

Amplifying the private sector in development: Concerns, questions and risks

by **Bhumika Muchhala**

The role of the private sector in economic development has become an increasingly central question in the global political economy. The ascendancy of the private sector's leadership, rooted in its financial and political power, and increasingly its legal power as well, is reflected across the agendas, discussions and operations of various global institutions or bodies. These include the Group of 20 (G20), the largest multilateral development banks (MDBs), national and regional development finance institutions (DFIs) such as the European Investment Bank (EIB), and the United Nations post-2015 development agenda (which is to replace the Millennium Development Goals when they expire in 2015).

Specifically, over the last decade, there has been a sharp increase in publicly supported cross-border financial and regulatory support for private investments and public-private partnerships (PPPs).¹ Where previously the support

was in the form of loans, equity investments and guarantees, international institutions are now providing an increasingly larger share of public financing as well as official development assistance (ODA) to the private sector.²

Since the 1990s the scale of this support has proliferated dramatically. In the fallout of the global financial crisis, even as global ODA stagnated, in 2010 external investments to the private sector by international financial institutions (IFIs) exceeded \$40 billion. By 2015 this amount is projected to surpass \$100 billion. Over the past decade, multilateral development banks have experienced a dramatic spike in their private sector portfolios from 7.3 billion euros to 21.24 billion euros.

Between 2006-10, DFIs, particularly in Europe, increased their private sector portfolios by 190%.³ For example, Belgium's Bio more than

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trebled from 30 million to 100 million euros. The International Finance Corporation (IFC) of the World Bank and the EIB scaled up their private sector support from 1.5 to 3.4 billion euros between 2006-10.

Since 1990, financing to the private sector by MDBs has increased tenfold, from less than \$4 billion to more than \$40 billion per year. As a response to the global financial crisis, MDBs actively called on donors to scale up their institutional funding or capital base. The MDBs, including the World Bank, sought to expand their private sector financing, which raised serious concerns as to their developmental impacts on poverty eradication, environmental sustainability and human rights.

In the wake of the global financial crisis, the World Bank's portfolio for public finance directed to private sector infrastructure soared from 2009 to 2010. Meanwhile, the Bank's development finance loans and grants for social sectors such as health, education and pensions, and essential social services such as water and sanitation, have either decreased or stagnated.⁴ Private sector financing will thus comprise almost one-third of external public finance to developing countries. External public finance involves the provision of funds or a guarantee of lending to a private sector actor by a state-backed agent, such as a development bank or IFI (this does not include private-private flows such as foreign direct investment or remittances).

G20 Financing for Investment framework

Catalysing private investment has become a core task of the G20's new Financing for Investment (Ffi) framework, which was launched in the 2013 Russian G20 process. Chaired by Germany and Indonesia, the Ffi Study Group's agenda includes looking at ways to improve the investment climate and identifying new sources for long-term investment in coordination with the World Bank and other financial institutions, focusing on public-private partnerships in infrastructure.

At the March 2013 G20 sherpa meeting, the Russian official stated: "We are ... considering the possibility of modifying mandates of national and international development banks, with the

goal of focusing the institutions for development on promoting investment, primarily in infrastructure, and supporting public-private partnerships in this area."

Research by the Heinrich Boell Foundation (2013) shows that a World Bank paper titled "Long-term financing of growth and development", published with six other agencies in February 2013, has 12 annexes. Only one of the 12 annexes mentions the natural environment, while none appear to say anything about social development.⁵

A primary task of the Ffi framework is to generate the long-term finance for massive cross-border infrastructure operations, such as those identified by the G20's High-Level Panel on Infrastructure (which include the Inga Dam, East Africa and West Africa electricity grids).

The G20 claims that its infrastructure operations are to be integrated with the Group's food security strategy, in terms of regional integration and trade facilitation infrastructure that scales up food production, exports and imports. However, the infrastructure action plans that the panel mandated each development bank to design make little mention of food security or, for that matter, the social, environmental or rights-based dimensions of infrastructure mega-projects.

Scarce ODA channelled to private sector

Engaging business through development aid has become a central plank of many donor countries' official aid policies as national agencies increasingly look to business as prime partners. In the last seven years, bilateral development agencies have been channelling a rapidly growing share of ODA to the private sector. Since 2006, Belgium and Sweden have increased aid flows to the private sector by four and seven times respectively. This pace dwarfs aggregate ODA growth from these very countries.

The use of scarce ODA resources for private sector contracts and investments has long been a contentious issue. Public aid flows are distinct from private sources because their purpose is to finance the pursuit of the public goods (such as health services) funded by money collected by the state, for example through taxation.

Aside from direct flows to the private sector, ODA reaches the private sector through two other key mechanisms, public-private partnerships and public procurement.

Public-private partnerships

Public-private partnerships are joint programmes undertaken between governments and the private sector, in which governments usually guarantee private sector investment. Donor governments use ODA to subsidise the lending or other activities of development finance institutions.

Development debates are increasingly portraying the private sector as a more efficient vehicle for delivering development results without increasing public budget burdens and with the benefits of human and physical capital, technology and knowledge. However, such generalisations have proved to be dangerously simplistic, as different firms and sectors can have significant variations in development results. Meanwhile, the infusion of private sector financing does not offset or negate the critical need for, and distinct function of, direct public investments, particularly in essential social services.

There is an increasing range of researched evidence by academics, think-tanks, civil society and policymakers that urges caution on the various risks and controversies demonstrated by the history of PPPs and that calls for a deeper rethink on the role of the private sector in development.

A key concern regarding PPPs is: who pays for the risks and at what cost are profits made? Financial risks in PPPs are often disproportionately borne by the public sector, while profits are reaped by private investors and companies. This has led to the interpretation of PPPs as “publicly-guaranteed private profits”.

In many developing countries, the privatisation of water and electricity services has increased the financial sustainability of these utilities while consumers face unaffordable tariffs. The highly controversial privatisation of the water utility in the city of Cochabamba in Bolivia led to a 200% increase in water prices and triggered widespread riots in the country.⁶ In Ghana and

Namibia, subsidies for basic utilities were eliminated by privatisation, which led to increased rural-urban inequality.

Some key issues, among possible others, that arise with PPPs are:

(1) Risk and debt: Public guarantees for PPPs present an inequitable cost burden for developing countries that should be allocating financial resources to social sectors and other public investments. A significant aspect of the disproportionate risk is the debt burden that falls on the state in the event of project failure. Furthermore, debt sustainability calculations often do not take public guarantees of PPPs into account due to the “off-budget” placement of these funds.

(2) Ownership: The degree of ownership undertaken by developing countries is questionable when PPP contracts are secured, in many cases, between donor institutions and private firms.

(3) Tied aid: PPPs are often specifically targeted to firms from donor countries, which is a form of “aid tying”. This practice not only undermines the value of private sector development in developing countries, but also creates a de facto exclusion of developing-country firms.

(4) Management for development results: The development, equity, employment and poverty eradication outcomes of PPPs are at best unclear. While PPPs claim that their revenues will trickle down to benefit the poor, available evidence shows otherwise.

(5) Alignment: The objectives of private sector firms are not always aligned to public development concerns. The ability of states to ensure that private sector actors honour national development priorities is dubious.

(6) Rights and standards: Firms in PPPs that have violated human rights or labour rights, or that evade taxes, are not held accountable, much less systematically debarred from PPPs. Some advocates call for the state to use PPPs as an incentive or tool by which socially responsible behaviour by private actors is rewarded. Other advocates urge for stronger laws, regulations and limits to rein in private actors.

Public procurement

Public procurement is the purchase of goods and services by governments from the private sector. In 2011, approximately \$69 billion of ODA was allocated to procurement services annually, the vast majority of which was directed to donor-country companies. Many of these contracts to private sector firms are “earmarked”, meaning that developing-country recipients are required to give procurement contracts to donor-country companies (a policy which has been shown to increase supply costs by 15-40%).⁷

Broader concerns, critiques, questions

The purpose of public investment

Financial investments and lending from the public sector to the private sector have traditionally played a critical role in building a productive private sector. It is the role of public authorities to establish both legal and physical infrastructures to ensure an enabling business environment and, importantly, to strategically direct lending to credit-constrained domestic firms that cannot access financing from private capital markets. This lending, if embedded within national economic development strategies and industrial policies, should act as financial support channelled to economic sectors and companies deemed of strategic importance to the country.

However, in order to ensure that public investments are both accountable to taxpayers (the source of public monies) and yielding economic development outcomes, governments must ensure that financing is allocated to businesses that are creating decent work or social or public services, and are contributing to the expansion of the domestic tax base rather than to tax evasion or avoidance, including through corporate transfer pricing.

Given the profit-seeking mission of the private sector, balancing social and financial returns requires the state to implement a complex and nuanced balance of laws (e.g., labour, environmental) and regulatory systems (e.g., tax, investment) to ensure that private activities contribute to rather than undermine economic and social development.

Whose private sector?

The track record of private sector financing by multilateral and national financial institutions shows that more often funds are given to companies domiciled in donor countries rather than in developing countries. An assessment of all investment projects by the European Investment Bank and the International Finance Corporation in the world’s poorest countries during the second half of the 2000s revealed that only 25% of all companies supported were domiciled in developing countries.⁸

Roughly 49% of these institutions’ portfolios goes to companies in OECD countries and tax havens, and approximately 40% of the companies are big firms listed on some of the world’s major stock exchanges.

This finding raises questions as to whether IFIs are actually directing their financial support to the most credit-constrained companies in the world’s poorest countries, or whether their investment patterns are simply following market trends.

It also gives rise to several serious concerns on economic governance, development and ownership at the national level:

First, the companies that are critical to national development strategies in developing countries are domestic micro, small and medium enterprises (MSMEs). These MSMEs are domiciled in developing countries, not in donor countries. MSMEs are much more likely to be credit-constrained than are foreign firms, as they often lack access to private capital markets or are not able to raise money through debt or bond issuance. This is due to several factors, including the fact that limited credit supply in many developing countries combined with high interest rates make financing for local firms scarce and costly. Furthermore, small domestic firms are more likely to be considered either too small or too risky to access capital market financing, and are less able to list themselves on national stock exchanges, much less the world’s largest.

Second, most employment, in both the formal and informal sectors, in developing countries is created by the domestic MSME sector. Given that job creation is a stated goal of both interna-

tional and national financial institutions, their “tied aid” policies that require liberalisation of government procurement practices should be seriously examined.

Third, foreign multinational corporations (MNCs) do not always play a constructive role for national economic and social development. Not only have foreign MNCs been demonstrated to be more likely to evade taxes and engage in transfer mispricing, they also often have investor powers, particularly through trade and investment agreements, to legally prohibit governments from enacting pro-development state regulations and safeguards.

While financial institutions claim that their investments are directed to scaling up financing for MSMEs, external stakeholders claim that it has been almost impossible to track whether the money is actually reaching intended domestic MSME beneficiaries. This is because the financial intermediaries between the lender and recipient, usually commercial banks and private equity funds, do not provide disaggregated data on which projects and companies they support and what development impacts are achieved.

Development outcomes?

The May 2011 report of the World Bank Independent Evaluation Group (IEG), *Assessing IFC's Poverty Focus and Results*, found that less than half of the IFC projects reviewed delivered development outcomes, and just a third of the projects addressed market failures such as increasing access to markets or employment for the poor. The report sparked the question of whether donor governments are breaching their contract with taxpayers, given that their agencies are mandated to deliver poverty eradication and sustainable development as defined by the Millennium Development Goals (MDGs).⁹

Salient questions arise from these trends. Should development finance be subsidising donor-country firms and profit-based activities, particularly in large-scale infrastructure, that could be obtaining financing from private capital and financial markets? Is the private sector sufficiently incentivised and adequately regulated by the state to provide social services and public goods with positive development outcomes? And, what then is the developmental

role of the state in providing these goods and services? How does the privatisation of goods and services reconfigure the remit of the state?

Governance for equity and access

Equity in public-private partnerships is concerned with broad dimensions such as equitable distribution, access and affordability. Providing access alone has proven to be insufficient, as it is *equitable and affordable* access that is an essential dimension to fighting poverty.

To ensure this, regulation and enforcement are necessary, particularly of laws, policies and safeguards to ensure the economic and social rights of people, including women's rights, as well as environmental protection and sustainability.

The majority of evidence on private sector investments and projects suggests that regulatory agencies have a positive impact on access, efficiency and quality of services, as well as in reducing corruption. However, this may lead to price increases with inequitable distribution outcomes. In such cases, targeted subsidies and transfers to the poorest segment of consumers have the potential to increase equity.

The real challenge is that building competent and effective institutions for governance takes time and skill, which is often incompatible with the need to deliver quick public-private partnership deals.¹⁰

Contingent liability and debt

Public guarantees for public-private partnerships are often placed as an “off-budget” item. This means that the contingent financial liability, often of huge sums, which the state is required to pay in the event of project failure or risk, is not factored into national debt sustainability analyses and frameworks.

There are two urgent concerns with off-budget public guarantees. First, in the case of project failure or risk and payment by the state of the financial guarantee, the country can be at serious risk of indebtedness. Second, a highly asymmetrical financial risk burden is placed on the state in comparison to

the private firm, which sparks a questioning of the legitimacy of public financing for the private sector often enforceable by law.¹¹

Aid for the people or for firms?

In the current context of ODA contraction, a key concern is that the use of aid for private sector investments reduces funds for much-needed public sector investments, which still face huge financing gaps in many developing countries. Questions arise over whether private sector support can also be derived from other financial instruments, such as loans or equity.

Many civil society organisations argue that scarce aid resources should be earmarked for urgent public investments in social sectors, such as health and education, and some types of pro-development infrastructure, such as roads. While financial returns may not be forthcoming in the short or medium term, such investments are critical to building a resilient and thriving domestic private sector in developing countries.

Financial sector trumps real sector

On average, over 50% of public finance from donors to the private sector went to the financial sector, and this percentage may increase if recent trends persist. In 2010, the combined lending and investments in the financial sector of major DFIs and IFIs increased, on average, by over twofold compared to pre-crisis levels (before 2007). The IFC's commitments to the financial sector, including trade finance, constituted 42% of all its investments in low-income countries in 2010, and were four times the size of its investments in any other sector. The EIB funnels well over 50% of investments, and as much as 91% of its projects, to the financial sector.¹²

Public funds invested in private financial institutions usually target three main financial intermediaries: commercial banks, private equity funds and index funds. In pre-crisis years, commercial banks used to be the primary recipient of funds. However, starting in 2008, private equity funds gained in importance in relation to commercial banks as well as other forms of financial intermediaries, including microcredit enterprises. In the year 2008, 22% of the IFC's financial sector funds were invested in commercial banks while

59% went to private equity funds.

Ways forward

1) Align private sector financing to developing countries' investment and development priorities. Developing-country ownership should be respected by aligning investments to national development strategies, including national industrial and agricultural policies and strategic priorities for scaling up the domestic private sector. A coherent framework that sets clear guidelines for alignment and ownership, and regular reporting on results have been recommended by many actors as a first step forward.

2) Make development outcomes the overriding criteria for project selection and evaluation. To ensure that projects and investments have a developmental impact, objectives defined by both citizens and the state should be addressed by investments, along with clear outcome indicators and monitoring. One possible requirement could be that development outcomes are disclosed at the project, not the aggregate, level, which could improve accountability of public-private projects to affected communities.

3) Prioritise domestic MSMEs and companies over foreign companies. This is essential for private investments to actually support the development of competitive and locally-owned private industry. A thriving domestic economic sector is critical to stimulating domestic resource mobilisation through expanding the tax base and scaling up productive capacity and revenue. To help ensure this, private investments should be required to facilitate local-content requirements, as well as knowledge and technology transfer.

4) Regulate against tax evasion and tax loopholes. Since both international and national financial institutions have a development mandate, an official stance must be taken against tax evasion. For example, all firms involved should be required to disclose reliable annual information related to taxes paid, profits made, sales, and information regarding beneficial ownership, including trusts, foundations and bank accounts.

5) Compliance with international human rights, social and environmental standards.

Adherence to rights and standards must be ensured through regulatory systems and governance institutions, through third-party and independent monitoring, among other mechanisms.

6) Set higher standards for transparency of financial intermediary investments and review their use of investments. The several challenges posed by financial intermediaries in practising financial transparency and showing development impact must be addressed. Besides improved reporting by financial intermediaries to both governments and the public, criteria can be developed whereby public agencies only channel financing to intermediary institutions if the investment flows can be tracked and investigated.

Public versus private investment – an ongoing debate

Infrastructure investment is a basic component of industrial development.¹³ The longstanding debate on the benefits and risks of public versus private investment for infrastructure needs to be contextualised in the imperative for industrial policy, especially for developing and least developed countries that still lack basic infrastructure. In 2006 the Development Committee of the International Monetary Fund (IMF) and World Bank indicated that there has been an “overshooting in the reduction of the State role in investment, particularly in the case of investment in basic infrastructure. Insufficient State investment in basic utilities, roads, transportation, and port facilities has undermined the prospects for growth in many low- and middle-income developing countries.”¹⁴ Years later, the same Bretton Woods institutions have very determinedly changed their tune.

A key 1997 study by Odedokun on the initial and long-run effects of public investment expenditure on economic growth, relative to the effects of private investment, over the period 1970-90 for 48 developing countries, suggests that public investment in infrastructure facilitates private investment, especially in the long run.¹⁵ The study also finds that the long-term effects of public investment tend to be much more positive than the short-term effects of private investment on growth and efficiency. Still, the question of whether and to what extent and how

the state should be involved in infrastructure investment is fraught with controversy.

Salvaging the ethos of the developmental state

The surge in private sector investments, including through public-private partnerships, calls for a deeper rethinking and critical examination of the role and responsibility of the public sector, and, more specifically, of the developmental role of the state. Are there certain essential social services (such as healthcare and education) and certain basic infrastructure projects needed for development (such as roads) that should be carried out only in the public domain to ensure distributional equity in access and affordability?

To what degree can the inadequacies of the state in developing countries (in terms of physical and human capital, technology, knowledge and skills, and so on) be a justification for turning to the private and financial sector? Are there other choices? Can alternative paths be explored?

The discourse on the role of the private sector in development should assert the question of where and how the state can build and pursue its developmental role without relinquishing governance and legal powers to foreign investors (particularly through the enforcement power of trade and investment agreements), and both foreign and domestic private sectors that usually do not have a development mandate.

Can public-private partnerships take place in a context where the state is able to exercise due diligence and regulatory agency, including legal requirements, through the establishment of institutional governance over the private sector and foreign investors?

Bhumika Muchhala is a senior policy researcher with the Third World Network in the area of finance and development. The above formed part of her presentation on behalf of TWN to the United Nations Conference on Trade and Development (UNCTAD) Public Symposium on "New Economic Approaches for a Coherent Post-2015 Agenda" in Geneva on 24 June 2013.

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