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# Enterprise challenge funds for development: rationales, objectives, approaches

Robin Davies and Kerri Elgar

**Abstract**

Enterprise challenge funds use overseas aid to subsidise private investment in poverty-reducing business ventures in developing countries, where such ventures have good medium-term prospects of commercial viability but would probably have been left on the shelf without subsidies. These funds are viewed with instinctive affection by politicians and international development agencies and have a standard set of characteristics, which we describe. Nevertheless, there is considerable confusion about what international development agencies should be seeking to achieve by means of them, and how. We argue the main source of confusion is a failure to distinguish clearly between what we term enterprise development and business modification objectives, and the rationales and instruments appropriate to each. Enterprise development, in this context, involves reducing risks which impede the establishment or expansion of innovative, poverty-reducing, small- to medium-scale business enterprises. Investment projects should be managed and outcomes assessed on a portfolio basis, without excessive post-financing engagement and with a concentration on certain countries and/or sectors. Business modification, by contrast, involves strengthening incentives for the adoption of poverty-reducing business strategies by established (often multinational) firms, through changes at the margin. Here public subsidies do not reduce risk; rather they provide incentives for firms to take pro-poor investment decisions, and thereby facilitate changes in corporate strategy. In this case, proposals should be solicited from the widest possible field and projects supported should be few, substantial and closely managed. We do not seek to assess claims as to the impact of past and present enterprise challenge funds—the evidence base is too slim—but we argue future such mechanisms are more likely to succeed if they single-mindedly pursue one or the other of the above objectives, and shape themselves accordingly.

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# 1 Introduction

In public-private partnerships for international development, an international development agency (the 'public' party) transfers resources to, through or in cooperation with a private sector partner, with the objective of achieving or enhancing pro-poor outcomes in a developing country. Such partnerships may be divided (with Callan & Davies 2013) into two kinds: inclusive business partnerships, in which the development outcomes are a product of commercial activity, and service delivery partnerships, in which the development outcomes are a product of non-commercial activity on the part of the private sector partners. Enterprise challenge funds are a tool for supporting partnerships of the former kind. They use overseas aid to subsidise private investment in business ventures in developing countries where such ventures are likely, by design or in effect, to reduce poverty, and where they have good medium-term prospects of commercial viability but would probably have been left on the shelf without subsidies.

There are also socially-oriented challenge funds for international development. Such funds seek to encourage private initiative and innovation in areas such health and education service delivery. They do not generally aim to help start up or expand businesses. In practice, the distinction between enterprise challenge funds and social challenge funds is not perfectly clear-cut: in some circumstances social challenge funds, like enterprise challenge funds, might support businesses, particularly self-styled 'social enterprises', to adopt business models that benefit poor people in the communities where they operate. Nevertheless, the key feature of enterprise challenge fund investments, shared by some social challenge fund investments, is that they seek to overcome barriers to the establishment of self-sustaining, poverty-reducing business ventures.

Enterprise challenge funds can seem paradoxical. Politicians of all political persuasions tend to like them because they are 'catalytic' and, relying upon private ingenuity, not technocratic. Aid agencies tend to like them for these reasons too, and also because they offer a 'light-touch' yet defensible way of allocating aid funds. A recent inventory of currently active enterprise challenge funds, which makes no claim to exhaustiveness, suggests that they have somewhere in the vicinity of $A400 million at their disposal (O'Riordan et al. 2013). The instinctive affection with which the notion of an enterprise challenge fund is greeted might explain the fact that reviews and evaluations of specific such funds often find them to have been resourced and launched with more enthusiasm than forethought, particularly with respect to objectives and results measurement (see for example Armstrong et al. 2011). Fundamentally, though, these funds involve spending aid money in support of profit-seeking business ventures, on the basis of counterfactuals that can be hard to evaluate. One would expect this to be hard to defend, and a source of discomfort.



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In practice, not much defence is called for. Enterprise challenge funds tend to be relatively small, certainly by comparison with socially-oriented challenge funds. The inventory mentioned above found over twenty active enterprise challenge funds, among which only a few controlled more than $US10 million. Grant sizes usually range from $US100,000 to $US1.5 million or so, with most grants well under $US1 million.[1] Funds are generally promoted or defended by anecdote, and anecdotes about their positive impacts tend to be about their smaller-scale successes, achieved through the provision of financing for local enterprises unable to attract commercial financing. The cottage enterprise figures prominently.

Australia's Enterprise Challenge Fund for the Pacific and Southeast Asia (ECF-PSA) was conceived under a conservative Coalition government in 2006 and operated from mid-2007 to October 2013 with a funding allocation of just over $A20 million. It was initially viewed with scepticism by the centre-left Labor government elected in late 2007, but subsequently embraced. Prior to the election of the present Coalition government in September 2013, the then shadow minister (and now minister) for foreign affairs, Julie Bishop, regularly referred to it as an exemplar of the sort of aid that the Coalition wished to see more of, under the rubric of 'aid for trade'. She also said that it would be continued, though to date no follow-on mechanism with similar characteristics has been established.[2]

It is not clear, however, that the full range of characteristics of enterprise challenge funds past and present is apparent to politicians and other senior decision-makers. Here, from a 2013 speech, is what Julie Bishop said specifically about a future Australian fund:

> At a micro level, we will continue some Howard[3]-era initiatives such as the Enterprise Challenge Fund … that provided small grants to local businesses that were having difficulty accessing the capital to undertake a viable commercial project [with] … a tangible and significant benefit to a wider community.[4]

That is only a partial description of what the Australian fund did, which does not apply to at least two of the partnerships it established, namely those with WING Cambodia

[1] The single largest enterprise challenge fund is the Africa Enterprise Challenge Fund, whose cumulative resource allocation now exceeds $US200 million. However, this fund's maximum grant size is still quite low, at $US1.5 million.

[2] The Australian government announced the establishment of a Pacific Business Fund in December 2013, with an allocation of $15 million over five years. To be managed by the Asian Development Bank, which refers to it as the Pacific Business Investment Facility, this fund is a traditional business development mechanism, with a largely advisory function but also some risk financing capacity. Later, in June 2014, the Australian government announced a funding allocation of $140 million over four years for innovation-relation purposes, some of which will be used 'to address constraints to private sector investment, such as funding for early stage project development, assistance with arranging private debt and equity, as well as guarantees and insurance to offset risks'.

[3] John Howard, Prime Minister of Australia, 1996-2007.

[4] Address to the National Dialogue on the Role of the Private Sector in Development and Aid for Trade, 19 July 2013, University of Adelaide.



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and Carnival Australia in Vanuatu.[5] In fact the most successful such partnership, measured in terms of benefits delivered to the poor per dollar of funds invested—where in this case the benefits were experienced by poor consumers of mobile banking services—was that with WING Cambodia (ECF-PSA 2013, p. 5; Callan & Davies 2013, p. 11). This began life as a partnership with the ANZ Banking Group which, being Australia's third-largest bank by market capitalisation, is not exactly a local or capital-constrained business.

The partial description above is not just an abbreviation. A fuller description would add a quite distinct category of partnership that politicians and other decision-makers might be less willing and able to defend. Specific instances aside, the various partnership types supported by the Australian fund and its international cousins are certainly defensible in general terms. However, not all of them can or should be defended on the same grounds. Nor can all be effectively supported by means of the same type of funding mechanism. That is the message of this paper.

## 2 Surface characteristics

The first generation of enterprise challenge funds for development appeared around the turn of this century. The earliest funds usually mentioned are the UK's twin Financial Deepening and Business Linkages challenge funds, established in 2000. O'Riordan et al. (2013, p. 2) refers to an earlier vehicle, the UK's Business Sector Challenge Fund, launched in 1997-98, as perhaps the first enterprise challenge fund. Consciously or not, these funds combined features of domestic public-good challenge funds in the United Kingdom (particularly those promoting urban regeneration) with features of World Bank matching grant mechanisms intended to stimulate the development of markets for business support services. These latter mechanisms aimed to increase business demand, and therefore markets, for business support services of various kinds. Their approach stood in contrast to supply-side approaches that directly funded the provision of such services, either through public sector agencies or donor-funded entities.[6]

The early enterprise challenge funds pursued a broad objective, which tended to be expressed along the following lines:

> to provide the smallest possible financial contribution to a socially worthwhile project consistent with making it less risky and more financially sustainable to the private promoter (Irwin & Porteous 2005, p. 14)

Irwin and Porteous elaborated on the above statement by saying that the function of an enterprise challenge fund grant is to modify a project's risk-return ratio such that it clears whatever 'hurdle rate' might have been established by a firm's board or

[5] See http://www.enterprisechallengefund.org/index.php/project-profiles for descriptions of these projects.
[6] Phillips (2001) discusses the benefits and drawbacks of such matching grant schemes.



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investment committee. This rather stylised rationale continues to be cited in business cases for new funds (for example, in DFID 2012).

'First-generation' enterprise challenge funds set out to be 'catalytic' and 'light-touch' and also tended to be catholic about the nature of the proposals accepted in order to maximise scope for innovation and impact. More recent, second-generation funds have tended to impose greater geographical or sectoral restrictions on the range of proposals accepted, and have applied more stringent or at least more elaborate project selection criteria. Some have also taken a more active role in identifying proposals and assisting firms to develop and implement projects.

Overall, the menagerie of currently active funds is quite diverse. Overviews are included in Heinrich (2013), O'Riordan et al. (2013) and Brain et al. (2014). There are small, specialised funds restricted to one country (including Afghanistan, Vietnam and Ghana) or one theme (including the garment industry, renewable energy and microfinance) and there are large-scale funds covering multiple countries and themes, sometimes with multiple funding windows. Australia's ECF-PSA targeted nine countries and imposed no sectoral restrictions. The primarily UK-funded Africa Enterprise Challenge Fund (AECF) operates from regional hubs in Nairobi, Accra, Johannesburg and Harare and has country-specific windows as well as sectoral windows that might fund proposals benefiting any country in Africa. Multi-country and regional projects are also eligible for AECF support.

In the majority of enterprise challenge funds, agribusiness and financial services projects dominate, even where funds are not limited as to sector. Sweden's Innovations Against Poverty fund, Australia's ECF-PSA and the UK's Business Linkages Challenge Fund have covered a range of sectors but overall demand has been highest in agriculture and financial services, with some demand also in energy generation. The AECF focuses explicitly on agriculture and financial services. The UK's now-closed Financial Deepening Challenge Fund was limited, as the name suggests, to financial services. The UK's Food Retail Industry Challenge Fund is limited to agriculture and fisheries.

Enterprise challenge funds tend to be described not only in partial terms but also in terms of various surface characteristics, such as the resource allocation processes they employ, rather than by reference to fully-specified objectives. This preoccupation with surface characteristics tends to suggest an absence of clarity about objectives, which subject is developed in the following two sections. However, it will be useful as a preliminary step to attempt a reasonably full account of the surface characteristics of enterprise challenge funds.

Whatever else it does, a typical enterprise challenge fund will involve engagement—usually mediated by a contracted program management agent—between a public sector agency and private firms in order to advance a shared aim of delivering benefits of some



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kind to poor people with whom the firms interact. An enterprise challenge fund will always have at least the following set of characteristics.

**Table 1 Surface characteristics of an enterprise challenge fund**

| |
|---|
| 1. **Offers firm-related subsidies**: an enterprise challenge fund offers aid-sourced subsidies to specific firms, or sometimes to third parties at the behest of or in consultation with specific firms, to support business creation, reconfiguration or expansion |
| 2. **Issues a challenge**: subsidies are used for purposes of the proponents' own devising within parameters determined by the fund's design, which range from extremely broad to quite narrow in scope |
| 3. **Seeks benefits for the poor**: the investments supported confer benefits on poor people associated with relevant firms as suppliers, employees, distributors or end-users of products |
| 4. **Seeks commercial viability**: it is intended that benefits for the poor be provided on an ongoing basis, beyond the consumption of subsidies, as a result of relevant firms' achieving commercial rates of return within a medium-term timeframe |
| 5. **Requires additionality**: the subsidised investments must be ones that would not otherwise have been made, or else would otherwise have been delayed for so long as to create substantial welfare loss |
| 6. **Requires co-payment**: subsidies are set at a level, usually determined by a minimum matching ratio, that only partially compensates for whatever market or government failures have impeded an investment |
| 7. **Values systemic impact**: it is intended that similar benefits subsequently be experienced by other groups of poor people through the replication or scaling-up of investments, with less or no need for the provision of further subsidies |
| 8. **Values competitive neutrality**: it is intended that subsidies not give relevant firms a long-term or extreme competitive advantage |
| 9. **Values transparent resource allocation**: it is intended that proponents be selected against specified criteria (essentially relating to items 3-8 above) either in competitive funding rounds or on a first-come, first-serve basis |

The firm-specific, challenge, pro-poor, commercial viability, additionality and co-payment elements (1 to 6) are fundamental. A firm or some part of the firm perceives an opportunity to achieve acceptable commercial returns with co-benefits for poor people in its orbit, but experiences a constraint. The resourced offered by the enterprise challenge fund help alleviate the identified constraint. Neither the fund's designers nor



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its managing agent seek to perceive opportunities or identify constraints, as this would be to arrogate to themselves the role of private initiative.

It is clear enough that the potential for systemic effects (7) and respect for competitive neutrality (8) should be given substantial weight in the assessment of proposals. It need not be the case, however, that these things are absolute requirements. In practice they are present to quite varying degrees. That is why they are listed as 'values' above, rather than as objectives or requirements.

Transparency in resource allocation (9) is perhaps more contingent than the other characteristics listed. It is clearly important in principle: resources are in a sense being gambled, so it is essential that proponents and observers are able to see how decisions are made. In practice, the degree of transparency varies, particularly where resources are allocated on a first-come, first-serve basis. Transparency in its most general sense—that is, public transparency—is rare, and best exemplified to date by Australia's ECF-PSA.[7]

## 3 Rationale for public subsidies

It is not self-evident that there should be numerous ventures that actually meet the requirements and desiderata embodied in the table above (specifically, items 3-8). Indeed, not everybody who has been involved in the design, management and evaluation of enterprise challenge funds would claim as much. Elliott (2013) provides a pithy account, strongly anchored in his experience, of some of the challenges involved in actually making such funds work. He argues that in practice they tend to create institutionalised grantees and crowd out competitors, that they over-emphasise input-additionality (would the investment have happened without the subsidy?) relative to output-additionality (would the investment yield significant development results?) and behavioural additionality (would the investment lead the firm or other firms to make similar but unsubsidised investment decisions?), and that there is little evidence for the existence of causal relationships between the provision of subsidies and the achievement of development results. In short, he effectively argues that enterprise challenge funds tend in practice to pay lip service to their advertised resource allocation criteria, with little interest shown in what happens after resources are allocated to proposals.

Others (for example, Heinrich 2013, p. 19) have noted the relative dearth of evaluation findings in relation to enterprise challenge funds, which often lack or have only rudimentary built-in monitoring and evaluation arrangements. This reinforces the impression created by Elliott's observations, which is that the emphasis is on getting proposals approved, rather than on what happens subsequently. A comparison may be

[7] Extensive design, review and case study documentation was made available, much of which can be found at the following web page: http://www.enterprisechallengefund.org/index.php/publications-and-reports/publications.



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drawn with the lending processes of the multilateral development banks, which involve extraordinary effort in the loan preparation phase but often very little further effort once the loan is in the disbursement and repayment phases. Australia's ECF-PSA is perhaps the most fully evaluated fund, and the only one to submit itself to a cost-benefit analysis. Its performance against the above requirements and desiderata seem generally modest. Positive findings in relation to commercial viability are somewhat countered by less positive findings in relation to impact and value for money. It was estimated the fund as a whole will yield a 17 per cent return on investment by 2020 (ECF-PSA 2013, p. 7). However, this outcome was entirely dependent on the widely distributed consumer benefits delivered by a single activity, WING Cambodia, without which the overall return on investment would have been negative.

The problems mentioned above clearly relate to execution rather than conception. It is, however, arguable that some of these problems derive from a fundamental uncertainty or equivocation about the purpose of enterprise challenge funds, and specifically about the rationale for their provision of public subsidies to business ventures. Despite sharing the surface characteristics listed above, actual enterprise challenge funds are built and operate in very different ways. They often seem to embody divergent or even competing assumptions and philosophies. In any discussion among people involved in their design, management and evaluation, substantial fault lines quickly emerge.

The Development Policy Centre initiated such a discussion in 2013, establishing a working group on enterprise challenge funds to 'examine the rationale for their use, reflect on experience to date and develop principles-based recommendations to development agencies on their use in the future'.[8] This group, in the course of several meetings, discussed four 'big-picture' topics: the funds' objectives, their place in a broader array of approaches, their partnership structure and their impact. It also discussed four practical but still broad questions about the funds' design: geographical and sectoral scope, the terms on which financing is made available, the role of complementary services, and fund administration. (The working group, it should be noted, was convened in order to bring experiences, ideas and disagreements to light, not to achieve a consensus.)

[8] People who participated in one or more discussions of the working group included Alwyn Chilver, Adviser, International Development Assistance, Aurecon; Deva De Silva, Senior Operations Officer, International Finance Corporation; David Elliott, Director, The Springfield Centre; John Hardin, Fund Manager, Enterprise Challenge Fund for the Pacific and Southeast Asia; Melina Heinrich, Donor Committee for Enterprise Development (DCED); Andrea Iffland, Regional Director, Pacific Liaison and Coordination Office, Asian Development Bank; Amanda Jupp, Project Manager, Enterprise Challenge Fund for the Pacific and Southeast Asia, Coffey International; Adam Kessler, independent results measurement consultant; Morgana Ryan, Lead, Asia-Pacific, Accenture Development Partnerships; David Shearer, Director, Corporate, Australian Centre for International Agricultural Research; David Smith, Managing Director, Triple Line Consulting Ltd; Mark Thomas, Director, Nathan Associates; Mark Winters, Private Sector Development Adviser, Department for International Development, United Kingdom; and Jim Woodhill, Principal Sector Specialist, Food Security and Rural Development, Australian Department of Foreign Affairs and Trade. While this group was not asked to endorse the recommendations of the present paper, a number of its members provided valuable comments on an initial draft.



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It quickly became apparent in the working group's discussions where the principal fault lines were. A number of these related to what might be considered matters of emphasis. For example, some participants were more insistent than others that enterprise challenge funds should, in all their investments, pursue some form of market transformation, though what constituted a 'transformative' investment was difficult to pin down. Some participants were more insistent than others that resources should be recoverable in cases where business ventures were successful in commercial terms. And some were more insistent than others that managing agents should have or develop a depth of context-specific expertise on barriers to enterprise development, and be active in identifying and developing investment opportunities.

Other fault lines were of a different character, involving sharper differences of view. Some participants thought enterprise challenge funds should be strongly connected to, or embedded within, other interventions seeking to remove constraints to private sector development; others considered they should be run as standalone mechanisms. Some thought they should be tightly focused on certain countries and/or sectors; others that such restrictions should be avoided. Some thought that enterprise challenge funds should provide quite a high degree of technical support to proponents in the development of proposals and the management of ventures; others that resources should be largely or wholly directed to ventures requiring little or no such support.

In all the working group's discussions, the most prominent contrast was between the view that enterprise challenge funds should provide quite holistic support for the development of poverty-reducing business ventures, and the view that they should focus single-mindedly on triggering pro-poor investments by making risk-return ratios more favourable for proponents. Several working group participants referred in various contexts to a 'purist' concept of what an enterprise challenge fund should be and do. This essentially involves minimising engagement with private sector proponents beyond the point of venture selection and funds disbursement. According to this concept, enterprise challenge funds exist to lower barriers or counter disincentives to market entry. They 'start races but do not pick winners'. Other working group participants, by contrast, favoured a more expansive and pragmatic view of what an enterprise challenge fund should be and do. According to this view, an enterprise challenge fund is more akin to a social venture capital fund, and should be prepared to provide various forms of support to business ventures well into their lifespans.

The 'purist' perspective adheres to the logic of enterprise challenge funds earlier articulated in the quote taken from Irwin & Porteous (2005). The pragmatic perspective recognises that in many circumstances—for example, in the Pacific island countries—there are likely to be very few ventures for which the risk inherent in a business concept is the only constraint. The purist perspective, in the working group's discussions, tended to go with the view that there is little need for managing agents to be expert and active, and little need for investments to be linked to other development interventions or confined to certain countries or sectors. The pragmatic perspective



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tended to go with the view that enterprise challenge funds need to be complemented by, or embedded within, wider mechanisms for supporting private sector development—or even that there is little or no work for 'pure' enterprise challenge funds to do. This rather stark contrast of perspectives might be considered a disagreement about semantics, but can be analysed otherwise, as resting on confusion about the underlying rationale for the provision of subsidies.

One confusion derives from a misapplication of the pure logic of enterprise challenge funds. Purists argue that risk-reduction subsidies should be provided to trigger investments, without other forms of support. Yet some of the firms that have the least need for technical support also have the least need for small-scale risk reduction financing. It is not in fact credible that a major, multinational corporation could be induced to make a high-risk investment of perhaps less than a million dollars purely on the basis that its costs will be subsidised in a similar amount from the public purse. Perhaps its board or investment committee might apply quite a rigid risk-return threshold for larger investments, such that a public subsidy of some magnitude could be decisive. Indeed the International Finance Corporation and similar entities exist to provide such subsidies. But smaller investments are most unlikely to be subject to this kind of rigidity, or to require small subsidies simply for purpose of lifting the risk-return ratio above some threshold level.

This is not to say that there is no rationale for the provision of subsidies in connection with investments contemplated by such firms. It is simply that the rationale is most unlikely to be risk reduction for innovative investments. It is much more likely to be that the firm is operating in an environment where important public goods are missing, having not been provided by any level of government. The firm itself can be expected to compensate for this to some extent, for example by providing enterprise-specific training to local employees. But there will always be some threshold level of effort beyond which a firm will not go, and there is a case for the use of aid funds to compensate for missing public goods of a kind that would make it easier for firms, if they have the inclination in the first place, to change their business strategies so as to be more inclusive of poor people. Such changes might sometimes, but need not, involve a degree of innovation. The subsidy essentially has 'nudge' value, reducing the pain involved in making the change; it reduces cost rather than risk, though here 'cost' should not be interpreted in purely financial terms. In short, purists are applying a risk-reduction logic in cases where it does not apply.

In the case of smaller, local enterprises, the confusion is of the reverse kind. Pragmatists are preoccupied with the fact that small enterprises, no less than the major ones just discussed, face missing public goods and for this reason have serious capacity deficits and marketing and distribution problems. In the first instance pragmatists do generally espouse a risk-reduction rationale for the provision of subsidies, following, at least in principle, the logic that these should only be provided where the local financial sector, where it functions at all, perceives risks too great to be taken onto its own account.



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However, they also see a large role for subsidies to compensate for the absence of public goods. For some, this is in fact the dominant purpose of subsidies, and the degree to which the underlying business concept is innovative and high-risk is of much less interest.

The problem with this perspective is that, by contrast with the case of large, multinational firms, it is quite unlikely that such compensation to relatively small firms for missing public goods will deliver widely-distributed benefits. Subsidies that help small operators overcome purely risk-related barriers are likely to deliver a much higher pay-off, through replication and business expansion. The most efficient use of resources to subsidise small enterprise development would in fact be achieved by focusing exclusively on higher-capacity firms with promising but high-risk business ideas, and on helping them, through the provision of equity, subordinated debt or guarantees, to attract private financing. (A particularly perverse feature of the design of Australia's ECF-PSA, regularly noted in reviews of that fund, was the requirement that proponents furnish evidence that no other sources of finance were available.)

Given that risk-reduction subsidies, a scarce commodity, would preferably be provided only to stronger local firms with little need of technical help, one would expect that they might be provided in a 'light-touch' fashion in accordance with the preferred approach of first-generation challenge funds. Conversely, given that subsidies which compensate major firms for the absence of public goods are likely to be effective only if provided in association with substantial brokering services—to achieve effective and sustained engagement between companies and communities—one would expect that these might be provided with a somewhat heavier hand. Thus it would seem misguided to advocate a hands-off approach to working with major firms, and a hands-on approach to working with smaller ones. What would be true, however, is that larger local firms, as in the countries of Southeast Asia, can be supported by enterprise challenge funds in a relatively hands-off fashion, and that smaller firms, as in the Pacific island countries, for the most part need to be supported in a hands-on fashion by something other than an enterprise challenge fund.

In sum, purists apply a risk-reduction rationale for the provision of public subsidies in two quite different cases, but that rationale is applied wrongly in the second case—that of major enterprises. Here the rationale for the provision of subsidies should be that they compensate for the absence of certain public goods, reducing barriers to the adoption of alternative, pro-poor business models where there is already some disposition to move in this direction. Pragmatists, on the other hand, perceive and apply both a risk-reduction and an absent-public-good rationale for subsidies. However, the latter rationale is unlikely to lead to effective resource allocation in the case of local enterprises, and distracts attention from the main game of encouraging innovation and leveraging private capital through risk reduction.



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We have, then, two quite different rationales for the provision of subsidies—compensation for the absence of public goods, and risk reduction for innovative ventures. We might say subsidies of the former type compensate for government failure, and those of the latter type for market failure. While these rationales might not always be clearly perceived, or might sometimes be misapplied, they both represent reasonable calls on public money.

## 4 Objectives of enterprise challenge funds

We have so far examined the characteristics of past and present enterprise challenge funds and we have seen that this set of characteristics is consistent with quite divergent views about the purpose and construction of such funds. To a substantial extent, it has been argued, this divergence reflects a confusion about the rationale for their provision of public subsidies. These are in fact not exclusively for risk reduction; sometimes, particularly where major firms are concerned, they instead compensate for missing public goods. Where that is the case, their effect is not so much to support innovation as to reduce the effort involved in changing corporate strategy. In the present section, we suggest that focusing in this way on the rationale for subsidies clears the air and provides an opportunity to clarify the objectives of enterprise challenge funds.

What kind of concrete effect might we want to achieve by means of financial or other assistance provided through an enterprise challenge fund? In considering this question, it helps first to take a step back and think about what an international development agency might be trying to achieve more generally in the area of private sector development. There are three broad possibilities, as follows.

**Table 2 Possible objectives of donor-supported private sector development interventions**

| |
|---|
| 1. **Strengthening enabling environments**: helping to develop legal and regulatory frameworks, infrastructure, workforce skills and consumer knowledge in order to promote the growth of the private sector for the general benefit of a region or country |
| 2. **Fostering enterprise development**: helping to establish or expand particular enterprises for the general economic benefit of a region, with an eye to those enterprises' impacts on poor people as suppliers, employees or consumers |
| 3. **Facilitating business modification**: seeking to create incentives for the reconfiguration of major enterprises in order to promote their beneficial engagement with poor people through their supply chains, including as suppliers, employees or consumers |

Clearly an enterprise challenge fund, however it might be constructed, is not the right tool for pursuing the first of the above objectives, even if its operations might yield useful information for those looking to identify general constraints on private sector development. So the question is which of the other two objectives a given fund might



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have. It could function either as a vehicle for *enterprise development* or as a vehicle for *business modification*. These two objectives correspond to the two rationales identified above for the provision of public subsidies. They are very different, requiring different rationales, partnerships and approaches. Yet enterprise challenge funds to date have been characterised in ways that do not clearly specify which of these objectives they are pursuing.

Further, in practice, many funds pursue both objectives, though without actually saying so. They work with well-established, often multinational, corporations to tweak their operations in ways intended to make them more inclusive of the poor. At the same time, they work with local entrepreneurs in developing countries to establish or substantially expand businesses believed likely to have positive development impacts. Australia's ECF-PSA certainly did both of these things.

While it is sometimes noted that enterprise challenge funds work with diverse partners for quite different purposes[9], nobody working in the field appears to have entertained the thought that these mechanisms as currently designed might be pursuing two ends so different that they should not be lumped together. A mechanism that is good for promoting local enterprise development through risk reduction financing probably will not be good for promoting multinational business modification through compensation for missing public goods, and vice versa.

The above point is illustrated in connection with the question of project scale. First-generation enterprise challenge funds tended to target larger enterprises and offer larger grants on the basis that this would maximise impact. In practice, donors recorded higher demand for funding from small enterprises requiring grants toward the lower end of the relevant range[10], and needed to adjust their approaches accordingly. Thus demand for resources relevant to one objective, enterprise development, was allowed to swamp demand for resources relevant to quite a different objective, business modification. It is clear that these two objectives should not be set against each other.

Another symptom of confusion about high-level objectives is the lack of any consensus on what constitutes a bearable or optimal project failure rate. An independent completion report on Australia's ECF-PSA noted that of 23 projects selected, four were not completed and a further six were 'were considered weak in design and unlikely to have scale or be pro-poor' (Smith & Balan 2014, p. 2). An earlier review of the same fund had correctly predicted that, based on the UK's experience[11], the project portfolio

[9] For example, Deloitte (2004), on experience with implementation of the UK's Business Linkages Challenge Fund, says, 'the challenge of working with smaller companies can be seen as supporting them to develop their businesses, while the challenge of working with larger companies can be seen as supporting them to do business in a more pro-poor way'.
[10] In his review of the Ghana Business Linkages Challenge Fund, Elliott (2004) notes that while the grants were originally targeted at larger corporations, the program had to be recalibrated to take account of the fact that demand for assistance was coming almost entirely from small and medium-sized enterprises.
[11] Specifically, the reference is to Irwin & Porteous (2005), p. 19.



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could be expected to contain a number of 'dogs' and a smaller number of 'stars', as well as average performers. However, there is no agreement on even a rule of thumb for determining what level of failure might be regarded as inhabiting the grey zone between poor project selection and self-defeating risk aversion. It is possible this reflects the fact that the risk of failure is high and tolerable at the level of local enterprises, but low and intolerable at the level of multinational corporations.

# 5 Approaches and instruments

We have argued there are two very different types of broad objective that an enterprise challenge fund might pursue, and that different approaches and instruments are proper to each. There is little sense in fusing enterprise development and business modification vehicles. Table 3 below briefly summarises how the main differences of perspective between practitioners, as reflected in the discussions of the Development Policy Centre's 2013 working group, may be reconciled if one distinguishes clearly between the objectives of enterprise development and business modification.

**Table 3 Enterprise development and business modification: contrasting approaches and instruments**

| | **Enterprise development** | **Business modification** |
|---|---|---|
| 1. *Subsidy purpose* | Risk reduction financing for innovative business ideas, used wherever possible to leverage private investment but provided on a standalone basis if the local financial sector is not sufficiently developed. | Financing to help compensate for the absence of various public goods which, if present, would make it easier for a firm to engage poor people in its supply chain. Such goods include education and training, minor infrastructure and community organisation. |
| 2. *Partners* | Small- to medium-sized local firms with promising, pro-poor but high-risk business ideas in need of financial backing. In some cases, resources might be allocated directly to investors, to reduce their risk. | Large national or multinational firms sufficiently close to the threshold of an investment decision. In some cases, resources might be allocated to organised communities or NGOs, or consortia. A case might be made to concentrate a donor's efforts primarily on its own or neighbouring country's firms, in order to facilitate interaction rather than to confer commercial benefits. |



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| | Enterprise development | Business modification |
|---|---|---|
| 3. *Scope* | Geographical and sectoral scope preferably circumscribed so as to facilitate the provision of complementary business enabling assistance through other mechanisms where necessary, and to facilitate identification of the factors responsible for the success or failure of individual ventures in a given country or sector. | Geographical and sectoral scope preferably unrestricted so as to maximize the size of the proposal pool. Single-country funds are likely to generate too few proposals to be viable. Complementary business enabling assistance is less relevant. Likewise comparative monitoring, since supported proposals will be few and large. |
| 4. *Financing terms* | If a firm above some threshold size demonstrates sustained success over a defined period, the capital provided should be at least partially recovered on an agreed basis and the resources recycled. Firms should be encouraged and assisted to mobilise partial financing from commercial sources, supported by guarantee in some cases. Co-payment requirements should not be very demanding, and any leveraged private financing should be counted toward a firm's co-payment. | The fund's contribution is provided in grant form and not recovered, on the basis that it benefits the poor communities who engage with the firm. In some cases the firm might be the proximate fund-holder; in other cases grants might flow direct to intermediary organisations or communities. The highest possible matching ratio should be pursued for co-payments as, unlike in the case of small, local enterprises, the ratio offered by the firm is a direct measure of commitment. |
| 5. *Engagement* | The fund takes a light-touch approach as was envisaged for first-generation funds, seeking innovative business proposals from the strongest possible firms and undertaking periodic impact monitoring. Other mechanisms should be used to deal with the capacity-building needs of participating firms and weaker, non-participating firms, problems in the enabling environment, and the strengthening of local financial markets. | The fund's managing agent, or an inclusive business 'broker' of some kind, engages heavily with partner firms over a considerable period of time to develop and embed partnerships, provide training, community-organisation and other services, iron out problems, pursue sustained senior-level commitment within the firm, assess poverty impacts and identify opportunities for subsidised or unsubsidised replication of the initial investment in other areas of the firm's business. |



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| | Enterprise development | Business modification |
|---|---|---|
| 6. *Risk* | A portfolio, risk-spreading approach is adopted, with a substantial number of ventures supported and an expectation that a substantial proportion of them will fail—and a balancing expectation that this level of tolerance for risk will unearth some investments with highly positive impacts. | A conservative, stepwise approach is adopted such that only a small number of the most promising partnerships are supported, and these are supported in depth over an extended period of time. Tolerance for failure is low because it could have systemically deleterious effects on corporate strategies and on political confidence in public-private partnerships for development. |
| 7. *Systemic impacts* | Generally less likely to be achieved, for reasons of scale and because there is inevitably a perverse incentive to support the crowding out of competitors. Replication and scaling-up are most likely to occur where local financial institutions participate, and as a result alter their lending practices. | More likely to be achieved owing to the scale of the business ventures concerned and the competitiveness of the markets in which they operate. Sustained impacts are most likely to be achieved where a firm's corporate strategy has an explicit inclusive business element, and is not merely profit-driven. |
| 8. *Semantics* | Fund that employ the approaches and instruments outlined in this column are enterprise challenge funds. There is no point in trying to give this term a more restricted meaning than it currently has. But for practical purposes it would be preferable to refer to funds in the present category as 'enterprise development challenge funds', or similar. | Fund that employ the approaches and instruments outlined in this column are also enterprise challenge funds. But for practical purposes it would be preferable to refer to funds in this category as 'business modification/transformation challenge funds', or similar. |

# 6 Defending business modification partnerships

It should be registered that, while there are likely to be substantial benefits in clearly separating out the objectives of enterprise development and business modification, they come with one very substantial risk—namely, we thereby expose business modification partnerships to more direct inspection. Critics can more easily form the view that aid funding in such partnerships is needlessly subsidising investments by well-heeled firms.

The response to such critics should not be couched in terms of risk reduction, which term belongs to the realm of enterprise development. In any case, a critic will be



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unimpressed to hear that where a risk is unrealised, an aid-sourced subsidy proceeds straight to a wealthy firm's bottom line. Rather, the response should stress that the aid funding in question is supporting, not the company, but the formation of a partnership between the company and poor communities. This might appear to be a rather technical point. However, it can be given practical reality by requiring proposals to be submitted by consortia, not by companies alone, and further by making every effort to identify fund-holders other than the company itself, where this does not involve major inefficiencies.

In addition, in specific cases it would be preferable to detail how subsidies are actually being used, so as to make it clear that the companies themselves are not the beneficiaries. In the most straightforward case, subsidies might fund the supply of something which is of importance to the firm, such as education and training in certain fields, but which also has public-good characteristics. In other cases, a subsidy might be used to reduce the cost of purchasing from local suppliers until such time as those suppliers can secure orders large or long-term enough to bring their prices down. It might be used to reduce the cost of local labour until such time as labour productivity increases. Or it might be used to supplement the prices paid by consumers for a product until such time as sales increase to a certain level. In each case, the subsidy really accrues to a party other than the firm—the supplier, the worker or the consumer—even if for convenience the payment might flow to the firm.

In fact, if payments of the kind just described were actually linked directly to results, by being made in direct proportion to goods purchased, people employed or goods sold, impact measurement and public relations might both be easier.[12] This would almost certainly be too complex to put into practice but the principle remains: payments should be conceived as benefiting suppliers, workers and consumers, not the firm. It is for this reason that there should be no thought of cost recovery in the case of business modification initiatives.

## 7 Recommendations

The overall conclusions of this paper may be expressed in the form of three broad recommendations to agencies contemplating the design of new enterprise challenge funds or the further evolution of existing funds, as follows.

1. Two species of enterprise challenge funds, defined as challenge funds that seek to enhance the poverty impact of business activity, should be recognised and

[12] See Callan & Davies (2013), p. 11, on the G20's AgResults initiative: 'In principle, challenge funds grants could also take the form of results-based payments that are linked, for example, to demonstrated impact measured in terms of the consumption of a beneficial good or service by poor people, or in terms of other benefits such as employment. The AgResults initiative, an agricultural 'pull mechanism' launched at the G20 summit in Los Cabos in 2012 will involve such payments, and may be regarded as an inclusive business initiative with results-based subsidies (AgResults Steering Committee 2012).'



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separated conceptually and practically: enterprise development funds and business modification funds.

   a. Enterprise development funds should exist to provide risk-reduction financing for promising, high-risk, pro-poor business ideas.

   b. Business modification funds should exist to provide incentives for large, established firms to take pro-poor investment decisions by reducing transition costs associated with shifts in corporate strategy.

2. Enterprise development funds should be geared to invest in local businesses, providing capital (recoverable where possible) to the strongest such businesses with the best ideas, in the context of country strategies and in coordination with initiatives that provide business support services and help the public sector to improve business enabling environments.

   a. A relatively narrow geographical and/or sectoral scope is appropriate, with country- or region-specific funds preferred over very broad-ranging funds.

   b. Financial support should be provided in grant form for smaller projects but otherwise in the form of success-linked loans or guarantees to maximise recoverability.

   c. Co-payment should be required but with a modest matching ratio, and the fund manager and project proponents should attempt wherever possible to use fund resources to leverage commercial financing for projects.

   d. Projects and related risks should be managed, and outcomes assessed, on a portfolio basis, with an expectation that a non-trivial proportion of projects will fail.

3. Business modification funds should work with strong (including multinational) businesses, preferably in consortium with organised poor communities and/or NGOs using simple grant instruments, largely unconstrained by specific donor agencies' strategic priorities (except at a very broad level—e.g. Australian aid resources will be concentrated in the Asia-Pacific region).

   a. A broad geographical and sectoral scope is appropriate, so as to avoid overlooking high-quality partnership opportunities.

   b. Only a small number of partnerships should be entered into, and the fund's managing agent should be equipped to devote considerable financial and technical resources to each partnership over an extended period of time.

   c. The largest possible co-payments should be sought as part of the partnership selection process, as these constitute a direct measure of firms' commitment.



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d. Where possible without excessive efficiency loss, grants should be made to third parties rather than the business itself (e.g. a grant for financial literacy training could be made direct to an NGO, or temporary price or wage subsidies could be channelled directly to suppliers, workers or consumers).

e. Consideration should be given in some circumstances to providing results-based grants to firms—i.e. grants whose size tied to the quantity of inputs locally purchased, people locally employed and/or products sold to poor consumers.

f. Bilateral agencies should accord priority to partnerships with firms headquartered in their own or neighbouring countries, for reasons of effectiveness.

It is not for nothing that challenge funds, whether promoting enterprise development or business impact, hold such intuitive appeal for decision-makers. In principle, they should be able to achieve results, sometimes on a large scale.[13] But they have not been around for long and, as many reviews have concluded, they have generally been established with neither sharp enough aims nor robust enough monitoring and evaluation arrangements. They have, to date, not really been given a fighting chance. We have not sought in this paper to assess claims about the successes and failures of past and present funds, and in any case the evidence base would be too slim to support such assessments. We have sought, though, to propose one important way in which clarity about aims might be achieved—and to suggest broadly how such clarity might in future lead to more effective program construction and execution.

[13] And such large-scale results have sometimes been claimed, most notably in the case of M-PESA, a mobile banking platform which has achieved very wide reach within Kenya and beyond. M-PESA was supported by a grant to Vodafone's Kenyan affiliate, Safaricom, from the UK's Financial Deepening Challenge Fund, which was matched by Vodafone. See Mas & Radcliffe (2010) for a case study.



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