developed economies might be quicker to integrate the suggested policies, developing economies may struggle due to limited resources or differing priorities. This could create a two-tiered system, where MSMEs in developed nations benefit more from green transition initiatives compared to their counterparts in developing nations, potentially widening the economic gap. The same imbalance may even be created within different tiers of the supply chain in emerging economies with more established MSMEs being able to leverage the global developments while the smaller or women/youth led MSMEs are unable to cope with the rapid changes. Ensuring that the programs reach MSMEs in developing economies and are tailored to their specific needs is essential for its effectiveness. The national governments have an important role in building coherence between national and international policies and regulations.

- **Economic disparities and market challenges**: The recommendations could exacerbate economic disparities between developed and developing economies. While the proposed measures aim to promote technology transfer and green finance, MSMEs in developing countries may struggle to access these opportunities due to limited resources and infrastructure. This could lead to a widening gap in competitiveness and sustainability practices between MSMEs in different parts of the world. The subsidies and financial incentives may benefit one industry sector more than the other due to market dynamics.

- **Trade - offs in benchmarking and reporting standards**: Harmonizing sustainability reporting standards across all G20 countries may result in trade-offs between comprehensiveness and ease of implementation. Negotiating and implementing common outcome parameters will be slow, and updates might not reflect rapidly changing environmental concerns. There is a risk that emerging economies are not able to negotiate for their local priorities and adhere more to requirements of the buyer economies. Moreover, while local priorities need to inform the input parameters, wide disparities in on ground situations across countries may make it difficult to gauge impact. We need to balance comprehensiveness with ease of implementation and find a solution that works for all and doesn't hinder their ability to effectively participate in global trade and adopt sustainable practices. This prolonged dialogue and negotiations between countries may lead to a delay which is counterproductive to the urgency to act now. It is also likely that data availability in different countries will significantly differ and can impact the usefulness of globally available tools such as the SME Climate Hub. There may be a need to develop affordable and easy to implement data measurement systems especially for emerging economies.
- **Challenges in access to Green Finance**: G20 member countries differ in financial maturity and stability which will influence their ability to attract ESG/sustainable financing to facilitate MSMEs in the transition towards sustainability. Emerging economies will need increased funding and support through green/sustainable financing

mechanisms. Further, owing to formal definitions of MSMEs in emerging economies, many MSMEs fall in the unorganized sector and are excluded from formal schemes and programs. There is a need for innovative and suitable schemes to ensure that MSMEs in the unorganized sector are also part of the sustainable transition. The inclusion of the unorganized sector will also be important to improve the outreach and efficacy of the private sector led supply chain financing programs.

- **Technological Challenges**: Promoting low-carbon technology transfer among G20 nations may face technological challenges. While targeted subsidies and IP sharing mechanisms aim to facilitate knowledge sharing, differences in technology readiness levels (TRLs) and regulatory frameworks could impede the adoption of imported technologies. Improving the investment climate and addressing export challenges for developing economies would require significant infrastructure development and regulatory reforms, which may be difficult to achieve in the short term.

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