Book Review

The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines
by Michael U. Klein and Bita Hadjimichael

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Today’s microfinance industry is stepping beyond charitable subsidies toward commercialization, from dependency towards self-reliance. To speed and systemize the eradication of poverty, private capital has become more crucial for microfinance institutions (MFIs). In their book, The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines, Michael U. Klein and Bita Hadjimichael encourage practitioners and policy makers to enhance the private sector’s role in a broad range of areas that impact development.

At times, the public has characterized private capital in poverty eradication as opportunistic, exploitative, even immoral. Klein and Hadjimichael concede some abuse has occurred “by powerful groups” (p. 2). Yet, the recipients (the poor) feel that private firms are important and more effective than alternatives. Klein and Hadjimichael attribute this superiority to burgeoning ideas, competition, and best practices. Reminiscently, private sector industrialization in the 19th century in the United Kingdom doubled average worker incomes in 60 years (p. 5). Likewise, in the last decade private sector technical and organizational progress doubled
average worker incomes in countries like Botswana, Chile, China, Ireland, Japan, Korea, and Thailand (p. 5).

The authors contend that the private sector’s role in the development agenda is to complement the efforts of the public sector to meet the needs of poverty’s many dimensions. There is enough money in the world today to eliminate poverty (pp. 9, 15).¹ The challenge we face in eliminating poverty is not money but delivery systems and incentives that ensure intended beneficiaries are serviced (p. 9). Combining social, political, and economic influences and resources to eliminate poverty would enhance our ability to create the infrastructure needed to reach the poorest of the poor.

The Private Sector in Development uses microfinance as an example of facilitating access to financial markets for the poor. MFIs are highly capable and proven delivery systems of financial services to the poor internationally. The authors note, “The effect of microfinancing is likely to be greatest when sensible, market-friendly reforms create a good business environment” (p. 84). MFI ability to scale up is questioned when the authors observe,

Most people served continue to rely on subsidies, and risks of excessive subsidy dependence are clear. . . . The greatest challenge is, thus, how to scale up the provision of microfinancing on a sustained commercially viable basis. . . . Large scale solutions are, however, unlikely to be sustained unless larger financial institutions are able to downscale their operations and serve the market for small credit and financing on a commercial basis—indeed at a continued subsidy. (pp. 84, 85)

Technology based solutions (credit cards and prepaid electronic cards to create credit history for the poor) and governmental solutions (improve property rights to create collateral options for the poor) are suggested as vehicles to scale up microfinance.

Throughout the eight chapters of The Private Sector in Development, Klein and Hadjimichael measure the success and failures of a large mix of poverty-eliminating approaches. These

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measures are substantiated by empirical research from the World Bank and independent sources. The findings are well presented, with dozens of statistics, graphs, tables, and charts strategically placed every few pages to enhance reader understanding.

To illustrate the need to alleviate poverty through effective delivery systems, market disciplines, and wise use of resources, the authors draw conclusions from “Where Has All the Education Gone?” a research project conducted by Lant Pritchett in 1996. The study identified the correlation between education and per capita gross domestic product (GDP) growth from 1960 through 1985. The research shows that educational capital growth in Asia was about 2.7% and per capita GDP growth was about 4.1%. In contrast, during the same time period Sub-Saharan Africa educational capital growth was about 4.2% while per capita GDP growth was only .6% (p. 7). The authors conclude that although adequate education is required for developmental growth, strong performance is best achieved when (1) human capital, (2) infrastructure, and (3) institutional frameworks are capable, with capability defined as a function of these three components combined in market operations.

Further, “studies on the effect of foreign direct investment (FDI), the most powerful mechanism to transfer best practice across borders, suggest that its contribution is most significant when domestic capability is high” (pp. 7, 18, 19). Capability is shown to be high when competitive market approaches are practiced. The private sector market approach facilitates innovation and creates jobs and improvements in service-delivery and economic performance—investment follows these conditions and per capita GDP rises. Thus, education alone will not alleviate poverty. Effective market-like delivery systems must be set in place to scale the eradication of poverty.

Throughout the book the authors emphasize job creation and the investment climate in development models. They point out that simply creating jobs is not enough to solve the world’s poverty epidemic—enterprises need to use best practices and jobs need to be productive and raise standards of living. Research provides that
“State-owned enterprises or subsidized private firms have generally failed to deliver sustainable productivity growth” (p. 17). At the same time, merely investing money into a developmental project has not proven to alleviate poverty. A firm’s capability and investment must go hand-in-hand to ensure resources are used wisely and improve economic performance. “The potentially biggest hope for poverty reduction comes from mechanisms that transmit best practice to areas where the poor live and work. The private sector development agenda emphasizes the crucial contribution of competition in this regard. . . . Special assistance to fledgling entrepreneurs through microcredit or business development services may help speed up the diffusion of best practice” (pp. 127, 128). Klein and Hadjimichael are deliberate in repeatedly reporting that competitive markets create the key drivers and incentives that encourage organizations to become efficient, use best practices, innovate, invest, create productive jobs, and raise standards of living.

The discussion of competition and investment in development markets leads the authors to examine the pros and cons of financial subsidies. At times, pro-poor intervention may require subsidies, and subsidies are in demand by both non-profit and for-profit organizations as well as the beneficiaries of subsidies. In the case of microfinance, subsidies assist institutions in reaching the extremely poor where, historically, other organizations have been unsuccessful. The authors explain, however, that cost-benefit analysis should be set in place when subsidies are used, as certain challenges arise when subsidies are granted. Although the cost of capital to organizations or individual beneficiaries appears to be less, donors, taxpayers, or investors absorb the true cost of capital. The authors present evidence that long term subsidized debt among private firms “results systematically in net negative economic outcomes” (p. 74). Further, other challenges like waste, inefficiency, and diverting funds for private gain sometimes occur when subsidies are issued. These challenges can be avoided if monitoring systems are set in place.

To remedy financial subsidy challenges, Klein and Hadjimichael suggest that information systems should be implemented to create
transparency and to assess credit opportunities. Regarding information systems the authors submit, “Informational problems make it hard to recognize and assess credit opportunities and, thus, lead to some good deals being left on the table. If one can overcome these information problems, the additional deals that would be concluded can be expected to earn the full, unsubsidized cost of capital” (pp. 74–75). Moreover, “Transparency is further enhanced when subsidies are unbundled, as they would be in private competitive markets. Then the subsidies provided for a particular activity could be calculated with some precision. In addition, results could be assessed” (pp. 164–165). Ultimately, The Private Sector in Development argues, “Subsidies can be designed to be compatible with the market solution” (p. 129). Market solutions for subsidies include establishing performance output goals, auctioning off the right to serve certain people of competing providers to the lowest subsidy bidder, and allowing information to flow so donors can choose the most deserving charities to provide subsidized funding. The authors also specify that “best practice appears highest if such support measures are delivered in ways that are consistent with market principles and that do not create unsustainable dependence on subsidies” (p. 128). Some approaches taken to promote development in the lives of the poor produce self-reliance while others lead to dependence.

The authors conclude, “The role of entrepreneurs and markets is critical for poverty reduction, because the key to rapid poverty reduction lies in transmitting advances in technology or organizational improvements across the world” (p. 167). The book outlines methods for market mechanisms to be introduced where competition will improve poverty reduction. The last chapter recognizes again the question of whether or not the for-profit motive will undermine development work. The authors establish that evidence proves for-profit market mechanisms are an integral part of the solution, yet stress that in order to create sound markets, for-profit motives need to be balanced between cooperation and competition. In sum, competition and market mechanisms transmit best practices to create effective poverty-eliminating delivery systems.
The Private Sector in Development: Entrepreneurship, Regulation, and Competitive Disciplines holds true to its title. This work thoroughly explores the private sector’s historical role in development with hard evidence of the successes and failures of a variety of poverty-eliminating approaches. Klein and Hadjimichael’s suggestions for how the private sector can complement efforts under the development umbrella—for now and the future—are well articulated and provide practitioners and policy makers a platform from which to discover effective ways to employ market mechanisms within their respective areas of influence. Though the book does not focus primarily on the microfinance industry, the principles highlighted make brilliant, practical contributions to support the commercialization of microfinance.

The strongest poverty-eliminating principle in The Private Sector in Development is clear: The private sector eradicates poverty and increases the quality of life of the poor. The eradication of poverty is a macroeconomic challenge and necessitates the cooperation of many moving parts from both the public and private sectors influencing the social, political, and economic environment. If we are to halve poverty by 2015 (Millennium Development Goal [MDG]), the public sector should continually allow more opportunities for the private sector to participate and play a larger role in development.

Notes

1. “One perspective is provided by data from the annual Human Development Report (HDR) published by the United Nations Development Programme (UNDP). For some years, the report has presented estimates of the additional resources it would take to meet all basic needs in the world. The HDR for 2000 puts the number at US$80 billion per year (UNDP 2000). That figure translates to US$1,400 for each of the richest 1 percent of people in today’s world.”