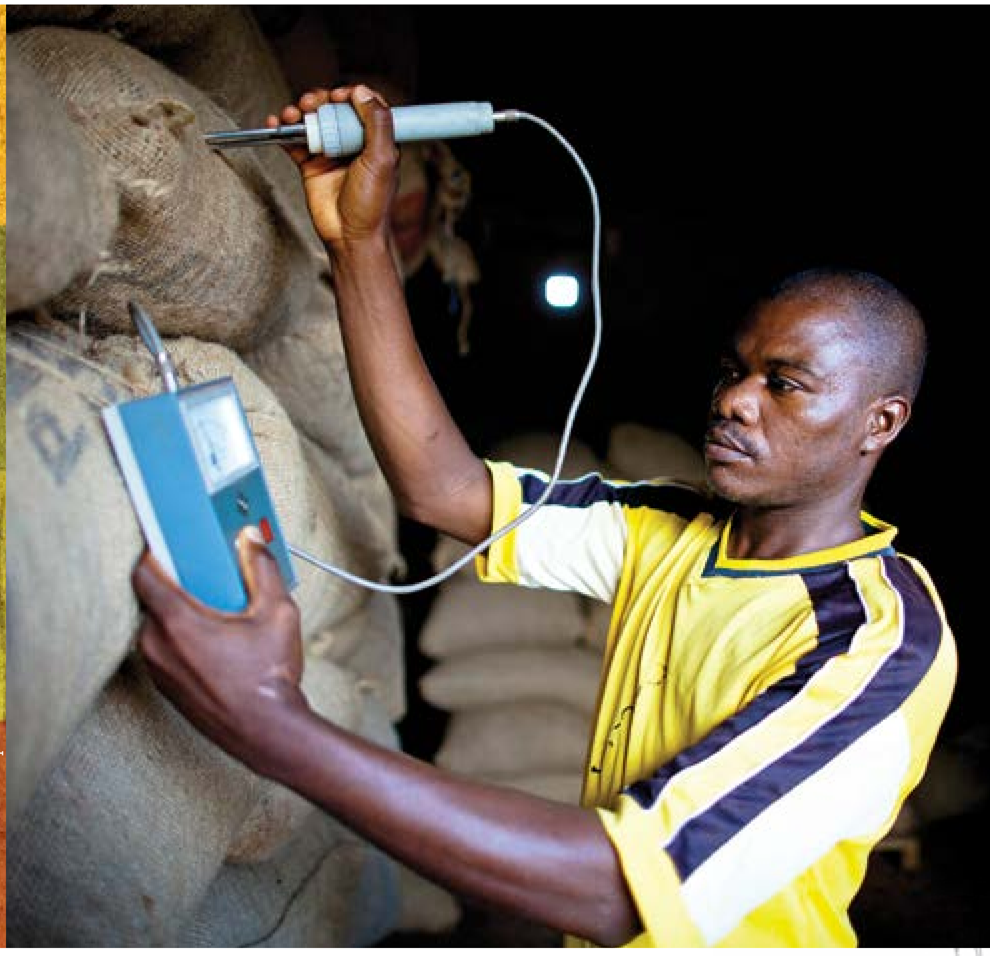
Reimagining the Role of the Private Sector in Global Development



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In the span of one decade, the private sector has become a prominent contributor to global development, even in low-income and postconflict contexts. But the principal purpose of private business activity is to make profits for shareholders, not to achieve development impact.

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These diverging interests can be aligned with better norms and standards, as well as voluntary improvements in business and aid agency practices, if efforts are made to blend commercial with philanthropic and official finance, and to build trust and accountability between development partners. However, to understand where the opportunities lie in these efforts, the private sector needs to be disaggregated into distinct types of businesses.

A Changing Context and Background

A decade ago, the idea that the private sector could become a major contributor to development was far-fetched. Today, it is acknowledged as not only a major player, but as potentially the major player. Since the 1980s, private foreign investment in developing countries has risen 15-fold; and since 2000, private capital has accounted for 80 percent of all capital flowing to these countries. Even low-income countries get one-third of their external funds from private sources. The private sector's role is so significant that it no longer even makes sense to discuss "the private sector" per se; there are many different types of private sector contributors, each making substantial contributions. The issues revolve around how these players interact with each other as well as with nongovernmental organizations (NGOs), with national governments, and with official development agencies.

Today, hundreds of private equity funds have a substantial track record of investing in small, medium-sized and scalable businesses around the world, with about 400 funds in China alone, as well as multiple funds operating in Africa, Latin America, Asia and elsewhere. These funds have demonstrated their development impact. Even using the narrowest measure of returns—after-tax financial returns—these funds appear to have performed better in developing countries than in advanced economies during the past decade. Yet, of course, these funds' ability to make money, not their ability to achieve development impact, has been the principal driver of private equity to developing countries.

Private equity funds in developing countries have made money through growth and scaled businesses, not through debt and leverage. Therefore, these funds put a premium on investing in countries with large, rapidly growing markets. Many developing countries have passed the threshold of minimum economic size that had hampered private capital flows, and so they are now better candidates for foreign private capital investors. With gross domestic product in many countries now running into the tens or hundreds of billions of dollars, it becomes worthwhile to consider whether there are enough opportunities for effective private investments. At the same time, households in these countries have more purchasing power. Several business models have cropped up showing that it is possible to make money all the way along the value chain when targeting households that spend more than $2 to $5 per capita per day, but that it is much harder to make significant profits when targeting consumers with income levels lower than this.

Another factor driving private capital toward developing countries is the emergence of better

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local partners and stronger local financial markets in these countries. Domestic entrepreneurs and investors help mitigate project and operating risk, provide significant informational advantages, and avoid foreign exchange risks. And local partners and businesses provide the "bankable" projects that were previously in such short supply.

Measuring the Private Sector's Development Contribution

Investment, jobs and tax revenues are all recognized contributions of businesses to development—as long as markets are operating reasonably freely, competitively and in undistorted ways. But in developing countries, these conditions cannot always be assumed to be a good reflection of how markets work. Absent them, there can be a major gap between what is good for business and what is good for development.

The most obvious example of this gap is basic corruption: when government officials grant companies special privileges in return for private gain. Though most businesses frown on this, they still fight regulatory measures in their home countries that would give teeth to monitoring and transparency—for example, rules on reporting payments made to foreign governments.

More and more companies are adopting voluntary measures for reporting these payments. Perhaps 2,500 multinationals already have some form of sustainability reporting, in an effort to make sure that management is aware of risks that could affect their brand. In addition, some companies are working with NGOs to assess their development impact more broadly; a good example is Oxfam's Behind the Brand initiative. These approaches strive to create a "race for the top" by encouraging firms to follow performance standards that closely align development impact with financial returns.

Multinationals' principles to maximize long-term shareholder value can be closely aligned with development impact because a long-term view of sustainability can raise brand value, improve hiring and recruitment, and generate cost savings through efficient reduction in natural resource use. As more large companies take such a long-term view, any gap between their activities and broader development impact becomes narrower.

This changed mindset suggests that the operations of large corporations can and do have a positive impact on development in countries that have well-functioning markets. A somewhat different question is whether private businesses can play a stronger role in creating new markets that can accelerate economic progress in countries that are at an earlier stage of development—that are, in other words, at the base of the pyramid.

It is difficult for major multinationals to retrofit their operations to serve low-income customers. A better approach is to design a start-up that explicitly targets the base of the pyramid. The profitability of such businesses has been hotly debated. Some have felt that the returns from producing and marketing the goods and services that are consumed by the 2 billion people in the world who spend less than $2 per day are too low to be commercially attractive to the private equity world. Data from Acumen are suggestive; it invested in 70 organizations out of a sample of 5,000 potential businesses, and its after-tax profit from the top 8 investments was reported to be only about 6 percent.

However, other examples, like that of Bridge International Academies, suggest that commercial returns are quite feasible once an operation has reached a critical scale. The issue then becomes one of attracting sufficient grant or social impact capital to reach scale. For this, official aid donors or private philanthropists are needed. These investors view "return" differently, in terms of development impact. And therefore, from this broader perspective, they see subsidizing the initial investments that enable firms to reach a viable commercial scale and that empower firms following innovative business models to create profitable markets serving the base of the pyramid as an effective way to leverage resources that make a significant difference in the lives of people living in poverty.

The potential for this combination of, first, initial up-front investments made by government or private philanthropists, and second, the growth of commercially viable businesses, is a new form of public-private-philanthropic partnerships that is attracting considerable interest as a way to catalyze businesses to create development impact.

Not all development problems, however, can be easily solved with market mechanisms. Cases where people living in poverty are geographically isolated, or where there is conflict, can make the costs of doing business too high to be profitable.

One exception to this is the case of major natural resource developments, like mining and hydropower, where significant returns can be made. The indirect contributions of such projects to development, operating through the social services and infrastructure that the government provides using the funds it receives from royalties and taxes, can be hard to trace for the local population or may simply never be generated. In such cases, it is preferable to create new platforms where direct, visible contributions from the project can be made that explicitly enable the project to serve as a framework for development.

This kind of framework is being tried in the Great Lakes region of Africa, where a major hydropower project is being considered. The risk is that peace may not hold without a tangible dividend for people whose expectations have been raised that a cease-fire will bring about a rapid improvement in their lives. Women's priorities are to address sexual violence and to improve livelihoods, but also to gain access themselves to power through off-grid solutions for households, and community clinics and schools. By linking and integrating these projects with the hydropower project itself, the chances for both sets of projects to succeed should rise. In this case, it becomes hard to separate the financial return to the hydropower project from the development impact of the off-grid platform. Each reinforces the other.

Another way of measuring the private sector's development impact is to consider the alternative

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of government activities for service delivery. Social enterprises are examples of businesses that do not necessarily strive to make money, but to provide services at lower cost than public providers. Their impact is therefore measured in terms of lower unit costs rather than profits. The financial deficit can be covered by public grants or private philanthropy.

Disaggregating the Private Sector

The alternative measures of private sector impact mentioned above highlight the need to disaggregate among the various players. Large multinationals and private equity providers are focused on making money (and are bound to this objective by fiduciary obligations), and they indirectly provide additional development benefits through employment, skills training, technology transfer and entrepreneurial development. But the main driver for these investors must be profitability. The role for public policy is to ensure that these firms' incentives to achieve both profits and development impact are as closely aligned as possible. And this alignment comes from lengthening time horizons for shareholder maximization, from open and competitive markets, and from a culture of zero tolerance for corruption. Norms and standards of good sustainable practices can be developed, with NGOs actively participating in setting such standards and monitoring their implementation.

The importance of protecting brands and commercial reputations in a world with an active press and social media and a demanding middle class is helping to drive a process that is aligning business interests and development impact.

Large infrastructure and mining ventures cannot afford to simply rely on governments to use the funds they generate in taxes and royalties for sound development. These pathways are too diffuse for average citizens to understand, especially in conflict environments where peace is closely linked to the prospects for immediate improvements in the people's living standards. Therefore, alternative platforms to showcase short-term development benefits (often in the local community) should be considered as part of a vital package of interventions that will jointly achieve both profits and significant development benefits. Partnerships with aid agencies, NGOs and philanthropists that generate this package of complementary investments are desirable.

Small and medium-sized enterprises, which are often oriented toward new business opportunities targeting moderately low-income households, achieve development impact through growth and the creation of new jobs. Although these ventures strive to become commercially viable, they may need up-front, patient capital to enable them to grow to a scale that is financially viable. This process can take several years, depending on the sector and the level of development of the needed supporting ecosystem of suppliers, infrastructure and off-the-shelf technology. Although, in theory, there is a role for public policy to provide the requisite capital, in practice private philanthropists appear to be operating more effectively in this space.

Social enterprises, specifically those targeted toward very-low-income households, often cannot be expected to make money directly; but they are still useful modes for delivering goods and social services at lower unit costs and perhaps more effectively than public alternatives. The role for public policy can be to fund such enterprises explicitly, and to encourage them to innovate and continue to drive down costs through new technological and business model solutions.

Blended Capital

Risk mitigation is the most important constraint on the private sector as it seeks to become more actively involved in development. Here, experience with official agencies has been disappointing. On one level, official agencies have failed to grow as much as the private

sector. Since 2000, global official nonconcessional flows (consisting of equity and long-term debt) have been negative, meaning that repayments on old loans have exceeded disbursements on new projects. Information on guarantees by official agencies is not systematically collected, but individual studies suggest that the scale of these is quite limited, and thus is unlikely to reach an average of even $10 billion per year globally.

On another level, commercially priced risk mitigation instruments are exactly what the private sector feels are most needed and desirable. The ability to combine official capital with private capital has many advantages. Not only can it spread financial risk, but official agency involvement can also provide a higher political profile for a project. Given the growing budget constraints facing many agencies, the promise of gaining greater leverage and catalytic impact on development from the use of public funds is alluring.

At the roundtable, many examples of the opportunities to blend official and private capital were discussed. Three main constraints emerged.

First, official agencies have had difficulty expanding their administrative capacity to participate in more deal flows. Agency budgets have been held down to cut costs, and recruitment of staff with the necessary skills has suffered.

Second, few agencies possess the needed array of instruments to be able to function as one-stop-shops for a private sector partner. Grants, guarantees, long-term debt and technical assistance and capacity building may all be needed to make a project work well. While all these instruments do exist in parts of the official system, they are scattered among different agencies. The need for multiagency collaboration—given that each agency has its own separate calendars, approval processes and priorities—creates a complexity for practical deal-making that has led to evident frustration.

Third, the culture and accountability of official agencies in dealing with the private sector can be overly risk averse. And this constraint applies not just to the actual financial decisions made about whether to pursue a project and on what terms but also to the speed with which decisions are made. The "time-is-money" culture that permeates private equity decisionmaking is not matched by official agencies.

A slightly different form of blending has to do with the sequencing of types of capital rather than the use of a range of instruments. Early-stage capital was seen as a gap, but even this can be subdivided into initial, small-scale funding (less than $1 million) to subsidize first-mover innovations (largely filled by private philanthropists), and somewhat larger early-stage, patient capital ($1 million to $20 million) to achieve minimum efficient scale. This scaling up capital is among the hardest to find.

Blended finance, therefore, remains an area of much promise, but one where practical obstacles to realizing the potential gains are significant. Efforts to chip away at these obstacles are being made with some success, but more could be done to institutionalize them.

Transparency and Accountability

A long-term strategy to change bureaucratic cultures in both the private sector and official agencies may be required to build the degree of trust and accountability that is needed to construct high-performing private-public-philanthropic partnership platforms. More dialogue on norms and standards could potentially improve speed and decrease bureaucratic risk aversion. For instance, a dialogue process to inculcate the idea that a primary role of government is to reduce risk would help. Speed, scale and sustainability must be balanced. The cultural changes and accountabilities are two-way. The private sector can do more to emphasize sustainability, while official agencies can do more to think about speed and scalability.

Multinational companies committed to the long-term maximization of shareholder value are managing the expectations of their shareholders. Some companies have become privately held. Others have stopped issuing quarterly financial reports and profit guidance. Sustainability reporting is being brought into the boardroom and taken out of departmental silos focusing on corporate social responsibility. Long-term strategies and scenarios that include, for example, implicit prices for carbon are being factored into current investment decisions.

Trust can also be built at the transactional level, through engagement with local and international civil society groups. As one example, corporations that have made pledges to reach 1 million smallholder farmers are asking how to manage this effort without being criticized for exploiting small farmers. Avoiding conflicts over land, water, technology transfer and other practical issues of control that emerge in partnerships are critical to successful development impact.

Trust is most important in situations of conflict and when dealing with historically marginalized and excluded communities. Some companies have introduced explicit grievance mechanisms to try to ensure that there are avenues for mitigating issues that arise in implementation.

Official agencies, for their part, are trying to improve speed and scalability. Some have introduced partner relationship focal points to improve responsiveness. Others are using private sector benchmarks for decisionmaking speed. There is more discussion about "transformative" projects that can potentially have an impact at scale. The nature of official agency involvement in conflict situations is being reviewed, although considerable issues arise of how to manage the ability to balance high-quality social and environmental safeguard standards with the ability to move at speed with private sector partners in the context of postconflict or fragile states.

Areas for Further Research

- **Context:** There is considerable private sector involvement in official conferences on development—including the post-2015 Development Agenda that will follow the United Nations' Millennium Development Goals, the Group of Twenty's B20 business forum, the World Economic Forum, the Global Partnership for Effective Development Cooperation and the UN's Global Compact—as well as numerous sectoral and country-based discussions. There is less agreement that these forums are generating real impact. How to bring the private sector voice more effectively into the poverty-reduction dialogue, especially in situations of conflict and marginalized communities, remains a work in progress.

- **Measuring the private sector's contribution:** Data on the development impact—social, economic and financial returns—of private equity is scattered and not generally available to researchers. Proper benchmarks against which returns for private equity in emerging economies should be compared are lacking. Industry practitioners feel isolated. Expectations can lag behind reality.

- **Disaggregating the private sector:** Practical advances will only happen when the private sector is disaggregated into specific elements—multinationals, infrastructure and extractives, small and medium-sized enterprises and social enterprises. Each face distinct issues.

- **Blended finance:** Risk mitigation has high theoretical potential, but little (and declining) practical implementation. If absolute volumes are to grow exponentially, bureaucratic and administrative obstacles in the boardrooms of private companies and official agencies must be overcome. Ongoing experiments to increase jointly financed projects could be studied to assess the impact on the volume of completed deals. Some gaps in specific types of missing capital could be filled, either by official or philanthropic agencies.

- **Transparency and accountability:** Assessments could be made of the impact of selected confidence-building steps, including reporting requirements, lengthening time horizons, grievance mechanisms, consultations with civil society, independent sustainability assessments, benchmarks for speed and a focus on scalability and transformative impact.