

Subsidies and Market Systems Development (MSD):

DFAT's Operational Framework for Private Sector Engagement

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Executive Summary

The Australian Department of Foreign Affairs and Trade (DFAT) Operational Framework for Private Sector Engagement (the Operational Framework) is soon to be released. It will articulate a strategy for the continued development of DFAT culture and systems to enable the department to better share assets, networks and expertise with the private sector. The Operational Framework will provide practical tools and approaches that aim to amplify the impact of Australia's aid program through partnership with the private sector.

This knowledge exchange brief focuses on issues of market distortion and subsidies to market actors relevant to the Operational Framework. The brief examines the way that Market Systems Development (MSD) programs such as the Market Development Facility (MDF) utilise subsidies; particularly how levels of additionality and concessionality are determined. The brief, whilst acknowledging donor concerns around providing public money directly to the private sector argues that many of the considerations surrounding market distortion and private sector subsidy are not dissimilar to risks associated with other forms of program. It concludes that whilst partnering with the private sector can deliver sustainable impact at scale, development funders should remain cautious of any sort of partner selection bias.

This knowledge-exchange brief is part of a series developed by the DFAT funded Market Development Facility (MDF). The briefs reflect a range of perspectives from roundtable discussions facilitated by MDF at DFAT in Canberra in October 2018 as part of MDF's learning agenda. The briefs acknowledge the diversity of policy perspectives on MSD and incorporate examples and lessons learned from MDF and other MSD programs. The

learning agenda aims to support learning and information sharing by MDF, one of DFAT's largest, most sectorally diverse and geographically dispersed MSD programs. Learning Agenda sessions are aimed at deepening understanding of the value, application and complementarities of MSD as well as other private sector approaches in complex economic and political environments.

Purpose

The Operational Framework identifies how to partner with the private sector and provides tools to support this. Its development reflects some of the historical challenges that DFAT staff have had in engaging the private sector. Businesses have provided feedback that beyond flagship programs such as the Business Partnership Platform (BPP) they remain unclear on the mechanisms through which partnership with DFAT is possible. There is also an identified need for more flexible partnership approaches and more regular and appropriate engagement of business leaders with decision makers.

Whilst DFAT has made considerable progress in its approach to partnering with the private sector, there remain concerns amongst donors with providing public money directly to the private sector and that this is inherently more problematic or more risky than partnering with NGOs or government bodies. Partnership with the private sector may involve blended finance, grants or provision of technical assistance. These are all forms of subsidy, the delivery of external resources into a system. MSD programs are one of the key platforms through which DFAT 'subsidise' the private sector and so offer a useful prism through which to examine this debate and the ways in which MSD programs minimise damaging market distortion.

Analysis

The debate about private sector development and market distortion – through subsidies – reflects deeper conversations that have been targeted at MSD and other private sector programs. It has been argued that the profit incentives of business make this class of activity riskier, or less ethical, than funding for government or civil society actors. There is little evidence to support this.

All fiscal transfers, whether they be to government, civil society or private sector actors, are a form of subsidy. All subsidies run the risk of being ineffective or of enabling rent seeking; the distortionary impacts of aid have long been understood. Aid programs can distort the relationship between the government and its citizenry. Governance programs can distort a government's policy framework and can incentivise governments to build in structural costs which may not be sustainable. Achieving change through development assistance is, by definition, distortionary. What needs to be determined is which distortionary effects are intentional and desirable, which are acceptable and which must

be avoided. Weighing up the potential positive vs. negative distortions of development assistance is an essential part of the planning process.

The fundamental challenge of working with the private sector is asymmetry of information around incentives and market intelligence. MSD programs invest heavily in analysis to try to mitigate these risks. By being an informed market actor (as opposed to less targeted programs) MSD programs are in a better position to identify risks and incorporate safeguards.

Experience from MSD programs teaches us that money (i.e. a direct subsidy) is rarely the primary constraint to investment choices. More often than not it is a lack of insight, or knowledge about opportunities, an unwillingness to take on additional risks, or a fear of an informal business 'growing too big' and therefore attracting unwanted attention from the authorities. Nonetheless concessionality or the 'softness' of blended finance provision to partners is still carefully considered on MSD programs.

Concessionality is determined on a case by case basis. It is recognised as important not to over subsidise partners, or minimise their 'skin in the game', as this risks reducing a partner's commitment. The level of concessionality should also be based on the context. When dealing with first movers in a risky market a larger subsidy may be needed, whereas later adopters may require a much lower (or no) subsidy. Additionality must also be demonstrated. MSD programs generally establish an additionality hurdle - that changes would not take place without intervention - before activities are approved. They also consider displacement; that MSD program resources are not displacing the efforts and investments of others. This decision making process is supported by rigorous monitoring of results that track the relationship between the provision of the subsidy and the changes it delivers. No evidence of a causal link, equates to no intervention or no 'claiming' of impact.

Subsidies need to have a demonstration or catalytic effect. This is key to sustainability. Whether or not a subsidy is going to a public or private sector actor, the question of whether or not it is transformational is the key determinant of whether or not an intervention is worth funding. Form should follow function. In the same way that working with the government should not be seen as end in its self, working with the private sector should not either. Normative outcomes should be identified and pursued where appropriate, but not used as a basis for decision making. The fundamental challenge is finding the right tools and the right partners to deliver sustainable transformational change. The only way to do this is through analysis of the system and the selection of the correct partner in that specific context.

Conclusions

Reflecting broader concerns about partnering with the private sector there remain considerable amounts of misunderstanding about the MSD approach. There is however a strong argument that whether or not aid funds are used to fund or subsidise government, community organisations or business actors, there is a need to carefully manage distortionary impacts. Subsidies in the form of interventions need to prove additionality, consider levels of concessionality and have a transformational impact. MSD programs do not work with or subsidise business as an end in its self. They do this because practitioners have found that it is an effective pathway for growth and poverty reduction. For all programs, whether working with the private sector, NGOs or government, transformation of the system should be the goal. Considerations on the type of partner and type of subsidy used should just be part of the process.



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