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Designing better donor strategies for inclusive business

By Linda Kleemann

Inclusive business has been rising on the donor agenda for about ten years. Following Prahalad's (2004) book on "Fortune at the Bottom of the Pyramid", there has been a shift within the donor community towards promoting business as a means of achieving development objectives. Donors see a chance of leveraging additional funding for development with the prospects of creating financially self-sustainable initiatives that scale up autonomously. A growing number of firms are interested in investing into low-income markets, and in collaborating with donors for their inclusive business activities. Several donors and development banks are active in this field and collaborate via platforms such as the Inclusive Business Practitioner Hub. This policy brief argues that a careful analysis of this web of business activities is needed, before and during any donor intervention in order to find a suitable intervention strategy, that highlights risks and - lacking evidence on impacts - asks where donors can be useful in supporting inclusive business. There are several working definitions of inclusive business that differentiate this concept from related ones. The relevant differences are:

Extent of inclusion: The difference with the Bottom of the Pyramid (BOP) approach is that low-income people are not only seen as customers. The World Business Council for Sustainable Development (WBCSD) and the Donor Committee on Enterprise Development (DCED) define inclusive business as ventures that "integrate low-income communities into companies' value chains as customers, suppliers, retailers, and distributors" (DECD 2014), whereas the International Finance Corporation defines inclusive business a "private sector approach to providing goods, services, and livelihoods on a commercially viable basis,

either at scale or scalable, to people at the base of the economic pyramid" (meaning people below 8 USD in purchasing power parity terms) "making them a part of a company's *core* business value chain as suppliers, distributors, retailers, or customers". The first definition also includes businesses that do so outside their core business operations, while the second focuses on scalability and core business.

Economic inclusion: Whereas social businesses explicitly target social problems, inclusive businesses focus on economic inclusion, i.e. inclusion of people in markets.

Inequality reduction: BMZ (2012) sees inclusive growth or pro-poor growth as the policy approach mirroring inclusive business as a market based approach. However to the extent that inclusive growth is interpreted as inequality reducing growth, there is a gap between the two concepts (see Pegels 2015 for a discussion of the inequality aspect in inclusive growth). Accordingly, If inclusive growth is to be caused by inclusive businesses, then only businesses that disproportionately benefit the poorer parts of the population can be considered inclusive. Hence a firm that includes the poor, but still benefits its (high income) shareholders relatively more would not be inclusive. This is not reflected in the above definitions. On the contrary, by its definition, inclusive business does not imply any restriction on profit making goals of companies. It does also not imply a hierarchy of profit and inclusivity goals. There is thus the question of how firms resolve potential conflicts between social mission and financial goals (Hahn et al. 2010). Whether there is such a conflict or not may change over time. The same is true for potential trade-offs between green and inclusive and financial goals.

Key Points

- Inclusive business as a market based approach does not necessarily mirror the policy approach of inclusive growth
- Evidence on the impacts of inclusive business on development objectives is lacking
- Sensible donor intervention strategies in inclusive business depend on the level of trade offs and binding constraints
- A step by step procedure is proposed to define these strategies

Poverty Reduction, Equity and Growth Network (PEGNet)

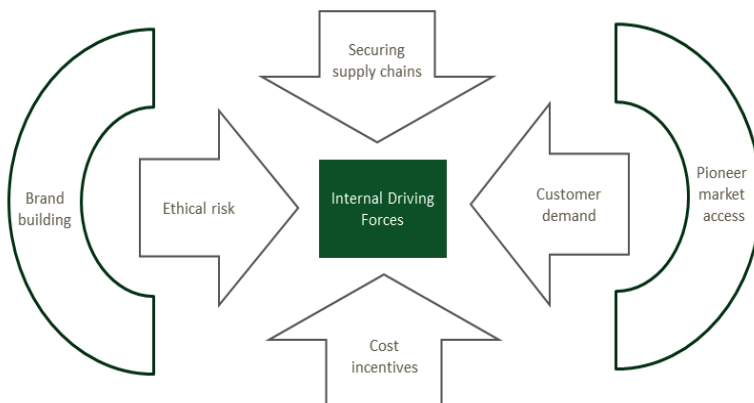
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Driving forces of inclusive business

Given a business opportunity scenario, i.e. a positive (longer-term) cost-benefit ratio, (scenario 1 in Figure 1a) and given a competitive market, businesses would venture into inclusive approaches out of self-interest. WBCSD (2016) argues that inclusive business makes economic sense for companies because it encourages innovation, expands the labour

Figure 1a: Classification of driving forces of inclusive business in different scenarios

Scenario 1: Win-Win Situation: Commercial incentives driving the inclusive business opportunity

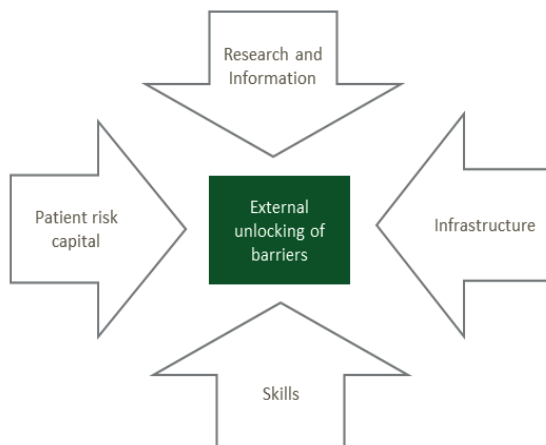


Source: Author

pool, acts as a supply chain strategy and can provide a competitive advantage. Donor intervention would thus not be needed and would run the risk of increasing profits with no or little additional social impact. Possible business strategies in this case are: brand building and lowering of reputational risks including pre-empting governmental regulation and pioneer market access including cost

Figure 1b: Classification of driving forces of inclusive business in different scenarios

Scenario 2: Weak trade-off between commercial incentives and inclusivity



Source: Author

reduction (internal driving forces in Figure 1a). However, there are a number of cases where either the private sector does not see an existing opportunity (internal constraints) or

where there is a barrier that can be unlocked (external constraints). In these cases governments or donors can bridge the gap (the four arrows in Figure 1b).

Learning models show that organisations can persistently fail to notice profitable opportunities or innovations. This result can be explained by Schwartzstein's (2014) model of selective attention. Learning models show that beneficial innovations are frequently not made because they are not "noticed" as being relevant (Hanna, et al. 2014) or due to false beliefs (World Bank Group 2015). Hanna et al. (2014) show that even agents with extensive experience can persistently fail to notice profitable innovations in such cases. These failures to notice a business opportunity may be aggravated by organizational structures and incentive systems, such as business unit thinking and short-term profit incentives (Halme et al. 2012). This implies that inclusive business ventures may not be realized because the opportunity is not even analyzed.

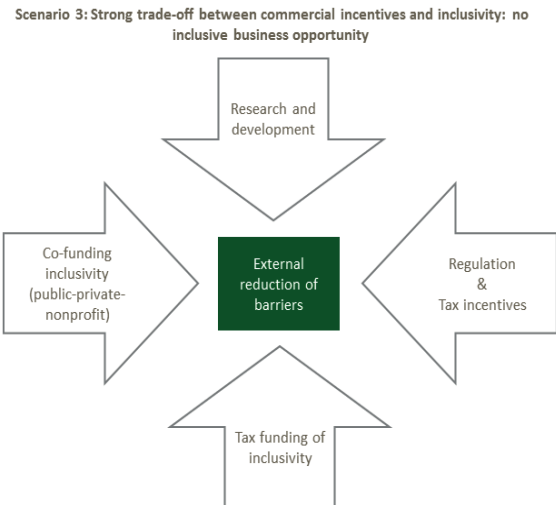
A second internal constraint relates to risk and timing. Inclusive businesses often venture into unknown and therefore high-risk options that require substantial time before turning profitable. This time-lag to recover investment costs may be longer than existing financing schemes or shareholders allow. External constraints include the well-known: weak governance, corruption and regulatory gaps, security risks that may stop businesses from investing in low income countries. Poorly qualified staff and unsuitable local suppliers also increase costs of inclusive business ventures.

Sensible entry points for donor interventions on inclusive business depend crucially on the scenario and on the level of trade-offs or barriers. In the win-win scenario (Figure 1a) no intervention is needed. It is self-sustaining and self-diffusing. However, donors and civil society can try to influence demand by advocating for changing societal standards for the level of inclusiveness that is demanded.

The weak trade-off scenario (Figure 1b), is defined through the existence of barriers to unfolding inclusive business opportunities. It is first necessary to find out which of these constraint(s) are binding. Thorough analysis of the market developments and costs, as well as developing a better understanding of the reasons for failed attempts can help to identify binding internal and external constraints. In learning from failures and successes, it is important to separate between global failures such as management errors, incentive structures etc., on which donors do not have an influence (see Mas & Morawczynski 2009



Figure 1c: Classification of driving forces of inclusive business in different scenarios



Source: Author

for the positive example of M-PESA), and opportunity specific reasons for failures, which may provide an entry point for donors. Businesses should normally be themselves the experts in identifying business opportunities. In some cases explained above, they may be “blind” for new opportunities. There would be a proven inclusive business opportunity, i.e. it is profitable, but businesses do not take it up, because they do not consider it relevant. In this case the information gap is binding and research and information provision can unlock inclusive business development as e.g. shown by Hanna et al. (2014). In cases where external constraints are identified, it is further necessary to clarify the roles of the different actors in remedying these constraints. This concerns in particular the extent to which private and public sectors respectively are and should be involved in the investment into public infrastructure such as roads and the development of worker skills. The case is clearer where governance and regulatory environment constitute binding constraints. A typical case in agriculture is a situation where local (small-scale) suppliers are unable to deliver products in the necessary quality or adhere to international standards in terms of traceability, food safety or certifications. In this case donors often invest into general improvements of the supplier base in terms of production practices and compliance with international standards and businesses are expected to invest in their specific requirements. Where these two overlap, case-specific decisions are taken. For instance, certification with private voluntary standards could be financed by the businesses

if they intend to own the certificate and co-financed by donors if the producers own the certificate (left arrow in Figure 1b).

Finally, the strong trade-off scenario (shown in Figure 1c) describes situations in which there is no inclusive business opportunity due to lack of demand, high costs, lack of technology or other factors. This opportunity gap can then only be bridged by tax incentives or co-financing. In addition, research may – in the longer run – create new opportunities. None of these cases is static. Changes in any factor may cause jumps between the three scenarios. This also means that donors can potentially cause a jump to the win-win scenario.

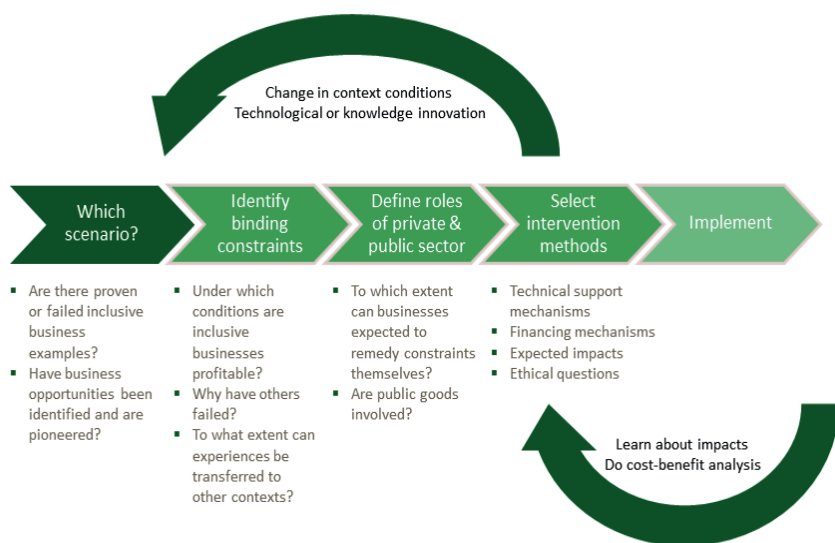
How to select the appropriate intervention strategy

Donors need to find out first in which scenario they operate to reduce the risk of rent seeking. This is not easy, because the difference between the three scenarios is often not clear, in particular for pioneer business cases with many unknown factors. Second, for the trade-off scenarios, it is necessary to find out which constraint(s) are binding. Third, based on these analyses, the decision in terms of financing and technical support mechanisms can be taken. Figure 2 guides through these steps.

In selecting appropriate mechanisms, there are in particular two types of selection biases that have to be considered. The first is favouring large businesses over SMEs. Large businesses have a higher potential of scaling up in little time and are better able to comply with standards that often come with donor support. This makes them attractive partners. Whether this is problematic or not depends on the answers to the following questions: are inclusive SMEs more inclusive than large scale businesses? Which kinds of inclusive business models have the highest replication potential? The second selection bias concerns the particular type of poor populations that are favoured by inclusive businesses. Contract farming models for instance are known to favour the advanced smallholders, i.e. those that are better off among the large group of poor smallholders. For each inclusive business solution in its local context, donors have to be aware of the implicit selection of particular parts of the poor population. This will usually be the comparably better off among the poor (Baumüller et al. 2013).

In addition, there are ethical considerations around the question what can be considered an improvement with prominent examples being job security, property rights and consumer

Figure 2: Steps to define donor intervention strategies for inclusive business



Source: Author

health, and the long-term consequences for cases where public services are substituted with private services. Facebook’s free basics is a recent controversial example. Finally, the basis for justifying interventions in inclusive business needs to be strengthened

considerably in order to improve and inform future decision making for donors as there is – so far – weak ground for arguments based on inclusive business impacts. There are hardly any impact analyses of inclusivity aspect of business or different donor instruments that adhere to scientific standards. In particular, existing studies focus on case studies with little external validity, lacking counterfactuals and report mainly potentials rather than demonstrated impacts. Hence, there is considerable insecurity on what contribution to inclusivity can be expected from businesses, in addition to the insecurity about what levels of inclusivity in which sectors and contexts are financially viable. Establishing causality in measuring impact on the target group (low-income people) is not easy, and measuring overall development impacts is even more difficult, i.e. time-consuming and costly. What makes this question even more complex is the dynamics with which these factors change over time. Hence donors should invest in empirical studies that try to find suitable counterfactuals and use state of the art methods to establish causality, as well as establishing assessment models and comparable indicators.

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PEGNet Policy Briefs

provide information and key policy recommendations on the poverty-equity-growth nexus. The views presented are those of the authors and do not necessarily reflect the views of PEGNet. In case of questions or comments, please directly contact the authors.

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