Soft Hearts and Hard Heads: The Private Sector's Centrality to Poverty Reduction

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1. Introduction

"Private sector" and "poverty reduction" are two topics that seldom complement each other in people's minds. Recently, however, the Asian Development Bank (ADB) and other multilateral and bilateral development institutions[1] with an interest in poverty reduction have begun to look more closely at the relationship between poverty and the private sector. Increasingly, researchers of development are examining not only how the private sector contributes directly and indirectly to poverty reduction, but also concluding that it contributes significantly to poverty reduction. Two fundamental pillars must be in place for sustained poverty reduction: (i) creating a good investment climate—one that encourages the private sector to invest, create jobs, and improve productivity; and (ii) empowering and investing in poor people, so they can contribute to and participate in growth. This is achieved by providing or enabling access to health care, education, and social protection.

2. The Private Sector's Contribution to Poverty Reduction

The Asian experience shows that growth is a very powerful driver of poverty alleviation. And a healthy private sector, given the right enabling environment—a good investment climate—will be the key driver of growth, the first pillar of any poverty reduction strategy. The second pillar is the social sector investments that enable the poor to take advantage of the opportunities in a growing economy.

[1] An International Financial Institutions (IFI) Working Group on Poverty and the Private Sector, chaired by ADB, was convened to articulate the linkage between the private sector and poverty reduction and put these themes in the public domain. The Working Group consisted of the German Investment and Development Company, Export Development Corporation (Canada), Industrial Fund for Developing Countries (Denmark), Export Risk Guarantee Organization (Switzerland), the European Bank for Reconstruction and Development, the European Investment Bank, and the International Finance Corporation. It has agreed on the proposed agenda and developed an inventory of recent IFI work on poverty and the private sector. Its medium-term work program centers on identifying priority areas, disseminating and communicating best practices in integrating pro-poor programs into private sector investments, and developing mechanisms for monitoring progress on implementing the agreed agenda.

Across countries, differences in investment climate have led to contrasting growth performances. And across countries, the impact of growth on poverty reduction has also varied enormously. In India, for example, the same growth rate has reduced poverty in some states (e.g., Kerala) by 6 times as much as in others (e.g., Bihar). One reason for this is differences in education opportunities and levels of health spending, which allow poor people to take advantage of opportunities in a growing economy. Another is governance. Corruption invariably hurts the poor, and poverty has fallen less in those states where governance and the rule of law are weak. This emphasizes, again, the importance of the twin pillars—a congenial private sector-led growth/investment climate, and social investments enabling the poor to participate in growth.

This paper focuses on a few of the ways that the private sector can affect poverty reduction. It touches on (i) sustainable job creation; (ii) introducing private infrastructure to create fiscal space; (iii) pro-poor infrastructure via creative concession design; (iv) corporate social responsibility; and (v) privatization strategies incorporating equity and distributional impacts. The discussion is intended to illustrate the diverse and sometimes unexpected means by which the private sector can have an impact on poverty.

3. Sustainable Job Creation

Some statistics attest just how much the private sector contributes to poverty reduction through growth, which brings employment and generates incomes.

- Private firms are the biggest source of job creation in the developing world, creating up to 87 jobs for every 1 job created in the public sector over the last decade. In the future, job creation in the public sector will decline even more, especially given fiscal constraints and the widespread recognition of the lower efficiency of state-owned enterprises (IFC, 2000)
- The private sector, through the employment it creates, offers a powerful path out of poverty to those at the bottom of the economic ladder. A recent survey found that 89 percent of those escaping poverty found a livelihood in the private sector (58 percent in the informal private sector, and 31 percent in the formal private sector). Only 11 percent found a livelihood in the public sector (IFC, 2000).
- Countries with a higher share of private investment grow faster, create more jobs, and therefore reduce poverty faster, given the impact of growth on poverty reduction. Countries where public investment dominates grow more slowly. To illustrate, Asian countries growing at 5 percent or more per year had a far higher share of private investment (63 percent of total investment) than slow growers (countries growing at 3 percent or less per year), where private investment was less important.

4. Private Infrastructure and Creating Fiscal Space

With growing demands on government, in industrialized and developing countries alike, for welfare-enhancing services, and without a similar strengthening of revenue capacity, there is a strong case for prioritizing public expenditures, and ensuring that scarce budget resources do not finance those activities which could be financed equally well by the private sector.

When the private sector finances what was previously a budgetary outlay, room is made in government budgets for those expenditures that really do need public support—notably social expenditures. In this way, the private sector contributes to poverty reduction *indirectly*. The "fiscal space" argument is a complex one: Freeing up budgetary resources does not automatically guarantee that they will be used for high-priority social expenditures: at the very least, agreement on public expenditure priorities and close oversight and monitoring of the expenditures would help ensure that these indirect impacts materialize.

In addition to freeing up resources, private infrastructure is important in meeting the requirements for basic services delivery. With Asia's population growing at 60 million each year, and with increasing industrialization, urbanization, and growth, demand for infrastructure will increase rapidly. Public budgets cannot possibly provide this, so private capital will have to fill the gap. The challenge: to ensure that the poor do not get squeezed out.

a. Filling the infrastructure gap: The key to reducing poverty

In India, studies show that infant mortality rates in villages with electricity are half those in villages without power. Access to clean and reliable water vastly reduces debilitating disease: in India alone, more than 500,000 children under the age of three die each year from waterborne diseases. Without clean water, the health care system fights a futile battle against disease. Reliable energy frees time for gainful livelihood activities the unproductive time spent gathering fuel, provides light and heat for schools, and allows children to do homework after dark and improve their education. Roads and telecommunications provide easier and cheaper access to markets and put remote villages in touch with health care and education services. If private sector solutions can expand access further, the poverty benefits will be palpable. The public sector has traditionally provided infrastructure in most developing countries, investing as much as 8 percent of GDP in Asia. Yet, the traditional "public monopoly" approach has failed the poor. Study after study shows that the poor have limited access and get low-quality services:

- Close to 1 billion people in developing countries lack adequate access to clean water; 2 billion lack adequate sanitation; and electricity has yet to reach 2 billion people worldwide. Ironically, when the public utility fails them, poor people face very costly alternatives to obtain essential services. Evidence shows that the price of water purchased from informal vendors can be 20 times higher than the price of piped water. And poor people pay up to 10 times more for paraffin used in kerosene lamps than they would for grid-supplied power. These facts tell us that affordability, or ability to pay, is often not the issue—access is. This is confirmed by surveys of poor

households, which invariably show that there is "willingness to pay" for these services.

- In addition, public infrastructure is often inefficient and costly. Losses due to subsidized prices, theft, and inefficiency eat up 10 percent of all developing country fiscal revenues: For example, the losses of Pakistan's largest power company, KESC, are almost equivalent to the country's total public spending on social services, more than 1.7 times total expenditure on education, and five times total expenditure on health care—but only 47 percent of the population is connected to the grid. And the price subsidies are invariably regressive: higher-income households consume most of the subsidized services—power, water, and transport—provided by state monopolies, effectively disenfranchising the poor.

b. Changing role of government.

As a result, in many developing countries throughout the world, governments are reexamining their role in the provision of basic services, and are becoming facilitators and regulators of private providers rather than being providers themselves. Nonetheless, there are real fears that commercialization and privatization mean higher prices and less access for the poor. But is this always so? Maybe not.

Restoring weak public utilities to health—i.e., commercializing them, and often later privatizing them—is the key to expanding access to new users, including the poor. Financially unviable utilities have no resources for new investment, system expansion, or upgrading service. They cannot expand service to new poor areas, or undertake much-needed rural electrification programs. Their inefficient operations push prices up as they try to recover their costs from a small, or shrinking, revenue base.

Thus, fundamental changes to make the utilities operate along commercial—and often private sector—lines are a "must" to improve the situation for the poor. An example helps illustrate the compelling need for such reforms: in the 1990s, when ADB began supporting sector reforms in Bangladesh, power shortages were an almost daily occurrence; outages took place on 335 out of 365 days each year. Power supply was erratic, produced by old power stations with no funds for maintenance, let alone expansion. Power theft was rampant, and the utilities received payment for less than half of the power they produced. Worst of all, only 15 percent of Bangladesh's population had excess to electric power.

Reforms consisted of unbundling the main utility into three separate "businesses" —generation, transmission and distribution—and introducing financial autonomy and commercial accounting, billing, and management, into each of these new businesses, in order to turn the utility around. With these reforms, for the first time in history, good governance and accountability were introduced in the utility. Reforms led to the dismissal of the old management, whose rewards had previously been based on "civil service" considerations such as permanent employment and seniority, and hiring of professional managers. With better management and improved operations, 80 percent of the power shortages have been eliminated, new connections now reach 25 percent of the population instead of 15 percent, service has improved, and collections in some areas are at an all-time high (90 percent of

billing). While system losses remain a problem, and there is still a long way to go in Bangladesh, these reforms represent an important beginning and demonstrate the importance of commercial/private sector orientation in infrastructure.

5. Infrastructure and the Poor: Creative Concession Design

There is growing recognition that the creative design of concessions can make infrastructure services more accessible to the poor. For example, designing infrastructure concessions to include "public service obligations" (PSOs), which are explicitly supported by the budget, is getting increasing attention as a way to make services more available to the poor, often at lower prices than those they currently pay. (It is important to distinguish budget-financed PSOs, delivered through the private utility, from PSOs that the utility itself is obligated to finance, typically through cross-subsidies. The latter are not recommended: since there are limits to such cross-subsidies, such PSOs are often not sustainable and maintaining them will cause financial losses in the utility.)

For example, the concessions privatizing the loss-making Buenos Aires Metro and Sao Paolo's bus system were awarded with the "public service obligation" to keep loss-making lines to poorer urban areas in operation and to continue unprofitable nighttime service. The concessionaire also had to agree to slower-than planned phasing of layoffs. These "PSOs" were far from costless; in fact, their cost exceeded the revenues expected from the concession in the initial years. The concession was therefore awarded to the bidder requiring the smallest subsidy, over the fewest years. The Government was much better off (as were the poor), since the "minimum subsidy" (the public sector's contribution to the public-private partnership) was far less than the transport system's expected future losses.

"Some development agencies are exploring 'corporate responsibility partnerships' with the private sector."

In Chile, concessions for profitable urban power franchises include a PSO requirement to expand into rural areas. Private power companies have bid to provide these services, again on a least cost (smallest subsidy) basis, with remarkable improvements for poor areas: 76 percent of Chile's population is now connected to the grid.

In Peru, public-private partnerships for rural telecommunications services will connect 5,000 towns and give Internet access to 554 district capitals by 2003. Private telecommunications operators bid for the minimum subsidy to provide rural phone service. Early pilot projects show that the private investment mobilized is twice the subsidy provided, and is far less costly (i.e., more efficient) than public provision would be.

In yet another example, privatization was seen as the only solution for Manila's water and sewerage system, which had left 40 percent of the population unserved, had losses equivalent to over 62 percent of revenues, and provided erratic supply. Sewerage covered only 7

percent of the population. A transparent bidding process included a PSO to bring slum households into the utility's catchment area. The winning bidder for the western half of the metropolitan area—Lyonnaise des Eaux, supported by ADB's Private Sector Department—is now providing water connections to slum communities that previously relied on far more expensive, unreliable, and unsafe water from informal vendors. Thanks to creative design and public-private partnership, close to 68,000 poor households have become paying customers with access to cheaper and safe water (see following article).[2]

Another lesson from this experience: the poor can, and do, pay. Maynilad, the private utility, has raised water tariffs since privatization. However, these higher tariffs are still far lower than what slum residents paid to middlemen for water that was unsafe and unreliable. Household surveys conducted two years after Maynilad took over confirm both "ability to pay" and customer satisfaction levels.

6. Corporate Social Responsibility

Corporate social responsibility (sometimes referred to as responsible corporate citizenship) is increasingly being explored as a way for the private sector to make a contribution to poverty reduction. The hypothesis is that private companies can have an impact on poor people through the way they do business: how they deal with social issues, labor, environmental issues, health and safety, corruption, and the local economy. Calls for social responsibility on the part of the private sector have been gaining volume in recent years. A lot of these are coming from nongovernment organizations and from the grassroots in a provocative way; however, managers are also increasingly taking a long-term view and seeing corporate responsibility and community relations as important ingredients of reputational risk. The development benefits are an added benefit.

A project supported by ADB's Private Sector Department in Sri Lanka offers an interesting example. AES, a private power company, allocates 5 percent of its annual in-country profits to community development and social projects that benefit the poor. Another example from the Philippines: private companies contribute 1 percent of pretax profits to Philippine Business for Social Progress, a social development foundation that funds community and poverty programs. However, as with PSOs, there are limits to what can be expected. Private firms are not charities or development agencies, and their willingness to contribute through such mechanisms will relate to the economic benefits the firm derives from them—not development needs.

Some development agencies (e.g., Britain's Department for International Development and the International Finance Corporation) are exploring "corporate responsibility partnerships" with the private sector, which use public funding to subsidize and support a private company's

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[2] In water, telecommunications, and power, the initial capital cost of connection can be quite high, and special financing mechanisms typically are needed to ensure that the poor can afford the connection (as distinct from the cost of recurrent service). Such schemes are sometimes organized by the utility; in some countries, microcredit nongovernment organizations have financed such schemes.

socially focused program, and make infrastructure services more available and affordable to the poor. In Guinea, for example, a private water utility was contracted to provide water in major towns and cities. Concerned about a large tariff increase, donors subsidized a share of the private operator's costs while the water tariff was gradually raised until it covered costs. This arrangement enabled the water utility to extend the system, enabling the poorer, marginal areas to be connected to the water grid; and also made the service more affordable to the poor.

In the Philippines and Bangladesh, private rural electric cooperatives receive subsidies from aid providers based on the achievement of specific performance targets, such as reducing system losses, increasing sales, meeting customer connections targets, improving collection rates, and repaying loans. In Thailand, a major hotel chain receives donor grants to expand its in-house training program for hotel service and catering to include street workers and others emerging from rehabilitation centers, training them for future livelihood.

7. Privatization Strategies that Consider Distributional Impacts

When governments privatize state-owned companies, whether these are utilities, manufacturing companies, or banks, the manner of their sale can have distributional consequences. Some countries have explicitly factored distributional considerations into their privatization programs. In the 1990's, Bolivia privatized six major sectors. The revenues from privatization were shared with the population at large. The rationale was that nationally owned assets had been created with the people's taxes in the first place, and when those assets were eventually sold, the revenues should be returned to the people. In Poland, 20 percent of shares in privatized enterprises were reserved for employees, many of whom lost their jobs. Sharing the benefits of privatization with the public helped to create public support for the privatization process and "democratized" the distribution of wealth as well. It is early days in Asia for this type of privatization, but the issue is also relevant. Both IBRA (Indonesia's bank restructuring agency) and Thailand's new asset management company now own many companies that they must restructure and dispose of. Whether governments sell through initial public offerings, through a state investment company, to a local management team, or to employees (or a combination of all of these) will affect different income groups differently.

8. Conclusion

In sum, there are strong links between private sector development and poverty reduction, and the private sector can and does contribute to poverty alleviation. It does so by delivering growth—the first pillar of poverty reduction—and creating the jobs and livelihoods that are a stepping stone out of poverty for many poor households. Creative approaches to delivering infrastructure services, socially aware approaches to business, privatization that considers the social context: these are all possible ways to contribute. They need only our imagination and soft hearts—but hard heads—to get them going.

References

IFC (International Finance Corporation). 2000. *Paths Out of Poverty—The Role of Private Enterprise in Developing Countries*. Washington, D.C.