

# Reimagining the Role of the Private Sector in Development

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## EXECUTIVE SUMMARY

The private sector is willing to contribute more to sustainable development, but companies lack models of what to do and how to engage in partnerships with the public sector. The private sector is needed to develop and take to scale new patterns of sustainable production. But for it to do so, it needs to form new partnerships with aid agencies and other public financial institutions. These partnerships should focus on:

- Mobilizing long-term private finance for sustainable development;
- Generating more innovation in technologies and business models;
- Building mechanisms to hold the private sector accountable for development results.

Every high-level development report and project now has private sector involvement. The time is ripe to systematize this approach and experiment with new forms of public-private partnerships.

## WHAT'S THE ISSUE?

In today's world, only a minority of people (about 2 billion of the global population of 7.1 billion in 2013) enjoy a lifestyle that reflects a middle-class or higher standard of living, where the basic necessities of life are met and where families have some discretionary income to enjoy a vacation and leisure activities, pay for good-quality and differentiated products that meet their taste and aspire to own their homes and

educate their children. We need to reimagine a world where, within 15 to 20 years, most people (at least 5 billion) will have such a lifestyle. This progress will be driven by population and income growth in developing and emerging economies, which, if current trends continue, will create a large, majority, global middle class that will demand much higher levels of consumption. Demand for food, water and energy, for example, is forecast to grow by 50, 40 and 30 percent, respectively, by 2030. Meeting these needs with business-as-usual production would be simply unsustainable. Carbon emissions would be too high, aquifers and soil quality would degrade too far and competition for land use would create significant social tensions. The world of 2030 will be a world of resource scarcity.

The private sector appears ready to take on a far more significant role in sustainable development than ever before. The High-Level Panel advising U.N. Secretary-General Ban Ki-Moon on the post-2015 development agenda consulted the chief executive officers of 250 companies that command annual revenues of \$8 trillion and are located in 30 countries.<sup>1</sup> Their conclusion was a consensus that sustainability needs to be built into their corporate strategies in order to take advantage of the commercial opportunities for growth and the compelling business case that underpins sustainable development, a new form of development that is being championed by the United Nations and development agencies around the world.

The companies that were consulted spoke of the importance of public-private partnerships as a delivery mechanism, with precise targets, regular milestones

and clear accountability. They framed the business case around four pillars:

- *Innovation and growth*: Addressing the needs of poor and near-poor consumers in developing countries—and, more broadly, mitigating climate change—opens up huge new opportunities for innovation, market development and growth.
- *Resource scarcity*: Most of the inputs that business needs—land, water, energy and minerals—are becoming increasingly scarce and ever more expensive. To remain cost competitive, forward-looking companies understand that in the coming decade they will need to do more with less.
- *Cost saving*: Managing operations sustainably by minimizing energy, water and packaging and eliminating waste saves companies significant sums of money.
- *Employee engagement, motivation and retention*: The best university graduates are becoming more selective. They want to work for companies that are not only financially successful but also possess socially conscious values and thus want to “do the right thing” and contribute to a better world.

However, these companies also said they have trouble implementing sustainable development without complementary action by the public sector. At the most basic level, the public sector needs to make sure that the private sector has the right incentives to embrace sustainable development, and where it does not already have these incentives, to use tax, subsidy and regulatory instruments to align private incentives with sustainable development. The most egregious example of how private and social incentives can be mismatched is in fossil fuels, where governments across the world provide an estimated \$1.9 trillion per year in producer and consumer subsidies, contributing to climate change. Other examples are easy to find—poor management and subsidized boat construction have led to massive overfishing in international and coastal waters. Lack of payment for implicit ecoservices, like the flood

mitigation provided by mangrove forests, has generated large unintended costs from development projects.

These are all examples of inefficient development. They can be solved by sharing information and creating public policy that mimics what an efficient market solution would be if there were proper markets for all environmental and social goods and bads. The politics may be difficult—for example, full costing of water and greenhouse gas emissions could raise the price of wheat fourfold—and ensuring fair social and distributional consequences from exploiting natural resource assets is challenging, but there are many good examples from which to draw lessons.

“Getting prices right” is a necessary but not sufficient condition for achieving sustainable development. Two other things also need to happen to realize the potential of a vastly more prosperous world in 2030, given the limitations of natural resources—what have been termed “planetary boundaries.” First, there needs to be significant innovation in moving to more sustainable patterns of production. And second, these innovations need to spread at scale throughout the world. Together, innovation and scaling up are key characteristics of sustainable development. For both, the private sector is indispensable, but it is not yet contributing to its full potential. The issue is how to encourage the formation of public-private partnerships that can do better on both counts.

## WHAT NEEDS TO HAPPEN, AND WHY?

### *Mobilizing Private Finance*

Massive investments are needed to implement sustainable development; most estimates of the incremental investment spending that is needed in developing countries are at least \$1 trillion a year more than what is currently spent.<sup>2</sup> Aid remains an important source of finance for some low-income countries, but it is clear that the bulk of this funding will need to come from the private sector. Talk about using aid to catalyze private finance has been common but, thus far, the experiences of public-private partnerships suggest that existing mechanisms will not suffice.

In the aggregate, there is no shortage of money; global savings total more than \$18 trillion a year. Nor is there a shortage of high-return projects in sustainable development. Most studies show rates of return of high double-digit levels in energy, power and transportation, but new mechanisms to identify and fund such projects are needed.

One promising initiative is the Power Africa program announced during President Barack Obama's recent trip to Africa. This initiative seeks to double access to power in sub-Saharan Africa, providing 10,000 megawatts and contributing to the \$300 billion in investment needed to achieve universal access to modern energy sources, according to the International Energy Agency.

A list of 30 priority projects has been identified as the core program for Power Africa. Technicians to provide host governments with technical assistance are being provided by the U.S. Agency for International Development (USAID). The Millennium Challenge Corporation will embed the projects in its country compacts. The U.S. Overseas Private Investment Corporation will commit up to \$1.5 billion in financing and insurance. The U.S. Export-Import Bank will provide up to \$5 billion in export credits for U.S. firms. Private companies, including General Electric, have indicated a willingness to provide money and technology.

Though it is a promising beginning, Power Africa indicates the scale of the challenges involved. One initial obstacle is developing a full pipeline of the best projects. There are few large-scale facilities available to do feasibility studies. The World Bank and the African Development Bank have some capability, but it falls far short of what is required. This bottleneck has been identified several times in the past, including in the submission by the Multilateral Development Bank Working Group on Infrastructure to the Group of Twenty, but no action has been taken to improve the situation.

A second concern is the difficulty of coordinating multiple agencies in a partnership. If project success depends on the use of a broad array of tools—

including technical assistance, guarantees, financing, export credits and the like—and each agency has its own procedures and timetables, projects that are already complex become hard to bring to a financial completion. The risk of failure goes up substantially and, when added to the already high risks of investing in low-income countries, can make the investment seem unattractive to a private investor. It would be preferable to have multiple instruments combined in a single agency rather than spread out, as is currently the case.

Third, far too little attention is paid to the precise nature of risk mitigation. The main categories of risk include macroeconomic risk (especially exchange rate risk, which can make fees unaffordable if a full pass-through is possible, or raise costs if there is only partial pass-through); political risk (almost all public-private partnerships are recontracted at some point, and regulatory regimes and dispute resolution mechanisms can be a problem in some countries); technology risk (especially when operating in a new environment); business model risk (especially when scaling up is needed to bring down unit costs); construction risk (with major social risks concerning land in particular); and operating risk (on both the revenue and cost sides, including the costs of recruiting and training key personnel).

Even this partial list shows the limitations of existing public agencies in trying to be truly effective in catalyzing private funding. In many instances, they simply do not have the instruments to bring down risks to acceptable levels. More creativity is needed in risk-taking and risk-mitigation (through guarantees), first-loss financing, feed-in tariffs and other types of contingent financing.

Experimentation with new instruments in official aid agencies will not happen automatically. Bureaucratic risk-aversion seems to be too strong. One idea is to force the issue by asking aid agencies to set an explicit target for the volume of private sector financing that is catalyzed by each dollar of aid. Based on existing experience, a leverage ratio of at least 5:1 should be feasible. This would give a clear target to each agency to

force it to adapt to a new world where long-term private financing for sustainable development is needed.

### *Generating More Innovation*

With the public sector increasingly bogged down in dealing with fiscal problems and political crises, innovation to solve global problems is being driven by private sector solutions. The increased demand for resources created by a larger and more prosperous global middle class is estimated by McKinsey & Company to be between 30 and 80 percent by 2030.<sup>3</sup> A substantial portion of that demand will need to be met through productivity improvements, and the greatest scope for productivity gains is in developing countries. The challenge is to get the right mix of policies to support more sustainable production and consumption patterns. If the right policy mix of prices, access to capital and awareness raising (by both consumers and producers) can be put in place, there is scope for considerable productivity increases through innovation in all three basic systems of land, water and energy.

The prevention of land degradation and the restoration of already degraded soils are among the most cost-efficient ways of increasing the availability of land for agricultural use. No-till agricultural techniques, along with other measures to conserve and improve carbon in organic matter and improve the water holding capacity of soil, have been developed and can be implemented with sufficient capital and operating cost expenditures.

Increasing small-holder farm yields, large farm yields and reducing food waste are other examples where innovation and productivity gains are potentially substantial. Precision farming equipment, irrigation, infrastructure investments and access to power can all generate substantial increases in food supply. Food waste can be reduced by using better storage techniques (including cold storage) and transportation modes. These investments and innovations will become more attractive as food prices rise.

Innovation in reducing water use is another priority. Major savings are available by reducing municipal

water leakages and from using better irrigation techniques and pricing policies. For example, thanks to subsidies, India uses 40 times more water per ton of wheat than Russia—and water is 20 times as scarce in India.

Energy is the third major sector where innovation is essential. Building efficiency provides the scope for the largest gains, thanks to the massive new construction that is needed to manage urbanization in developing countries. The world's urban population is growing by about 100 million people per year, and how these people are housed and transported will drive the demand for energy.

Beyond innovation in physical technology, there is considerable promise for innovations in processes that can speed the dissemination of proven technologies. The Innovations for Poverty Action nonprofit, for example, evaluates techniques that can bring down poverty rapidly. Its current list of technologies with a proven impact comprises chlorine dispensers to improve safe water, school-based de-worming, investment vouchers for small-holder farmers and remedial education. Delivering these programs at scale requires innovating with business models and delivery systems.

How can we encourage more innovation? The most significant issue is how to reduce uncertainty. Private investors are reluctant to innovate without some sense of the long-term prices that will prevail. Under current conditions of major subsidies, prices depend significantly on political processes that determine the extent or speed of a reduction of subsidies. A lack of clarity on these processes and the timeframe for implementation hampers innovation.

A second source of uncertainty is the absence of financing structures that can fund the various stages of innovation, from proof of concept to viable business models at scale to implementation.<sup>4</sup> Products that do not yet exist in a domestic market (e.g., solar units or microleasing) can take 8 to 20 years before reaching significant size, while products that replace existing goods and services with better or cheaper versions

can scale much more quickly (three to five years).<sup>5</sup> Tailored financing for each development stage, and sustained financing to cover costs until scaled-up operations can generate a self-sustaining operation, is necessary.

Third, innovation will not happen without more coherence in global development policies. Subsidies to the private sector are needed to fund innovations, but such subsidies are illegal under current World Trade Organization rules, creating the risk that new products could be threatened with trade sanctions, as is currently happening with solar panels. This uncertainty about future policy adds to innovation risk.

### *Becoming More Accountable*

Although the private sector is an indispensable partner for poverty reduction, it is viewed with deep skepticism in many parts of the world as a reliable development partner. The private sector today needs to overcome the legacy of socially damaging behavior by a few companies in the past, as well as demonstrate that a market economy can contribute effectively to solving social and economic problems.

Firms, especially those in extractive industries, are increasingly aware that their “license to operate” and the value of their brand depend on the trust they can build that they are contributing to solving long-term development problems. The opportunities for growth are better in a country or community that is also growing and prosperous, but firms do not explicitly monitor the contribution they make to this broader type of performance. As a result, the language and information systems that managements use to make decisions can be limited.

Firms need to be aware of layers of accountability. They are, first and foremost, responsible for the impact of their direct operations along financial, social (e.g., how many jobs created) and environmental dimensions. However, they have found that people also hold them accountable for the actions of their suppliers, for the distributors and retailers associated with the firm and for the health of the broader community that they

support and influence. Brand management requires an understanding of each of these layers. The recent U.N. High-Level Panel on the post-2015 agenda recommends that large firms (along with governments) start to report systematically on their financial, social and environmental footprint, along the lines recommended by the Global Reporting Initiative, in a concerted effort to transparently demonstrate that the private sector can be a trusted partner in development.

Several industry standards on reporting are being developed in a range of sectors—including extractive industries, palm oil and finance—and these standards should be encouraged. Other standards pertain to land acquisition by foreign investors. In each case, there is a move to go beyond “do no harm” to proactively promote good practices through a dialogue that builds an international consensus around norms.

### **WHAT'S NEXT?**

For some time, the development discourse has been cast as a debate as to whether the public sector or the private sector is better equipped to contribute to poverty reduction. But now it is time to put this debate aside and to recognize that the answer must be that both should act together. The private sector will not contribute fully if it is simply left to its own devices by government—that line of thinking needs to be debunked. There are too many policy issues that generate risk for private investors that need to be sorted out. Equally, the public sector cannot go it alone. It has neither the resources nor expertise to develop scaled-up solutions to the most pressing social and environmental issues of the day. New public-private partnerships are needed.

Finance, innovation and accountability can all be advanced through public-private partnerships that lay out expectations for firms and governments in a transparent way. These partnerships are based on total clarity about what each party does. This is a strong incentive to start to develop a new language of business impact that recognizes the broader contributions that the private sector makes to development and poverty reduction.

New partnerships would work better with new instruments. One innovation that appears promising is the new Global Development Innovation Ventures platform of USAID, the U.K. Department for International Development and the Omidyar Foundation. This platform provides a variety of new tailored financing solutions.

Another instrument could also be to use leverage targets to encourage aid agencies to engage more proactively with the private sector. Absent that, bureaucratic inertia could turn the “scaling up” agenda into an episodic feel-good exercise with one or two examples but without the needed change in agency culture.

Third, more attention could be paid to risk mitigation instruments. One way to encourage this attention would be for guarantees and other risk instruments to be counted explicitly toward meeting aid commitments. Currently, they are not even measured in international reporting, let alone valued in terms of the impact achieved.

Finally, a new dialogue on the treatment of subsidies and patents on goods and services that are geared toward development solutions is needed. Innovation must be encouraged, but in a way that allows for rapid dissemination at reasonable cost.

## ENDNOTES

1. “A New Global Partnership: Eradicate Poverty and Transform Economies through Sustainable Development,” report of the High-Level Panel of Eminent Persons on the post-2015 development agenda to U.N. Secretary-General Ban Ki-Moon, May 30, 2013.
2. Amar Bhattacharya et al. “Infrastructure for Development: Meeting the Challenge,” G-24 Secretariat, 2012.
3. Richard Dobbs et al., “Mobilizing for a Resource Revolution,” McKinsey & Company, 2012.
4. USAID’s “Development Innovation Ventures” is a pioneering model that explicitly recognizes these stages.
5. Mike Kubzansky, “Why Business Models Matter,” in *Getting to Scale*, edited by Laurence Chandy et al. (Washington: Brookings, 2013).