

Private Sector Engagement

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Main takeaways:

►► For most donor agencies, Private Sector Engagement (PSE) is a fundamentally new way of operating to leverage private finance, innovation and capabilities for the SDGs. The term covers diverse approaches, including engagement with companies around their core business; and with private investors and financiers to mobilise private finance.

►► PSE involves a shift away from a transactional relationship and towards a more strategic and equal one, between donors and the private sector. To adapt, donors are launching new programmes, changing administrative and legal systems, and acquiring new staff skills and cultures. Donors are also learning how to manage the risks of playing a catalytic, rather than controlling role.

►► The wide range of PSE strategies and modalities means that a general verdict on whether PSE ‘works’ is not meaningful. Lessons on effective practice are however emerging for specific formats. Donors are also enhancing results measurement to fill knowledge gaps.

This synthesis note provides an introductory overview of PSE for donor agency staff new to PSE. It also offers a handy summary of current key issues and practice for staff already implementing PSE programmes or working to professionalise their agencies’ PSE approach.



PSE – a new way of operating to achieve the SDGs

Donor agencies agree that government budgets and capabilities are not sufficient to achieve the Sustainable Development Goals (SDGs). At the same time, ‘private business activities, investment and innovation’ are

recognised as ‘major drivers of productivity, economic growth and job creation’ as well other all development goals (SDG agenda). Most donors therefore see the need to engage with the private sector in a more strategic and systematic manner to achieve the SDGs (e.g. GAC, 2021; DFAT, 2018; OECD, 2017): PSE is about an ‘agency-wide call to action, and a mandate to work hand-in-hand with the private sector’ to design and deliver development programs ‘across all sectors’ (USAID, 2019).

SUSTAINABLE DEVELOPMENT GOALS



Some agencies also highlight specific thematic priorities for PSE: these include tackling gender inequality, e.g., through gender-lens investing (GAC, 2021; SDC, 2021), or the health and economic crises caused by COVID-19 (SDC, 2021).

Defining Private Sector Engagement

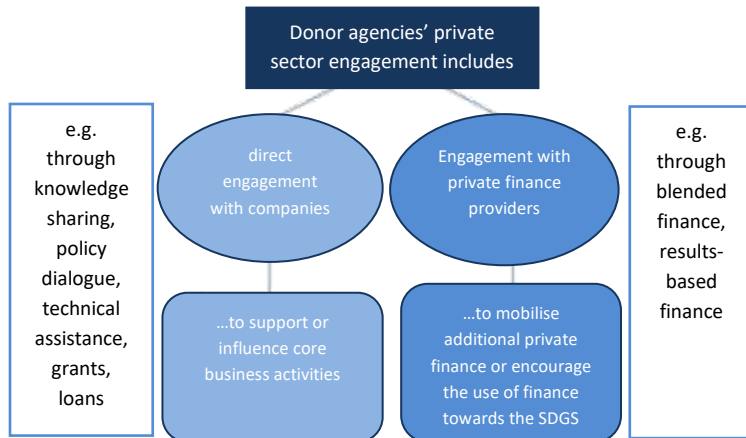
What does PSE actually cover? PSE comprises a wide range of approaches, and the precise definition and scope of PSE are still somewhat debated. The OECD uses a very broad definition of PSE as ‘an activity that aims to engage the private sector for development results, and involves the active participation of the private sector’ (OECD, 2016). In light of current donor practice and existing typologies, the DCED’s PSE Working Group has opted to narrow down two main sets of PSE strategies (DCED, 2019):

- 1) Engaging (typically) large, international or donor country companies as a key stakeholder or partner, around their core business or related activities; and
- 2) Engaging with private investors, funds and financial institutions, to leverage additional private finance or encourage its use towards SDG-relevant projects.

In distinction to other forms of donor interactions with the private sector, these PSE strategies are characterised by co-funding and co-ownership (sometimes also involving co-

design and co-steering), and thus put donors and the private sector on an equal footing (see also [SDC, 2021](#)).

Graphic 1. Different categories of private sector engagement (based on [DCED, 2019](#))



Further DCED reading: [DCED \(2019\): Operational framework and categorisation of PSE strategies](#)

1. Engagement with companies around their core business

By engaging companies around innovative or improved core investments and activities, donors hope to achieve lasting as well as scalable development results, driven by business interests in sustainable and profitable business operations. For example, while USAID's 2019 PSE policy 'welcomes all kinds of PSE for greater impact', it prioritises 'engagement with prospective partners' core business for more transformational outcomes at scale' ([USAID, 2019](#)). Categorisations by [OECD \(2017\)](#) and others suggest that there are diverse PSE approaches for enhancing companies' core business impact on the SDGs, in particular:

- *Knowledge sharing and relationship-building*, e.g. through multi-stakeholder platforms;
- *Policy dialogue* to improve corporate practices, e.g. through standard-setting initiatives;
- *Capacity-building*, to enhance business operations towards better development outcomes;
- *Technical assistance*, e.g. in the form of feasibility studies on new business models;

- *Financial support*, including matching grants for the implementation of new business models or joint programmes. Some programmes also provide loans or equity to businesses.

Many donors award financial support as well as technical assistance through competitive facilities such as centrally managed or regional *challenge funds* (for more information see [DCED, 2017](#)).

2. Engagement with private finance providers

Investments with SDG impact often don't happen because financial service providers and businesses are put off by large upfront investments, uncertain political contexts or a perception of low returns (e.g. [SSF, 2019](#)). Innovative finance strategies aim to reduce risk and encourage the private sector to finance businesses and projects with development impact. There is however no single definition of Innovative Finance or specific approaches, such as the ones outlined below:

- **Blended finance:** Blended finance serves to catalyse additional finance for development while achieving financial returns, but specific definitions vary ([DCED, 2019](#)): Some focus on combining finance from different *sources*, for example using public funds to mobilise private finance. Others emphasise that blended finance is about combining different *financial instruments*. Common examples are grants or guarantees by a donor agency to mobilise loans or equity from private financiers. OECD defined blended finance much more broadly, as the use of finance with a development *purpose*, to mobilise finance with a commercial purpose ([OECD, 2018](#)). Ambiguities in definitions do not preclude major commitments, e.g. by Global Affairs Canada (CAD1.5bn, during 2018-2023) ([GAC website](#)) and the EC (EUR3.1bn, for blending operations by the EFSD between 2017 and 2021) ([EC, 2021](#)).
- **Results-based Finance:** Many Payment for Results Initiatives mobilise pre-financing for SDG-relevant projects by agreeing to fully repay or financially reward investors or implementers upon verified achievement of results. There are different formats ([USAID, 2018](#)), including Development Impact Bonds

(DIBs), which are supported by donors such as USAID, FCDO and SECO. In DIBs, a private investor provides a grant to a public organisation, and is rewarded with a premium by the donor upon achievement of the desired results. Strictly speaking, DIBs therefore do not generate additional finance, as it is the donor who ultimately funds the programme (Freiburghaus, 2017). Leverage may however be achieved by attracting additional outcome funders, or through higher efficiency by shifting financial risk to private investors (Ibid). A recent adaptation, aimed at mobilising more finance for development, are Social Impact Incentives: a social enterprise acts as implementer and is paid a premium by donors for development impact achieved; this additional revenue allows the enterprise to attract and repay private investors (Roots of Impact, 2016; Devex, 2019).

Another closely related term is *Impact Investing*, i.e., investments into companies or funds made with the intention to achieve development impact, typically alongside a financial return (DCED, 2016; GIIN website). The investors in Development Impact Bonds and Social



Impact Incentives are often Impact Investors. Donors increasingly use blended finance approaches to mobilise private finance for impact investments; impact investors themselves increasingly provide blended finance to encourage financial providers to cater to underserved clients (GIIN, 2018).

Further DCED reading: DCED (2019): [Donor Engagement in Innovative Finance](#) and [two-page summary](#)



Institutional implications of PSE

In order to harness the private sector's long-term commercial interests for development, the donor-private sector relationship has to become more equal, long-term and strategic. This implies a fundamentally new way of operating: Donors play a catalytic role in achieving results, rather than fully designing, funding, and managing short-term projects with the private sector (USAID, 2019). PSE

therefore requires donors to relinquish some control and predictability, and to learn how to engage with the private sector with a 'collaborative mindset' (SDC, 2021). Increasing donor interest in innovative finance is also leading to a shift in responsibilities, procedures and expertise in both donors and development finance institutions (DFIs). Some donors now use grants as risk mitigation instruments and are lending to, or investing in, business without involvement of their DFIs (DCED, 2019).

As a result, donors have started new programmes, adopted new administrative and legal systems, and promote new staff skills and cultures, e.g. through training and recruitment (DCED, 2018; DCED, 2019). Many donors have also created new positions, teams and internal mechanisms to lead and coordinate PSE work (DCED, 2018); examples of new staff roles include relationship managers for strategic corporate partners or focal points for PSE-related enquiries. Whole-of-government approaches including one-stop online portals for the private sector are on the rise. Programmes are being re-designed, often following consultations with businesses, to include more flexible funding mechanisms (e.g. central funds accessible across the agency), and a wide range of financial and non-financial instruments to cater to different business needs. There is also an increased focus on 'co-creating' innovative business models jointly with companies and investing in the relationship with partners after successful collaborations (DCED, 2017).

Several donors have developed comprehensive plans or strategies about these and other ways to strengthen internal capabilities and systems for PSE; examples include USAID's PSE Modernization Initiative (launched in 2021) or DFAT Australia's Operational Framework for PSE (DFAT, 2019). Some have also developed dedicated guidance and advice for staff, such as SDC's PSE Handbook (SDC, 2021) and summary of lessons from Market Systems programmes on private sector partnerships (SDC, 2019), as well as DFAT Australia's PSE Guidance Note (DFAT, 2020).

Further DCED reading: DCED (2017): [Towards strategic PSE: Programming innovations and organisational change](#) and [two-page summary](#); DCED (2019): [Donor Engagement in Innovative Finance](#).



Managing risk

Embracing private-sector driven development implies that donors assume greater risk, too. Taking risk is inherent to business and the basis for reaping financial rewards. Managing it requires businesses to experiment with new solutions, operate flexibly and respond swiftly to market developments. Donors, whose systems are traditionally aimed at reducing risk and controlling deliverables through tightly managed contracts, are still learning about the full implications of sharing business risk. More than with non-profit entities, they also face additional reputational risks.

A key evolution in donor agencies' approach to managing these risks is an increased focus on effective relationship management with businesses: Clear management and governance structures in partnerships, results-based management, and the flexibility to adjust approaches over the course of engagement are all critical aspects for identifying and addressing potential risks (USAID, 2019).

Donors also still use and enhance traditional systems for screening potential partners, including:

- **Exclusion lists and criteria:** Most donors exclude certain industries, project topics and companies from partnerships for development; many also explicitly exclude companies convicted of corruption, fraud or criminal activity (NSI, 2014).
- **Partner assessment and selection:** Donor agencies typically assess companies past performance, reputation, financial, social and environmental policies and practices, as well as future plans (USAID, 2019; USAID, 2019a) to review shared ethics, including adherence to responsible business practices. Compliance with the OECD Guidelines for Multinational Enterprises and the UN Global Compact principles are considered an advantage (NSI, 2014). Most recently, SDC has developed a detailed framework for assessing PSE prospects (SDC, 2021).

A key consideration for donors is how to review risks without making the process too burdensome for businesses. This may include using public information as much as possible, and existing due diligence for repeated

partners (USAID, 2019a). It is also critical to understand partners' business needs, such as confidentiality issues; agencies may therefore commit to protecting intellectual property and sign non-disclosure agreements on sensitive business information, at least for an agreed amount of time; they can also engage legal teams for support, and opt for pragmatic solutions (e.g., asking for ranges rather than full financial information) (USAID, 2019; SDC, 2020).



A specific risk arising from engaging with individual companies and investors is negative market distortion. While PSE seeks to change (distort) market outcomes that are unsatisfactory, any provision of finance, knowledge or networks to individual companies may also negatively distort markets and reduce societal welfare (DCED, 2018a), in particular by

- raising the market power of individual companies at the expense of others: By requiring farmers to buy inputs from a single international partner company, for example, regional companies risk being crowded out of the market (ARTE, 2017).
- raising barriers to market entry (e.g. by facilitating too rigorous standards); and
- reinforcing information asymmetries, or leaving them unresolved (e.g. by compensating individual investors for the lack of market information through blended finance) (DCED, 2018a).

In practice, there are no easy answers to avoiding such distortions, as programmes face many trades-off between efforts to make individual partnerships a success and promoting market-wide and long-term solutions. Yet, increased attention to market structures, as practiced by

Market Systems programmes, can help to make more informed choices and mitigate distortion risks at each step of the intervention process, e.g., by

- assessing the market and monitoring interventions, to tackle an actual market failure and avoid displacing market players that would undertake the activity anyway ('additionality')
- actively crowding in other market players, once an initial partnership has succeeded, including by publishing information on markets and successful business models; and
- working with competition authorities and experts, including to better understand a company's market power before and during intervention. (DCED, 2018a)

Further DCED reading: DCED (2018): [Minimising the risk of negative market distortion in PSE. A practical framework](#); DCED (2014): [Demonstrating Additionality in PSD and two-page summary](#)



PSE to promote Responsible Business Conduct



Responsible Business Conduct (RBC) is often a condition for donor partnerships with business and features among the criteria used in partner assessment and selection (see above). More recently, however, it has also become an objective in its own right that is being pursued through different PSE modalities –

partly driven by an uptick in private sector commitments to RBC as well as a growing range of legislative requirements and policy measures by governments:

RBC refers to companies avoiding and addressing negative social and environmental impacts of their core business operation (including their supply chains), while contributing to sustainable development where they operate (OECD). As such, it is broader in scope than PSE projects that have as their main objective the integration of low-income populations in companies' core business models (e.g., as producers or consumers).

- Some agencies have launched specific PSE facilities with the primary objective to promote RBC, such as the NL MoFA's [Fund against Child Labour](#) or [RBC vouchers](#) programme to co-fund assessments of supply chain sustainability.
- In order to foster systemic change, some donors focus on convening, co-facilitating, and contributing to, discussions on RBC of sectoral or national private sector groups and platforms. This includes investor platforms, with the view to encourage investors to consider RBC in their investment decisions.
- In many agencies, there is also an ambition to coordinate and align PSE strategies more generally with government efforts to mandate and encourage RBC (e.g., [GAC, 2021](#)).

Further DCED reading: DCED (2022): [Promoting Responsible Business Conduct – A scoping paper for donor agencies supporting PSE and two-page summary](#)



Evidence on results and good practice

The general shift among donors to engage strategically with the private sector is cautiously supported by internal USAID research showing that market-oriented partnerships are more likely to produce sustained results after the end of projects (USAID, 2019). A review of 29 USAID partnerships with the private sector (USAID, 2020), further revealed that the commercial orientation and core business alignment of partnerships were key to the continuation and scaling of activities after the end of USAID co-funding. Yet, given the wide variety of PSE strategies and modalities, a general assessment of whether PSE 'works' or not would not be meaningful. In addition, past assessments of specific strategies and modalities have largely focused on the private sector's financial contributions, rather than development outcomes (USAID, 2019). Recent reviews and policies have therefore called for enhanced results measurement systems (e.g. [OECD, 2017](#)). Selected insights from recent evaluations of popular formats are summarised below.

- *Challenge funds*: Challenge funds are among the most popular PSE formats to date. Many evaluations have

however not taken 'account of basic evaluation requirements such as assessment of additionality' (EPS PEAKS, 2014). Recent reviews (several are listed [here](#)) have found mixed results: While some funds have not been successful in catalysing any wider effects beyond the project, context analysis to understand market-wide impact and hands-on management have been identified as success factors in funds that are on track to achieve their development targets (Deval, 2017; Sida, 2018, EPS PEAKS, 2014).

- *Multi-stakeholder platforms*: Key achievements of multi-stakeholder platforms include promoting policy dialogue and peer or cross-sector learning on how to contribute to the SDGs (Sida, 2018; ICAI, 2015). The wider effects on participants' core business operations, including through self-reported platform functions such as standard-setting or services, however, remains unclear (Sida, 2018; DCED, 2017a; Pattberg and Widerberg, 2014).
- *Blended Finance*: Each dollar of concessional blending capital has mobilised on average \$4 of commercially-priced capital to date (Convergence webpage). Survey data from impact investors further show that blended finance can be an effective tool to de-risk transactions and 'attract funding for large-scale, high impact investments' (GIIN, 2018). Yet, the evidence base is still limited and there is a lack of data on poverty impacts (OECD, 2018; Collacot, 2016); indeed, only 6% of finance mobilised through ODA goes to low-income countries (OECD, 2020).
- *Results-based finance*: According to USAID (2018), there are few studies on the longer-term impact of Payment by Results programmes and more longitudinal and intensive research is needed. Clist (2018) concludes that there is some evidence of successful, small projects. An evaluation of three DIBs (UKAid, 2019) finds that they encouraged investors to take additional risk, but also notes high transaction costs and conditions for DIBs to be successful.



Development actors already increasingly prioritise knowledge generation about 'what works' across different PSE Strategies. For example, the promotion of "measurement and monitoring of the impact of blended investments towards the SDGs" is considered as a priority action area (OECD website). In the area of direct business engagement, USAID's PSE Evidence and Learning Strategy aims to fill critical knowledge gaps and generate guidance on effective practice (USAID, 2019b); in 2020, USAID has also launched an Evidence Gap Map on PSE. In addition, a number of PSE portfolio evaluations by different donor agencies are expected to be finalised in 2022.

Further DCED reading: [Impact stories on PSE](#) on the DCED website; DCED (2017): [Donor facilities for partnering with business](#); DCED (2017): [Engaging the private sector through multi-stakeholder platforms](#)



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