Minimizing the Risk of Negative Market Distortions in Private Sector Engagement: A practical framework

DCED Private Sector Engagement Working Group
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The Donor Committee for Enterprise Development

About the DCED Private Sector Engagement Working Group and this report

The DCED is the forum where donors, foundations and UN agencies share experience, innovations and effective practice in private sector development (PSD). Increasingly, donors are engaging directly and strategically with the private sector, as partners in achieving a wide range of development outcomes – including PSD.

In 2017, DCED members have formed a Working Group on Private Sector Engagement (PSE), to support donors in the institutional changes needed to engage business as a strategic partner. These include building staff capacity for PSE and developing appropriate ways to design and implement different engagement strategies.

One particular aspect of this is how to minimize the risk of negative market distortion in PSE. Such negative distortions may arise when donors confer market advantages to individual companies, such as financial benefits, knowledge and networks. While PSE strategies typically try to distort markets in positive ways to bring about pro-poor change, negative distortions may still arise if interventions are poorly designed or implemented.

In an initial step to explore ways to mitigate the risk of market distortions in PSE, the PSE WG has commissioned Endeva to produce this report. The report's main contribution is to frame a very complex topic in a simplified and accessible way to raise awareness of risks and possible solutions. **Looking ahead, the PSE Working Group is keen to advance discussions on this further; any feedback on this report and ideas for future work can be shared with the DCED Secretariat at admin@enterprise-development.org**.

For more resources on private sector engagement, please refer to the DCED knowledge page on the theme: www.enterprise-development.org/implementing-psd/private-sector-engagement

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Interviewees include:

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- Andreas Blüthner, Director Food fortification & Partnerships, BASF
- Paddy Carter, Director, Research and Policy, CDC Group
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1 Summary

Private Sector Engagement (PSE) has evolved into an important approach among donors. PSE includes activities that aim to engage the private sector for development results, and involve the active participation of the private sector, including companies and commercial financial intermediaries. Instruments range from policy dialogue and knowledge exchange to challenge funds and grants for feasibility studies to blended finance and impact bonds.

All PSE interventions pursue two objectives: to improve welfare and to tackle market failures. The rationale for the design of certain instruments is typically to address an underlying market failure, while the desired outcomes are mostly defined in terms of welfare improvements. The dual objective leads to tensions during implementation. By supporting individual market players rather than markets as a whole, PSE interventions run the risk of distorting markets in a negative way.

This report reviews how PSE interventions may give rise to negative market distortions, in three areas: Reinforcing the market power of targeted companies at the expense of other firms, raising barriers to market entry, and reinforcing information asymmetries. For example, capacity building and grants for companies to conduct activities with positive development impact can strengthen their market power in an unfair way if selection criteria de facto exclude local or smaller players. Information asymmetries can be reinforced if some companies get access to information through donor support, but others don't.

Such risks of negative market distortion can be actively countered if explicitly considered in PSE programming. Intervention design and results measurement can pay explicit attention to effects on market structures. In addition, solutions to reduce risks of negative market distortion include actively crowding in other commercial players; including by ensuring timely exit from support; involving competition agencies and know how; and making relevant information publicly available.

While the above-mentioned solutions are mostly straightforward and well known, the incentives in donor agencies mean that they can seem unrealistic to implement. For example, considering market distortions in results measurement might be seen as extra workload, including on the partner side. Making findings of feasibility studies publicly available may not seem possible if they include sensitive business data. A discourse is needed on how to minimize market distortion risks that increases the appeal and success of these measures. Here, approaches such as Market Systems Development could provide fruitful lessons.

Developing PSE interventions with a stronger focus on market structures can further increase the effectiveness of the approach as it can make the difference between helping a few select partners and a positive system-wide change. It aligns with current trends, such as a more adaptive and experimental approach to development programming, an increasing interest in measuring, learning and information sharing, and a growing appreciation of systemic solutions.

The table below summarises key market distortion risks for PSE strategies, which are grouped into six categories, as well as possible solutions identified in this paper. Short case studies are used throughout the paper to illustrate different PSE strategies and possible distortive effects. As such, the case studies are not limited to interventions aimed at private sector development, the main interest of the DCED, but draw on examples with different development objectives.

Table 1: Summary of findings

Original market failure	PSE interventions to address market failure[1]	Market distortions that may be caused by interventions	Strategies to mitigate the risk of market distortions
Externalities: Companies don't pay for activities that could have wider societal benefits (or don't cover the cost of harmful side effects of their business)	***Provide* capacity building and technical assistance** to companies that were unwilling to invest in building capabilities for activities with positive development impact	Market power of the individual company is reinforced at the expense of other firms	**1. Design against and measure market distortions** **2. Crowd in other commercial actors** **3. Involve competition agencies and experts** **4. Publish information**
	Compensate companies for generating positive development impact (or avoiding negative impact) through **matching grants** and **public-private co-investments**		
Public goods: Services that benefit the public (e.g. regulation, social services) don't exist or are not commercially viable	***Provide* policy dialogue** to bring in place required regulation	Barriers to market entry increase	
	Compensate companies for the provision of services with cash incentives, e.g. **Impact bonds** or other results-based mechanisms.		
Information asymmetries: Information on commercial opportunities in low-income markets is not widely available	***Provide*** funds for research (e.g. **feasibility studies**) and organizing **knowledge sharing**	Information asymmetries are reinforced	
	Compensate commercial players for lack of information and increased risk **with guarantees** as well as **equity in investment vehicles**		

[1] For a detailed overview of different PSE strategies, as currently conceptualised by the PSE Working Group, please click here

2 The dual objective of PSE strategies: Tackling Market Failures and Improving Welfare

Companies are now recognized as critical players in improving welfare and creating opportunities for poor people in low-income countries. Donors are working to leverage this potential through private sector engagement (PSE) strategies. The OECD defines private sector engagement as an activity that aims to engage the private sector for development results and involves the active participation of the private sector.[2] In practice, PSE includes a range of collaboration formats, many of which involve support to international companies that invest in core business (or core business-related) operations in developing countries. Note that subsequently, the term 'company' will be used to refer to the commercial players that donors or their intermediaries engage as partners.

The objective of donors in engaging with companies is twofold:

1) **Improving welfare.** PSE activities allow companies to contribute to development objectives, which may otherwise be beyond the scope of the business. The commercial return of engaging in these activities may be perceived as too low, or the associated risks as too high, to make them a rational choice. In economic terms, the activity produces positive externalities, where the marginal social benefit is greater than the marginal private benefit.[3]

2) **Tackling market failures.** PSE activities actively address market failures, which hinder the market from producing optimal outcomes. By either fixing the market, or compensating companies for the higher cost associated with doing business in a malfunctioning market, donors help overcome market failures, ultimately contributing to better functioning markets.

Donors therefore seek to support companies in activities that they would not have undertaken anyway. PSE activities need to be justified as 'additional' by showing that the intervention tackles market failures and improves welfare more than the company would have done on its own.

The two objectives of PSE programmes can lead to tensions in implementation. There is an underlying hypothesis that fixing markets and improving welfare in collaboration with companies naturally goes hand in hand. As the examples below will show, this is not always the case. In particular, given the incentives of the parties involved, supporting one company in increasing welfare and improving the market at large can be difficult to reconcile or even impossible to achieve. It stands to reason that tackling market failures is often a secondary concern, since attention is mostly paid to welfare outcomes (including in the metrics used to measure success of an intervention).

This paper aims to provide a practical framework that enables donors to pay more attention to negative market distortions caused by PSE interventions. To be clear, any donor intervention has a distorting effect on the market. As pointed out by ODI (2015) for direct subsidies as an example, "the

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[2] OECD (2016). *Understanding Key Terms and Modalities for Private Sector Engagement in Development Co-operation*. Retrieved July 2018 at www.oecd.org/dac/peer-reviews/Inventory-1-Private-Sector-Engagement-Terminology-and-Typology.pdf

[3] Economics Online (2018). Retrieved July 2018 at www.economicsonline.co.uk/Market_failures/Positive_externalities.html

whole point of a public subsidy is to change (distort) market outcomes that are unsatisfactory."[4] We are concerned here with undesirable distortions, that reduce overall societal welfare.

We can cluster PSE interventions by the main causes of market failure they seek to address: externalities, public goods, and asymmetric information, as summarised in the table.[5] The following sections explain these market failures in more detail.

Market Failure	PSE approach	Intervention types
Externalities: Companies don't pay for activities that could have wider societal benefits (or don't cover the cost of harmful side effects of their business)	Provide	Companies may not have the ability to implement activities with specific welfare outcomes, and building these capabilities is not considered to pay off commercially. **Capacity building and technical assistance** thus enable them to implement activities with a positive externality.
	Compensate	**Matching grants** and **public-private co-investments** compensate companies for the positive externalities they generate (or negative externalities they avoid).
Public goods: Services that benefit the public don't exist or are not commercially viable	Provide	**Policy dialogue** can bring about required regulation or other public goods.
	Compensate	**Impact bonds** and other cash incentives pay for the provision of public goods through the private sector via a results-based mechanism.
Information asymmetries: Information on commercial opportunities in low-income markets is not widely available	Provide	By paying for research such as **feasibility studies** and organizing **knowledge sharing**, donors provide missing information.
	Compensate	**Guarantees** as well as **equity in private investment vehicles** compensate commercial players for the lack of information and associated risk when investing in low-income contexts and innovative business models.

2.1 Externalities

Private sector activity may have positive or negative side effects on society as a whole. These so-called externalities are associated with market failure when it is not commercially viable to invest in an activity with positive societal impact (e.g. worker training), or when the company is not fully covering the cost of negative societal impacts (e.g. pollution). Consequently, a company will undertake too much or too little of an activity, rather than the optimal amount. Donor agencies often use matching

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[4] ODI (2015). *Why subsidise the private sector? What donors are trying to achieve and what success looks like*. Retrieved May 2018 at www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9948.pdf

[5] Miller, H. (2013). *What practical approaches/frameworks are there for effectively delivering subsidy to private sector entities for development purposes?* Retrieved May 2018 at assets.publishing.service.gov.uk/media/57a08a39ed915d622c00061d/How_to_Deliver_Private_Sector_Subsidy_HM21.pdf

grants and public-private co-investments to expand activities bearing positive externalities and those that reduce negative ones. Examples includes investments into environmentally friendly technology or in business models with high welfare outcomes.

Addressing Market Failure – Example 1

Compensating companies for generating positive externalities:

Engagement of two bed net producing companies in the fight against Malaria

Using bed nets comes with positive externalities. By avoiding mosquito bites, not only the users are better off, but the entire population benefits since malaria vectors are prevented from spreading. The Universal Coverage Campaign aimed to fight malaria by achieving 100% coverage of at-risk populations with long lasting insecticide treated bed nets (LLINs) by 2010. By the end of 2010, about 289 million LLINs had been delivered to sub-Saharan Africa, enough to cover 76% of the 765 million persons at risk. All LLINs procured under these schemes have to be certified by the WHO.

Companies delivered the nets as suppliers in a standard procurement process. In order to use this massive procurement scheme to create jobs in Africa, the WHO engaged Exxon Mobile and Sumitomo Chemicals as well as UNICEF and Acumen Fund in a consortium. Sumitomo Chemicals' product Olyset Net was the first LLIN that was certified by the WHO. The consortium facilitated engagement with a local partner.

In 2003, the company entered into a partnership with A to Z Textile Mills Ltd. to produce Olyset Net in Arusha, Tanzania. It transferred the technology royalty-free and helped with the setup of the production. Acumen Fund provided the first interest-free loan of US$ 325,000 to A to Z in 2003 in order to invest into the new technology. In 2007, the two companies created the joint venture 'Vector Health International' (VHI). Acumen Fund provided another US$ 675,000 as both loan and grant for expansion of the production facilities in 2005. A new factory was built that employed 7,500 people and had the capacity to produce 30 million nets per year.

Source: Christina Tewes-Gradl (2011) Sumitomo Chemicals and the Fight Against Malaria Using Bednets, Harvard Kennedy School

2.2 Public goods

Public goods represent another source of market failure that donors aim to tackle through PSE. Public goods are available to the public on a non-excludable and non-rivalrous basis. Due to the universality of their benefits, they are often provided by governments. Governments may however fail to do so effectively, and it is difficult for companies to make profits from producing or selling them. Results-based incentives such as impact bonds involve the private sector into the provision of public goods by compensating them for part of their investment and ideally fostering innovation and improved delivery. Regulation can also be conceptualized as a public good. While regulation is typically provided by government, companies can also self-regulate through standards, and help bring about government regulation through policy dialogue.

Addressing Market Failure – Example 2

Multi-stakeholder dialogue to advance consumer welfare:

Strategic Alliance for the Fortification of Oil and Other Staple Foods (SAFO)

Roughly two billion people around the world suffer from micronutrient deficiency, as many low-income consumers cannot afford the balanced diet that would provide them with adequate amounts of micronutrients, including vitamin A. Vitamin A deficiency causes night blindness and weakens the immune system. Fortifying basic staples with vitamin A is an easy and cost-effective way to fight malnutrition. However, consumers are often not aware of their deficiency and the benefits of fortified foods. Therefore, food producers are reluctant to fortify staples, since the additional cost cannot be justified by higher prices or demand. Regulation is sometimes used to mandate fortification.

The German development agency GIZ and the German chemical company BASF have joined forces to facilitate the establishment of functional markets for fortified food in developing countries. In several countries, including Tanzania, a multi-stakeholder dialogue has been set up to advance the fortification of oil. In addition, GIZ advises the public sector on malnutrition policies, while BASF works with staple food producers on developing technical capacities and business models. Between 2008 and 2012, SAFO has reached more than 150 million people in several developing and emerging countries by increasing the countrywide availability of affordable vitamin A fortified staple foods.

In Tanzania, the initiative coincided with a push by the World Bank to mandate fortification of oil with Vitamin A. The stakeholder facilitation by SAFO provided fertile ground for this process, and a way for all stakeholders to voice their perspective. Regulation that mandates the fortification of oil was passed in 2011 and came into force in 2014.

Source: Christina Tewes-Gradl (2011) Sumitomo Chemicals and the Fight Against Malaria Using Bednets, Harvard Kennedy School.

2.3 Information asymmetry

Information asymmetry refers to a scenario in which one party in a transaction has more information than the other, leading to an outcome that is sub-optimal. This may be the case when donors provide information directly to partner companies through knowledge sharing and paying for research such as feasibility studies. Economists also identify information asymmetries as one important cause for the lack of capital in low-income markets, arguing that risks are generally rated higher by investors than they are in reality. Without financial and other business development services, companies face serious constraints in developing new business approaches that improve welfare. Donors compensate private financial intermediaries for this lack of information by providing guarantees or putting equity into private investment vehicles.

3 Risks of negative market distortions

PSE activities take place in markets that do not function properly. However, they do not tackle market failure at the systems level, as alternative approaches such as Market Systems Development would. Rather, they typically engage with selected players in the market, either on the intermediary or at the company level. This is justified by the more immediate welfare results that are expected from these interventions. Yet, this entry point creates a considerable risk that markets are distorted further, with negative societal consequences.

We identify three main types of market distortion, that can be linked to the types of interventions and market failures that justify them (see Table 1). The reality is certainly a lot more complex than this simple framework, with more types of distortions, and more interrelationships. However, as we are only beginning to understand the forces at work, and well-documented evidence of the phenomenon is extremely limited, this oversimplification shall help to get a basic understanding of the problem.

Table 1: PSE strategies and risks of negative market distortion

<table>
<tr><th>PSE strategies</th><th>Market distortions</th></tr>
<tr><td>Companies may not have the ability to implement activities with specific welfare outcomes, and building these capabilities is not considered to pay off commercially. Capacity building and technical assistance thus enable them to implement activities with a positive externality.</td><td rowspan="2">Reinforcing market power of individual companies: By supporting individual actors financially or technically, those players can gain an unfair advantage over other. (Self-)selection mechanisms often lead to supporting large companies from donor country companies that are already stronger than local, smaller companies, thus widening existing capacity advantages.</td></tr>
<tr><td>Matching grants and public-private co-investments compensate companies for the positive externalities they generate (or negative externalities they avoid).</td></tr>
<tr><td>Policy dialogue can bring about required regulation or other public goods.</td><td rowspan="2">Raising barriers to market entry: By developing regulations and standards or selecting a set group of market participants, others can be excluded from competing in the market on a level playing field.</td></tr>
<tr><td>Impact bonds and other cash incentives pay for the provision of public goods through the private sector via a results-based mechanism.</td></tr>
<tr><td>By paying for feasibility studies and organizing knowledge sharing, donors provide missing information.</td><td rowspan="2">Reinforcing information asymmetries: By making information available only to individual market participants rather than to the market at large, asymmetries are further reinforced. Compensation strategies, on the other hand, leave underlying information asymmetries untouched.</td></tr>
<tr><td>Guarantees and equity in private investment vehicles compensate private players for the lack of information and associated risk when investing in low-income contexts and innovative business models.</td></tr>
</table>

3.1 Reinforcing market power of individual firms at the expense of others

In order to incentivize companies to expand activities with positive externalities, donors provide them with technical or financial support. In the process, they necessarily strengthen the ability of the company to compete in the given market. However, this support is not open to all companies.

- First, certain criteria apply, including company size, years of existence, or country of incorporation.
- Second, participating in the selection processes for this support requires specific resources and capabilities, which only larger companies may be able to afford, such as staff with partnering skills or travel budgets to participate in networking events. Similarly, a success indicator of many programmes relates to the amount of private finance leveraged by public funds. Brain et al note: "The danger of having too strong a focus on leverage ratios is that it may encourage fund managers to …choose well-capitalised grantees for which the additionality of the challenge fund and non-distortionary impact of aid is most difficult to demonstrate. The matching fund requirements of challenge funds can, paradoxically, create a barrier to entry for the firms which are most in need of grant finance."[6]
- Third, direct access to donors and their programmes is often easier for companies from the donor's own country than for local companies.

As a result, the market power of already dominant firms may be further expanded, leaving competitors at a disadvantage. In extreme cases, artificial monopolies or oligopolies can be the result. Increasing the power of individual firms can result in higher prices or poorer offering for consumers. As Brain et al note with reference to challenge funds: "Under the guise of market development, the risk of actually generating competitive asymmetries – where particular firms are given privileged access to finance and other support – is difficult to defend as a legitimate use of public aid."[7]

At the intermediary level, subsidized finance can easily crowd out commercial providers. Intermediaries often focus on financial returns, and hence attract companies that would already be bankable on the market, while social and environmental aspects of development may not be given sufficient attention.[8] It is also difficult to determine the correct price for the loan, since externalities are hard to calculate, and subsidies are usually also justified with high risk and illiquid credit markets. Aldane provides an example from the energy market: "There are certain countries in Africa currently where renewable energy is financed through concessional and commercial money. The commercial financing has a cost of 5 percent, the soft money goes at zero, and then it is sold at 2.5 percent. That's when private sector investors pull out because this is not a market they can be in."[9] Miller summarizes: "By making investments on a non-commercial basis, backed by large donor resources and plenty of

[6] Brain, A., Gulrajani, N., Mitchell, J. (2014) *Topic Guide: Meeting the challenge: How can enterprise challenge funds be made to work better*. EPS PEAKS, UK

[7] Brain, A., Gulrajani, N., Mitchell, J. (2014) *Topic Guide: Meeting the challenge: How can enterprise challenge funds be made to work better*. EPS PEAKS, UK

[8] Eurodad (2013). *A dangerous blend? The EU's agenda to 'blend' public development finance with private finance*. Brussels.

[9] Aldane, J. (2017). *Blended finance: can the new rules avoid market distortion?* Retrieved February 2018 at www.devfinance.net/blended-finance-distorting-reality/

liquidity, donors may be crowding out private lenders and suppressing the development of a more sustainable commercial lending industry."[10]

Market Distortion – Example 1

How interventions in the market for anti-malaria bed nets strengthened the market power of just a few companies

Sumitomo Chemicals and local partner A to Z (see page 4) soon acquired a dominant position in the market for bed nets. The demanding technical specifications for the long-lasting insecticide treated bed nets (LLINs) that would be procured for the Universal Coverage Campaign led to an oligopolistic market. In 2010, seven manufacturers supplied almost all the nets in Africa, with Vestergaard-Frandsen and Sumitomo/A-Z sharing the greatest part of the market. In 2013, the Global Fund halted contracts with both suppliers, since an investigation had shown that they bribed Cambodian officials for awarding LLIN contracts.

In Tanzania, the local market for bed nets was virtually destroyed through the campaigns. Ironically, this market had also been established with support from public donors. From 1998, public health NGO Population Services International (PSI) started a multi-year social marketing campaign to develop a commercial market for nets. As a result, Tanzania became the biggest producer of insecticide-treated nets, the predecessor technology to LLINs, with four local manufacturers. 20,000 retailers sold the nets to customers, who bought them for around US$ 3. In 2004, 3.3 million nets were sold.

In 2004, the Ministry of Health and Social Welfare under the National Malaria Control Programme initiated the Tanzania National Voucher Scheme (TNVS). The scheme provides a subsidized net to all pregnant women and their infants. This subsidy further stimulated the commercial market. In 2009, the TNVS was readjusted to ensure that women had to pay no more than US$ 0.3 per net. To implement the complex control system required by this new policy, LLINs had to be produced and distributed by just one manufacturer, VHI. This change effectively left the three other manufacturers without business, since without LLIN technology, they could not compete on the global market. In addition to the TNVS, two campaigns for free distribution of nets were implemented from 2008 to 2011, the Under-five Catch Up Campaign and the Universal Coverage Campaign. In total, 25.3 million free nets were handed out to Tanzanians, a population of 44 million, as part of these campaigns. As a result of these interventions, the commercial market for nets had completely dried up. All manufacturer besides A to Z had gone out of business.

Source: Christina Tewes-Gradl (2011) Sumitomo Chemicals and the Fight Against Malaria Using Bednets, Harvard Kennedy School; The Guardian (2013) Global Fund halts contracts over bribes for mosquito bednets in Cambodia.

[10] Miller, H. (2013). *What practical approaches/frameworks are there for effectively delivering subsidy to private sector entities for development purposes?* Retrieved May 2018 at assets.publishing.service.gov.uk/media/57a08a39ed915d622c00061d/How_to_Deliver_Private_Sector_Subsidy_HM21.pdf

3.2 Raising barriers to entry

Regulation and standards are important public goods that govern private sector activity, ideally enabling companies to improve their performance, grow, and participate in a competitive marketplace. Yet, when the bar is set too high, some players may be left out of the game without good reason. Standard setting for environmental and social results, in particular, can effectively favour larger or champion companies at the expense of smaller competitors or those that lag behind in the implementation of standards. Standards may require technical or administrative capabilities that can be too expensive for a small firm to afford. Likewise, at the intermediary level, only larger financial institutions or professional services firms have the capacity to live up to the administrative and reporting standards for implementing public programmes.

Results-based mechanisms such as impact bond facilities, on the other hand, may exclude companies with limited capabilities from accessing cash incentives.

Market Distortion – Example 2

SAFO: The risk of limiting the market for oil

Edible oil production in Tanzania is dominated by two large oil mills, which sell their products in supermarkets. Still, small mills constitute 40% of the market. While fortification is technically fairly simple (just dose and mix vitamin A into oil), there is no supply chain of vitamin A, production and packaging equipment that would enable small mills to easily comply with the regulation. When the Government of Tanzania passed regulation to mandate the fortification of oil with vitamin A, there was a risk that small producers would be shut out of the market.

Source: Christina Gradl (2012) Building a Strategic Alliance for the Fortification of Oil and Other Staple Foods (SAFO). Harvard Kennedy School. Interview with Dr. Andreas Blüthner, BASF

3.3 Reinforcing information asymmetries

Where donors provide information directly to companies via knowledge sharing and feasibility studies, information asymmetries can be reinforced. For example, information about local markets and potential profitability of specific business models can, if not shared publicly, further disadvantage other companies, especially if they are not be eligible for donor support or unable to pay for such information. In addition, the willingness of users to pay for information is reduced. As a result, market forces to make that information more widely available are further weakened.

Where donors use targeted support such as guarantees or equity to reduce perceived risk and encourage lending or investments by financial intermediaries they leave underlying information asymmetries untouched. As in the case of providing missing information directly, compensating financial intermediaries for market failure can even weaken pressures to find a more sustainable and systemic solution to the problem. For example, paying away the pain for companies can take away an important and influential voice in demanding governments to fix market failures.

4 Solutions to counter negative distortions

Solutions to avoid or limit negative market distortions from PSE strategies exist (as summarised in Table 2). First and foremost, a cross-cutting solution is to pay attention to the effects of PSE interventions on market structures.

(1) Interventions can be designed consciously to address market failures and avoid negative distortions, including through a reflection of market-wide effects in results measurement systems.

In addition, three other solutions are helpful to consider in all PSE interventions.

(2) Donors can draw on a variety of strategies to crowd in other commercial actors, to avoid the accumulation of market power with individual or few players.

(3) Donors can involve competition agencies and experts, for example to ensure that PSE interventions don't create harmful barriers to market entry for other commercial players.

(4) Donors can work towards making relevant information from PSE interventions publicly available, to reduce information asymmetries.

These strategies are explored in more detail in the following sections.

Table 2: Market distortions and corresponding solutions

Market distortions	Solutions
Reinforcing market power of individual companies at the expense of others	(1) Design and measure against market distortions (2) Crowd in other commercial players (3) Involve competition agencies and experts (4) Make relevant information publicly available
Raising barriers to market entry	
Reinforcing information asymmetries	

4.1 Design against and measure market distortions

PSE strategies are designed to tackle market distortions and to address specific welfare concerns. Performance indicators of programmes do however not always put market structures at the centre. As a result, the design of concrete activities within the programme may overlook the impact on market structures.

The design of effective PSE interventions needs to be based on a thorough assessment of its context. A solid understanding of the market failure and how it is addressed is critical to mitigate the risk of negative distortions. For example, Egger notes that "effectiveness and efficiency are strongly influenced by the framework conditions in a country or region… and are at the root in explaining why in one case a (type of) subsidy may be the right intervention, and in another, the wrong."[11] Van der Meer and Noordam (2004) find that "one-time investments, such as investments in training and set-up costs can have a permanent impact if the market failure is solved. But if the market failure is not overcome the grants may promote temporary activity only."[12]

Understanding market failure is closely linked to the question of additionality, i.e. whether an activity would not have happened, or not happened in the same way, without donor support. As elaborated by DCED (2014), there are practical ways in which donor programmes can enhance their assessment of additionality at the design stage.[13]

Reviewing possible negative distortive effects of the chosen PSE approach in the design phase enables programmes to include these in their monitoring systems and take appropriate mitigating measures as needed. Keeping effects on market structures in focus along the way enables donors to learn from interventions, and adapt their design over time.[14] DFID has started a third-party evaluation of parts of its PSE portfolio containing a focus on market distortion. The exercise can provide important insights, both regarding further evidence for market distorting effects of interventions and on how to measure them.

This more adaptive approach is in line with current thinking in development as laid out by Bill Easterly in 'From Planners to Searchers'. Instead of planning complicated programmes and then tracking milestones, adaptative approaches work by making small changes, observing the results, and then adjusting.[15] William Kovacic, Professor of Global Competition Law and Policy at George Washington University, advocated for this approach in the interview: "One intervention is not going to trigger a market failure, so long as the emphasis is on learning and adapting. When donors start by acknowledging that these interventions involve inherent experimentation and uncertainty, they open the door for productive dialogue and review with critical stakeholders. When the resulting lessons can be integrated into the project, potential market distortions can be avoided. A prerequisite of this is that guidance on how learning can be integrated is included in the project design stage."

4.2 Crowd in other commercial players

Proactive efforts to make interventions accessible to a larger and more diverse pool of players can be made throughout the intervention process, thereby reducing the risk of negative market distortions. In practice, however, PSE interventions differ in their objectives making such efforts more or less likely. For some, working with individual partners is only a means to demonstrate impact and then crowd in

[11] Swiss Agency for Development and Cooperation (2007). *Development Aid and Subsidies – an Art.* Retrieved March 2018 at www.shareweb.ch/site/EI/Documents/To%20SORT/SDC%20-%20Conceptual%20Foundation%20-%20Development%20Aid%20and%20Subsidies%20an%20Art%20-%202007%20-%20en.pdf

[12] World Bank (2004). *The Use of Grants to Address Market Failures.* Agriculture and Rural Development Discussion Paper 27. Retrieved February 2018 at https://documents.worldbank.org/en/publication/documents-reports/documentdetail/414541468314691378/the-use-of-grants-to-address-market-failures-a-review-of-world-bank-rural-development-projects

[13] DCED (2014): Demonstrating additionality in private sector development initiatives. A practical exploration of good practice. www.enterprise-development.org/wp-content/uploads/DCED_Demonstrating-Additionality_final.pdf

[14] The DCED Standard for results measurement offers a practical framework for results measurement and adaptive management. Learn more here: www.enterprise-development.org/measuring-results-the-dced-standard/

[15] Barder, O. (2012). *Complexity, Adaptation, and Results.* Center for Global Development. Retrieved March 2018 at www.cgdev.org/blog/complexity-adaptation-and-results; William Easterly (2006) Planners vs. Searchers in Foreign aid. Asian Development Review.

other commercial players to achieve industry-wide change. For others, the priority is to maximise the growth and development impact of individual partners, with less concern in practice for market-wide effects. Regardless of the approach, practitioners will always face an underlying tension between the success of the individual partner and promoting competition, with difficult choices at each step of the intervention process. The following list highlights options to consider:

- **Broadening, and raising awareness of, engagement opportunities**: At the basic level, taking measures to ensure that as many eligible companies as possible are aware of engagement opportunities helps to prevent repeated benefits to companies with a pre-existing relationship with donors. Eligibility criteria may also be defined to allow for as wide a participation as possible. William Kovacic notes in the interview: “By focusing engagement on the issue, rather than the partner, donors can aim to build into initiatives a wider range of participation, and thus, minimize the distortions that may be created by long-term engagement with a single private sector partner.”
- **Ensuring timely exit from support**: Crowding in may also require ‘stepping out’ as soon as possible. By granting a company support beyond the minimum needed to demonstrate innovation or profitability, donors may be able to achieve greater immediate development impact, but also risk greater distortions. Finding the right time for ‚stepping out‘ and ensuring a positive demonstration effect is however not a trivial task; when donor funding is withdrawn too early, initiatives may collapse because they have not yet reached commercial sustainability.
- **Bringing in other commercial players**: Once an intervention appears likely to be successful, resources may rather be allocated towards crowding in other players.
    - This may mean actively seeking competitors or new entrants to support the replication or expansion of an innovative model rather than (or in addition to) offering continued assistance to a company to scale-up a donor supported project. For example, after working with one company to establish a vocational training centre, donors could invite industry competitors to contribute course modules and host smaller companies for career fairs or special events. Market entry by other players is also facilitated by actively sharing information about a market or successful business model (see section 4.4), or by shifting from partnership-based grants to systematic subsidies or other financial incentives available to all market players.

> It is important to note that crowding in competitors requires a good understanding of the current market structures and incentives. In the second phase of SAFO (see case example 2), GIZ invited the company the company DSM to join the partnership with BASF. As a result, the cost of coordination increased while the return on investment in terms of reputational gains was reduced, resulting in limited traction and finally the end of the SAFO collaboration.

- Regarding strategies that leverage private sector finance, this may mean actively facilitating the replacement of the concessional element of support with commercial terms. For instance, donors might take measures to sell investments as soon as projects become bankable, rather than profitable. Martin Vogelsang of EVPA argues: “Donors have a key role to play at the first rung of the investment chain – getting projects to bankability.” This could mean working more closely with local banks to identify this point. Another example is to seek new investors to replace donor divestment from an equity portfolio once it starts performing well.

Countering the risk of market distortion – Example 1
Options for crowding in other bed net manufacturers to create a competitive market
The case study on Sumitomo Chemicals and its partnership with A to Z Textiles in Tanzania (see page 4 and page 8) raises the question: why [have] none of the other producers in Tanzania acquired the capacity to produce LLINs? Did they not have the capacity to step up production? Did the support A to Z received (…) create an unfair advantage that competitors were not able to emulate? Likewise, why did donors not build on the Sumitomo Chemical / A to Z joint venture to support other companies in Africa in taking up LLIN production. By creating competition among local producers, donors could have supported local procurement while not creating an unfair advantage.” Source: Christina Tewes-Gradl (2011) Sumitomo Chemicals and the Fight Against Malaria Using Bednets, Harvard Kennedy School

4.3 Involve competition agencies and experts

Local competition authorities and international experts could be valuable partners in gathering and incorporating local knowledge of market structures and individual companies' market power into the intervention process. Furthermore, donors could work with competition authorities and experts to build mechanisms into interventions that help address distortions, should they arise.

For instance, competition authorities could host a complaint mechanism should monopoly powers lead to abuse in a donor-facilitated PSE initiative. While mere possession of monopoly power does not in itself constitute violation of competition laws, the abuse of such power – particularly if it is used to weaken competition further by excluding rivals - calls for intervention from competition authorities. Examples of abusive practices typically include predatory pricing, loyalty rebates, tying and bundling, refusals to deal, margin squeeze or excessive pricing.[16]

Additionally, donors could ensure awareness of a competition authority's 'whistle-blowing' programmes, should a business linkage initiative unintentionally facilitate collusion. Anna Caroline Müller of WTO recommended a similar approach in the interview: “To help ensure that anti-competitive practices do not result from business linkages programmes, donors may want to require transparency with regard to business opportunities and contracts and/or to implement complaint mechanisms.“

Countering the risk of market distortion – Example 2

[16] Retrieved at 25 October 2018 at http://www.oecd.org/competition/abuse/.

SAFO: Enabling small producers to fortify oil with Vitamin A

When developing the regulation to fortify oil with vitamin A, the Government of Tanzania had to balance public health concerns with effects on market structures. While fortification became mandatory in 2014, small mills were exempt for another two years. In practice, regulation has not been enforced after 2016.

Non-governmental organization pointed out that the regulation would not achieve its objectives if 40% of the market were excluded, in particular since small mills cater mostly to low-income people, who are most at risk of vitamin A deficiency. In response, SAFO partners BASF and GIZ partnered with the development organization MEDA in its project MASAVA (funded by Canada's International Development Research Centre) to build the capacities of small oil mills. Three small mills were selected and equipped to fortify oil with vitamin A. In addition, MASAVA introduced an e-voucher system to subsidize the purchase of fortified oil for low-income consumers. While the project proved that small mills can upgrade to fortify oil, it also showed that barriers in the supply chain remain high and incentives limited, as low-income consumers do not pay a premium for fortification. BASF is now seeking to support a local social entrepreneur to build the supply chain for fortification.

BASF was also careful to avoid the risk of market limitations on the supplier side. For example, BASF advised mills technically without preconditions such as long-term binding contracts so as to avoid any allegations or even the perception of abuse

The SAFO case study shows that PSE activities need to balance development objectives with limiting the competitive functions of market structures. Trade-offs can appear. Interventions may need to be designed to allow other suppliers to be phased in over time, allowing market structures to evolve

Source: Christina Gradl (2012) Building a Strategic Alliance for the Fortification of Oil and Other Staple Foods (SAFO). Harvard Kennedy School. Interview with Dr. Andreas Blüthner, Director Food Fortification and Partnerships, BASF; Susan Horton, Nadira Saleh, TCE Mosha (2017): Masava - Promoting fortified sunflower oil through evouchers; Alexandra Löwe and Mbaraka Hamisi (2018): MASAVA - Promoting Locally Fortified Sunflower Oil Using E-Vouchers, ODI

4.4 Make relevant information publicly available

Many PSE interventions build on the rationale that not enough information is available on low income markets and innovative business models for companies to invest in them. Donors consequently pay for feasibility studies and cost-share in business model development to produce such information. However, this information is rarely made available to others. One reason is that many of these documents include sensitive business information. Therefore, information sharing would need to concentrate on non-company related information, including market data and lessons from business model development. With this approach, even projects that did not achieve the intended outcomes can contribute to developing approaches further by raising awareness of what works - and what doesn't. Besides sharing documents, donors could also consolidate insights in joint facilities or 'hubs' that are involved in different donor programmes.

5 Taking realities inside donor agencies into account

Most of the solutions presented in the previous chapter are simple and well known. The question arises, therefore, why they are not being used already. To find answers, it is worth taking a closer look at the particular ’economy’ within donor agencies, and how it impacts the choices of members of where to invest their own resources, time and attention.

As touched on in section 4.1, a fundamental dilemma is the trade-off between incentives to maximise the growth and development impact of individual partners, which involves risks of market distortion, and crowding in competition to maximise the growth and development impact of the industry as a whole. This applies to most donor-funded PSE programmes and investments made via Development Finance Institutions, whose operational logic is to help individual partner companies succeed. External as well as internal stakeholders want to know what the outcomes a certain PSE activity on the stated welfare objectives, be it economic opportunity, health, education, or environmental protection. The effect on market structures often appears to be a “blind spot”, also evidenced by the lack of documented evidence on market distorting effects of interventions.

In order to show the impact of their activities, programme managers have an incentive to produce compelling narratives of individual companies and their contributions. They may thus decide to support a company for longer than absolutely needed, and pay more attention to making selected cases successful than to crowding in others (which might imply risking the individual success story). The direct stakeholders around programme managers often add pressure to focus on fewer companies. Partner companies themselves have, of course, no interest to share their insights or business models with others, or to share benefits with competitors in any other way. Politicians are often questioned by civil society organizations on the benefits of aid for recipient countries, and appreciate cases of companies from their own country that have benefited from aid.

Programme managers also spend a considerable amount of time with the bureaucratic procedures inside donor organisations. There is hence limited appetite in increasing the complexity of procedures further, be it in extended measurement guidelines or increased reporting requirements.

A number of emerging trends however favour a stronger focus of PSE programmes on market distorting effects. In general, donors are moving towards a more adaptive and experimental approach to programming that acknowledges complexities and encourages learning along the way. This is accompanied with an increasing interest in measuring, learning and information sharing. There is also a growing concern that interventions with individual firms may be less effective than hoped, and a renewed interest in finding more systemic approaches.

In order to develop solutions that can realistically be implemented within donor agencies, given the prevalent incentives outlined above, we can rephrase the four types of solutions as questions for further discussion and experimentation:

1) How can we pay attention to the impact of PSE interventions on market structures with tangible benefits for effectiveness and without complicating procedures further?

2) How can we actively crowd more companies and intermediaries into our programmes, enabling us to tell even more powerful stories of impact?

3) How can we involve competitions agencies and experts to keep markets as open and fair as possible, thereby enhancing the implementation process?

4) How can we make relevant information about markets and business model insights publicly available in a simple and efficient way without disclosing sensitive company information?

As part of PSE, donors have developed a range of innovative, effective and efficient instruments. As a whole, PSE stands for a central paradigm in current development work, namely to leverage existing resources as much as possible and build sustainable systems in collaboration with other players from all sectors. PSE interventions have enabled companies both from recipient and donor countries to tap into low-income markets and develop innovative business models. M-PESA is only the most well-known example of cases where these models have gained traction and created far-reaching societal and business value. In its relatively short lifespan of about two decades, the approach has thus proven its value and potential for further development.

Putting the effects of PSE interventions on market structures more into focus provides an opportunity to enhance effectiveness and efficiency even further. If more PSE interventions can substantively contribute to improving market structures, the systemic effects of PSE programmes will grow. Private Sector Development approaches such as Market Systems Development (MSD) offer a wealth of insights on how to design more system-oriented interventions. The Donor Committee for Enterprise Development, with its Working Groups on PSE and MSD, may thus provide a productive forum for exchange by bringing practitioners together in a peer learning dialogue.