Conference note 3
October 2016

Where next for development effectiveness?

Investing in private enterprises

Paddy Carter

2016 CAPE Conference

1. Introduction

How should development effectiveness principles apply when donors make investments in private enterprises? This question divides those who believe that conforming to inappropriate principles will only serve to reduce the flow of investment into capital-starved countries, versus those who believe that without following development effectiveness principles, public money is being misspent and invested in enterprises that generate profits but do not do enough to promote development.

Donor investments in private enterprises are dominated by development finance institutions (DFIs), such as the World Bank's International Finance Corporation (IFC), the private sector windows of development banks and trust funds that they manage, such as the Climate Investment Funds, with smaller sums disbursed by challenge funds (such as the Africa Enterprise Challenge Fund). Some bilateral aid agencies also invest directly or via privately managed funds. The argument that development effectiveness principles must be followed by these entities, if they are to be considered part of official development assistance (ODA), is superficially attractive. But it contradicts a shibboleth of development effectiveness: best-practice blueprints should not be imposed regardless of context. Existing development effectiveness principles may not be appropriate for private sector investments. If so, one response could be to develop bespoke effectiveness principles for the sector.

This note is part of a series of papers to inform debate in the run-up to the Second High-level Meeting of the Global Partnership for Effective Development Co-operation (GPEDC) in November.

2. The existing context: Busan and the GPEDC

Aid effectiveness principles have evolved since their original articulation in the 2005 Paris Declaration. The four current principles for effective development cooperation are:

1. Ownership of development priorities by developing countries
2. Focus on results
3. Inclusive development partnerships
4. Transparency and accountability to each other.

These principles are elaborated at length in the Busan Partnership for Effective Development (2011), which also contains a section on the private sector, consisting of promises to (paraphrased):

- engage with stakeholders to improve the policy and regulatory environment
- involve the private sector in the policy-making process
- develop new mechanisms to mobilise private finance
- promote 'aid for trade', and
- explore ways of making business and development mutually reinforcing.

The GPEDC Mexico Communiqué (2014) also contains a section on Business as a Partner in Development, of a similar nature.[1] Neither of these documents comes close to articulating what it would mean for a DFI, or similar vehicle, to follow development effectiveness principles.

The DFIs all have individual legislated mandates, strategies and operating procedures. They have also collectively articulated a set of common principles for successful cooperation with the private sector, motivated by the belief that working with the private sector involves

Scope

Countless conferences and policy papers have declared that the fate of the Sustainable Development Goals (SDGs) rests, to a large degree, on the private sector. A number of initiatives exist to encourage the private sector to contribute more to the SDGs, such as the UN Global Compact.

The GPEDC is not just about aid effectiveness; it aims to 'advance the effectiveness of development efforts by all actors'. This note, however, will concern itself with the narrower issue of direct investments in private enterprises by public international development agencies. There are debates to be had about whether, when public development finance is blended with private, aid effectiveness principles can be imposed on the whole, and about what should be required of private finance more generally, but those debates are beyond the scope of this note.

different approaches from those used in cooperation with the state (EBRD, 2013):

1. Additionality
2. Crowding-in
3. Commercial sustainability
4. Reinforcing markets
5. Promoting high standards.

These principles do not obviously overlap with GPEDC development effectiveness principles, although they do indicate the results that DFIs regard themselves as targeting.

The Busan Partnership Agreement is operationalised by a set of indicators to be gathered in periodic monitoring exercises. The monitoring exercise is intended to apply to all ODA, and countries are also encouraged to monitor non-ODA flows. The recognition of investments in the private sector as ODA is under revision, but donor contributions to DFIs are eligible as ODA, as are other private sector instruments.

Some indicators are clearly intended for government-to-government aid (such as the percentage of aid on budget), but many could be applied to private sector instruments (such as use of country results frameworks). The GPEDC Monitoring Advisory Group has suggested that one of the indicators, an evaluation of public–private dialogue, could be an 'entry point for applying the effective development cooperation principles to the private sector as a development actor' and that an appropriate indicator for blended finance should be developed. However, as things stand, the GPEDC process has not articulated how its principles and agreed indicators apply to DFIs and other donor-backed investment vehicles. There is an opportunity for the Second High-Level Meeting of the GPEDC, in Nairobi this coming November, to define principles to govern this increasingly important form of development cooperation.

3. Development effectiveness principles for the private sector

This section discusses the application of the Busan Principles to donors' investments in the private sector. We do not assess the extent to which they already are being applied: see WBG (2010) and CPDE (2016) for evaluations.

We propose some potential commitments and indicators for development effectiveness when donors invest in private enterprises. Our position is that private sector investment is sufficiently multi-faceted and distinct from government-to-government aid that, rather than trying to come up with a single indicator, the GPEDC should consider stand-alone commitments and indicators for each of its guiding principles.

Ownership of development priorities by developing countries

In other areas of development, it is easy to understand the connection between ownership and effectiveness. It seems self-evident that efforts to improve quality and coverage in the health sector, for example, are more likely to succeed if the ministry of health and health workers support rather than thwart the project.[2] In the context of private sector investment, ownership, in this sense, is inherent in the deal. If a DFI lends money to, or invests equity in, a food processing business, for example, the owners of that business have a stake in its success.

But the concept of ownership is not just about those directly involved in the success or failure of a project or investment, it is also about society at large. The Busan Principles and advocates on this issue from civil society talk of democratic ownership, which is distinct from government ownership. In fact, in this context the government is sometimes perceived to be acting against the interests of its citizens: witness the reaction to the World Bank giving domestic governments more ownership of environmental, social and governance standards.[3] Some of these issues are dealt with by the third principle: Inclusive development partnerships.

In this context, though, there is a very clear direction in which some critics of the existing system want DFIs and donors to move, to fulfil the principle of ownership, and that is to organise their interventions around national development strategies (CPDE, 2016). Some also call for more parliamentary scrutiny and consultation with local government.

The response from most DFIs to the idea that they should only invest in enterprises that align with the government's development strategy would be as follows. Smart industrial policy does not entail rigid adherence to a plan but allows for experimentation with promising-looking investments. DFIs have a demand-driven business model and do not create enterprises, but merely invest in them. Suppose there are ten potentially viable projects in a country, of which seven conform to the government's plan but three lie outside. Supporting only those seven would do nothing to increase the quantity of investment in the government's plans, it would only mean forgoing the three other investments. This, DFIs would say, is because the supply of funds looking for bankable projects exceeds the supply of bankable projects looking for funds (Development Committee, 2015).

It is not obvious how much of a problem conflicts between donor-backed investments and national development strategies are in practice. If a country's national development plan favours certain sectors but is generally supportive of private enterprise wherever it may flourish, then conflicts do not arise. Major strategic private investments in infrastructure and the social sectors are very likely to involve the government. For example, the IFC will produce a Systematic Country Diagnostic in cooperation with the government.

While most DFIs and donors would say that they already consult national governments, many would still strongly resist the idea of more active day-to-day involvement by politicians in investment decisions. However, when donors invest in the private sector, even if the true cost is a fraction of the face value of the investment, they are still spending scarce development finance, and should be spending it where the intended beneficiaries want it spent.

Recommendations

DFIs and other donor-backed investment vehicles should commit to supporting national development strategies. The GPEDC should track whether donors incorporate country preferences into their investment strategies. Attempts to achieve wider ownership of investment decisions would be impractical.

Focus on results

Every DFI and bilateral agency will claim that it is focused on results. The question is, which results? The GPEDC principles require the use of country results frameworks, so that each country and its development partners are working together to achieve the same things, measured in the same way.

It is not clear to what extent this principle has ever been followed, even for government-to-government aid. Anecdotally, some donors say that they gave grants and technical assistance to develop national statistical agencies, but saw little return. Despite commitments under the Busan agreement, most donors probably regard themselves as primarily accountable to their taxpayers and responsible for providing their own evidence of the results that they deliver.

DFIs are no exception. The main results they focus on are making investments happen that would not otherwise (additionality), crowding-in other investors to those deals, and creating sustainable profitable enterprises. Financial returns are important because DFIs and similar entities have a business model based on recycling returns without requiring continual replenishment of grant funds, and because profits are an indicator of having created a sustainable business (although it is possible to lose money investing in a profitable business). DFIs regard job creation as the best way of capturing the development impact of increased investment, and most calculate direct and indirect job creation statistics (which requires making some assumptions about attribution). There are also scattered attempts to assess more far-reaching macroeconomic effects and also to evaluate wider development impacts at the household level. There have been efforts to standardise results measurement; in 2013, 25 DFIs and other similar bodies signed the IFIs Harmonized Development Results Indicators for Private Sector Investment Operations. The best route forward may be for countries to consider how to engage with these initiatives as they formulate their own results frameworks.

There is a perception that DFIs and other donor-backed investment vehicles need to be more focused on poverty

Do we need to throw it away and start again?

This debate raises some fundamental questions about development cooperation and the private sector. There is an argument that aid effectiveness principles are fundamentally incompatible with the existing model of international DFIs and donor-driven investment, where investments are made on a deal-by-deal basis, with minimal democratic participation from the host country. According to this view, if development banks that invest in private enterprises are needed then they should literally be locally owned, not donor controlled.

A counter view might be that in most less-developed countries this vision is too close to describing how we would like the world to be, and too far removed from how the world actually is. In this 'grim realist' view there are issues around technical capacity and the risk of political capture, so outsiders may be both more effective in terms of development impact and more likely to get access to funding, because they are trusted by, and also serve the national interests of, the donor countries.

and less on financial returns (Romero, 2015; IEG, 2011). The principle of country ownership and the use of country results frameworks need not imply a focus on poverty, and in some cases the activities of DFIs, driving economic growth and creating jobs that tend not to benefit the poorest and most marginalised communities, may actually be better aligned with de facto government policy than the extreme-poverty orientation of international development discourse. In any case, there is a place for a division of labour in development policy, and not every entity or activity needs to target the same set of results to the same extent. DFIs and other investments can target a sub-set of results, they need not try to do everything.

Another complication matching DFI investments to results frameworks is that they manage a portfolio of investments and may use high returns on some to cross-subsidise lower returns on others. So some may only indirectly serve development ends.

Few would probably argue against the proposition that more should be done to ensure investments have the maximal impact on sustainable development; whether using country-defined results systems would be helpful is much less clear.

Recommendation

Countries and donors should commit to harmonising the relevant elements of country results frameworks with those used by DFIs and other donor-backed investment vehicles. No indicator is necessary.

Inclusive development partnerships

In the context of private sector development, there are two main areas where critics might ask DFIs and donors to take a more inclusive approach when they invest in the private sector. The first is by undertaking more extensive consultation with (and perhaps offering compensation to) affected communities, where appropriate, and also putting in place better grievance procedures. The second is by taking a more inclusive approach to the local financial sector and trying to foster it, rather than supplant it.

There can be no argument that certain investments, such as those that will displace communities or impact their environment, require consultation and redress. It is also hard to see valid objections to putting open and rigorously followed grievance procedures in place. But consultations and other measures to include stakeholders in investment decisions must be proportionate to the risk and size of the investment. Cost matters. All overheads either require scarce grant funds from donors or must be covered by financial returns on investments. There is a trade-off: holding grant contributions constant, higher overheads imply making fewer and more profitable investments. But if investments are profitable, and dealing with a DFI or donor is too onerous, private enterprises will go elsewhere. So there are limits to what can be imposed on private enterprises. For smaller or lower-risk investments, it might be best to rely on the local legal system. While it is perfectly valid to require higher standards for ODA-funded investments than is required of others, we should perhaps be cautious about raising barriers to investment in developing countries that we do not have in our own economies or that developing countries would not impose on themselves. The challenge is to identify the best point on the quality/quantity trade-off, from the developing country's perspective.

It is hard to do justice to this complex issue here. It would be equally challenging for the GPEDC to agree on guidelines that match appropriate ways of conforming to the principle of inclusive partnerships to the size and nature of different investments.

DFIs and donors will say that developing local capital markets is one of their main objectives, and that local financial intermediaries are major recipients of, and

Public–private partnership (PPPs)

PPPs are a specific form of contractual arrangement whereby the government signs a long-term service agreement with the private sector. Rather than pay for, say, the construction of a hospital, which it then owns and operates, the government agrees to pay a private entity to build, own and run the hospital for some period of time. PPPs are controversial because they are often thought to be substantially more expensive than traditional public procurement, more profitable for the private party and, because the contracts are long-term, onerous contracts can create a serious problem for public finances. DFI and donors may also be involved in the promotion and financing of PPPs – the World Bank and the IFC are active advocates of PPPs.[4]

In the case of PPPs, one might assume that official government ownership can be taken for granted, because they are parties to the deal, so the concern is more about democratic ownership. In the context of PPPs, transparency and accountability are probably the most important of the aid effectiveness principles.

channels for, their funding. Furthermore, if one accepts that DFIs and other donors are doing what they should (which one need not accept), by only supporting enterprises that would not find support elsewhere, it is hard to see a deleterious impact on local capital market participants. One exception could be when a DFI or donor funds an enterprise that would be able to find finance locally, in order to change the nature of that enterprise and make it more developmental. The case that DFIs undermine the local financial sector is hard to substantiate.

Recommendation

Donors should commit to putting in place rigorous procedures for identifying groups at risk, consulting affected communities and handling grievances. Monitoring could be based on an independent rating of these.

Transparency and accountability to each other

The quantity and quality of information in the public domain about the activities of DFIs and donors has increased sharply in recent years. DFIs make information, of vary degrees of detail, available on their websites and a number of organisations now report data that is compliant with International Aid Transparency Initiative standards, and the OECD Development Assistance Committee is currently reforming its reporting standards for donor private sector instruments. But information about how much is invested in what is only half the story, and there is a case that the transparency demanded under the Busan Principles does not go far enough.

First, it is impossible to ascertain the degree of subsidy inherent in an investment on the basis of its face value. The development rationale for making the investment may not be publicly disclosed, and the evaluation of risks and proceedings of any consultations may not always be in the public domain. OECD and IATI systems do not require co-investors to be listed, and even if corporate identities are given that does not mean it is possible to identify the beneficial owners. Exactly who owns the businesses that DFIs are supporting is likely to be of great interest to developing countries. Information concerning the tax behaviour of the enterprises invested in may not be collected or disclosed.

There are some potentially valid commercial sensitivity issues here, but enterprises are not being asked to disclose their secret formulae or confidential pricing agreements with suppliers. Some governments have adopted open contracting standards, and it seems reasonable that donors might impose certain transparency requirements on investees. After all, if enterprises are receiving public support, it is usually supposed to be because they have no private sector alternatives. Certainly in the context of PPPs, it seems essential that citizens are able to see what their governments are signing up to.

There are, again, cost implications here. DFIs and donors often invest via intermediaries that are not set up to collect and disseminate information of the sort campaigners may wish to see, and requiring them to do so could add significantly to their overheads. But there is a strong case that donors and DFIs should be required to disclose information that goes well beyond anything required under the Busan Principles, and the GPEDC should consider establishing a consultation process to determine exactly what.

Recommendations

Donors should commit to a process that will establish shared transparency requirements when investing public money in private enterprise. Indicators could include the percentage of PPPs that conform to Open Contracting Partnership data standards, and the percentage of investments where: full beneficial ownership information is available; the upfront investment case is public; some indication of the degree of concessionality is stated.

4. Conclusion

Everybody has a shared interest in increasing the positive impact that DFIs and donors have on sustainable development, through their investments in the private sector. If doing things differently – more in line with development effectiveness principles, perhaps yet to be articulated – would make DFIs and other donor-backed investments more effective, then rather than be on the defensive, these entities should embrace new requirements. But this is a value-for-money problem; it is possible that more consultations and so forth might improve outcomes, but not in a cost-effective way.

These debates hinge on how effective DFIs and other donor investments are. If you are sympathetic, then insisting on procedures that would result in them doing less of something useful will seem like a retrograde step, and the fact that what they do may often seem inconsistent with generally accepted principles will seem less important. If you are a sceptic, then these principles are more likely to seem like the path to rescuing the situation.

Investment involves confidential negotiations, and technical analysis of risks and expected returns to arrive at pricing (valuation) decisions. Day-to-day investment decisions are never going to be taken by a committee of ‘stakeholders.’ Partnership and accountability should apply when formulating investment strategies and monitoring their execution, and in ensuring that those making day-to-day investments take full account of the consequences of their decisions on local communities. This note has made some recommendations which might not go far enough in the eyes of some critics, but we think they are realistic. The area with the greatest scope for improvement is transparency.

Notes

1 A joint Statement for endorsement by representatives from the public and the private sectors was also released at Busan: Expanding and enhancing public and private co-operation for broad-based, inclusive and sustainable growth, which recognised five principles: Inclusive dialogue; Collective action; Sustainability; Transparency; and Accountability for results.

2 Killen (2011) surveys some of the evidence showing that following development effectiveness principles does, in fact, result in more effective development.

3 For example, Gordon, G. 'Development banks and the silencing of dissent', 5 September 2016, The OpenDemocracy blog.

4 Regarding value for money, the most optimistic reading of the evidence thus far from advanced economies is that it is mixed (Hodge and Greve, 2009). In the developing country contexts, straight value-for-money comparisons with traditional procurement are rare, but a systematic review found some evidence of positive developmental impacts but large variation across sectors (IOB, 2013).

References

Busan (2011) 'Busan partnership for effective development co-operation'. Fourth High-Level Forum on Aid Effectiveness, Busan.

CPDE (2016) *The development effectiveness of supporting the private sector with ODA funds*. CSO Partnership for Development Effectiveness and the Trade Union Development Cooperation Network.

Development Committee (2015) 'From billions to trillions: transforming development finance post-2015. Financing for development: multilateral development finance'. Discussion note prepared jointly by the AfDB, ADB, EBRD, IADB, IMF and WBG.

EBRD (2013) *Multilateral development bank principles to support sustainable private sector operations*. European Bank for Reconstruction and Development.

Hodge, G. A. and Greve, C. (2009) 'PPPs: the passage of time permits a sober reflection', Economic Affairs 29(1): 33-39.

IEG (2011). *Assessing IFC's poverty focus and results*. World Bank Independent Evaluation Group.

IOB (2013) 'Public–private partnerships in developing countries: a systematic literature review'. IOB Study no. 378. Ministry of Foreign Affairs, The Netherlands.

Killen, B. (2011) 'How much does aid effectiveness improve development outcomes? Lessons from recent practice'. Busan background papers.

Romero, M. J. (2015) *A private affair: shining a light on the shadowy institutions giving public support to private companies and taking over the development agenda*. EURODAD.

WBG (2010) *Safeguards and sustainability policies in a changing world: an independent evaluation of World Bank Group experience*. Independent Evaluation Group, World Bank Group.

Overseas Development Institute
203 Blackfriars Road
London SE1 8NJ
Tel +44 (0)20 7922 0300
Fax +44 (0)20 7922 0399

odi.org

ODI is the UK's leading independent think tank on international development and humanitarian issues.