

EVALUATION DEPARTMENT

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ANNEXES 4–8

Norwegian Development Assistance to Private Sector Development and Job Creation

A Mapping of Policy Objectives, Aid
Flows and Lessons from the Literature

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Annex 4. Literature Review: Development Effects of PSD Support

As discussed in Chapter 3, development effects are the intended and unintended consequences of a development intervention. They are especially pertinent in private sector development (PSD) support. Firms' responses to PSD may produce a number of different development effects and may affect development objectives both positively and negatively. This annex explores several of the challenges and issues that arise in designing and implementing effective PSD support, as described in the extensive theoretical and evaluative literature on the subject.

Introduction

A number of donors have explicitly recognized the challenges of direct support. The UK Department for International Development (DFID), for example, concluded in its PSD strategy that “the core” of its PSD strategy “is to make markets function better and with greater fairness. More accessible and competitive markets enable poor people to find their own way out of poverty by providing more real choices and opportunities.”

The strategy thus emphasized general support, rather than direct support. DFID also emphasized the lack of knowledge, at that time, on the impacts of PSD support, and as a result the International Growth Center was started. This is a center that conducts research on the general conditions that foster economic growth and poverty reduction. In addition to this center, which is tailored to research, DFID has today about 80 PSD experts with competences on general instruments for economic development.

Similarly, the Swedish International Development Cooperation Agency (Sida) relies to a large extent on general support. The agency states that “to avoid a distortion of competition, Sida is very restrictive with direct support to individual businesses. Instead, Sida works with international partners, member-driven business organisations and national, regional and local authorities.”¹ However, Sida also supports IFC and has its own DFI – Swedfund.² The World Bank's International Finance Corporation (IFC), in an evaluation of its own PSD support, noted many of the concerns we summarize below, including jobs lost for competitors.³ The IFC report emphasized general instruments for job creation, including additional jobs along the value chain.

Background on the Literature Review

The ambition of the literature review was to identify best practice on how private sector development may be used to achieve the stated Norwegian policy objectives. The policy objectives identified from the mapping of policy objectives framed the literature review. Moreover, we used the conceptual framework to search for literature on various types of PSD interventions and we used the theoretical framework of markets and the findings in the academic and evaluation literature to discuss the emerging lessons.

We stated in the inception report that we planned to conduct a systematic review of this literature. However, it turned out to be an enormous literature and conducting a systematic review was thus not possible within the time frame of this evaluation. We therefore conducted a review of the literature relying on research published in high-ranked journals and adding relevant evaluations.

¹ www.sida.se/English/how-we-work/our-fields-of-work/market-development/private-sector-development/

² For a review of Swedfund, see <https://eba.se/wp-content/uploads/2018/05/2018-01-Swedfund-webb.pdf>

³ IFC (2013). IFC Jobs Study: Assessing private sector contributions to job creation and poverty reduction.

The review started with the literature we know from regular reading and participation in workshops and conferences over the last decades. This was complemented with literature searches on selected topics guided by the main Norwegian policy objectives for PSD support, and influential scholars within each sub-field. A particularly useful tool is citation searches (we used Google Scholar) that show new contributions that cite early influential contributions. We also searched known databases for evaluations, such as at the MIT Poverty Lab and at 3ie - International Initiative for Impact Evaluation. In selecting relevant literature, we particularly focused on review papers that covered a large amount of literature. These tend to be published in particular journals, such as *Journal of Economic Literature*, *Journal of Economic Perspectives*, and *World Bank Research Observer*. We have also covered some evaluations that have had influence within agencies that implement PSD interventions. These were found on institutional websites.

The literature review covers two types of literature, but in an integrated manner. The first analyzes the underlying structures of the economies where the PSD projects are implemented. The purpose is to identify constraints that PSD projects may contribute to solve. Based on this literature, one can formulate hypotheses regarding the effects of PSD projects. The second type of literature will be evaluations of PSD interventions. The review covers both types of literature under each objective. Regarding evaluations, the review covers evaluations that are designed so that they are likely to identify the effects of the interventions. This means that the evaluation has a strategy that can credibly identify what would have happened without the PSD intervention. Reports that do not meet this standard will not be used as evidence. In some cases, some influential reports may still be discussed with the purpose of illustrating methodological problems. In selecting relevant literature, we normally report on the most influential contributions to the literature. These will normally not be the most recent ones. The seminal contributions will, however, be supplemented with more recent contributions.

After the initial phase of identifying and reviewing the relevant literature, we developed a summary focusing on how to promote private sector development and job creation in developing countries as a means to pursue relevant development objectives. We used this to develop a synthesis of the lessons that were identified. The full summary is contained as an unpublished working note.

Development Effects

Job Creation

PSD support may affect development objectives such as decent work, economic growth and poverty reduction through the channel of job creation. The measurement of job creation is therefore a key issue in the evaluation of private sector development. However, there is not always a link between job creation and these objectives.

For example, a number of assumptions need to be fulfilled for private sector development to reduce poverty through job creation. First, private sector development must lead to additional aggregated activities at the market level. This will not necessarily happen if one firm's growth leads to a decline for other firms. Second, increased aggregate production must lead to higher demand for labor. This may not be the case as the introduction of new technology in some cases may reduce labor demand. Third, the vacancies must be filled by poor people and fourth, the wages must be higher than the income that the poor could generate elsewhere and high enough to bring them above the poverty line.

This causal chain highlights how we will use theory and the empirical literature that tests theory to critically examine the links between private sector development and their potential development effects.

Crowding Out

PSD support comprises a broad range of activities such as large-scale regulatory reform initiatives, sectoral-level interventions, direct business development packages, projects providing microfinance for small businesses and entrepreneurs, and employee trainings (ICAI, 2014; Villanger & Berge, 2015). Many interventions are designed primarily to generate and catalyze investment by private businesses in order to contribute to inclusive and sustainable economic growth.

There is concern, particularly among development finance institutions, that such aid projects may have the effect of crowding out private investment, particularly projects that directly provide capital for investments in specific firms. This is direct support and as noted, about 70% of Norwegian PSD in 2017 was direct support.

In the classic case, many small firms are providing the same product at a market price equal to the cost of production. The addition of another firm, added with the help of Norwegian PSD support, will reduce the market share of the other firms while the total production stays the same. This is full crowding out.

With other market structures, there may be only partial crowding out. In the case of limited competition, an additional firm may drive down prices and increase quantities traded, which in turn will lead to higher production and job creation. PSD support aim at increasing investments or establishing new businesses in a market should therefore be preceded by a pre-investment analysis of the degree of market power before aid is invested. This includes an analysis of any underlying market failures that may explain market concentration. That is, if there are increasing returns to scale, or asymmetric information, then an additional firm may not help, even in the case of market concentration. The tools of analysis are standard within the subfield of industrial organization. The initial analysis of market power may include calculation of Herfindahl indexes but should be followed by deeper analysis of the underlying market failures that potentially can be counteracted by PSD interventions.

Such market analysis of the underlying market failures is an element in Rodrik's growth diagnostics, but only as one element. The market analysis should be industry-specific and focus on whether any market concentration is the result of information asymmetry – i.e. insiders in existing firms know the customers, workers and the technology better than potential competitors and regulators. The analysis should also consider whether the technology itself requires large upfront investments, which may create a natural monopoly, and if that is the case, what PSD interventions may help.

Empirical literature has attempted to estimate the degree of crowding out, which was summarized in Hatlebakk (2016). The empirical literature estimates the extent of crowding out, which may be counteracted by crowding in: if foreign investments come with improved technology that is copied by local firms, then one may imagine that domestic investments will increase as a result of foreign investments. The limited empirical findings seem to support the conclusion that there will be some degree of crowding out in most markets.

A very informative case is microfinance. A core review by Banerjee, discussed in more detail in Hatlebakk (2016), concludes that what “is also striking is the lack of strong evidence linking this

business creation to increases in consumption. Indeed, there is no evidence of large sustained consumption or income gains as a result of access to microcredit.”

This conclusion appears to conflict with a parallel review, which uses some of the same literature: "In general, quantitative evaluations of microcredit institutions – quasi and experimental – show that improving access to finance does have a positive effect on business expansion and job creation." The difference is, however, explained by the stage in the causal chain, as Banerjee also concludes that microfinance leads to "business creation and/or some amount of expansion". That is, microfinance may lead to new businesses and employment creation, but will have limited impacts on consumption levels and poverty reduction.

The general finding from the literature is that there is not full crowding out of microfinance, but despite some expansion of businesses, it does not have a transformative effect on local economies in terms of poverty reduction. Another important finding is that providing finance can work extremely well under some circumstances, while it is found to deliver no impact in other circumstances, again highlighting the need for an initial analysis of the market.

Other Potential Development Effects

Beyond the direct effects of a PSD project, two additional types of indirect effects are often highlighted: that the project will buy inputs from other firms, and that the employees will spend their salaries on other goods. Some agencies may limit the indirect effects to the first type. All money flows, not only aid to private sector development, will have both types of indirect effects. Foreign aid that finances a hospital, for example, will need building materials, beds, food and other supplies, and the doctors and nurses employed will spend their salaries.

While the crowding out effects discussed above are different, they relate to the initial direct effects. If there are no direct effects, then there can be no indirect or induced effects. One evaluation report argues, for example, that if there is unemployment in an area then there will be no displacement effect. But this is a misunderstanding: if a PSD intervention crowd out private investments, then there will be no direct effect on jobs in the first place, and then no indirect or induced effects either, and the level of unemployment will stay the same.

Crowding out and additionality are closely linked terms. A PSD investment project will add to aggregate investments unless there is full crowding out. As a result, the concept of additionality is also central to the discussion of whether or not a particular private sector development intervention is justified.

Modalities of PSD Support

The Role of Government

The private sector, including small-scale farmers and the informal sector, accounts for 90% of employment in developing countries. Large-scale transformation in these countries would therefore involve changes in the private sector. But this transformation is hampered by market failures that constrain efficient allocation of resources, decent job creation, capacity building and many of the other development objectives intended to be achieved through the private sector.

Both the theoretical implication of market failures and existing empirical evidence suggest that it is important for governments to develop the private sector in poor countries by providing general support to improve the business environment and relieve other binding constraints they face due to

market failures. Cravo and Piza, in particular, report on a meta-analysis of 40 evaluations of different forms of PSD support. They conclude that "matching grants stand out as effective in creating jobs and improving firm performance", with matching grants defined as government reimbursement of "costs firms incur on training, marketing, and/or attending trade fairs".

A program of matching grants, they note, "is justified on the grounds that these investments have positive externalities and that, on their own, firms are likely to invest less than the optimal level".

In short, matching grants are grants that are meant to stimulate investments in cases where the private sector will underinvest as each firm will not consider the positive externalities on other firms. On the surface, this may be similar to blended finance, but the latter term appears not as well defined as matching grants. The standard definition is "the strategic use of development finance for the mobilization of additional finance".

This is a general formulation, and a more detailed discussion of the mechanism indicates that it covers a wide range of PSD investments, including risk mitigation/guarantees, concessional debt, and equity investments, and is motivated by the same arguments as PSD investments in general, such as additionality, crowding in, and addressing market failures. An OECD report on the evaluability of blended finance also demonstrates that the term covers a wide range of PSD instruments, as all types of aid in the DAC system is listed.

Governments, including the Norwegian government, may have overlapping objectives with private firms and households. In fact, in an economy with no market failures, economic theory (the first and second welfare theorems) indicate that private decisions will maximize public welfare if we allow for a welfare maximizing redistribution of resources. This implies a separation of redistribution of resources and government regulation related to market failures.

Thus, in theory it may be feasible to favor women, marginalized groups, workers, or the poor in general, through redistribution schemes that may not reduce the size of the cake. In practice, however, we know that redistribution may have costs, high taxes may distort incentives, and what we may term as government failures may add to the costs of distorted markets. On top of the market and government failures that may result from redistribution schemes, comes the core underlying market failures. Correcting these may also have additional costs, but in general it is found that government intervention is likely to increase public welfare.

Capital Provision

These theoretical findings are highly relevant for the case of private sector development. The rationale for providing capital is the lack of capital in less developed capital markets. The underlying cause for lack of capital will be market failures, including asymmetric information and thus limited liability. In the international capital market, real interest rates are now close to zero. In poor countries, however, it may still be risky to lend money as the lender may not perfectly observe the type and actions of the borrower, while the borrower may have limited resources to provide as collateral. This is, however, not an argument for direct support for providing additional capital, and any agency providing capital will meet the same challenges of lack of information and collateral. On the contrary, it is an argument for general support to remove the constraints for why there is limited investments in the first place, such as developing a national credit registry collating the borrowing history of individuals and firms so that banks can identify willful defaulters, financial delinquencies and pending legal suits.

However, even if there is room for such welfare improving general support, they may not always be easy to identify. For capital market interventions, in fact, Stiglitz argues that it may be better to intervene outside these markets, to focus on general support to reduce the underlying risks that otherwise escalates the problem of asymmetric information. As Stiglitz says: "It may be foolhardy for the government to go where the private market fears to tread: credit rationing in private capital markets does not necessarily suggest a role for government providing credit.... In some instances, such as the imperfect capital market, I suspect that there may be little scope for government intervention."

In practice, however, capital provision may be an effective policy instrument for generating more investments in less developed capital markets. In that case, the new investments would increase production, and there would normally be more use of labor (unless it was a labor-saving investment). Investments may also involve the need for a more skilled labor force, and thus the need for competence building. In this case the policy objectives economic growth and job creation would be positively influenced. But what about the other development objectives of Norwegian PSD support?

There is, of course, no guarantee that availability of capital will solve problems other than the need for capital. One will normally need additional policy instruments to reach additional goals. Let us say one is concerned with safe working conditions, then some sort of control mechanism, potentially combined with training, may be needed. The same will be the case for any environmental regulations. Another route is to invest selectively in businesses with relatively high performance in these dimensions.

Inclusive Economic Growth, Jobs and Poverty Reduction

A central question for this evaluation is how PSD aid can contribute to inclusive and sustainable economic growth, job creation and poverty reduction. We start with the basic relationship between aid and economic growth before we discuss inclusiveness, job creation and poverty reduction. It is essential to understand the relationships between these objectives, and the constraints that may hinder achieving them, in order to understand the effects PSD interventions may have. For the core constraints, we review available evaluations that attempt to estimate the effect of interventions.

The standard economic theory envisages three main pathways in which aid can influence per capita economic growth:

- Increase the amount of capital for investments.
- Increase the human capital (competence building).
- Foster the use of improved technology.

Capital and labor are normally complementary, so increased investments lead to job creation (building new factories requires more workers).

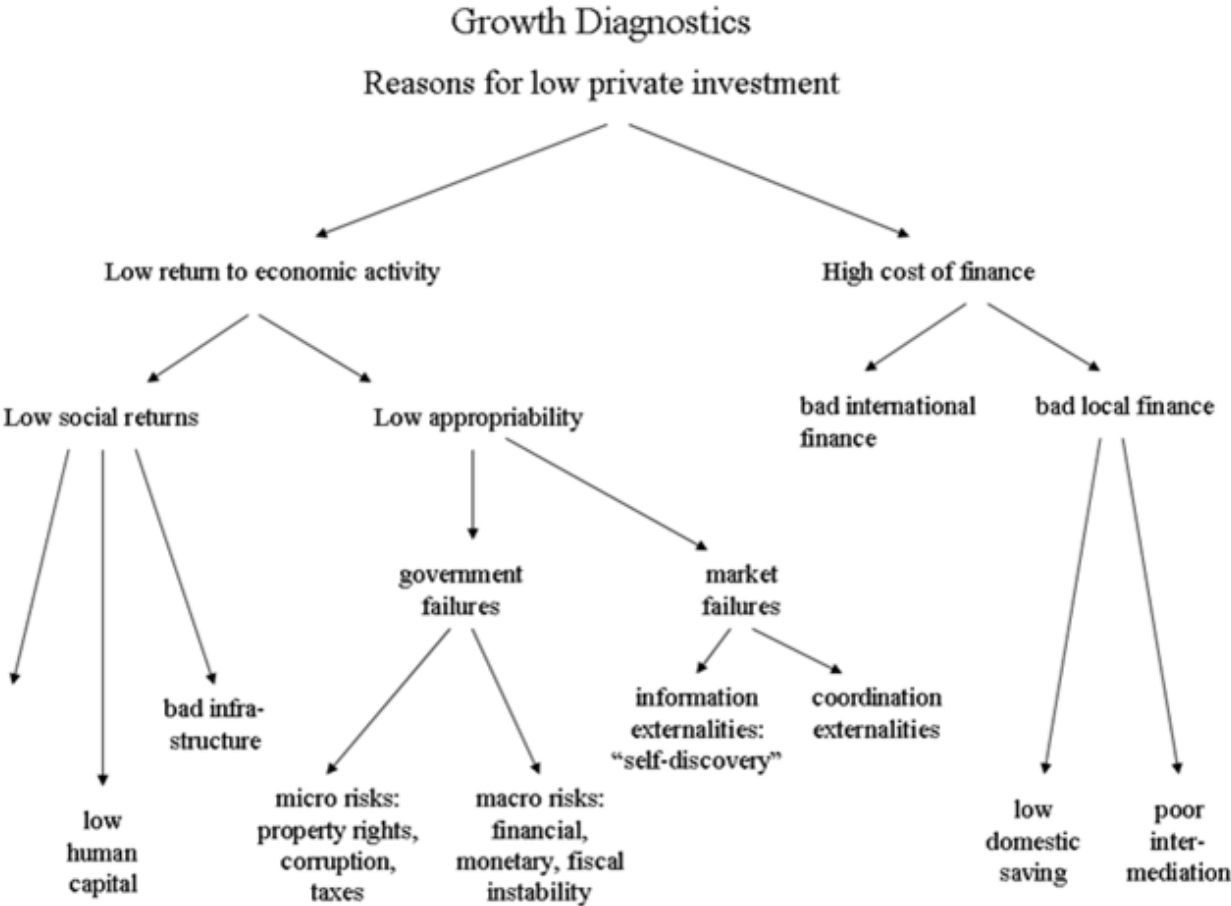
Physical Capital and Technology

Theory predicts that increasing the amounts of physical capital available for investment could lead to higher investments in countries where capital is limited.⁴ Putting investments to productive use will contribute to economic growth as long as it is not replacing a similar investment. PSD support can

⁴ Increasing the amount of capital in countries with well-functioning capital markets, such as in Norway, is not likely to influence the investment level.

potentially play an important role through *general support* when there are underlying market failures that PSD aid can solve. A central question is why there is limited capital in a country. Rodrik (2004) has developed a growth diagnostic tool (see Figure A.3.1) that can be helpful for such analysis and that may suggest what kind of general support should be provided. There are several practical applications that provide insights into how this can be done, but the approach requires much resources and technical capacity and is perhaps more suited for multilateral development banks.⁵

Figure A.4.1. Illustration of Growth Diagnostics



Source:

Beyond provision of capital, aid can introduce new technology that will increase production capacity. New technology can be provided in the form of *direct* support, which is the case when it is embedded in the investments, by providing power plants, bridges and factories based on technology that may not have been available initially. Support to diffusion of new technology can also be made in a *general* way, through support to innovation and research institutions.

Self-discovery

Hausman and Rodrik (2003) propose several concrete interventions to foster the use of new technology, some of which are suited for smaller donors or for limited geographical and sectoral areas.

⁵ See section 4.7 in M.P. Todaro and S.C. Smith (2015). *Economic Development*. 12th edition. Pearson.

One proposal is to establish a co-financing facility to subsidize the costs of “self-discovery.”⁶ The term has become standard, and is now presented in a leading introductory text-book in development economics.⁷ Hausman and Rodrik argue against the view that economic growth will ignite once the general conditions for private sector growth have been established; conditions such as a proper institutional framework in a country, that price distortions are eliminated, and that sound economic policies are in place. Even if those conditions are satisfied, there may not be growth unless entrepreneurs in the country know or can find out which investments would be profitable to undertake, that is, unless there is sufficient self-discovery.

Since self-discovery is costly for entrepreneurs, and the benefits of actually discovering a profitable opportunity will accrue also to the other entrepreneurs, a typical market failure situation arises and provides a rationale for PSD interventions. In essence, such interventions are public-private cooperation for identifying new profitable industries, with the benefits being available for all potential firms. Hausman and Rodrik recommend establishing or strengthening existing forums where businesses and sectoral associations come into close and regular dialogue with the government. This is important for the strategic aspect of supporting discovery: once companies have identified obstacles to profitable investment, the government and donors need to be involved in helping to remove these obstacles and facilitate expansion.

This approach was instrumental for the establishment and huge expansion of the rose farm industry in Ethiopia⁸ (Gebreyesus and Lizuka, 2012), which caused large-scale job creation and reductions in poverty and food insecurity (Getahun and Villanger, 2018).⁹ In this case, the key triggers for the growth were the discovery, the improvements in the general conditions for the sector, the inflow of capital and the introduction of improved technologies (for Ethiopia).

This literature indicates that the specific market failures that provide a rationale for industrial policy interventions are country and market specific. Thus, a careful market analysis is required in each case (Rodrik, 2010). The argument implies that developing countries should have an industrial policy in order to stimulate structural transformation and move out of poverty. The selection of the actual instruments used should depend on what market imperfections hinder private sector expansion. This requires a market analysis at the project and sector level (i.e. in the market that the project will be operating in).

This approach is similar to IFC's creating markets concept. One recent evaluation concludes, based on case studies selected from the IFC portfolio: "*IFC's activities and interventions that contribute to creating markets can be clustered around four interrelated channels: fostering innovation; generating*

⁶ Hausmann, R. and Rodrik, D. (2003). Economic development as self-discovery. *Journal of development Economics*, 72(2), 603-633.

⁷ See section 4.6 Economic development as self-discovery, in Todaro and Smith (2015). *Economic Development*. 12th edition. Pearson.

⁸ Getahun, T. and E. Villanger (2018). Active private sector development policies revisited: Impacts of the Ethiopian industrial cluster policy. *Journal of Development Studies*. <https://doi.org/10.1080/00220388.2018.1443211>; Gebreyesus Mulu & Iizuka Michiko (2012). Discovery of Flower Industry in Ethiopia: Experimentation and Coordination. *Journal of Globalization and Development*, 2(2), 1-27.

⁹ This is just one example. The Hausman and Rodrik paper has been highly influential (with 2200 citations in google scholar, which include academic papers as well as the grey literature). For one recent review of the literature, see: Maloney, W. F. and Nayyar, G. (2018). Industrial policy, information, and government capacity. *World Bank Research Observer*, 33(2), 189-217. For one recent test of the theory, see: Javorcik, B. S., Lo Turco, A. and Maggioni, D. (2018). New and improved: Does FDI boost production complexity in host countries? *Economic Journal*, 128(614), 2507-2537.

demonstration effects; enhancing skills, capacities and governance structures at firm level; and supporting integration into value chains".¹⁰ The evaluation studies different sub-sectors, with agriculture being essential under the heading: *Market creation and the poor*. A core finding is that it is difficult to reach smallholders, and the evaluation concludes: *"A clear understanding of market gaps and constraints to reach the rural poor is critical for effective and targeted intervention"*. This is followed by a conclusion on the lack of evidence that resembles the general findings in Hatlebakk (2016): *"Evidence of the direct welfare implication of market creation efforts for the poor is lacking. Evidence from previous IEG evaluations, the portfolio reviews, and the 16 case studies points to the need to invest in monitoring and evaluation (M&E) to better understand the effects of market creation on the poor"*.

Focusing at the aggregated level, it is not clear that PSD aid will have an effect on total investment in the recipient country. Even if PSD aid is leading to increased access to some types of capital, it may be accompanied by a similar decrease in other types – which would typically be the case if there are limited profitable investment opportunities in the recipient country. However, there is reason to believe that higher incomes can increase the savings rate of the population. And with savings taking place, then potentially more investments may be made. If the PSD aid increases income for the target population, then they will save some of this, which in turn may increase the amount of domestic capital in the economy.

Building Competences and Human Capital

Knowledge is a public good; it will not only benefit the recipients of education, but also society at large. Since the benefits go beyond the individual, there will normally be under-investments and thus a need for government or donor funding. We also know that there will normally be under-investments in human capital within firms as they do not consider the positive externalities on other firms that may learn from new technology introduced by one firm, or from the investments in employees who may move to other firms in the future. Therefore, there is also need for government or donor support in this case.

In cases where the country lacks crucial capabilities within important sectors, donors may support various forms of knowledge building, skills enhancement, and training, including potentially more specialized knowledge transfers. The spread of knowledge may be costly, especially where institutions for spreading knowledge (such as universities, research institutes, vocational schools, polytechnic colleges, and other educational institutions) do not exist or do not function well. If well-functioning institutions are already in place, spreading additional knowledge and diffusing technology may be cheaper, and donors should to the extent possible engage with existing institutions.

The free-rider problem related to positive externalities suggests that companies will be reluctant to incur the cost of training their own workers, at least if the costs are high. Once workers are trained, they may move to other companies that did not incur costs training their own workers. This is a good example of a market imperfection where PSD interventions may reduce inefficiencies. This can be provided both as direct and general support. Direct support to one firm for training the workers will have the same social benefit even if these workers starts to work in a competing firm. General support

¹⁰ IEG (2019). *Creating markets to leverage the private sector for sustainable development and growth*. An Evaluation of the World Bank Group's Experience through 16 Case Studies.

may reach more broadly, such as support to vocational schools, but be less fine-tuned to the needs of the companies.

Innovation theory also highlights how the efficiency gains of other institutions can be used as vehicles for the spread of knowledge. Institutions such as industrial parks can bring together many companies that have similar interests and can share knowledge and learn from each other. Another example with the same rationale, but less demanding in terms of technical and financial requirements, is support to “clusters” in order to support learning and knowledge networks. Supporting such agglomeration effects is, in principle, an area where PSD interventions can reduce market failure. However, trying to *create* such clusters can lead to government failure since it is very difficult or even impossible for a government to select the companies that have potential for benefiting from a cluster (see Getahun and Villanger, 2018 and the references therein).¹¹

Skilled labor supply is an essential resource for industrial growth and economic development of any country. One of the most common skill development interventions undertaken by government and development aid agencies is *technical and vocational training (TVET)*. Another related intervention is *on-the-job training* where participant firms often receive subsidy to hire and train workers. *Business training and entrepreneurship programs* are popular interventions aimed at increasing the human capital of business owners and entrepreneurs.

McKenzie and Woodruff (2013) provide a good overview of the first studies of business training.¹² They conclude that training programs only have moderate effects on existing businesses, but that new businesses get started faster. There are only modest effects on business practices, and few studies find effects on sales and profits. One might not expect substantial effects of one-fits-all programs since businesses have very different needs. This creates problems for researchers investigating the impacts of training programs.¹³ If a wide variety of programs are needed, each one adapted to particular business, how can one systematically examine the effects of such programs? The simplest approach may be to offer individual guidance. One evaluation has examined the impact of that strategy, potentially in combination with a subsidy (cash-grant): Karlan, Knight and Udry (2015) found immediate positive effects of both individual guidance and cash grants, as well as the combination of the two, on investments and business practices in general, but in the long run these effects disappeared.¹⁴ Neither short-term nor long-term profit changed, and no jobs were created.

¹¹ <https://www.tandfonline.com/eprint/8fM29rmd4bW956tEkVvm/full>

¹² McKenzie, D. and Woodruff, C. (2013). “What are we learning from business training and entrepreneurship evaluations around the developing world?” *World Bank Research Observer*. 29(1): 48–82. One of the first studies, which is included in the review, was conducted in Tanzania by a CMI-NHH team: Berge, L.I.O., Bjorvatn, K. and Tungodden, B. (2015). «Human and financial capital for microenterprise development: Evidence from a field and lab experiment». *Management Science*. 61(4): 707–722. First version: CMI-Working-Paper: 2011/1.

¹³ Fischer, G. and Karlan, D. (2015). "The Catch-22 of External Validity in the Context of Constraints to Firm Growth". *American Economic Review*. 105(5): 295-299.

¹⁴ Karlan, D., Knight, R. and Udry, C. (2015). "Consulting and capital experiments with microenterprise tailors in Ghana". *Journal of Economic Behavior and Organization*. 118: 281-302.

Inclusive Economic Growth

The *inclusiveness* in inclusive economic growth points to the fact that the development objective is to ensure that *all* women and men benefit from economic growth. We use Addison's and Niño-Zarazúa's (2012)¹⁵ definition and framework:

"Inclusive growth deals with policies that allow people from different groups –gender, ethnicity, religion-, and across sectors – agriculture, manufacturing industry, services, to contribute to, and benefit from economic growth. It links macroeconomic fundamentals with microeconomic determinants of growth."

There is a large strand of literature with this focus, and an important part of this has analyzed the degree to which the poorest groups take part in and benefit from economic growth.¹⁶ The focus in the literature has been on what characterizes a pro-poor economic growth and how growth in various sectors impacts poverty.

We know that economic growth can lead to poverty reduction, via a trickle-down effect, while increased inequality will slow down this process.¹⁷ Ravallion (1999) has shown that a higher growth rate is needed to reduce poverty at recent levels of inequality (the last year with good data was 2008) compared to the level of inequality only nine years earlier.¹⁸ The World Bank has a target of 3% extreme poverty in 2030.¹⁹ To reach this target Ravallion calculated the need for 4.5% growth at the present level of inequality, while 3.4% would be needed at the lower level of inequality. Most countries will use a combination of economic growth and poverty reduction, ideally an economic growth that benefits the poor, either by creating jobs and income, as in inclusive growth, or via expansion of welfare programs. The latter may be feasible even without an inclusive growth process, but the support for welfare policies may be limited if the wealthier segments of society feel that the poor have not contributed to the growth process.²⁰

The extent to which an individual is *included* is determined by whether she benefits from the economic growth. The income accruing to individuals stems from either income from using their labor (i.e., wages) or income from owning capital (i.e., the rental price of capital or the interest rate). Since poor and marginalized groups usually do not own capital of substantial value, participation in the labor market and changes in the wage rate determine whether they benefit from economic growth.²¹ This implies that growth in some sectors can be more inclusive and more poverty reducing than growth in other sectors. A sector's poverty-reducing potential is related to the degree to which it employs unskilled labor, since the poor can provide their labor as a production input. Thus, agriculture is potentially the most poverty-reducing sector, followed by construction and manufacturing. The mining

¹⁵<https://www.wider.unu.edu/sites/default/files/Events/PDF/UNU-WIDER%20Presentation%20What%20is%20Inclusive%20Growth.pdf>

¹⁶ Ravallion, M. and Chen, S. (2003). Measuring pro-poor growth. *Economics letters*, 78(1), pp.93-99.

¹⁷ Kalwij, A. and Verschoor, A. (2007). "Not by growth alone: The role of the distribution of income in regional diversity in poverty reduction". *European Economic Review*. 51: 805-829.

¹⁸ Ravallion, M. (2013). "How long will it take to lift one billion people out of poverty?" *World Bank Research Observer*. 28(2): 139-158.

¹⁹ The target is set higher than zero, since we shall always expect some poverty among people affected by disease, war or natural disasters.

²⁰ For a variation on this argument see: Moene, K. O., and Wallerstein, M. (2006). The Scandinavian model and economic development. *Development Outreach*, 8(1).

²¹ These are direct effects. There could also be indirect effects of economic growth, such as lower prices for goods, or new or improved products available such as medicines, transport and communication.

and utilities sectors do not seem to help reduce poverty, since the labor employed by those sectors is usually more skilled and the employees are already above the poverty line.²² This highlights the role of job creation in poverty reduction.

A crucial question is *how* PSD interventions can lead to inclusive growth. Distortions that hinder marginalized groups from participating in economic activities are likely to hamper economic growth (see Villanger, 2015 and the references therein)²³. Interventions against discriminatory practices may create opportunities for marginalized groups to use their labor productively, which in turn will contribute to inclusive economic growth. Similarly, for business development and access to capital; if certain groups are barred from access to capital, this will exclude them from the opportunities of growing their own businesses and result in lower economic growth.

Providing equal opportunities for women in economic activity is a good illustration of the potential for PSD support to foster inclusive economic growth. Bringing more women into the labor force can provide a substantial boost to per capita growth. Narrowing the gender gap in employment in 15 emerging-market developing countries²⁴ is estimated to increase growth by almost 1% per year on average, which pushes up incomes per capita by more than 10 % in the next decade.²⁵ Similarly, women-owned small and medium enterprises (SMEs) face a number of barriers to entry and business growth, such as access to finance, education and training, legal and cultural barriers and infrastructure-related challenges. Access to finance is almost always a challenge for SMEs, but worse for women due to gender-related factors such as women's lack of collateral, weak property rights and discriminatory regulations, laws and customs. It is estimated, for the same countries, that closing the credit gap between men and women would on average lead to 12% higher incomes per capita over a ten-year period.²⁶ Again, there are big differences in impacts across countries, so the markets need to be analyzed before the PSD intervention is chosen. In Brazil and Vietnam, where the credit gaps were the widest, the income gain was as high as 25-28 %.

The Role of Agriculture for Inclusive Growth

As discussed, the majority of unskilled labor in poor countries is engaged in agriculture²⁷. The World Bank (2007) development report on agriculture concluded: "In the 21st century, agriculture continues to be a fundamental instrument for sustainable development and poverty reduction." When the Norwegian government says that 90 % of employment in developing countries is in the private sector (Meld. St. 35, 2014-15, p. 11), the majority of these jobs will be small independent farmers. We know from the literature on structural transformation that labor and other inputs flow back and forth between urban and rural sectors.²⁸ This implies that investment in urban sector may also benefit the rural sector as prices for consumer goods may decline and people move to the cities for temporary or

²² Loayza, N. V. and Raddatz, C. (2010). The composition of growth matters for poverty alleviation. *Journal of Development Economics*, 93(1), 137-151.

²³ Villanger, E. 2015. Entrepreneurial abilities and barriers to microenterprise growth: A case study in Nepal, *Journal of Entrepreneurship*, 24(2).

²⁴ These were Brazil, Russia, India and China, and Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, Turkey, South Korea and Vietnam.

²⁵ <https://www.goldmansachs.com/insights/public-policy/gmi-folder/gmi-report-pdf.pdf>

²⁶ <https://www.goldmansachs.com/insights/public-policy/gmi-folder/gmi-report-pdf.pdf>

²⁷ www.worldbank.org/en/news/feature/2014/11/12/for-up-to-800-million-rural-poor-a-strong-world-bank-commitment-to-agriculture

²⁸ See Barrett, C.B., Carter, M.R. and Timmer, C.P. (2010). "A Century-long Perspective on Agricultural Development". *American Journal of Agricultural Economics*. 92(2): 447-468. For a longer version of the same arguments see Timmer (2009). *A World without Agriculture*. The Henry Wendt Distinguished Lecture. The American Enterprise Institute.

permanent jobs. Still, with a massive surplus of labor which leads to poverty, in the rural areas in many countries, a key approach will be to invest directly in the rural sector. This includes non-farm economic activities, such as the in the large informal sector, but also investments in agriculture itself.²⁹

What lessons does the literature provide for investments in job creation and economic growth within agriculture? There is some debate on the issue of whether one should support smallholders, versus commercial agriculture. Hatlebakk (2018) reviewed the literature³⁰ and concluded that investments in smallholder agriculture is the most direct, and thus efficient, way to create jobs and reduce poverty.³¹

Identification the best interventions for development of smallholder agriculture requires an analysis of the underlying constraints on development, and identification of general support that may relieve these constraints, which quite often will be market failures. Relevant policies may include investments in infrastructure (roads for market access, irrigation to increase productivity) and social safety nets so that small farmers can take on production risk, including new technologies. Safety nets for farmers may include agricultural insurance, but also insurance against risks poor farmers face outside agriculture, for example affordable health services.³² This also involves investment in the development of farming techniques that are adjusted to local conditions and the extension services necessary to spread and adjust the knowledge to the same local conditions. This includes adoption of so-called climate-smart agriculture.³³ With respect to the adoption of new techniques it appears that model farmers function better than extension workers in many contexts.³⁴ Although each farmer may have limited incentives and means to invest in new techniques, this may still be profitable for the society at large, both within staple food production and potentially for some cash crops.

The Role of the Informal Sector

Besides agriculture, many poor and marginalized people are engaged in the informal sector.³⁵ Many are engaged in petty trading. This varies from vegetable sales on city sidewalks, via rural weekly markets, to shacks and market stalls. Beyond petty trading the informal sector will include food preparation and sales of different kinds, small workshops, often sidewalk businesses, transportation, and construction businesses of many different types and scales. With so many people working in the informal sector, it is essential for governments to have a balanced policy that allows for job creation suitable for this segment, while at the same time gradually extending the tax-base to include these

²⁹ For a longer version of this argument see section 4.1 on structural transformation in Hatlebakk (2018).

³⁰ Hatlebakk, M. (2018). Norwegian aid to food security, nutrition and agriculture. CMI Report 2018:01.

³¹ For two different views on the role of commercial farming that still are not so different in their general policy prescriptions, see: Deininger, K. and Byerlee, D. (2012). The Rise of Large Farms in Land Abundant Countries: Do They Have a Future? *World Development*. 40(4): 701-714; and: Collier, P. and Dercon, S. (2014). African Agriculture in 50 Years: Smallholders in a Rapidly Changing World? *World Development*. 63: 92-101.

³² For a discussion of variations on delivery of weather-based insurance or emergency aid see: Smith, V.H. (2016). Producer Insurance and Risk Management Options for Smallholder Farmers. *World Bank Research Observer*. 31(2): 271-289.

³³ For a broad introduction see: Dinesh, D. et al. (2017). The rise in climate-smart agriculture strategies, policies, partnerships and investment across the globe. *Agriculture For Development* 30: 4-9. For a more detailed discussion, including on the gender aspects of climate change and adaptation, see: Kristjanson, P. et al. (2017). Addressing gender in agricultural research for development in the face of a changing climate: where are we and where should we be going? *International Journal of Agricultural Sustainability*. 15(5): 482-500.

³⁴ de Janvry, A., Emerick, K., Sadoulet, E. and Dar, M. (2016). The agricultural technology adoption puzzle: what can we learn from field experiments? FERDI-WP-178.

³⁵ For a broad discussion of the role of the informal sector in economic development, see: La Porta, R. and Shleifer, A. (2014). "Informality and Development". *Journal of Economic Perspectives*. 28(3): 109-126.

sectors.³⁶ The informal sector is, almost by definition, a labor-intensive sector. Any capital-intensive industry will more easily be detected by the government, and thus be regulated and taxed. This implies a trade-off: for job creation, and thus poverty reduction, one may want to stimulate sectors that are dominated by informal businesses, but this conflicts with the target of broadening the tax base. Some policy instruments may, in principle, help achieving both targets. But in general, government interventions in the informal sector are often focused on regulation and taxation. For example, it is a concern that informal sector jobs may be insecure, hazardous, and in conflict with international labor standards, including regulations against child labor. ILO may be best placed to combine these conflicting targets. ILO has made guidelines on formalization and decent work standards for the informal sector.³⁷

The informal sector is usually very competitive, with low entry-barriers making it an opportunity for a wide range of people to make a living. We shall thus expect extensive crowding-out effects. An example is vegetable trading, which is usually comprised of mature markets with high degree of competition. Here, PSD interventions may focus on infrastructure that eases access to markets and the quality of the produce.

Sustainability, Clean Energy and Climate

The *sustainability* aspect of sustainable economic growth concerns the degree to which the economic growth does not harm the environment in a way that is unsustainable. A rationale for Norwegian PSD support is to contribute to the green shift, which implies that the PSD aid-funded projects should not only meet minimum standards but go further and contribute to solving some of the current environmental and climatic problems (Meld. St. 35, p. 77-79).

One key feature in the literature on sustainable economic growth is the finiteness of the world's natural resource base. The limited amount of raw materials, their depletion and the consequences for future economic growth and human wellbeing have received a lot of attention in the literature since 1960. In recent years, however, there has been a large-scale development of alternatives to many raw materials. Solar and wind power is rapidly expanding and offering prospects of being an alternative to fossil fuels, recycling can preserve the raw materials in the production-consumption circle and the development of synthetic substitutes can compensate for depletion of some natural raw materials (see for example Bontempi, 2017³⁸).

Economic growth models that predict both rising incomes and falling pollution levels can lower emissions via three channels: scale, composition or technology.³⁹ Emissions may increase with the level of production. If so, then scaling down production, and thereby accepting lower living standards, would also scale down emissions. This is not compatible with many of the SDGs and the aims of Norwegian

³⁶ For a broad discussion of taxation in developing countries, see: Brautigam, D., Fjeldstad, O. H., & Moore, M. (Eds.). (2008). *Taxation and state-building in developing countries: Capacity and consent*. Cambridge University Press. For a theory-based discussion, see: Besley, T., & Persson, T. (2013). Taxation and development. In *Handbook of public economics* (Vol. 5, pp. 51-110). Elsevier.

³⁷ ILO (2013). *The Informal Economy and Decent Work: A Policy Resource Guide supporting transitions to formality*. ILO has also produced an extensive statistical report on the informal sector: ILO (2018). *Women and men in the informal economy: A statistical picture*. Third edition.

³⁸ Bontempi, E. (2017). A new approach for evaluating the sustainability of raw materials substitution based on embodied energy and the CO2 footprint. *Journal of Cleaner Production*, 162, 162-169

³⁹ Brock, W. A. and Taylor, M. S. (2005). Economic growth and the environment: a review of theory and empirics. *Handbook of economic growth* (Vol. 1), 1749-1821). Elsevier.

PSD policy of contributing to poverty reduction, making the other avenues more attractive. Reduction in emissions can be achieved while maintaining economic growth by changing the composition of the outputs produced. For example, one may ban products using ozone-depleting gasses. Emissions would be reduced through the pure composition effect if an economy moves towards producing a set of goods that are cleaner on average than the set they produced before, with the same scale and technology. Lastly, technological change creating more environmentally friendly production can lead to a fall in emissions without affecting the level of production (and growth) or the composition of products.

For developing countries, the cost of transiting to a low-emission society is likely much lower than for the countries that financed the development of the new technologies. Nevertheless, the private benefits may not be sufficient to cover the costs, and support in terms of PSD aid may be necessary to reap the benefits for society of uptake of new technology in the local economy. Energy is a key sector in this transition.

Crowding Out of Polluting Sources of Energy

Clean energy is defined as any energy source that will not contribute with emissions that add to local environmental or health problems, or to global warming. Clean energy will normally be renewable energy sources, such as hydro, wave, wind and solar power.

In most cases, increased production of clean energy will replace other forms of energy, such as coal, natural gas and oil.⁴⁰ Standard economic theory, confirmed by empirical analysis, shows that in the normal case a new producer of clean energy will drive down prices so that total energy consumption increases.⁴¹ Despite the increase in demand, the new clean energy will to some extent replace the alternatives, so that the use of coal, oil and gas will decline, with the most expensive technologies being replaced first.

In heavily regulated energy markets, or in the opposite extreme of unregulated energy markets with limited competition, there may be an additional effect of clean energy that goes beyond simple replacement of other energy sources. If clean energy is provided by a new supplier that does not enter the (often tacit) collusion among local energy suppliers, or does not enter the regulated energy market, then the price may decline more than we shall expect in competitive markets. In this case, the price may decline from a collusive to a fully competitive price, and demand thus increase with so much that the addition of clean energy will be a de-facto addition. In this extreme case, the increased demand may imply more demand for the not so clean alternatives.⁴² These cases of heavy regulation of the energy market, or a private market with only a few providers, are quite relevant for poor countries.

To understand the impact of a new supplier of clean energy on the use of not so clean energy sources, it is essential to understand the existing market conditions in the market where the investment is made. Essential components include pre-investment analyses to assess the cost structure of the clean energy source compared to the alternatives, the demand situation, including both industries and

⁴⁰ For a national level analysis of substitution, see Bello, M. O., Solarin, S. A. and Yen, Y. Y. (2018). Hydropower and potential for interfuel substitution: The case of electricity sector in Malaysia. *Energy*, 151, 966-983.

⁴¹ For the importance of lower electricity prices for the manufacturing sector, see Abeberese, A. B. (2017). Electricity cost and firm performance: Evidence from India. *Review of Economics and Statistics*, 99(5), 839-852.

⁴² This will happen if the new competitive price is lower than the marginal income for the incumbent producers prior to the entry of the clean producer.

households, government regulations, and the competitive situation, including number of producers and the likely degree of collusion on either price or produced quantity.

Types of PSD Interventions in the Energy Sector

One priority for Norwegian PSD support to the energy sector is rural electrification.⁴³ If this is done through grid-extension, then it has a parallel to transmission lines, except that electricity is normally flowing one way, towards the village. Whether grid-extension should be prioritized to local village level production should depend on an analysis of costs in relation to emissions reduced. In remote villages, local solutions such as micro hydropower plants, wind and solar energy may be cost-effective. We know that for most countries the villages that are not yet connected to the grid are likely to have relatively low demand for electricity.

For large scale hydropower plants, which constitute a large part of Norwegian PSD support, the impacts will vary between local markets. In a country with a well-developed energy market, only very large-scale developments are likely to affect the price of energy. In that case, an additional normal size hydropower plant may not affect the price, but if costs are lower than for competing producers, the clean energy provider may replace polluting ones. Thus, if the core objective is to reduce emissions then the best intervention may be to build a hydropower plant. This is, however, not a sufficient argument for Norway to support a hydropower plant. For defining best interventions in this area, it is necessary to analyze additionality; whether the private sector, the local government, or international agencies will provide the necessary investments.⁴⁴ Impact analysis of large scale hydropower plants, which may affect the price of electricity and thus the consumption of electricity throughout the network, may require relatively complex market analysis.⁴⁵

Promote Responsible Business

Responsible business and corporate social responsibility (hereafter responsible business) go beyond labor standards. The European Commission defines responsible business as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis”. We adapt an expanded description by Blowfield and Frynas (2005) that reflects contexts in developing countries.⁴⁶ According to this definition, responsible business is an umbrella term that recognizes that firms:

- have a responsibility for their impact on society and the natural environment, sometimes beyond legal compliance and the liability of individuals
- have a responsibility for the behavior of others with whom they do business (e.g. within supply chains)

⁴³ For an analysis of the impacts of rural electrification, see van de Walle, D., Ravallion, M., Mendiratta, V. and Koolwal, G. (2013). *Long-Term Impacts of Household Electrification in Rural India*. Policy Research Working Paper 6527. The World Bank.

⁴⁴ In Hatlebakk (2016) we discussed the case of Brazil, which has had a well-developed energy market for decades. We argued that the role of Norwegian PSD support has likely been limited, due to the well-developed market. The energy market itself, however, has contributed to Brazil's development, see Lipscomb, M., Mobarak, A.M. and Barham, T. (2013). Development effects of electrification: evidence from the topographic placement of hydropower plants in Brazil. *American Economic Journal: Applied*. 5(2): 200–231.

⁴⁵ For one example, see: Steward RedQueen (2016). *What is the link between power and jobs in Uganda*. An independent evaluation commissioned by CDC.

⁴⁶ Blowfield, M. and Frynas, J. G. (2005). Editorial Setting new agendas: critical perspectives on Corporate Social Responsibility in the developing world. *International Affairs*, 81(3), 499-513.

- need to manage their relationship with wider society, whether for reasons of commercial viability or to add value to society.

Beyond the expected effects on growth and job creation, there are at least three major areas firms can *potentially* contribute to responsible business. First, a firm can *reduce poverty* by paying 'living wage', offering equal wage for women, and establishing factories in poorer areas. In addition, transnational firms can improve working conditions and labor standards in host countries by respecting the standards in their own firms and by promoting them in the industries of the developing country. For example, firms may require that their suppliers do not use child labor or prevent freedom of association among workers. Second, firms can contribute towards the *promotion of human rights* by respecting human rights in their own firms and by requiring other firms in their value chain to respect human rights. Large firms may also use their leverage to call for the respect of human rights in countries where they operate. Third, firms can also work to *improve governance and transparency* in countries where the state fails to uphold such norms. Firms may argue that they do not have the power to influence governments to respect human rights or improve governance. However, compared to local governments, many multinational firms have strong individual and collective bargaining capacity which is evidenced by the favorable conditions they are able to obtain for themselves (Wiig and Kolstad, 2010).⁴⁷

In *practice*, there are challenges in realizing these potential contributions of firms. Some of these challenges are related to the inherent misalignment between international development priorities and intrinsic interests of shareholders and firm executives. We list here three key challenges (Frynas, 2005, 2008; Kolstad et al., 2008).⁴⁸ First, corporations are primarily accountable to shareholders and as such the values and priorities of shareholders will affect the responsible business activities companies are willing to undertake. For example, companies in Angola support education and health initiatives but do not support initiatives related to governance as improved governance may not be in their interest.⁴⁹ In fact, when the civil war ended in early 2000s, diamond companies active in Angola suffered a decline in their relative stock performance as their abnormal returns declined.⁵⁰ Second, CSR is often understood differently in different countries and by different companies (Jenkins, 2005).⁵¹ Consequently, the expectations of what activities fall under responsible business varies across countries and companies. Many focus on micro-issues, related to local communities geographically close to a company, ignoring the most important macro issues relevant for development such as governance and institutions (Frynas, 2005; Kolstad et al., 2008). Third, corporations may not have the human resources and expertise to engage in measures with the most effect. For example, large companies may contract small number of larger suppliers instead of many smaller firms because monitoring large number of small firms is difficult, although small and/or informal enterprises are more

⁴⁷ Wiig, A., & Kolstad, I. (2010). Multinational corporations and host country institutions: A case study of CSR activities in Angola. *International Business Review*, 19(2), 178-190.

⁴⁸ Kolstad, I., Wiig, A. and Larsen, H. (2008). *Hvordan gjøre gode ting bedre? Norske bedrifters CSR aktiviteter i utviklingsland*. CMI Report, 2008:4; Frynas, J. G. (2005). The false developmental promise of corporate social responsibility: Evidence from multinational oil companies. *International affairs*, 81(3), 581-598; Frynas, J. G. (2008). Corporate social responsibility and international development: Critical assessment. *Corporate Governance: An International Review*, 16(4), 274-281.

⁴⁹ Wiig, A. and Kolstad, I. (2012). Assigned corporate social responsibility in a rentier state: The case of Angola. *High-value natural resources and post-conflict peacebuilding* (pp. 163-170). Routledge.

⁵⁰ Guidolin, M. and La Ferrara, E. (2007). Diamonds are forever, wars are not: Is conflict bad for private firms?. *American Economic Review*, 97(5), 1978-1993.

⁵¹ Jenkins, R. (2005). Globalization, corporate social responsibility and poverty. *International Affairs*, 81(3), 525-540.

likely to employ large numbers of poor people, and agricultural smallholders are more likely to be poor than large commercial growers (Jenkins, 2005).

Empirical Evidence

The empirical literature on the impacts of responsible business in developing countries is limited, and what exists shows that the contribution of firms is negligible.⁵² Firms primarily focus on responsible business practices that increase their business opportunities and working conditions and improve their positive image. Most contributions tend to focus on narrow philanthropic measures (Kolstad et al., 2008). Assessment of responsible business practices among oil companies in Angola revealed that firms acted strategically to obtain licenses from the Angolan government instead of conducting activities that would improve conditions in the country (Wiig and Kolstad, 2010). Similarly, the review in Kolstad et al. (2008) shows that Norwegian firms did little to improve human right issues in China or reduce inequality in Brazil. The key lesson from the limited empirical evidence on responsible business practices is that firms need to be incentivized to act responsibly (Frynas, 2008; Kolstad et al., 2008; Jenkins, 2005).

Greater acceptance and expectations of responsible business practices has led to coordination among firms and between firms and governments. Currently, approximately ten thousand international firms participate in the UN Global Compact to align strategies and operations with universal principles on human rights, labor, environment and anti-corruption, and to take actions that advance societal goals.⁵³

The Role of Aid

Bilateral and international development agencies have embraced the idea of promoting a responsible private sector since the late 1990s (Jenkins, 2005). For example, DFID created a Socially Responsible Business Unit in 1997 following the publication of the first white paper on international development which committed the department to promoting ethical business and voluntary codes of conduct on core labor standards (Jenkins, 2005). Below we discuss, based on the literature, some of the measures development aid agencies could take to promote social responsibility among businesses in developing countries. For more details see Kolstad et al. (2008) and Newell and Frynas (2007).⁵⁴

Practicing responsibility by development agencies: Development agencies can promote responsibility by adopting responsible measures in their own practices. This includes adhering to rigorous standards in their own dealings; integrating responsible business principles in their lending, grant and procurement processes and investing in capacity building of own staff. PSD support can be given conditional on the recipient adhering to the standards.

Facilitate knowledge transfers: Responsible business activities in developing countries have been criticized for not being integrated into larger development plans and priorities and that beneficiaries are not involved in the design (Frynas, 2005). Development agencies can facilitate knowledge transfer by organizing training and discussion forums for information exchange; facilitating closer links between government and industry representatives; facilitating collaboration between NGOs working on

⁵² There is, however, a large literature in consumer research, which we will not cover here, on the impact of CSR on brand perception.

⁵³ <https://www.unglobalcompact.org>

⁵⁴ Newell, P. and Frynas, J. G. (2007). Beyond CSR? Business, poverty and social justice: an introduction. *Third World Quarterly*, 28(4), 669-681.

responsible business and companies; and supporting specialist local intermediary organizations that can provide advice and support on responsibility.

Incentivizing and facilitating adoption: Development agencies can promote responsibility among firms by supporting advocacy on responsible business practices; support business associations that can share good practice and provide peer pressure; and support specialist local intermediary organizations that can provide advice and support.

Developing capacity of governments, labor and civil society organizations: Beyond firms, developing the capacity of other stakeholders may also contribute towards developing a responsible private sector. Activities for this group include supporting civil society organizations that can encourage responsibility locally such as universities and media; supporting labor unions to defend workers' rights and promote core labor standards; supporting multi-stakeholder dialogues, at local, national and international levels, which bring together businesses, intermediary organizations and civil society.

Generating knowledge: There is little empirical evidence concerning the impact of promoting responsible business. Development agencies could finance impact evaluation of such activities that can produce knowledge and guidance on what works and what does not.

Experience of Norwegian Development Cooperation in Promoting Human Rights

A recent report evaluated the performance of Norwegian public entities in relation to the implementation of the UNGP in Norwegian development cooperation.⁵⁵ The evaluation was based on case studies in Tanzania and Mozambique and covers the Ministry of Foreign Affairs, Norway's embassies, Norad, Norfund, GIEK and Innovation Norway. Among its key findings:

- **Relevant policies, guidelines and procedures** UNGP is very well aligned with Norwegian development cooperation through its incorporation in the national framework. UNGP is frequently and clearly referenced in high-level Norwegian policy documents, especially in white papers and the National Action Plan. However, the documents focus more on creating awareness among partners and Norwegian companies and much less on implementation and follow-up.
- **Assessing the human right risks and impacts of Norwegian development aid involving firms** The evaluation found significant gaps. While the institutions typically ensure that the human rights risk assessments are conducted, they depend on the local project partner's human rights due diligence. The state entities did not have the capacity, competence and contextual understanding to assess whether the quality of their partners' human rights due diligence is sufficient to meet the UNGP.
- **Grievance, remedy and sanctions** The only entity that has specific mechanisms for addressing grievances resulting from development projects is GIEK. Existing mechanisms in the other organizations are primarily to address corruption allegation.

Decent Work

The SDGs' focus on "decent work"⁵⁶ states that the jobs should be of a certain standard, provide a certain minimum salary, grant some rights for the workers at the workplace and provide a secure

⁵⁵ KPMG (2018). *UNGP, Human Rights and Norwegian Development Cooperation Involving Business*. Report 11/2018. Norad Evaluation Department.

⁵⁶ See SDG 8, and also <http://www.ilo.org/global/topics/decent-work/lang--en/index.htm>

working environment. This relates to how PSD support can be applied to improve the investors' environmental, social and governance standards.

Basu and co-authors provided an early review of the literature on labor standards.⁵⁷ The finding is that general support through regulations can have unintended consequences in some cases. Basu (1999) studied the case of child labor.⁵⁸ Regulation in developing countries may not reach all informal economic activities, including work on own farm and the large informal sector. Stricter regulations in some parts of the economy may shift labor, including child labor, to other sectors, potentially including illegal activities. There may thus be a trade-off: if labor standards improve the working conditions in some industries, then this may involve increased labor costs for those industries, which in turn may lead to fewer workers employed, people who would need to find alternative employment.

The positive impacts of labor standards are well documented, see for example the work by ILO.⁵⁹ DFID has also implemented programs for improved labor standards, in particular in the garment sector.⁶⁰ The potential negative effects for workers who may be forced into other jobs is not so easily documented. A supplement to stricter labor standards could be to support those who may no longer have a job in the regulated sector. This includes education for children, but also training programs and adult literacy programs.

ILO is key in designing and analyzing programs for decent work, including integrated market analysis.⁶¹ A recent report has summarized the findings from a number of projects (18 were selected for analysis among 109).⁶² The report concludes that the evidence is weak, and states that it is premature to make definitive conclusions on how and where market development projects can improve job quality most effectively. As a result, the recommendations for donor policies are quite general. The recommendations include that job quality should be integrated in project design, long project time frames should be built in, rigorous post-project impact evaluations should be funded and research on identifying impacts should be commissioned.⁶³

Practices Towards Promoting Responsible Business

With a weak evidence base, we cannot conclude on best practices, but some lessons emerge. In providing PSD support to firms and organizations, current responsible business practice involves communicating expectations, but also to support regulations related to wage levels and labor standards. It is expected that firms that receive PSD support comply with local wage and labor standards, and ideally lift these standards by providing a good example for competing businesses. In some cases, and if there is a demand for products of decent standards, this may be profitable in the short run. In other cases, it may be profitable in the long run as the company complies with and potentially affects the stricter standards that may follow economic development. Similarly, there may

⁵⁷ Basu, K., Horn, H., Roman, L. and Shapiro, J. (Eds.). (2008). International labor standards: history, theory, and policy options. John Wiley & Sons. For a short version see: www.wider.unu.edu/sites/default/files/AL07-2003.pdf

⁵⁸ Basu, Kaushik. 1999. "Child Labor: Cause, Consequence, and Cure, with Remarks on International Labor Standards." *Journal of Economic Literature*, 37 (3): 1083-1119.

⁵⁹ https://www.ilo.org/wcmsp5/groups/public/---ed_protect/---protrav/---travail/documents/projectdocumentation/wcms_681644.pdf

⁶⁰ See Smith, R. et al. (2014). Evaluation of the Responsible and Accountable Garment Sector Programme. www.opml.co.uk.

⁶¹ For a number of reports, see: www.ilo.org/empent/Projects/the-lab/lang--en/index.htm

⁶² www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/---ifp_seed/documents/publication/wcms_568481.pdf

⁶³ This include to fund research to develop indicators, MRM tools, and unpacking the impacts and importance of different job quality aspects to target populations.

be a cost in the local market, but a benefit in the international market if western consumers value responsible behavior. But we shall also expect, in some cases, that implementing responsible business standards may be a cost for companies, but still worth it for shareholders, including any international development agencies. The best advice is for international companies to gradually lead the way towards better wages, and higher labor standards, and in the process follow advice from the ILO.⁶⁴ One example is IFC's guidelines on labor standards.⁶⁵

⁶⁴ www.ilo.org/global/topics/decent-work/lang--en/index.htm

⁶⁵ www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_handbook_laborstandardsperformance

Annex 5. Norway and Other Selected Donors of PSD Support

Private sector development (PSD) has recently taken center stage in development aid discourse and priorities.⁶⁶ At the same time, some donors have been increasing their aid to PSD. Analyzing Norwegian PSD support using DAC codes allows for comparison with other DAC member countries according to DAC sectors.

Main DAC Donors of PSD Support

The largest donors within private sector development (DAC-200-300) are Japan (17% of all ODA to these sectors), EU institutions (16%), the World Bank International development Association (IDA)⁶⁷ (13%), Germany and USA (9% each), while there, for example, is zero ODA recorded for the International Finance Corporation (IFC) for these (or any other) sectors. The latter reflects the character of multilateral organizations, as these organizations may be both registered as donors and as agreement and implementing partners for aid allocated from other donors. The IFC, for example, is an agreement partner for direct multilateral aid from Norway and is already included in the statistics reported in the tables below. IDA, on the other hand, is active both as an agreement partner for projects already included in the tables, and a provider of aid.

Multilateral Donors of Private Sector Support

In contrast to Norwegian grant-driven aid, the support from the multilaterals will quite often be loans.⁶⁸ ODA from IDA to DAC 200 sectors in 2016 was, for example, 88% loans. The largest IDA project in 2016 was USD 86 million loans to the Bangladesh government for rural transmission and distribution of electric power, while the largest IDA grant in 2016 was the USD 29 million grant to DRC for developing the hydropower market in Southern Africa.

Norway allocates PSD support via IDA (as agreement or implementing partner) and these are registered as Norwegian projects in the Norad and OECD databases. This includes support to IDA through trust funds, which can be used strategically to provide directions for the World Bank. Norway also gives so-called core support to IDA, which is classified as administrative support (DAC-910), rather than as going to specific sectors (such as DAC-200/300) support.

The EU is the other major multilateral donor within DAC-200 and 300 sectors, which in reality means the EU commission and the European Development Fund (EDF). After IDA and the EU institutions, the largest multilateral donor within DAC 200 and 300 sectors is the Asian Development Bank, which allocated USD 1.5 billion in 2016 to DAC-200-300 out of a total of USD 2.7 billion (56%).

⁶⁶ See Mawdsley, E. (2015). DFID, the Private Sector and the Re-centring of an Economic Growth Agenda in International Development. *Global Society*, 29(3), 339-358, and Villanger, E. (2016). Back in business: Private sector development for poverty reduction in Norwegian aid. *Forum for Development Studies*. 43(2), 333-362.

⁶⁷ The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries: <http://ida.worldbank.org/about/what-is-ida>.

⁶⁸ From 2014 all Norwegian aid is classified as ODA-grant in the OECD-DAC statistics. Prior to 2014, when all Norfund projects were registered individually, most projects were registered as ODA equity investments in the OECD-DAC statistics.

Comparing Norway and Selected Other Donors: PSD Support by Sector

Note that only DAC codes (and not Norwegian budget codes) can be used for comparison with other countries. The total Norwegian PSD aid over DAC codes 200 and 300 was NOK 3.5 billion in 2017 (see Table 2a in Chapter 4). For DAC-300, Norway is at the same level as Denmark and Sweden, while Norway allocates more to DAC-200 sectors, due to the energy support.

Aggregate USD figures are reported in Table A.4.1 (Table 3 in Chapter 4) for selected donors.⁶⁹ The drop in Norwegian support, as measured in USD from 2014 to 2015, is primarily explained by a drop in the value of Norwegian kroner in 2015. As shown in Table 2a in Chapter 4, the support measured in NOK did not decline in 2015. We note that Norway, Denmark and the UK gave approximately the same priority to private sector development (15%-16% of the aid budget has been allocated to DAC sectors 200 and 300), while Sweden allocates relatively less to these sectors (10%), and Germany more (28%).

Table A.5.1. ODA for DAC-sectors 200 and 300 (current million USD)

Country	2010	2011	2012	2013	2014	2015	2016	Sum	All aid	Share
Norway	432	667	709	643	635	482	383	3951	25661	15%
Sweden	315	406	474	503	430	329	327	2785	27209	10%
Denmark	350	453	411	376	343	259	247	2439	14785	16%
United Kingdom	1213	1396	1395	1464	1744	2236	1867	11341	72269	16%
Germany	3020	3057	2472	3439	4563	4966	4458	25975	93348	28%

Source: DAC-CRS database on disbursements

Table A.5.2 splits the above Table A.5.1 on sub-sectors and shows PSD, in aggregate and as a share of total ODA to these sectors, for Norway as well as the other four selected donors.

⁶⁹ All international aid flows are from the DAC-CRS database on disbursements. As the Norad database report all numbers in current prices, we use the same from the DAC-CRS database. The DAC-CRS database does not yet contain data for 2017.

Table A.5.2. ODA for DAC-sectors 200 and 300 (current million USD)

DAC-sectors	2010	2011	2012	2013	2014	2015	2016	Sum	Share
<u>Norway</u>									
Energy (230)	169	274	362	237	197	117	79	1436	36%
Finance* (240)	44	136	78	103	8	5	8	382	10%
Business* (250)	32	34	41	26	212	193	179	717	18%
Agriculture (311)	76	85	99	158	113	83	57	671	17%
Fishing (313)	23	27	30	33	29	25	20	187	5%
Industry/mining** (320)	52	60	63	59	51	39	23	347	9%
Trade (331)	20	18	18	15	15	12	10	107	3%
Other	15	33	19	11	10	8	8	104	3%
Total	432	667	709	643	635	482	383	3951	100%
<u>Sweden</u>									
Transport (210)	25	36	34	27	19	11	8	161	6%
Energy (230)	60	63	72	96	51	90	44	474	17%
Finance (240)	12	15	23	24	33	15	17	139	5%
Business (250)	46	95	103	104	97	26	68	539	19%
Agriculture (311)	64	82	125	100	100	62	87	620	22%
Forestry (312)	15	18	11	14	15	16	20	109	4%
Industry/mining (320)	47	44	46	71	55	52	43	358	13%
Trade (331)	39	49	52	54	46	47	31	318	11%
Other	8	4	8	12	14	10	9	65	2%
Total	315	406	474	503	430	329	327	2785	100%
<u>Denmark</u>									
Transport (210)	82	103	89	45	10	3	1	334	14%
Communication (220)	3	1	18	1	22	9	12	65	3%
Energy (230)	31	68	24	82	56	31	23	315	13%
Finance (240)	2	3	9	1	4	29	32	79	3%
Business (250)	41	78	65	68	56	48	54	410	17%
Agriculture (311)	123	132	127	112	126	88	98	805	33%
Industry/mining (320)	45	47	57	41	60	34	16	301	12%
Trade (331)	7	3	13	23	7	5	5	63	3%
Other	16	17	9	3	3	13	5	67	3%
Total	350	453	411	376	343	259	247	2439	100%
<u>United Kingdom</u>									
Transport (210)	179	142	270	325	263	235	217	1 630	14%
Energy (230)	134	258	325	258	179	174	271	1 599	14%
Finance (240)	197	238	247	246	504	823	530	2 785	25%
Business (250)	55	187	49	83	65	138	121	698	6%
Agriculture (311)	114	171	244	249	269	465	382	1 894	17%
Forestry (312)	35	52	43	43	194	182	107	655	6%
Industry/mining (320)	157	172	82	108	151	133	161	964	8%
Trade (331)	209	74	96	119	98	82	62	739	7%
Other	133	102	40	34	21	4	16	350	3%
Total	1213	1396	1395	1464	1744	2236	1867	11341	100%
<u>Germany</u>									
Transport (210)	178	261	210	367	141	480	418	2 055	8%
Energy (230)	1 383	1 246	790	1 227	1 621	1 799	1 879	9 944	38%
Finance (240)	725	792	685	878	1 841	1 674	1 096	7 691	30%
Business (250)	239	206	220	215	194	199	246	1 520	6%
Agriculture (311)	268	345	280	414	356	538	574	2 776	11%
Industry/mining (320)	89	98	140	172	205	139	108	951	4%
Other	137	110	146	166	205	137	138	1 039	4%
Total	3020	3057	2472	3439	4563	4966	4458	25975	100%

Source: DAC-CRS database on disbursements.

* Includes Norfund with a recoding in 2014 from DAC-240 to DAC-250

** Includes Oil for development

When the funding of Norfund in 2014 was consolidated into an annual allocation of NOK 1.5 billion (which constitutes basically all of the DAC-250 support in Table A.4.2), and separate projects were no longer reported, the funding was also recoded from financial intermediaries (DAC-240 codes) to business support services (DAC-250). These two sectors combined have constituted 28% of the Norwegian private sector support over the period 2010 to 2016. The Norwegian DAC-240/250 support is the median share among the five comparison countries, with Germany having the highest share of 36%, and Denmark the lowest share of 20%.

While DAC-240/250 aid can ultimately go to multiple industries, the other DAC codes are more specific. We find that Norway and Germany prioritize the energy sector, where Germany supports a diverse portfolio of renewable energy sources, and Norway primarily supports hydro-power. Denmark also supports a sector that is important domestically, with 33% going to agriculture. Denmark and the UK support the transportation sectors (14% for both countries), in contrast to Norway where this support is basically zero. In Denmark, the transportation support is for road transport, while the UK also has significant allocations for transport policy and management. Direct support to industry and mining is relatively low in all five countries, while forestry is supported by UK and Sweden, and Norway supports the fishery sector.

Annex 6. The Program Theory of Norwegian PSD Support

This Annex elaborates in greater detail the overall program theory discussed in Section 4.6, which also presents a schematic representation of the program theory (Figure 4). The page numbers in the text below refer to Meld. St. 35, 2014-2015, which provides the most detailed descriptions of the underlying mechanisms that are supposed to lead to the development objectives.

Results Chain

The main **inputs** of support can be recognized as the building blocks of economic growth models, i.e. investments in physical and human capital and in technology development. It also is recognized that it is necessary to improve the local, national and global conditions for the private sector to invest and expand, and that good governance should be promoted (p. 5-8). Norwegian PSD support will be provided in many concrete ways as physical capital intended for investments, including in infrastructure. Similarly, the PSD support is intended to build human capital in several ways.

Improving the international conditions for the private sector will be conducted through multilateral institutions and via international collaboration. For improving the national conditions for the private sector, direct engagement is prescribed, especially on advice and capacity building. It is assumed that this requires recipient ownership in order to be successful and that education and research are necessary inputs (p. 17).

The inputs are used for a range of **activities**. Norwegian PSD support will attempt to increase investments in numerous ways, which reflects the importance attached to the provision of capital as an input. It is acknowledged that foreign aid is very small compared to international investments, and that aid should therefore seek to be catalytic. When it comes to investments, Norwegian PSD support is aimed at mobilizing investments from private investors (pp. 7, 15, 24 and 51).

Norfund is considered one of the most important instruments for reducing poverty through PSD support; its main activity is to invest in and use its competence to develop viable companies in poor countries. Norwegian support to increase investments includes direct investments made by Norfund (p. 7), infrastructure and business support by multilateral organizations such as the World Bank (p. 7), infrastructure investments through private-public cooperation (p.8), support to the improvement of conditions conducive for private investments (p. 15), education initiatives to attract foreign direct investments (p. 17), and support to conducting feasibility studies for assessing the viability of new investment projects (e.g. the Norad Enterprise Development for Jobs grant scheme).

Support to build competences is provided through many channels. Support is given to university collaboration and to connecting knowledge hubs in Norway with similar hubs in the recipient countries (Meld. St. 35, 2014-2015, pp. 8, 17). Moreover, Norfund contributes with knowledge and competence directly in its investments, for example through board participation. This is another form of human capital building (p. 26).

The support to provision and diffusion of improved technology is recognized, as it is stated that growth in developing countries can only be maintained by promoting innovation and the development of modern modes of production (p. 13). However, it is mostly in agriculture that innovation and technology diffusion is a central part of Norwegian PSD support. Norway intends to use its experiences of connecting research and development (R&D) with innovation and the private sector to connect research communities in Norway with those in the recipient countries (p. 33). There are also some

initiatives under the promotion of clean energy, and it is envisaged that civil society organizations will have a role in promoting new technological solutions for energy efficient solutions at the household level (p. 52).

In terms of improving the national conditions for the private sector, Norwegian PSD includes many large initiatives, among them technical assistance, capacity-building programs and institution-building programs such as Oil for Development, Fish for Development, the clean energy initiative and tax collaboration. International conditions for the private sector in developing countries are promoted through multinational organizations and international collaboration.

Support for promoting good governance is intended to improve the recipient's governance practices, considered key to proper resource management and as "a requirement for private sector development" (pp. 8, 53, 69-72). This support is usually given to the recipient government. One exception is support to the Extractive Industries Transparency Initiative.⁷⁰

Responsible business is to be integrated in implementation of all Norwegian support to PSD,⁷¹ and International Finance Corporation (IFC) Performance Standards on Environmental and Social Sustainability are the main tool for assessing environmental and social risks for Norfund.⁷² There is a strong focus on communicating international responsible business standards to the private sector (p. 80-83). The OECD Declaration on International Investment and Multinational Enterprises (OECD 2011) and the UN Guiding principles on Business and Human Rights (UN 2011) form the most important framework for responsible business. Norway works actively in the international arena and through multilateral organizations to promote decent work life and establish joint efforts to promote workers' rights (p. 83). A Norad support mechanism is available for firms to apply for funds to ensure compliance with responsible business standards (p. 28).

Further down the results chain, these activities are expected to produce **outputs**, especially increased aggregated investments in businesses and the development of viable businesses. These are expected to lead to increased production of goods and services, including financial services, energy and food – especially food that the poor consume as part of the food security efforts (see the sub-program theory for agriculture in Annex 5). Investments are especially expected to lead to increased availability of renewable energy and particularly electricity, which again is supposed to be available for the poor. The various activities to improve competences of local people are expected to enhance their human capital in a way that creates value added, either in the market or in the public sector.

Provided that the government has ownership of the reforms, the support is expected to contribute to improved local and national conditions for the private sector. International market conditions for the private sector in poor countries are expected to improve through international initiatives in areas such as trade (for example, via World Trade Organization (WTO) engagement and the UNIDO value chain development into international markets).

The communication of the government's expectation of compliance with responsible business standards as part of the Norwegian PSD interventions is intended to elevate the firms' understanding

⁷⁰ The Initiative works for transparency in natural resources extraction and management.

⁷¹ The Norwegian Ministry of Foreign Affairs has also established a new portal for corporate social responsibility. See <https://www.regjeringen.no/no/aktuelt/portal-naeringsliv/id2589726/>.

⁷² See St. meld 10 (2014-2015) and https://www.regjeringen.no/no/tema/utenrikssaker/naringslivssamarbeid-i-utlandet/innsikt/forventninger_retningslinjer/id2076270/

of how they could meet these standards. The program theory does not envisage how to ensure that jobs are created and that existing jobs are decent, other than at the general level of conveying the Norwegian expectations and collaborating internationally to achieve a decent work life. It is stated that the Norwegian government expects all firms to respect and contribute to a decent work life and abide by basic workplace standards and workers' rights and that workers are given "a living salary" (p.83). Norwegian policy emphasizes that it is the recipient government's responsibility to put adequate regulations in place to ensure a decent work life, and a key part of the policy is to work at the international level to promote joint efforts through collaboration with the WTO and in the UN system, including the ILO and multilateral finance institutions. Norway has a national strategy for these efforts.

Similarly, the support to governments on good governance practices is expected to create recognition of these approaches by the recipient government. It is explicitly stated, however, that due to strong interests in maintaining existing patterns, many practices such as corruption, illegal capital movements and tax evasion are very difficult to change,

Regarding **outcomes and impact**, if investments have been additional,⁷³ they have likely contributed to economic growth. Similarly, if investments in renewable energy have been additional and led to increased use of such energy, they have likely contributed to sustainable economic growth by increasing the share of clean energy in the energy mix. The investments have then also contributed to sustainability. An important assumption in the program theory is that all firms that receive support operate in a sustainable way and act responsibly. In Norfund, the IFC Performance Standards are used to ensure partner firm compliance.

Support to agriculture has a high potential of stimulating sustainable and inclusive growth. The envisaged support to smallholders, such as investments in climate-smart, productivity-enhancing technologies, is likely to contribute to both sustainable economic growth and poverty reduction. Again, other environmental impacts could nuance this picture.

Investments contribute to inclusive economic growth depending on the degree to which all people benefit from increased income. Since poverty reduction is a key development objective, inclusiveness implies a focus on whether the poor have benefitted. This is likely at the overall level given the relationship between growth and poverty reduction, but there could well be pockets of groups that are not benefiting. This is not problematized much in this theory, although it is mentioned in relation to support for energy and agriculture. It is assumed that there is a direct relationship between job creation and poverty reduction, but there is not much focus on what kind of investments will lead to more job creation and poverty reduction.

The support is intended to be conditional on recipients abiding by the responsible business principles. However, for many of the development objectives, the ambition is not only to ensure that the projects financed with Norwegian PSD aid adheres to the requirements. The ambition is to contribute to improved standards generally through international collaboration such as through ILO and the OECD.

It is also emphasized that support to private entities should be conducted in a competitive way, in line with the rules for the individual countries and international standards (pp. 49-50). This is likely included

⁷³ The private sector may grow, create jobs and contribute to achieving development objectives without any targeted private sector development initiatives. To justify public interventions, such interventions must therefore bring about something that would otherwise not have happened, i.e. they must bring additionality. Additionality is discussed in Chapter 3 and Chapter 5.

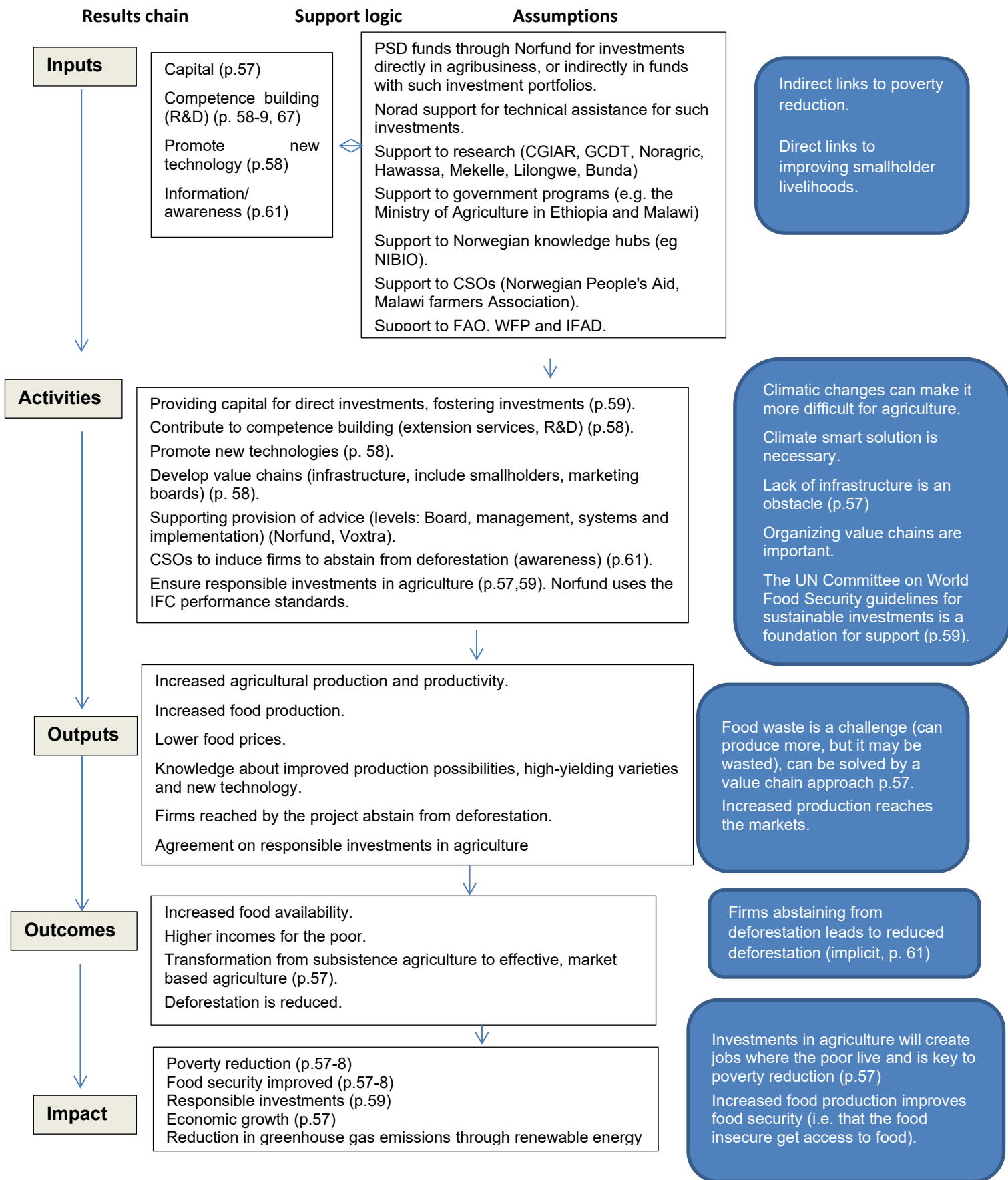
in order to prevent distortion of markets. This is an important point for PSD and particularly for direct support to firms.

Annex 7. Program sub-theories for agriculture and clean energy

Program theory for support to agriculture

In the program theory for agriculture, there is no clearly articulated theory of how such support will lead to the envisaged development effects. Nevertheless, components of such a theory, and the links between them can be found in the documents and can also be recognized from the overall theory of Norwegian PSD support.

Figure A.7.1. Program theory for Norwegian PSD support to agriculture



Reducing poverty and improving food security are the main intended development effects of Norwegian PSD support to agriculture (see the “Impact” stage in the bottom box in Figure A.6.1.). In addition, development objectives include promotion of responsible investments in agriculture. Norwegian PSD support to agriculture will take “agriculture’s contribution to growth and value addition as starting point, both for small-holders and larger entities” (Meld. St. 35, 2014-15, p.57).

To achieve these development effects, Norwegian PSD support to agriculture will channel funding to partners for investment in agriculture, conduct competence building among farmers, improving farming practices, support value chain development, contribute to research and development and dissemination of new technologies and fund knowledge dissemination and awareness rising. When economic growth is an objective, these **inputs** (see the “Input” stage at the top of Figure A.6.1) follow the rationale of Norwegian PSD aid. Norway collaborates with many different agents. The largest funds go to local government programs, sometimes via multilateral organizations, Norwegian NGOs, local NGOs, and Norwegian and local research institutions.

Voxtra, for example, is a capital fund for investment in agriculture where Norfund is a major shareholder, together with other Norwegian investors and donors. The support is also channeled through multinational organizations such as the UN organization for nutrition and agriculture (FAO), the World Food Program (WFP) and the International Fund for Agricultural Development (IFAD), through civil society organizations (CSOs) such as the Norwegian People’s aid and the National Smallholder Farmers Association of Malawi, and to research, development and knowledge hubs such as the Consultative Group on International Agricultural Research (CGIAR), Global Crop Diversity Trust (GCDT), the Norwegian Institute of Bioeconomy Research (NIBIO), Noragric and a number of universities in Africa (Hawassa, Mekelle, Lilongwe and Bunda College). There is also close collaboration with local ministries of agriculture, particularly in Ethiopia and Malawi.

The inputs financed by Norwegian PSD aid are used for many different **activities** (see the “Activity” stage in Figure A.6.1). For example, Voxtra invests in companies with the aim of improving smallholders’ livelihoods. Voxtra provides capital for farms or companies for their investments in businesses that benefit smallholders, such as in production of improved seeds. Voxtra provides advice to firms they have invested in, ranging from board level advice to recommending improvements in management systems, sales and marketing and governance. This is assumed to strengthen the development effects of the investments. Teaching smallholders improved agricultural production techniques is another competence building activity. Other types of funded activities include diffusion of new technologies and efforts to promote climate smart agriculture, which may increase yields at the same time as it reduces water consumption and greenhouse gas emissions.

Most of the activities identified in *Working Together* fit logically with economic growth models; by way of increase in capital, knowledge/human capital and technology development. However, there are additional activities funded that aim to promote inclusiveness, sustainability and responsibility of this type of support.

When it comes to responsible business, it is stated that Norway will use the UN Committee on World Food Security guidelines for responsible investments in agriculture and food systems (CFS-RAI) as a

foundation for its support to agriculture (p.59).⁷⁴ The guideline contains ten principles.⁷⁵ The intention is that these principles will shape Norwegian support in this area, and we therefore treat this as an assumption rather than an independent activity in this theory.

To promote sustainability, a key element of the support is to avoid contributing to deforestation (Meld. St. 35, p.61). There are also some activities funded by Norway that aim at committing firms to abstain from deforestation. Support to CSOs through the Climate and Forest Initiative has contributed to such commitments and support to the Tropical Forest Alliance may have contributed to lower levels of deforestation due to large multinational companies' adaption of their production activities (Meld. St. 35, 2014-15, p.61).

The activities funded are assumed to lead to certain **outputs** (see the "Outputs" in Figure A.6.1). Each activity can lead to one or more of the outputs. For example, to promote diffusion of high-yielding varieties can increase agricultural production and productivity, increased food production, and lower food prices. The Voxtra example is illustrating, in one of their investments, they aimed to double the production of a high yielding maize seeds and ensure the distribution to smallholders in Kenya. If this leads to a large increase in the aggregate production of seeds, it would be likely that the prize would be lower than what it would have been without the intervention.⁷⁶

In turn, the outputs are expected to lead to some **outcomes and impacts** (see the "Outcome" and "Impact" in Figure A.6.1). Following the Voxtra example, the increased maize production and productivity would likely increase incomes for the smallholders and reduce poverty if the involved farmers were classified as poor. Moreover, the project would likely lead to lower maize prices, which is a main staple and important for food security in the Kenya.⁷⁷ Therefore, the project would likely contribute to food security.

Responsible investments may also be a logical outcome in this theory. As an example, if Voxtra was a signatory to the agreements to abstain from deforestation, it could take this into account and encourage smallholders not to clear forest when expanding their cultivation. Similarly, Voxtra could have taken the guidelines for sustainable investments as a directive for their investment, and this could in turn have led to more sustainable investments in accordance with the ten principles. Theoretically, there is a logic in how to promote sustainable investments in the sector, although it is not made explicit how compliance with guidelines and principles can be ensured.

It is stated that the majority of the poor live in rural areas, and that agriculture is key to poverty reduction. In light of the overall theory of Norwegian PSD aid, this suggests that there is an implicit assumption that increasing productivity in agriculture in rural areas should be supported in order to reduce poverty. We do not find such directions for the support. Rather, the support to agriculture takes a wider approach, not excluding support that does not focus on poverty reduction. The connection

⁷⁴ <http://www.fao.org/3/a-au866e.pdf>

⁷⁵ The principles are: Contribute to food security and nutrition. Contribute to sustainable and inclusive economic development and the eradication of poverty. Foster gender equality and women's empowerment. Engage and empower youth. Respect tenure of land, fisheries, and forests and access to water. Conserve and sustainably manage natural resources, increase resilience, and reduce disaster risks. Respect cultural heritage and traditional knowledge, and support diversity and innovation. Promote safe and healthy agriculture and food systems. Incorporate inclusive and transparent governance structures, processes, and grievance mechanisms. Assess and address impacts and promote accountability

⁷⁶ <http://voxttra.org/portfolio/western-seed/>

⁷⁷ <http://fews.net/east-africa/kenya/food-security-outlook/june-2017>

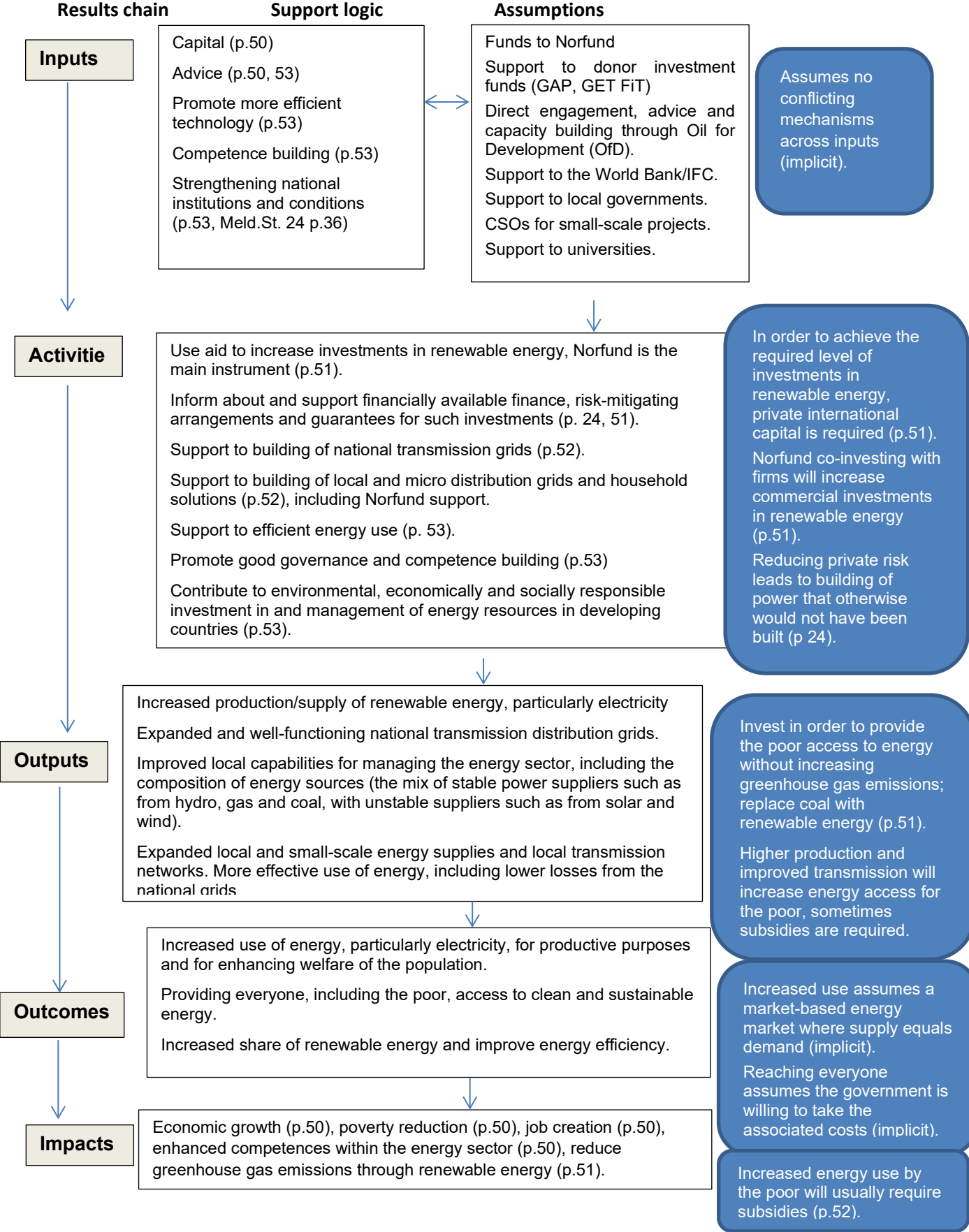
between the overall objective of poverty reduction and the activities that are supported appears not to be articulated.

Program theory for support to energy

The articulation of the expected links between the inputs financed by PSD support to energy and development outcomes and impacts are implicit, but many important relationships between cause and effect in energy markets seems to be incorporated. For example, the supply of renewable energy in a market is expected to displace more expensive thermal power and thereby lowering average generation costs (see for example Kim, 2019)⁷⁸. This will lead to a higher share of renewable energy in the economy and more use of energy, which in turn could lead to economic growth in the recipient country. Although *Working Together* does not articulate such relationships explicitly, there are clear statements that the envisaged support will contribute to the development objectives, with some exceptions which we return to below. The components of this program theory, and the links between them are explained in the document and can also be recognized from the overall program theory of Norwegian PSD support.

⁷⁸ Kim, R. 2019. Modelling the Employment Impact of Energy Investments. EDFI Impact Conference 2019.

Figure A.7.2. Program theory for Norwegian PSD support to energy



The **inputs** (see the “Input” stage at the top of Figure A.6.2) are funds for investments (i.e. capital), which are channeled through Norfund, through multilateral organizations (particularly the World Bank), to joint donor initiatives and via recipient governments and CSOs. Norfund is an important instrument for achieving the aims of Norwegian development policy in the energy sector. In order to increase investment in energy, Norway also supports “innovative instruments”, instruments that combine traditional aid and commercial finance (Meld. St. 35, 2014-15, p. 24). This includes general support, such as providing capital to existing finance, risk-mitigating arrangements, guarantees for such investments, and disseminating information to private investors about such opportunities (p. 24, 51). The support promotes more energy efficient technology, particularly for achieving higher energy efficiency in the use of biomass (such as more efficient cook stoves) and electricity (Meld. St. 35, 2014-15, p. 24). The inputs also include knowledge provision through competence, capacity and institution building programs in many forms. Moreover, the support includes institution building and improved governance of the energy sector in the recipient country.

These inputs are used for a range of **activities** (see the “Activity” stage in Figure A.6.2). Most importantly, this program theory features Norfund investments in renewable energy. Funds are provided to Norfund to unleash commercial and private investments in renewable energy production. Norfund is considered the main instrument for these purposes (Meld. St. 35, 2014-15, p.51). Norfund makes direct investments in energy companies, both equity and loans, and takes positions in SME funds. Norway also funds innovative instruments directly through donor funds such as a GET FiT, which includes risk guarantees for investors and an additional payment to investors per kWh supplied from small-scale renewable energy generation projects.⁷⁹ The support includes a range of instruments for investments in energy through the World Bank group. Moreover, Norad provides support to several universities and educational programs that build capacities relevant for managing the energy sector (Meld. St. 35, 2014-15, p.44).

These activities are expected to produce **outputs** (see the “Output” stage in Figure A.6.2), especially to contribute to increased supply of electricity through increased production, expanding transmission and distribution grids and reducing energy losses. More effective use of energy, including lowering losses from the national grids, is expected to lead to more electricity available for other purposes.

In addition, it is envisaged that the support will improve local capabilities for managing the energy sector, including the composition of energy sources. To ensure a stable electricity production the support will promote an adequate base of stable power suppliers, such as that produced from hydro, gas and coal. This will allow for an increase in unstable suppliers such as from solar and wind (p.52). The educational support is expected to increase competences locally for managing the energy resources.

The support is also expected to expand local and small-scale energy supplies and local transmission networks. This will be implemented in rural areas and other areas with limited electricity grids, areas where many of the poor typically live. It is assumed that in some cases this will require subsidies in order to ensure energy for the poor.

Outcomes and impact: Ensuring universal access to reliable, sustainable, affordable and clean energy for all is stated as an objective in itself. This is largely in line with SDG 7.⁸⁰ This indicates that the welfare

⁷⁹ <https://www.getfit-uganda.org/about-get-fit/instruments/>

⁸⁰ SDG 7 is slightly different: “Ensure access to affordable, reliable, sustainable and modern energy for all”.

effects of electricity consumption at the individual and household level is important. It is typically the poorest segments of the populations that are barred from using electricity. There are many reasons for this, but the key obstacle is that the poor live in rural areas where there is no electricity grid. Even when electricity is available, the poor may not afford to be connected or to pay for using the electricity according to the tariffs in use.

Commonly, many of the poor in a developing country are not connected to the electricity grid and therefore the increased availability of electricity only benefits the more affluent. The program theory acknowledges this point by focusing on support to extension of the local grids and individual house solutions, and explicitly recognizes that “It will often be necessary to use aid to contribute to reducing the risk for private initiatives, and for subsidies in order to ensure that the poor also get access to energy.” (Meld. St. 35, 2014-15, p. 52).

Reliable electricity supplies are also seen as important for economic growth, job creation and poverty alleviation (p.50), although the concrete linkages between the support and these development objectives are not elaborated. Norfund is more concrete and argues why energy is a prerequisite for development:⁸¹ “In Africa, electricity access is a major or severe constraint for over 50% of the local businesses. The unreliable energy supply makes them uncompetitive; it slows job growth and drags down annual GDP growth.” An example is provided from Tanzania where power outages cost businesses around 15% of their sales. Further, Norfund argues that the provision of energy is expected to contribute directly and indirectly to job generation. It contributes directly during the investment phase, and indirectly because firms save costs from fewer interruptions to production due to electricity black-outs and the effects due to increases in the amount of electricity supplied which can be used in production processes. Here they provide examples of estimates to substantiate these linkages.

There is no mention of a key assumption for how most of these inputs and activities can lead to the desired outcomes: there needs to be a market relationship between supply and demand of energy. If the energy sector is market-based, many of the activities may lead to more use of energy. However, in highly regulated energy markets where the government exercises strict control, as is the case in many developing countries, the gains from increased energy supply can be captured by the government. In this case, support to increasing the energy supply could end up with limited or no effects on development objectives.

⁸¹ <https://www.norfund.no/development-rationale/category1064.html>

Annex 8. Suggested case studies and methodology for evaluation C

Evaluation C concerns the effectiveness and efficiency of Norwegian PSD. We applied our conceptual and theoretical framework and the insights developed in this evaluation as the basis for suggesting relevant cases.

The suggested case studies represent both direct and general support, and they illustrate the usefulness of conducting market analysis at the project and sector level in order to inform whether the intervention is likely to achieve the envisaged development objectives. In addition, the cases aim to achieve some of the key development objectives as identified by our mapping, including how they work to follow up the objectives of responsible business. A theory-based analysis (see for example IFC, 2013) is essential when it comes to support to private sector development.

We know from economic theory that in a competitive market an extra firm, or an extra investor in an existing firm, will have at best a marginal impact on market prices, production and sales. Thus, even if the investor reports profits and job creation, there will normally be only a marginal impact on market outcomes and thus social welfare. The de-facto impact will depend on the slopes of the demand and supply curves, the degree and type of competition, and the type and size of the investment. If a new investor is able to establish itself in competition with a prior monopolist, then we shall expect large impacts. If a new investor establish itself in a market with no supplier, where it thus becomes the monopolist, then the benefits will depend on the government's ability to regulate the new monopoly. If a new investor establish itself in a mature market with many small suppliers, and thus potentially a flat supply curve, then we may expect no impact, and thus full crowding out of other firms.

Our proposed methodology of the cases includes conducting market analyses of the interventions in the cases. This will entail analyzing the competitive situation and maturity of the market in which the intervention is planned. For example, in a mature market with unlimited supply at a fixed marginal cost the counterfactual of an investment will, by definition, equal the outcome after the investment. This implies that the intervention will have no impact. This is the extreme case, but many real-world markets are close approximations to this textbook case. In particular, many investments supported by microcredit programs will be of this type, as many clients operate as petty traders in mature markets. Similarly, many large-scale investments in urban markets are of this type. Foreign investors, such as DFIs, may compete with local firms, including those financed by remittances and national investors living abroad.

In other cases, there will be lack of competition, and a PSD intervention may have an impact. As is discussed in this report, the investor will in that case tend to meet the same constraints as other investors, which explains the lack of competition in the first place. Therefore, these underlying constraints may still lead to lack of impacts, and in the case of de-facto impacts on job creation, the costs may be high. So even if an investment has a positive impact on the number of decent jobs created, the costs may be high, and the first best intervention would be to target the underlying constraints rather than to invest.

Core underlying constraints are likely to be distance and costs of reaching markets, large start-up costs, access to essential inputs (including an educated work-force), asymmetric information regarding labor efforts (hidden behavior/moral hazard), asymmetric information on production decisions under risk (hidden information and thus adverse selection), and lack of start-up capital (which may be explained

by asymmetric information as a creditor cannot judge whether you are a good investor, or whether you will make the necessary efforts and do not take risks knowing that the creditor will share the costs).

We suggest selecting three cases among the four types described here: 1) Support to a micro-finance fund that invests in mature markets with widespread competition (*direct support*). Microfinance is usually provided for poverty reduction and inclusive economic growth.⁸² 2) A program that supports small scale agriculture for poverty reduction, inclusiveness and climate smart adaptation, to illustrate the case of high transportation costs and lack of inputs (*general support*). 3) A hydropower project as this is a major sector for Norwegian support, either a large-scale power plant, or a fund that invests in small-scale power plants (*direct support in terms of the investment, general support in terms of increasing production of electricity*). Objectives include reduced greenhouse gas emissions through renewable energy and sustainable economic growth. 4) A broad-based multilateral PSD program that targets multiple general market constraints (*general support*). Objectives include job creation and inclusive economic growth.

The methodology for analyzing the cases will include: a) a market analysis, and b) an analysis of the likely impacts of the PSD support provided. These analyses will build on available statistics and interviews with key actors in the market under study, including the recipient of the Norwegian support. Within the time-frame and budget of the case studies, it will not be feasible to conduct a full impact analysis. However, we will use available statistics to describe change over time, and develop detailed a program theory for the intervention (in-depth versions similar in structure to those applied in this report) to discuss how much of this change that is likely explained by the investment supported by Norway.

The core indicators will be number of jobs created, to what extent decent jobs are created, poverty reduction, whether initiatives have been included to promote decent jobs in the existing stock of workers (or involved workers) and the degree to which there is compliance with the responsible business policies in Norwegian PSD aid.

** See for example <https://www.norfund.no/our-impact/>