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Private sector development – business plan or development strategy?¹

Karin Küblböck and Cornelia Staritz

Private sector development (PSD) has taken on an increasingly prominent role in international development cooperation. This note argues that the private sector has to play an important role in sustainable economic and inclusive development but points out three concerns for effective PSD interventions: PSD is not a “technical solution” but there are different theoretical approaches to the question which policies support a sustainable and inclusive private sector. There is no “one” homogenous private sector but important interest conflicts and the interest of foreign firms should not be equated with the interest of the local private sector and national development concerns. A pro-development international policy environment in particular in the areas of trade and investment policies is crucial for PSD which stresses the importance of donors’ policy coherence.

PSD has taken on an increasingly prominent role in both the debates as well as budgets of development cooperation at the multilateral and bilateral level. While the promotion of private sector activities in developing countries has for a long time been part of development cooperation strategies, in the past years there has been a shift towards a more proactive role of the private sector, defining it as a partner to address development challenges. As a consequence, the private sector is increasingly granted space in international and national policy discussions, proposing development solutions and designing, financing and implementing development activities together with official development actors.

The central questions are whether current PSD interventions and their underlying strategies and theoretical approaches correspond with a “business model” – mainly serving rather narrow (international) business interests – or a “development model” – contributing to sustainable economic and inclusive development – and how interventions should be designed to achieve the latter.

Shortcomings of the dominant “business enabling environment” discussion

There is generally broad agreement in development thinking and practice that a dynamic private sector plays a crucial role in economic development as an engine of investment, innovation, and growth that offers an effective way to create employment, incomes, and prosperity. However, there is no consensus on which type or segment of the private sector is best suited for economic growth and inclusive development and particularly which policies are required to develop such a private sector. This disagreement is based on diverging theoretical approaches concerning economic development more broadly. Three broad approaches that implicitly underlie PSD interventions can be identified (see also Reiner/Staritz 2013).

The structuralist approach considers government interventions crucial and structural change key for economic development. In this view, economic development requires shifting production factors from low- to high-productivity activities which allow for learning, externalities and higher profits and wages. As market forces alone provide inadequate signals for sustainable development, governments are required to shape the economy by pursuing selective policies favoring certain sectors, or by being directly involved in production activities (Amsden 1989).

The neoclassical approach assumes that the private sector develops best in response to market forces. Countries should focus on their comparative advantages based on natural endowments rather than actively attempting to transform their economic structures via selective policies. Governments should provide a business enabling environment focusing on horizontal or neutral policies that facilitate the economic sphere by ensuring property rights, reducing regulatory burdens through deregulation, and improving infrastructure.

The neostructuralist approach emphasises the importance of a business enabling environment and market forces but also stresses that this is not sufficient for sustainable private sector and economic development. Market failures and coordination problems such as non-existent markets, asymmetric information, barriers to entry and power imbalances are widespread particularly in developing countries which requires government intervention and selective policies that directly shape the economy, interfere in markets and focus on structural change.

Even though the development discourse has been changing in the last years, most PSD policies continue to focus on the creation of a business enabling environment and a favourable investment climate in the context of the neoclassical approach. A strong influence in this regard is exerted by the *Doing Business* reports of the World Bank which

collect data on the administrative costs of establishing and running enterprises and rank countries accordingly. These reports have been a driving force behind regulatory reform in many developing economies.

There is however scepticism if the *Doing Business* indicators are actually the main barriers for PSD in partner countries. Complex and expensive regulations are problematic but are often not the main obstacles for the development of local enterprises. Greater hurdles are often, for example, low productivity and linkages to other firms; access to information, markets and financing; lack of trained staff, technical or managerial expertise; and missing infrastructure. Such obstacles are however not addressed by deregulation and the creation of property rights but require complementary policies such as public investment in infrastructure and services, vocational training, technology transfer or local value creation. In the labour market, for example, rather than “over-regulated” labour markets, it is often a lack of trained workers that hinders PSD (UNIDO/GTZ 2008).

Some business enabling criteria may even be in direct conflict with broader development goals. These include the deregulation of labour markets that was for a long time included in the rankings² and is often associated with a reduction in labour standards. Corporate taxation is another striking example. In the *Doing Business* reports, a country that lowers corporate taxes can improve its ranking position.³ As adequate tax revenues are crucial for social and economic development, lowering corporate taxes can directly contradict development goals.

But even if the expectations associated with the *Doing Business* reforms are met and more companies are set up or become more successful, this still does not necessarily lead to a dynamic economy and inclusive growth. The commercial interests of individual firms may even be diametrically opposed to development goals, as some business activities in the extractive sector or the strong pressure on wages and tax cuts by the local and international private sector have shown. Hence, the operations of markets may not provide the conditions for sustained and inclusive economic growth, particular in the context of global competition. “Global competition is so intense that unless deliberate policies are introduced to foster a systematic program of upgrading, producers may engage in a race to the bottom, entering a trajectory of immiserizing growth in which economic activity expands, but real incomes fall” (Kaplinsky/Readman 2001: 1). Further, not all sectors and enterprises have the same effects on dynamic and inclusive development. (Neo-)Structuralist approaches emphasise the importance of structural change and upgrading for economic development.

A major part of the private sector in developing countries comprises informal activities and micro-enterprises. While approaches linked to the neoclassical approach emphasise the growth potential of the informal and micro-sector, (neo-)structuralist approaches highlight the generally low productivity and missing linkages with other firms and sectors. Furthermore, a major part of the informal sector is not based on freely chosen entrepreneurial activity but consists of ac-

tivities people have to engage in under precarious circumstances, as they lack other formal employment alternatives. The discussion about “right” and “wrong” types of enterprises shows that for economic development it is not the number of companies that is crucial but their potential to increase productivity, generate innovation, cooperate with other companies and develop networks (Bateman 2013).

The PSD strategies of some donors focus not only on creating a business enabling environment but also on selective policies, e.g. by supporting individual enterprises or business associations, vocational training or business linkages between companies. In particular due to the successful industrialization of emerging economies such as China and the global financial crisis, these more interventionist strategies have become more important. Industrial policy is being “re-discovered”, not only among bilateral donors but also partly by organisations such as the World Bank and the OECD, which are well known for their negative attitudes to selective interventions (OECD 2011; Lin 2011). Yet, this paradigm change is still in its infancy. For instance, the past World Bank chief economist Lin, reports that less than 10 % of World Bank economists are sympathetic to his arguments pro industrial policy (Wade 2012).

Critique of “one size” perspective on the private sector

Debates about the private sector as the engine of development often portray the private sector as a homogenous field with similar interests. This is particular problematic as large businesses are increasingly integrated as “development actors”, influencing policy debates and programmes. But interests of local private sectors in partner countries, the private sector in donor countries and the international private sector, which is dominated by transnational corporations (TNCs), differ substantially, as well as measures to support them. For example, a free market and global competition tend to help large, well-established and often global companies. Local SMEs (Small and medium-sized enterprises), however, often require protective measures or selective support. Micro-enterprises in the informal sector could possibly be given more help by an effective social security system than with deregulation or loans. This means a level playing field between very different players – large foreign or transnational companies and local ones – could destroy local structures and have negative developmental effects.

However, PSD-strategies are often portrayed as invariably leading to win-win situations – for donor countries’ businesses, firms in partner countries and broader development objectives. While this might be the case – e.g. when supplier development and knowledge transfer programs align TNC, local supplier and public interests as TNCs’ sourcing becomes more efficient while at the same time local spill-overs are ensured leading to employment generation, improved competitiveness and technological skills in local firms – there are also conflicts of interests. “Wherever firms seek to suppress technology transfer, to externalize social costs or to restrict competition, this creates a conflict of interests with governments and other local stakeholders. Further conflicts may arise with regard to the distribution of gains along the

chain. Lead firms often try to diversify their supply base in order to weaken the bargaining power of suppliers and to be able to appropriate a larger share of value added. If they succeed in doing so, they restrict capital formation in local firms and may even drive local firms into bankruptcy." (Altenburg 2007: 30) TNCs may further put pressure on the partner country government to cut taxes and exempt them from certain requirements such as national equity shares, contributions to skill development, and local content that have the explicit objective to increase local value added and make foreign firms strategies more locally embedded (Staritz 2012).

An analysis of PSD-flows shows that a major portion of funds goes to large companies based in industrial countries, e.g. via subsidies, low-interest loans or guarantees (Kwakkenbos 2012) with the aim to achieve additional development impacts. For projects of large companies it is, however, often difficult to assess additionality. A review of several Multilateral Development Banks and DFIs (Development finance institutions) found that 55 % of the projects would have been realized without the public finance (Spratt/Ryan-Collins 2012). Due to the increase in public pressure, large companies increasingly have a commercial interest in improving their image by introducing standards or investments in social programmes. Hence, the boundary between business interest and development outcomes may be unclear and there is the danger that scarce ODA funds are increasingly used for business promotion (Kwakkenbos 2012; European Think Tanks Group 2011). At the development cooperation side, the profit pressure that some bilateral and multilateral development banks are confronted with may result in "following" the market and avoiding riskier projects which may also reduce the additionality and development dimension (Kwakkenbos/Romero 2013).

Consideration should also be given to which sectors or companies should be private at all and which responsibilities are best met by public providers. After a focus on the privatisation of nearly all sectors in the 1990s, the view has gained ground again in recent years that the public sector has an essential role to play in central infrastructure and services such as health and education. For financing infrastructure projects in developing countries, the combination of public and private resources in the context of public-private-partnerships (PPPs) or infrastructure funds has become a popular mechanism. However, recent studies of the involvement of public bodies in private infrastructure funds indicate the risk that the investment decisions might be mainly based on private financial interests rather than on the social objective of providing necessary public goods (Hildyard 2012). There is growing evidence that PPPs have proved a very expensive method of financing, due to, for example, demands from equity funders and other lenders for 20-25 % annual returns or due to costs of up to 10 % for arranging the financing. PPPs also involve high risks. In developed countries 25-35 % of such projects fail to deliver as planned. In developing countries – with lower negotiation and management capacity – the failure rates have been even higher (Griffiths et al. 2014). In this context, important questions relate to the balance of risks and the governments' capacity to put necessary legal conditions in place and to ensure their compliance.

Necessity to include the international level in PSD

Policy measures necessary for sustainable PSD need national policy space. The economic policy space today is, however, very restricted compared with the time when today's industrialised countries were developing. Multilateral and bilateral trade and investment agreements confine the use of classical industrial policy tools such as import and export restrictions, tariffs and taxes, subsidies for local businesses or conditions for foreign direct investment in order to increase local added value (such as local content regulations or trade balancing requirements). Knowledge transfer is also made more difficult by strict intellectual property rights, especially those under the WTO Trade Related Intellectual Property Rights (TRIPS) agreement. Conditions tied to bilateral and multilateral development aid may also reduce the policy space of partner countries (Chang 2012).

In addition, changes in global trade and the dominance of export-based development models, especially in large countries like China and India have increased global competition in particular in agricultural and labour-intensive industrial goods. The proliferation of global value chains may have enabled access to international markets for many developing countries. But their positions are often uncertain and exposed to fierce competition and opportunities for upgrading and generating higher rewards are contested (Staritz 2012). This is related to highly asymmetric market and power relations in these networks and in the global economy more general.

The discussion of appropriate conditions for PSD thus has to include the international level. In the past decades, conditions for international investment, trade and finance have been defined in such a way that freedom and benefits for TNCs were enhanced while the economic policy space for developing countries was often restricted (Kozak/Küblböck 2011). Hardly any binding measures have been implemented in the context of PSD that would expand the policy space and create a level playing field in the interest of inclusive development such as international tax agreements, environmental and social standards, and the regulation of banks and financial institutions. Policy coherence between donors' PSD and other development programmes and their economic policies are required, including a commitment to pro-development trade, investment and finance policies.

Conclusions

The private sector has to play an important role in sustainable economic and inclusive development as it provides an engine of investment, innovation, employment and prosperity.

However, PSD is not a "technical solution" but there is disagreement on which type of private sector is best for development and most importantly which policies support such a private sector. Recently, the need for selective industrial policies has increasingly been acknowledged but this remains to be translated into the practice of many donors that still largely focus on a business enabling environment.

Further, there is no “one” homogenous private sector but different firms with distinct interests. There are important win-win opportunities in particular in influencing the investment and sourcing strategies of foreign firms in partner countries by making them more locally embedded and inclusive. But there are also important interest conflicts and the interest of foreign firms should not be equated with the interest of the local private sector and national development concerns.

Lastly, in order to implement PSD policies for sustainable economic and inclusive development, governments need policy space. The discussion of suitable conditions for PSD thus has to include the international level. A pro-development international policy environment in particular in the areas of trade, investment and finance policies and policy coherence in donors' policies are crucial.

The improvement of democratic institutional structures and processes including governments, different private sector actors and civil society at the national and international level has to play a decisive role in negotiating and developing inclusive PSD policies. Particularly trade unions and NGOs have an important role in ensuring that PSD leads to inclusive development.

Clearly, for successful economic development not a business enabling but a development enabling environment is necessary, i.e. a combination of measures at various levels such as macroeconomic policies; infrastructure, education and social policy; strategic trade, investment and industrial policy; and the integration of these policies in a broad-based development strategy.

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1 This policy note is based on an ÖFSE working paper – for more details see Küblböck/Staritz 2015.

2 Since 2009 this is no longer included related to pressure from trade unions and civil society but the reports still publish estimates.

3 In the coming reports it was agreed to introduce a minimum threshold for corporate taxation. Countries with lower taxes than this threshold will not be ranked better.



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