

2013 BROOKINGS BLUM ROUNDTABLE

SESSION I: REIMAGINING THE ROLE OF THE PRIVATE SECTOR

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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, to do so, new partnerships with aid agencies and other public financial institutions are needed. 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 partnerships.

WHAT IS THE ISSUE?

The world of today is one where a minority of people (about 2 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 quality and differentiated products that meet their taste, 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, are 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 CEOs of 250 companies, which command annual revenues of \$8 trillion and are located in 30 countries.¹ Their conclusion: 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 (PPPs) 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 which 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 graduates are becoming more selective. They want to work for companies that are not just financially successful but that also have values they share and that “do the right thing” and contribute to a better world.

But companies also said they have trouble moving forward with 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, to use tax, subsidy and regulatory instruments to align private incentives with sustainable development. The most egregious example of where private and social incentives are 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 over-fishing in international and coastal waters. Lack of payment for implicit ecoservices,

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.

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 hard, but there are many good examples from which to draw lessons of success.

“Getting prices right” is a necessary, but not sufficient, condition for achieving sustainable development. Two other things 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.” One, there has to be significant innovation in moving to more sustainable patterns of production. Two, 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 is not yet contributing to its full potential. The issue is how to construct public-private partnerships that can do better on both counts.

WHAT NEEDS TO HAPPEN AND WHY?

Mobilize Private Finance

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

In aggregate, there is no shortage of money: Global savings are over \$18 trillion per 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 transport, but new mechanisms to identify and fund such projects are needed.

One promising initiative is the Power Africa program announced during President 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 of 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 USAID. The Millennium Challenge Corporation (MCC) will embed the projects in its country compacts. OPIC 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.

² Bhattacharya et al. “Infrastructure for Development: meeting the challenge”, G-24 Secretariat, 2012

While 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 this capability falls well 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 G-20, 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 financial close. 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 that can make fees unaffordable if full pass through is possible, or raise costs if there is only partial pass through); political risks (almost all PPPs 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 around land in particular); and operating risk (on both revenue and cost sides, including costs of recruitment and training of key personnel).

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

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 finance for sustainable development is needed.

Generate 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 to be between 30 and 80 percent by 2030.³ A substantial portion of that demand will need to be met through productivity improvements, and the greatest scope for

³ Dobbs et al., “Mobilizing for a resource revolution”, McKinsey & Company, 2012

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.

Prevention of land degradation and 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 brought down by better storage (including cold storage) and transport. 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 better irrigation techniques and pricing. 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 around 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 non-profit, for example, evaluates techniques that can bring down poverty rapidly. Their current list of technologies with proven impact comprises of 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 do we encourage more innovation? The most significant issue is reduction of 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 of or speed of reduction of subsidies. 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.⁴ Products that do not yet exist in a domestic market (such as solar units or microleasing) can take 8

⁴ USAID's "Development Innovation Ventures" is a pioneering model that explicitly recognizes these stages.

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 (3 to 5 years).⁵ Tailored financing for each development stage, and sustained financing to cover costs until scaled 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.

Be More Accountable

Although the private sector is an indispensable partner for poverty reduction, it is viewed with deep scepticism 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 performance. As a result, the language and information systems that management use to make decisions can be limited.

Firms have to be aware of layers of accountability. They are, first and foremost, responsible for the impact of their direct operations along financial, social (how many jobs created, for example) and environmental dimensions. However, they have found that people also hold them accountable for the actions of their suppliers, of the distributors and retailers associated with the firm and of 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 at transparency to 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 international consensus around norms.

⁵ Kubzansky, M. “Why Business Models Matter”, in Chandy et al. *Getting to Scale*, Brookings Press, 2013

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. It is time to put this aside and 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 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 transparency in 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, DFID and the Omidyar Foundation. This platform provides a variety of new tailored financing solutions.

Another instrument could be to use leverage targets to encourage aid agencies to engage more proactively with the private sector. Absent that, bureaucratic inertia could make 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 towards 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 towards development solutions is needed. Innovation must be encouraged, but in a way that allows for rapid dissemination at reasonable cost.