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“POVERTY REDUCTION FOR PROFIT?”

A critical assessment of the Bottom-of-the-Pyramid Approach
and of the ‘Opportunities for the Majority’-Initiative of the
Inter-American Development Bank“

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PREFACE

When I arrived to Washington DC in May 2009 to begin my internship at the office of the Austrian Trade Commission, my mind was firmly set on a thesis project on Haiti. The intensive study of International Development during my previous exchange semester at the Hubert Humphrey Institute of Public Affairs at the University of Minnesota had further deepened my interest for developmental issues and, combined with my interest and experiences in the region of Latin America, had inspired me to write about this exceptionally poor and disaster-struck country in the Western hemisphere.

It was not until August 2009, however, and many conversations with Austrian and other officials of various ministries and International Financial Institutions later that I decided to change the theme of my thesis to a more practical one, which I was personally closer to. In July 2009, I started my internship at the Opportunities for the Majority (OMJ) office at the Inter-American Development Bank where I was confronted with a new approach to development, leaving me fascinated and skeptical at the same time. Based on the Bottom-of-the-pyramid model developed by C.K.Prahalad, the OMJ office supports market-based solutions for the poor in the region of Latin America and the Caribbean. Curious to learn more about this new approach, I started reading and researching and eventually, decided to write my thesis about the Bottom-of-the-Pyramid approach and OMJ. Motivated and supported by my fellow colleagues in the OMJ office as well as Elisabeth Gruber, the Austrian Alternate Executive Director to the IADB, who immediately offered to function as my advisor of thesis, I pursued this idea and was able to complete a substantial part of the document until my departure from Washington DC by the end of 2009. The time in Washington DC, and at OMJ in particular, was very valuable for me and I appreciate having had the opportunity to work with such a young and dedicated team. Only after my transition back to Europe and several events at the Graduate Institute of International Studies and Development at the University of Geneva (where I am currently completing my last semester of studies) later did I fully realize how much I had learnt about development policy and social business. Much of this knowledge has been acquired and reproduced during the elaboration of this thesis.

TABLE OF ACRONYMS AND ABBREVIATIONS

ADB	Asian Development Bank
AfDB	African Development Bank
BoP	Bottom of the Pyramid
CAF	Corporación Andina de Fomento
CEO	Chief Executive Officer
DAC	Development Assistance Committee
EBRD	European Bank for Reconstruction and Development
EU	European Union
GDP	Gross Domestic Product
GNI	Gross National Income
HDI	Human Development Index
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IIC	Inter-American Investment Corporation
IMF	International Monetary Fund
LAC	Latin America and the Caribbean
LLDCs	Least Developed Countries
MDB	Multilateral Development Bank
MDGs	Millennium Development Goals
MIF	Multilateral Investment Fund

MNCs	Multinational Corporations
MNEs	Multinational Enterprises
NIE	New Institutional Economics
NGO	Non-Governmental Organization
OECD	Organization of Economic Co-operation and Development
ODA	Official Development Assistance
OMJ	Opportunities for the Majority
SCF	Structured and Corporate Finance
SECCI	Sustainable Energy and Climate Change Initiative
UN	United Nations
UNCTAD	United Nations Commission on Trade and Development
UNDP	United Nations Development Programme
UNODC	United Nations Office on Drugs and Crime
WB	World Bank
WRI	World Resources Institute
WTO	World Trade Organization

1. INTRODUCTION

The alleviation of global poverty remains one of the major challenges of our time. Heading the United Nations' ambitious Millennium Development Goals for the year 2015, it is also the mission of a multitude of organizations, global and local. However, despite many years of efforts and development interventions, mostly driven by the public sector, global poverty still persists. With the need for alternative and innovative strategies for poverty reduction and the increasingly important role of the private sector in our ever more globalized society, new private-sector led models of development have been developed. A prominent example is the Bottom-of-the-Pyramid model championed by C.K. Prahalad and Stuart Hart which intends to achieve the alleviation of poverty by creating a win-win scenario for companies and the poor. In directing profitable business activities at low-income populations and incorporating them into the formal economy, the theory predicts gains for the company as well as for the poor who will benefit from enhanced capabilities, a higher standard of living and eventually, the overcoming of poverty. Despite much criticism for dubious assumptions and the potential risk of exploiting the poor, Prahalad's model has enjoyed high acceptance among international development institutions. The Inter-American Development Bank has demonstrated particular interest and founded the Opportunities for the Majority Initiative dedicated exclusively to the support of BoP business solutions. By taking a closer look at the activities of this office and assessing them systematically, the aim of this thesis is to make a statement about the feasibility and effectiveness of the BoP approach.

On a more general level, the work is intended to contribute to the overall discourse on the role of the private sector in development.

1.1 Notes about language and terminology

Despite being a native speaker of German, I am writing this thesis in English. I am not doing it because I value one language more than the other, nor did I consider the predominance of English as the global "lingua franca" in academics and everyday life. Rather I resorted to English as working language for this project for practical reasons. Given that I began my research and readings in Washington DC, I was not

only constantly exposed to an English-speaking environment but also worked predominantly with literature in English language.

English also offers an advantage over German regarding the use of gender neutral language. The use of such terminology is important to me and it seems to be implemented more naturally in English as the singular and plural of most words are gender neutral and address both females and males alike.

Moreover, writing my thesis in English, gives me the opportunity to make it available to many international friends and colleagues whose support was critical in its development but who are not able to speak and read German.

At this point, it seems also important to explain the terminology I used to group, name and define the countries of this world. Traditionally, the categories “developed” or “industrialized” countries as opposed to “developing” countries have been most widely used in scientific literature as well as official documents.

However, since such terminology usually implies a definition of “development” in exclusively economic terms, it seems outdated, given the broader definition of “development” including social and institutional indicators which has meanwhile become the mainstream in recent development studies. In this thesis, I will therefore adopt a different terminology. I will call the USA, the EU member states, Switzerland, Norway, Canada, Japan, Australia and New Zealand countries of the “Global North” and all the others countries of the “Global South”. These two categories have become widespread in recent development literature (see for example Goldman 2005) as they emphasize the geographic division that correlates to some extent with the preponderance of poverty. Furthermore, this categorization of countries reflects the groups of “donor” and “recipient” countries within the context of development cooperation under the OECD-DAC. Nonetheless, it is important to remark that neither group of countries is homogeneous. Just as the USA or the EU might differ in their priorities and weight in developmental issues compared to smaller, yet wealthy countries, such as New Zealand, the group of countries in the Global South includes emerging powers, such as China, India and Brazil as well as small and impoverished nations in Africa and Asia. For the purpose of this thesis, however, the general division between the Global North and South should suffice.

1.2 Structure

The present thesis consists of five chapters: an introductory, two theoretical and two which are more practical in content.

The first chapter intends to give an introduction into the subject and lays down the main concepts and assumptions which provide the basis for the following analysis.

Chapter two discusses the issue of poverty. Following an overview of different definitions of the phenomenon, the theoretical concepts of state versus market failure will be addressed. Subsequently, I will review different strategies of poverty reduction, ranging from traditional aid-based approaches to newer models of private-sector led development.

The third chapter of the thesis then elaborates on the “Bottom of the Pyramid” model according to C.K. Prahalad, its origins, theoretical concept and points of critique. Two case studies will be included to better illustrate this relatively new approach to poverty reduction.

The practical and empirical part of this thesis will follow in chapter four. This chapter will provide an overview of the history and structure of the Inter-American Development Bank as well as its operations in the field of private sector development. Special attention will be paid to the activities of the Opportunities for the Majority Initiative, which supports the implementation of BoP business according to C.K. Prahalad’s model. Based on two case studies, I will try to evaluate if the points of critique raised at the theory of the model are justified also for the practice as executed by OMJ.

The final chapter of this work (chapter five) will eventually summarize the main findings and complete this work with an outlook for the future.

1.3 Research Issue, Questions and Hypotheses

As already evident from the title of this thesis, the main research issue concerns the critical assessment of the “Bottom of the Pyramid” approach according to C.K. Prahalad as a new private sector led development strategy. I intend to analyze it on

two levels: a) as a theoretical concept and b) in its implementation by the Opportunities for the Majority office of the Inter-American Development Bank.

Derived from this research issue, I formulated the following research questions and hypothesis, which I will try to verify or falsify in the present thesis:

- What is new in the “Bottom of the Pyramid” approach to poverty alleviation according to C.K. Prahalad in comparison with traditional public and private sector strategies for poverty reduction?
- The BoP approach represents a novel strategy for poverty reduction and can be clearly differentiated from traditional public or private sector led approaches.
- What are the major points of conceptual critique at C.K. Prahalad’s BoP model?
- C.K. Prahalad’s BoP model can be criticized for a number of theoretical weaknesses, such as a too narrow definition of poverty and development, an over-estimation of the BoP market size, insufficient targeting of Least Developed Countries, the inadequacy of MNCs as actors in development and the detraction from the imperative to correct government failures which altogether may eventually lead to exploitation of the poor.
- How is the BoP Model implemented by the Opportunities for the Majority (OMJ) office of the Inter-American Development Bank?
- The OMJ office of the IADB supports projects which fit C.K. Prahalad’s BoP business concept; yet not all of its projects fully comply with Prahalad’s theory.
- Do the conceptional points of critique at C.K. Prahalad’s BoP Model apply to the BoP projects of the OMJ office?
- The points of critique raised at the theoretical concept of Prahalad’s BoP model also apply to its implementation through OMJ projects, except in cases where a deviation from Prahalad’s model has been adopted.

1.4 Research Methods

The most important research method I used for the development of this thesis was the review of scientific primary and secondary literature, online resources as well as original documents of international development organizations, notably the IADB. My research process was complemented by an expert interview with Dana Martin, the principal private sector specialist of the IADB's Opportunities for the Majority office, who proved to be an additional valuable source of information.

Although my attempt is to draw general conclusions about the theory by C.K. Prahalad and the activities of OMJ, a complete assessment of all projects would go far beyond the scope of this thesis. In addition, empirical evidence on BoP projects is still scarce and further limits the possibilities for analysis. Due to these restrictions, my analysis will be primarily conceptual with heuristic intent. I will limit my assessment to a small number of carefully selected case studies and draw conclusions from them. I am aware that a few project examples cannot serve to validate or discredit an entire development model (as their outcome can depend on many factors); however, they can be useful to illustrate strengths and weaknesses of a model or expose potential inherent contradictions (see McFalls 2007, 89). Although some scholars despise this method for its lack of scientific rigor (see Karnani 2007), others value it especially in cases where not enough previous research is available and no precise outcome is predicted (see McFalls 2007, 89).

2. POVERTY REDUCTION STRATEGIES

2.1 Definitions of Poverty

"What is poverty? Poverty is hunger. Poverty is lack of shelter. Poverty is being sick and not being able to see a doctor. Poverty is not having access to school and not knowing how to read. Poverty is not having a job, is fear for the future, living one day at a time. Poverty is losing a child to illness brought about by unclean water. Poverty is powerlessness, lack of representation and freedom. Poverty has many faces (...)"
(World Bank 2010, www)

Defining poverty is not as straightforward as it may seem. Academics and practitioners throughout the world have developed countless definitions, unable to

establish universal defining criteria for this phenomenon. Nevertheless, framing the issue of poverty is essential because *“how one defines or describes it has significant consequences for any potential solution”* (Werhane et al. 2009, 10). Definitions, descriptions and measures of poverty always imply a normative component, i.e. *“the way in which one describes the problem and frames the data shapes how one envisions the solution and allocates resources.”* (ibid, 11) Therefore, it makes a big difference if subjective poverty measures are used based on survey data from specific target groups or if poverty is measured by criteria which can be more easily compared internationally, such as per capita income. Furthermore, it is important to distinguish between the concepts of absolute and relative poverty. While absolute poverty refers to the living condition below a certain fixed poverty line (most commonly used with monetary measures of poverty), relative poverty lines reflect a percentage of the (national) average income or consumption (see World Bank Institute 2005, 43).

In the following chapter I will present three of the most prevalent definitions of poverty and methods of measurement in international economics and development: monetary measures of poverty, biometric measures and measures based on the deprivation-of-capabilities approach. Each of these approaches having its merits and deficiencies, it is suggested that *“poverty lines are as much political as scientific constructions.”* (Deaton 2004, 7)

2.1.1 Monetary measures of poverty

In the beginning of development thinking after World War II, development was essentially understood as economic growth and measured in terms of GDP (see Raffer/Singer 2001, 32). This definition consequently led to a definition of poverty from a macro-economic perspective in terms of inferior levels of GDP and GDP per capita. However, with increasing academic activity in the subject, scholars also sought for a definition of poverty from a micro-economic perspective. Probably the most widespread of these was developed by economists of the World Bank in 1990. In its flagship publication *The World Development Report*, the institution first adopted the poverty line of a consumption/income of US\$ 1 per person per day as its measure for absolute poverty (see The Economist 2008, www). The World Bank's economists arbitrarily determined this specific cut-off point based on the comparison

of several national poverty lines of developing countries which all clustered around this amount (see *ibid*). The implicit assumption of this measure is that it reflects the cost of the most basic needs, which include expenditures for food, clothes and housing (see World Bank Institute 2005, 42). However, it would be erroneous to assume that the poor spend their entire budget – as small as it may be – on food and basic necessities. As Banerjee and Duflo (2007) find in their paper “*The economic lives of the poor*”, expenditures for food amount to 56 to 78 percent of total consumption of the poor, whereas considerable amounts are spent on intoxicants, such as alcohol and tobacco, and entertainment, such as festivals or television. Despite such criticism, the World Bank relies on this monetary approach for poverty measurement. To facilitate international comparisons, the amount of US\$1 was converted into Purchasing Power Parities (PPP), resulting in US\$1.45 in 2005 due to American inflation. Since this amount seemed rather high to World Bank researchers and policy makers and would imply significant changes in the global number of poor, the poverty line was recalculated in 2005 with the original method and finally, set at US\$1.25 (PPP) (see The Economist 2008, [www](#)). For the richer middle income countries, the poverty line was set at US\$2 (PPP) per day, thus indicating “moderate poverty” (see World Bank 2009, [www](#)).

The PPP approach is widely used not only by the World Bank, but also the IMF, other Multilateral Development Banks, and UN organizations. Although it seems attractive for helping to establish a common language among donors and researchers (see Werhane et al. 2009, 10), the PPP concept remains controversial and frequently leads to errors, notably because PPP exchange rates were originally not developed for poverty measurement (see Deaton 2004, 17). Accused of being inadequate, infrequently updated and inapplicable to the consumption of the poor, critics have repeatedly questioned the value of the PPP approach for the measurement of global poverty (*ibid*). Some critics even argue that the “(...) *PPP [approach] (...) reveals more about an organization’s ideological commitment for or against globalization than it does about those who live in poverty*” (Werhane et al. 2009, 10). Referring to converging national income averages, supporters of globalization tend to argue that global poverty is declining. Their opponents, however, claim that the economic expansion by multinational enterprises (MNEs), i.e. globalization, leads to widening income gaps between the rich and the poor. Inarguably, poverty measures based on

PPP may be useful when examining the global economy from a macro-view. It remains questionable, however, whether it is an accurate tool for depicting and addressing the problem of poverty (see Werhane et al. 2009, 11).

2.1.2 Biometric measures of poverty

As alternative approach to the measurement of poverty, biometric measures focus on the cost to obtain a certain amount of calories - usually 2000 per day, as suggested by the Food and Agricultural Organization of the United Nations – to calculate a poverty line (see Deaton 2004, 4). Sometimes a 4000 calorie per day-norm is used for agricultural laborers. In other cases, distinctions are also made based on gender and age of the persons (see *ibid*). The determination of this poverty line can be done by assessing a person's actual food expenditures matched by the income level at which, on average, 2000 calories are reached¹ (see *ibid*, 5).

A deficiency of biometric poverty measures is certainly that they do not account for the nature or quality of calorie intake. They usually assume that by consuming enough calories, the person will also take in sufficient protein and micronutrients, such as iodine, which are critical for human health (see *ibid*).

Poverty lines based on biometric measures are widely used, not only because the poor spend a large proportion of their budget on nutrition, but also because there seems to be more political support for poverty reduction programs involving food than for measures based on less meritorious goods (see Deaton 2004, 5). The right to food is perceived more compelling than the right to any other goods. Furthermore, the nutritional basis and the involvement of scientists in setting the norms seem to add legitimacy to such measurements (see *ibid*). Nonetheless, national biometric poverty lines are often flawed because they were only adapted to changes the national price level, but not to different implications of people's contemporary economic activities. Nowadays, people need to consume fewer calories than in the past because jobs in industry or the service sector require less physical energy than manual labor in agriculture. Similar points of critique can be applied in terms of differences between the calorie-need in rural versus urban areas (where usually people are more sedentary, thus in need of fewer calories than on the countryside) or

¹ The method referred to is known as the "Calorie Engel Curve".

in colder versus hotter places. However, if such changes were taken into account, the poverty line would have to be revised upward, which would increase the number of people defined as poor. Unsurprisingly, there is typically little political support for such initiatives (see Deaton 2004, 7).

2.1.3 Deprivation of capabilities

A third definition of poverty refers to the issue as “*the absence of one or more of the basic capabilities that are needed to achieve minimal functioning in the society in which one lives.*” (Deaton 2004, 11) Economist and Nobel laureate Amartya Sen laid the theoretical foundations of this approach, arguing that the mere focus on monetary income is not enough to describe and measure the complexity of development and poverty alleviation. Sen essentially defines development as the expansion of human freedoms, which fulfill both, a constitutive and instrumental role, in the process (see Sen 1999, 36). He identifies five types of freedoms which directly enhance people’s capabilities, i.e. the things people can be and do, but also complement and reinforce one another (see Sen 1999, 38): 1) Political Freedoms, i.e. civil rights to actively participate in politics through elections as well as open political dialogue and critique; 2) Economic facilities, i.e. a person’s income, relative prices and functioning of markets; 3) Social opportunities, i.e. access to education, health care and the like; 4) Transparency guarantees, with are to prevent people from corruption, financial irresponsibility and underhand dealings; and 5) Protective Security, i.e. the provision of social safety nets for the most vulnerable groups of society.

Amartya Sen’s approach acknowledges that poverty is relative to the norms and customs of an individual’s respective society and therefore, not limited to developing countries. Although the poor of rich nations enjoy relatively high levels of income (when compared internationally), deprivation of one or more of the human freedoms mentioned above, such as lack of access to education or health care, may still prevent them from the ability to fully participate in society (see *ibid*).

Based on this definition of poverty, the United Nations Development Program (UNDP) developed a more complex tool for poverty measurement. In 1990, the Human Development Index was introduced as a new statistic, which accounted for social as well as economic development (see Human Development Reports, 2009,

www). It is composed of three components measuring life expectancy, educational attainment and income. Based on results for these indicators, UNDP determines a ranking of all the countries in the world which is published in its annual Human Development Report (see *ibid*).

Although the HDI offers a more complete assessment of poverty than single-fold measures, critics have pointed out that it still does not account for a range of variables, e.g. environmental factors, and therefore fails to capture the full complexity of the problem (see *ibid*).

Also drawing on Sen's broad definition of poverty, the General Assembly of the United Nations adopted eight Millennium Development Goals in an unprecedented joint declaration at their Millennium Summit in 2000. An important merit of these Goals, which account for monetary variables as well as aspects related to health, education and the environment, is the fact that they are time-bound with the deadline of 2015 (see UN Millennium Goals 2009, [www](#)). Drawing on unsatisfactory intermediate results, critics, however, doubt that the Millennium Development Goals will be achieved by the designated date due to a lack of political will and/or insufficient financial resources for development (see chapter 1.2.2) (see Clemens/Moss 2004). The 2007 midterm review of the MDGs reveals progress particularly in the areas of child mortality, education and women's empowerment (see UN 2007, 4). The proportion of people living in extreme poverty has also declined notably (from one third to about one fifth of total world population) (see *ibid*); however, it is important to point out that this is mainly attributed to the rapid development in South- and East-Asia. The poverty rate in Sub-Saharan Africa has not decreased nearly as much and will probably not be halved by 2015 (see *ibid*). These unequal developments highlight the regional differences in progress and likelihood of achieving the MDGs on time. While it is still possible to meet the targets for some countries and world regions, the outlook for others is rather dire. Nevertheless the MDG concept merits appraisal as it represents a joint effort by the international community to increase support for development and became a widely accepted tool to depict the complexity of poverty, with each of the eight goals being divided into several more specific and measurable targets which are regularly monitored by UN authorities

Table 1: United Nations Millennium Development Goals (MDGs)	
GOALS	TARGETS
Goal 1: Eradicate extreme poverty and hunger	- Halve, between 1990 and 2015, the proportion of people whose income is less than \$1 a day - Achieve full and productive employment and decent work for all, including women and young people - Halve, between 1990 and 2015, the proportion of people who suffer from hunger
Goal 2: Achieve universal primary education	- Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling
Goal 3: Promote gender equality and empower women	- Eliminate gender disparity in primary and secondary education, preferably by 2005, and in all levels of education no later than 2015
Goal 4: Reduce child mortality	- Reduce by two thirds, between 1990 and 2015, the under-five mortality rate
Goal 5: Improve maternal health	- Reduce by three quarters the maternal mortality ratio - Achieve universal access to reproductive health
Goal 6: Combat HIV/AIDS, malaria and other diseases	- Have halted by 2015 and begun to reverse the spread of HIV/AIDS - Achieve, by 2010, universal access to treatment for HIV/AIDS for all those who need it - Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases
Goal 7: Ensure environmental sustainability	- Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources - Reduce biodiversity loss, achieving, by 2010, a significant reduction in the rate of loss - Halve, by 2015, the proportion of the population without sustainable access to safe drinking water and basic sanitation - By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers
Goal 8: Develop a global partnership for development	- Address the special needs of least developed countries, landlocked countries and small island developing states - Develop further an open, rule-based, predictable, non-discriminatory trading and financial system - Deal comprehensively with developing countries' debt - In cooperation with pharmaceutical companies, provide access to affordable essential drugs in developing countries - In cooperation with the private sector, make available benefits of new technologies, especially information and communications

Source: UN Millennium Goals 2009, www

2.2 Market Failures versus Government Failures

“Because no human institution is perfect, it is easy to find imperfections or ‘failures’”
(Mitchell/Simmons 1994, xvii).

The issue of poverty is highly complex, in its definition as well as in its reasons and potential solutions. Although acknowledging the importance of factors such as geography, history, cultural idiosyncrasies etc. for the explanation of poverty in particular regions, I will in this chapter focus on the theories of government and market failures, which are frequently cited as obstacles to development.

2.2.1 Market Failures

Adam Smith’s famous doctrine of the invisible hand claims that *“(...) maximizing behavior by individual economic agents in market relationships generates a socially rational use of scarce resources under certain defined conditions. Moreover, the voluntary exchange (...) through the market mechanism is itself a positive sum game for all participants since exchange enhances mutual welfare”* (Wallis/Dollery 1999, 15). This assumption of the *homo economicus*, i.e. perfectly rational and Pareto optimal human behavior in consumption and production seems to limit the necessity for active government intervention in the enforcement of property rights (see *ibid*). However, Neoclassical Economics or the magic of the “invisible hand” only works under certain conditions. Particularly, these are (see *ibid*, 17-21):

- Perfect competition

However, in the real world various reasons exist for the absence or limitation of this assumption. Geographic isolation, limited ownership of certain goods such as natural resources or market entry barriers such as lacking economies of scale are prominent obstacles to perfect competition and often lead to the creation of (natural) monopolies or public provision of goods and services.

- Perfect information and no information asymmetries

This assumption is clearly utopist, leading to adverse selection and policy efforts to reduce it

- No externalities

The concept of externalities implies that market prices do not reflect the total costs and benefits for society, making it impossible to generate socially efficient levels of consumption and production. In the real world, externalities (e.g. pollution) are inevitable and can at best tried to be internalized through taxes etc.

- Public goods

Public goods are characterized by non-rivalry and non-exclusivity in consumption. In other words, the consumption of a public good by one individual does not reduce the good's availability for consumption by others and nobody can be prevented from consumption by the producer of the good. As private firms have no incentive to produce such goods, market failure is inevitable.

- Macroeconomic stability

Efficient markets need a stable macroeconomic environment. This is however, threatened by periodic downswings in economic activity related to the business cycle. Government interventions thus seem justified to foster economic stability and prevent unemployment and falling incomes during times of economic bust.

As explained above, it is hard to find a situation in the real world in which all assumptions hold. Consequently, market failure is widespread and calls for government intervention. Additionally, there are several ethical arguments supporting an active participation of government in the economy (ibid, 22-23):

- Efficient markets may not meet socially accepted standards of equity of income distribution or limit extremes of wealth and poverty
- People do not always behave in their own best interest. Merit goods are goods which might not be desired by the individual but rather by the society as a whole (e.g. compulsory schooling, vaccination campaigns etc) and an thus justify public subsidies

- Efficient labor markets might not provide all members of society with equal economic opportunity, irrespective of gender, race or ethnicity, further making the case for active policy involvement for the well-being of society

Other economic theories, such as (neo-) institutionalism, which evolved from and at the same time criticize neoclassical economics, offer an analysis of the institutional framework in which markets and economic transactions operate. (In neoclassical economics, the institutional framework is a given assumption). (Neo-) institutional economics (NIE) draws attention to influences from the social environment, such as norms and rules enforced by political or other social institutions, which affect the behavior of otherwise rational, utility-maximizing individuals (see Gabler 2010, www). It also studies the ideal design of institutions which by laws and rules incentivize self-interested individuals to cooperate for the maximum benefit for society. Yet, it is not able to identify a perfect governance structure (see *ibid*). Importantly, NIE also introduced the concept of “bounded rationality”, rejecting once more the assumption of perfect information for economic actors (see *ibid*).

2.2.2 Government Failures

“Adam Smith clearly recognized that the wealth of nations is substantially correlated with the wealth of wisdom in their political constitutions.” (Wallis/Dollery 1999, 32) Just like markets, political and legislative systems are imperfect. In particular, the following sources of government failure have been found by public choice theory²:

- Legislative Failures

These are allocative inefficiencies which *“(...) arise from the excessive provision of public goods as politicians pursue strategies designed to maximize their chances of re-election rather than policies which would further the common good”* (Wallis/Dollery 1999, 37) As a consequence, politicians try to please certain interest groups with the provision of public goods, using strategies such as “logrolling”³, which eventually may lead to an oversupply of

² Public Choice Theory is a subset of positive political theory and applies analytic tools of economics to political science problems.

³ “Logrolling” here refers to the exchange of favors for mutual gain; especially the trading of influence or votes among politicians in order to win elections or pass certain legislations.

public goods in the economy and not necessarily foster the well-being of society as a whole.

- Bureaucratic failures

According to W. Niskanen (cited in Rosen 1991, 139) public servants do usually not carry out beneficial public policies effectively because of a lack of right incentives. They will strive to maximize their budget in order to increase their public reputation, power and patronage (see *ibid*). The implementation of effective public policies might be secondary.

- Rent Seeking

Given that government intervention in most cases implies a redistribution of wealth, bureaucrats tend to use the political system to allocate existing wealth toward themselves rather than to the benefit of society (see Rosen 1991, 149). This is a common explanation for government growth and its increasing intervention in the economy.

- Inefficiencies in public good production and delivery

Unlike in the private sector, managers of public entities do not have to make a profit, which can lead to less efficient production and delivery processes (see Rosen 1991, 80). Moreover, if more (public or private) entities are involved (e.g. via sub-contracting) the flow of information and designation of responsibilities can become problematic. These phenomena are known as principal-agent problems (see Rosen 1991, 84).

It has been recognized that “(...) *although governments cannot create wealth per se they nevertheless can play a key role in the process of economic development*” (Wallis/Dollery 1999, 55). Markets and governments are complimentary. Successful development of the private sector depends on appropriate institutional foundations set by the government whose role should essentially be an *enabling* one.

With this brief review of the theories of market and government failure, my aim is to stress that neither institution is perfect or to be preferred over the other. On the

contrary, it is the right balance among sectors, the public and the private, which is able to produce the most desirable results for society and economy. This is also and especially true with regard to strategies for development aid and poverty reduction.

2.3 Aid-based Strategies for Poverty Reduction

Traditionally, efforts to reduce global poverty have aimed at providing financial resources to public or private recipients in the Global South. During the past decades, significant amounts have been donated (and lent) by governments of wealthy countries, multilateral institutions, non-governmental organizations and individuals. Nevertheless, the problem of global poverty persists. In the following chapter, I will provide an overview of aid-based strategies for poverty reduction as well as possible shortcomings. A section will also be dedicated to the “Aid debate” before turning to the role of private business in poverty alleviation in chapter 2.4.

2.3.1 Bilateral Foreign Aid

There are many ways in which bilateral development aid can be granted. It can be a direct government-to-government contribution or pass through intermediary organizations, such as the UN or the World Bank. Sometimes it is granted in the form of specific projects in the recipient country, possibly involving the private sector and/or NGOs (see Werhane et al. 2009, 37) or by debt relief (see Easterly 2001, 124).

Nonetheless, regardless of *how* the financial flows from the Global North to South are organized, it is important to note that bilateral aid is often used as an instrument of diplomacy (see Werhane et al. 2009, 37). Therefore, bilateral foreign aid is typically not only in the interest of the poor recipient, but also to the advantage of the rich donor government which can leverage this instrument to promote its own culture and language, for example, or, in some cases, strengthen its own industries. The latter is especially true when bilateral foreign aid is granted based on conditions set by the donor, such that the recipient is obliged to buy goods or services provided by the donor in return for the aid granted (see *ibid*). Critics argue that such motives of domestic politics actually are more important for the nature and amount of aid granted than the actual needs of the poor (see *ibid*). Yet, some modern forms of

development aid, such as budget support, allow for a transfer of public resources from a donor country to the government in the Global South without any strings attached. The advantage of such untied aid modalities is greater freedom in the allocation of resources according to national needs and priorities for the recipient, leading to improved ownership of policy reforms for development (see UNCTAD 2008, 3). However, their success critically depends on the legitimacy, efficiency and strength of institutions in the recipient country. If these criteria are not met, risks of corruption and misuse of funds prevail (see Wahlers 2008, 15), adding to the debate about the merits of development aid as well as the ideal amount (see chapter 2.3.4)

2.3.2 Aid from Multilateral Organizations

Since the end of World War II, a number of multilateral institutions have been established with the goal to eradicate poverty and promote international development. Within a broader mandate, they also play an important role as providers of development aid. The funding process varies for each institution, but since they are all governmental organizations, all of them depend, at least in part, on contributions from member governments which, in the case of rich nations, usually account for nearly half of the aid budget (see Farlex 2009, [www](#)).

The United Nations (UN)

With social and economic development as one of its core competencies, the United Nations is one of the major authorities in development aid and policy. For that purpose, a number of specialized subordinate bodies have been created, such as the United Nations Development Programme (UNDP), the United Nations Committee for Trade and Development (UNCTAD), the United Nations Office on Drugs and Crime (UNODC) etc. However, policies for poverty reduction efforts are essentially generated within the UN's Economic and Social Council (ECOSOC), also the origin of the Millennium Development Goals (see chapter 2.1.3) (see Werhane et al. 2009, 31). With the adoption of the MDGs, the UN not only set a milestone in the development discourse and measurement, but also established a framework for the strategic disbursement of development aid. Although the international organization assumes a leadership role in achievement of the MDGs by 2015, success ultimately depends on the political will and commitment of its member states (see Werhane et

al. 2009, 34). The provision of financial development aid is critical in this respect. Therefore, the UN invited government officials as well as representatives from International Financial Institutions, the private sector and civil society to the first International Conference on Financing for Development in Monterrey, Mexico in 2002. In the so called “Monterrey Consensus”, the international community committed to increase resources for development, improve the situation of developing countries in the global trading and financial system and agreed upon a process of debt relief for the poorest countries (UN 2002, 3f). A follow up conference was held in Doha, Qatar in 2008, confirming the commitment of the international community and specifying future actions (UN 2010, www). As demonstrated by the Financing for Development Initiative, the UN plays an active role in poverty reduction. However, its resources are extremely limited and entirely depend on contributions from its 192 member states (see UN 2009, www). Economist Jeffrey Sachs is currently in charge of the UN’s effort to reach the MDGs. Being a fierce defender of foreign aid, he essentially calls for a major infusion of foreign capital into developing countries through intermediaries, such as the World Bank (see Werhane et al. 2009, 33). According to his theory, official development assistance (ODA) will accelerate the process of capital accumulation in the Global South, which will eventually raise the level of capital per person and lead to an end of poverty by 2025 (see Sachs 2005).

International Financial Institutions (IFIs)

For the purposes of this paper, the term International Financial Institutions (IFIs) refers to the Bretton Woods Institutions – the World Bank and the International Monetary Fund – and regional Multilateral Development Banks, such as the European Bank for Reconstruction and Development (EBRD), the African Development Bank (ADB) and the Inter-American Development Bank (IADB), which will be discussed in more detail later.

Although the specific mandate may vary among these institutions, they all share a common goal and *raison d’être*: the promotion of economic development and fight against poverty (see United Nations 2009, www). To achieve this goal, they engage in extensive development research and policy advice, additional to their primary role as providers of financing for developing countries. Besides non-concessional loans,

which account for the major part of the World Bank's capital flows to developing countries, it also provides a substantial amount (US\$14 billion in 2009) of grants, i.e. non-reimbursable financial assistance, to the 80 poorest nations through its IDA (International Development Association) window (see World Bank 2009, 55). In the case of the IMF, financial assistance is almost exclusively provided in the form of short-term loans to governments with the purpose of adjusting their balance-of-payments (see Werhane et al. 2009, 35). The 2009 lending volume amounted to SDR⁴ 1.8 billion (see IMF, 2009, 10). The IMF collaborates intensively with the World Bank and the United Nations in poverty reduction, particularly through its country-assessments and poverty reduction strategies (see Werhane et al. 2009, 35).

Another important institution, the World Trade Organization seeks to foster international development through the promotion of free trade and economic integration on a global level (see WTO 2009, www). Although it does not directly disburse large amounts of financial aid, it frequently bears the costs for training sessions for officials hailing from developing countries. The available budget for such activities amounts to approx. 30 million Swiss francs annually (see *ibid*). The WTO also works closely with the IFIs and UN institutions.

Unlike in the case of bilateral aid, financial assistance from multilateral organizations is less dependent on the national interest of one particular donor country. Nonetheless, given that the highest decision-making bodies of these institutions are made up of representatives for the respective member governments, political influence is certainly important. All these financial institutions essentially support a free-market based model of economic development through the promotion of large-scale economic growth (see Werhane et al. 2009, 37). Despite many efforts to eliminate world poverty over the decades, however, their success has been limited as global poverty still prevails. On the contrary, they have frequently been criticized as overly bureaucratic, elitist, conservative and even self-serving (see Yunus 2007, 11) institutions pursuing not always consistent policies. Another point of critique addresses their top-down approach to development which tends to objectify the poor (see Yunus 2007, 12) rather than giving them the opportunity to actively participate in the overcoming of poverty.

⁴ SDR (Special Drawing Rights) is an international reserve asset, artificially created by the IMF in 1969 based on four currencies (US \$, Yen, Euro and British Pound).

2.3.3 Private Philanthropy

Spurred by a moral obligation to share their own wealth with the underprivileged of the world, some individuals in the Global North have made significant donations to developing countries. Often times intermediaries like charitable organizations, NGOs or churches are involved in such investments (see Werhane et al. 2009, 38). The tradition of private philanthropy seems to be more developed in the United States than in any other country of the Global North. In 2006, private philanthropic donations for development amounted to US\$ 34.8 billion, compared to US\$ 23.5 billion official government aid (Hudson Institute 2009, 17). Unlike the IFIs, whose conception and approach to global poverty is primarily related to finance and economics, NGOs, when trying to attract individual philanthropists, tend to present the issue with a “human face”, using compelling stories about individual cases as well as emergencies or disasters (see Werhane et al. 2009, 40). In this way philanthropic agencies intend to make donors believe that their investment is not only personal and urgent but also unavailable from other sources, such as official development assistance (which is typically presented as ineffective or inefficient) (see *ibid*). Many of these private initiatives are also highly specialized on a particular development issue, e.g. The Global Fund to fight AIDS, Tuberculosis and Malaria, The Global Alliance for Improved Nutrition or Education International. However, just as in the case of public resources, there remains a risk that private donations will eventually not reach the poor due to bureaucratic inefficiencies or misuse of funds.

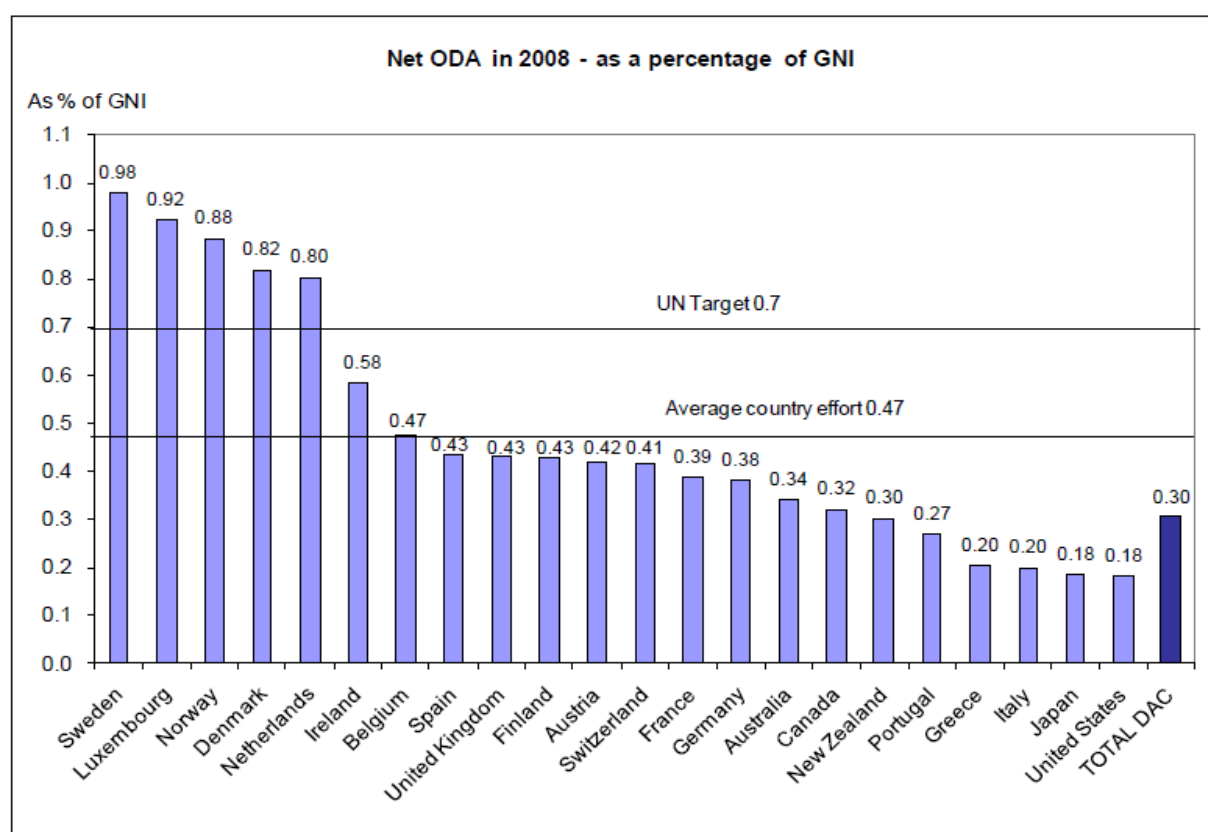
2.3.4 The Aid Debate

During the last 50 years, governments in the Global North have provided over US\$2.3 trillion in economic and humanitarian aid to their developing counterparts (see Easterly 2006, 11). In addition, large amounts of development aid have been provided by multilateral organizations and private individuals.

While some scholars still argue, that this amount is only a fraction of what would be needed to definitely end global poverty (see Sachs 2005), others call for new strategies for development, rejecting the concept of foreign aid as a whole (see Easterly 2006; Moyo 2009). This dispute, also known as the “aid debate”, has

become increasingly prominent in recent years involving scholars and celebrities from the Global North and South (see Pfutze 2007, 8).

The group of aid advocates following UN economist Jeffrey Sachs criticize that too little aid has been given in the past and that governments in the Global North have a moral obligation to increase donations for realistically ending poverty in the poorest countries (see Sachs 2005). In this spirit, leaders of the G8 countries agreed to a substantial increase of development aid at the 2005 summit in Gleneagles (see Collier 2007, 100) and the European Union set the collective goal of increasing the level of development aid to 0.56 percent of GNP by 2010 for its member states, on the way to the UN target of 0.7 percent by 2015 (see Eurostat 2009, www). However, overall compliance with the pursuit of this goal is unsatisfactory, as is evident from the following table.



Source: OECD 2010, www

Figure 1: Net ODA in 2008 as a percentage of GNI

On the other hand, aid critics, such as former World Bank economist William Easterly, claim that development aid more often results the opposite rather than the

desired effect. Instead of spurring growth and reducing poverty, it would encourage corruption, foster dependency and eventually prevent poor economies from developing (see Moyo 2008). Another controversy exists concerning the nature of development aid; if it should rather be granted in the form of loans or grants, conditional or without any strings attached (see Easterly 2006).

Fundamental critics, however, are convinced that, regardless of the nature of financial assistance, due to bureaucratic red tape of aid agencies and governments or severe misuse of funds, the major part of development aid does not actually reach the poor. Backing their arguments with some statistical evidence, e.g. the Global Accountability Report (see One World 2008), they pledge for the discontinuation of traditional aid and propose new models of development cooperation with a more active role of countries in the Global South and different criteria for aid disbursement (see Easterly 2006).

Some scholars, such as Collier (2007) occupy a more pragmatic “middle” position between aid advocates and opponents. Although generally supporting the idea of financial development aid, he criticizes the way in which it has been granted in the past and pledges for new standards and criteria for aid disbursement based on transparency and good governance. Moreover, he emphasizes that aid alone cannot be a solution for the end of global poverty.

2.4 The contribution of business to Poverty Reduction

“(...)[B]usiness contributions to poverty reduction are imperative if the challenges to peace and sustainability are to be seriously addressed.” (Boyle/Boguslaw 2007, 113)

Poverty Reduction has traditionally been considered the responsibility of the government and non-governmental or non-profit sectors (see Boyle/Boguslaw 2007, 115). However, with a decline in confidence in the role of the state as an agent for development (see Jenkins 2005, 529), increasing globalization and interdependence of economies and the limited success of traditional strategies for poverty alleviation (see chapter 2.3), the private sector seems to be emerging as an ever more important actor in society. This tendency was essentially fostered by the policies of

the “Washington Consensus”⁵ which promoted extensive liberalization, deregulation and a drastically reduced role for the state in economies in the Global South (see Jenkins 2005). As a consequence to the limited scope of the public sector, “(...) *firms are now being called upon to go beyond their traditional role of generating economic growth (and thus indirectly helping goals such as poverty alleviation) toward playing a more direct role in [development].*” (see Frynas 2008, 275) This call for greater involvement of private firms in poverty reduction also reflects the growing importance of the resources of the private sector, e.g. in the form of foreign direct investment (FDI) relative to official development assistance (ODA) to developing countries. The amounts of FDI already outpace ODA by a factor of three to one (see Jenkins 2005, 529). Drawing further parallels between the public and the private sector as actors in development, the UN special envoy for HIV/Aids in Africa proposed in 2005 that MNCs contribute 0.7 percent of their annual pre-tax revenues to combating HIV/Aids. This figure corresponds to the UN target for developed nations’ contribution to development aid as a proportion of GDP (see White/Jack 2005, [www](#)).

Recognizing the increasing importance of the private sector as actor in society, the United Nations in 2000 reached out to companies with the launching of the “Global Compact” as a broad-based policy initiative for businesses that are committed to aligning their operations and strategies with principles of good governance in the areas of human rights, labor, the environment and anti-corruption (see Global Compact 2009, [www](#)). Besides the mainstreaming of these principles, which are derived from the Universal Declaration of Human Rights, the ILO’s Declaration on Fundamental Principles and Rights at Work, the Rio Declaration on the Environment and Development, and the UN convention against Corruption, the Global Compact seeks to catalyze business action toward the support of other UN goals, notably the Millennium Development Goals (see *ibid*). Although the Global Compact represents a voluntary initiative which is not legally binding for the companies, it can be regarded as an important campaign to raise awareness for the role of the private sector in development and poverty reduction.

⁵ The term “Washington Consensus” was originally coined by economist John Williamson to describe a list of ten market-liberal policy reforms to be promoted by the Washington-based International Financial Institutions in 1989 (see Williamson 2004)

In addition to the UN, other national and multilateral development agencies have increasingly addressed companies as actors in development, expecting “(...) *that businesses will make long-term investments, and success will be measured not only through profits but through an improved business environment that is characterized by stability, security and peace, and by environmental and economic sustainability.*” (Boyle/Boguslaw 2007, 118) In this way, Brainard (2006) is convinced that “(...) *the private sector can bring to the fight against global poverty the same spirit of leadership, innovation, and initiative – and the same skills in scaling size up, driving costs down, and reaching out to new clients – that success in the global marketplace requires*”(p.3).

Nonetheless, concerns remain with respect to the role of business in development. In their efforts, firms can be tempted to prioritize their own interest over the well-being of society, which might eventually result in little positive, or even negative, contribution to development (see Reed/Reed 2009, 4). Furthermore, as a policy paradigm, a leading role of the private sector in development might contribute to legitimate a regime of business self-regulation which not necessarily fosters poverty alleviation, lacks accountability and transparency (see *ibid*). Fundamental critics thus insist that the responsibility for firms to engage in poverty reduction should not exceed the scope for which they can be held accountable for (see Jenkins 2005). However, as empirical evidence for these accusations is scarce and an evaluation would go beyond the scope of this paper, I will rather point out a variety of corporate actions in the field of poverty reduction with its differences concerning the concept, potential for success and social power relations.

Corporate activities in the field of poverty reduction can take different forms, from philanthropic donations, to business partnerships with the public or non-profit sector to innovative approaches including poor people into the core operations and value chain of a business. After explaining the rationale for firms to engage in poverty reduction, I will elaborate on each of the different activities in the following chapter.

2.4.1 The rationale for business to engage in Poverty Reduction

Debates about the role and responsibility of the private sector in society have been going for decades. While Milton Friedman (1970) argues that the only social

responsibility for business is to increase its profits, other scholars find that corporations as social institutions have an obligation to make broader contributions to the improvement of a society's wellbeing (see Brainard 2006, 16). R. Hahn (2009), for instance, draws upon the concept of Corporate Citizenship⁶ to argue that corporations have an ethical obligation to engage in poverty alleviation. Justification for such action may be found in the Universal Declaration of Human Rights (UN, 1948) which explicitly says that "*[every individual and every organ of society] has duties to the community in which alone the free and full development (...) is possible*". This definition clearly includes private players such as MNEs. According to this theory, governments are no longer the only guarantors of social, civil and political rights, but that the private sector increasingly assumes responsibility for the protection thereof while at the same time developing a corporate stake in these relations. Consequently, corporations take actions which have traditionally been associated with the public domain, such as providing a minimum of economic welfare, security, education and health (see *ibid*). In some cases, corporate codes of conduct can be an effective protection of social rights when governmental standards are not sufficient (see *ibid*).

Besides moral reasons for engaging in poverty reduction, business may also have an own genuine interest in becoming active in this field. Initiatives of Corporate Social Responsibility or Corporate Philanthropy are expected to have a positive impact on the reputation and customer loyalty for firms; yet the value for society of such initiatives is sometimes questionable (see Brainard 2006, 17 and chapter 2.3). Nonetheless, a growing number of business leaders seem to redefine business value beyond pure shareholder value and include social values into core business strategies (see chapter 2.4.4) to substantially foster international development and poverty reduction (see Brainard 2006, 17). Such enterprises are known to operate according to a "triple bottom line", i.e. they develop competitive corporate strategies which at the same time deliver economic, social and environmental benefits (see Hart 2005, 15). Poverty in all its manifestations, of poor education and health, delinquency, crime and unstable local and regional economic development, directly affects business activities in a negative way (see Boyle/Boguslaw 2007, 103),

⁶ Hahn's understanding of "Corporate Citizenship" refers to the fact that the private sector assumes increasing responsibility for the guarantee of social, civil and political citizenship rights in today's societies, thereby complementing and replacing the respective role of governments.

demonstrating all the more the private sectors' stake in resolving this global issue. Some scholars, such as C.K. Prahalad even argue that both goals, the corporate one of generating profits and the societal one of alleviating poverty, can be met simultaneously.

In what follows, I will further elaborate on the different forms of business engagement in efforts of poverty reduction.

2.4.2 Policy Dialogue

A rather indirect way of working toward the alleviation of poverty is the engagement of business in governance⁷ issues and rule-setting (see Reed/Reed 2009, 16). *"The privatization of governance has led to a situation in which political power and institutional capability are less and less rooted in formal constitutional powers, and increasingly derived instead from a capacity to wield and coordinate resources from a variety of state and non-state actors"* (Prieto-Carron et al. 2006, 985). Businesses have thus increasingly engaged in policy dialogue and lobbying for changes that affect economic as well as social policy. Unofficially, they have long become an accepted political player (see Hahn 2009, 318). Unlike strategies which intend to make the goal of poverty reduction part of the core business activity, *"(...) [T]he activist/advocate approach requires firms to engage in the policy process rather than try to solve the problem of poverty themselves"* (Boyle/Boguslaw 2007, 111). Companies can resist corruption, advocate human rights and promote change in public policies, alone or through multi-stakeholder initiatives, i.e. in collaboration with other businesses, NGOs or international (governmental) organizations (see *ibid*). Such advocacy for social issues implies a new role for companies (see *ibid*). Although some assert it an important potential for societal change, it implies some serious legitimacy issues as MNEs lack the legitimization procedures of state actors (see van Heerdenn/Bosson, 2006, 38) and are often accused of a lack of transparency and accountability in their actions (see *ibid*). This is particularly problematic in cases where corporations abuse their influence on official public decision makers and put downward pressure on wages and working conditions,

⁷ With "Governance", I refer to the *"coordination and coherence among a wide variety of actors with different purposes and objectives, such as political actors and institutions, corporate interests, civil society and transnational organizations."* (Prieto-Carron/Lund-Thomsen/Chan/Muro/Bhushan, 2006, 985)

avoid taxes and lobby against social and environmental regulation (see Prieto-Carron et al., 2006, 985). Furthermore, corporations have tended to advocate for voluntary codes of conduct and certifying initiatives rather than legally binding business regulation (see Boyle/Boguslaw 2007, 113) and supported the privatization of public goods and services, which might not always be in the best interest of poverty reduction (see Reed/Reed 2009, 16).

Evidently, MNCs are powerful players in the global economy with a potentially large influence on politics and society. Progress in the alleviation of global poverty will critically depend on how this influence is exercised. If corporations actively work to strengthen the ability of governments to reduce poverty (see Boyle/Boguslaw 2007, 116) and strive to facilitate social dialogue among their stakeholders toward a creation of effective “multi-stakeholder initiatives”⁸, their contribution to global poverty reduction can indeed be significant.

2.4.3 Corporate Social Responsibility and Corporate Philanthropy

Corporate Social Responsibility, defined 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*” (European Commission 2001, 6), was originally an initiative adopted by individual companies in the late 1990s (see Jenkins 2007, 529). In the attempt of avoiding legally binding regulations, MNCs and governments of the Global North proposed self-regulation as an alternative for business conduct (see Jenkins 2005, 527). However, given that such activities “*are voluntary, discretionary and dispersed across various nation states, accountability is difficult if not impossible*” (Boyle/Boguslaw 2007, 115). As of now, there exists no mechanism to hold companies accountable for their promises made (see *ibid*). This is why CSR has been frequently criticized as serving only corporate interests, primarily “*(...) as a public relations tool, a way to deflect criticism, engage critics and potentially capitalize on emerging business opportunities associated with doing, and being seen to be doing, good*” (Newell/Frynas 2007, 670), instead of truly contributing to the wellbeing of society at large.

⁸ “Multi Stakeholder Initiatives” are forums or organizations that include various parties such as companies, NGOs, trade unions, and government agencies and can take different forms, for example as learning forums (e.g. the UN Global Compact) or certification bodies (e.g. the Fair Labor Organization). (see van Heerdenn/Bosson, 2006, 43)

Traditionally, CSR activities have been concentrated in areas of labor rights and environmental issues; over the last years, however, with an emerging role for the private sector in development, CSR goals have increasingly been linked to international development and poverty alleviation (see Jenkins 2005). This tendency has largely been supported by the UN Global Compact, the MDBs which launched their own initiatives to foster CSR activities in this field and national development agencies. Nevertheless, critics often point out that the impact of CSR programs is insignificant except for a limited number of rather specific cases (see Boyle/Boguslaw 2007, 114) because such initiatives are usually not only employed without prior consultations with affected stakeholders in society (see van Heerdenn/Bosson, 2009, 40) but are also conditional on aligning with the overarching business mandate to generate profits and because they are often misused by companies for marketing purposes (see Yunus 2007, 17). Limitations of CSR activities seem to be all the more evident in the area of international development and poverty reduction (see Prieto-Carron et al., 2006). In addition to a lack of accountability, CSR efforts to alleviate poverty are often bound to fail due to a lack of corporate commitment and the conflict of interest between short-term financial profits and the need for long-term investment in poverty reduction. Furthermore, given that CSR agendas are still dominated by environmental or human rights issues, respective corporate action is currently predominantly defined in negative terms, i.e. by actions firms should *not* do (like harming the environment, employing child labor, disregarding labor standards etc.) whereas a focus on poverty reduction would require a more positive commitment, such as discriminating in favor of the poor in employment to include them into the formal economy (see Jenkins 2005, 540). Currently, MNCs employ often only few local (poor) people in countries of the Global South. As most of these corporations also do not produce goods for the poor, which could be provided to them at lower costs by “socially responsible pricing”, the poor don’t have a stake in the company as producers or consumers (see *ibid*). Given the central role of a company’s stakeholders in any corporate activity, as well as in CSR, the fact that the poor are excluded from such strategic decisions severely undermines the potential of CSR to significantly contribute to poverty reduction (see *ibid*).

Most importantly, however, poverty reduction strategies based on CSR or corporate philanthropy do not contribute to a structural change in society which would allow the

poor to exit the vicious cycle of poverty (see Prieto-Carron et al., 2006) or the “poverty trap” (see Collier 2007). This also explains why “[c]orporate practices such as transfer pricing, tax avoidance or the abuse of market power are not part of the CSR mainstream” (Jenkins 2005, 528). Likewise, potential ideological underpinnings of CSR, the actual agenda setting (i.e. which issues are included or excluded from CSR initiatives) as well as the absence of gender, class and race in CSR issues are debatable and demonstrate limitations of this corporate approach to poverty reduction (see Prieto-Carron et al., 2006, 979).

The fact that there currently exist no methodologies to systematically assess the impact of CSR on poverty reduction once again stresses the shortcomings in the evaluability of CSR actions and the possibility to hold companies accountable for their acts or omissions. As of today, we lack appropriate tools to rank multinational companies in terms of their CSR activities or to systematically compare CSR initiatives of different companies within the same industry (see *ibid*, 987).

2.4.4 Core Business Activity

Apart from engagement in poverty reduction through lobbying or CSR, some private sector organizations have declared poverty alleviation as a corporate priority by including it into the core business activities. The essential difference of this approach is that it does not rely on the benevolent intent of executives or philanthropic expenses (perhaps at the same time intended to improve the company’s image) but that it effectively seeks to combine the company’s mandate to generate profits with the goal to reduce poverty. On a more philosophical note, this reflects Stuart Hart’s (2005) vision of a “(...) *new, more inclusive form of commerce (...) that lifts the entire human family*” and contributes to a sustainable future.

In what follows, I am going to present three different organizational forms which aim to fulfill this double-mandate:

2.4.4.1 Social Entrepreneurships

Although some scholars (e.g. Yunus 2007, 31) clearly differentiate between the terms “Social Entrepreneurship” and “Social Business”, defining the latter as a subcategory of the broad endeavor of “Social Entrepreneurship” which accordingly describes “(...)

any innovative idea to help people (...)” (ibid), I will use the terms synonymously, as do Werhane et al., Boyle/Boguslaw etc.. By their definition, social entrepreneurships are businesses with a social mission, i.e. with the goal to create value for the society at large and not just for their shareholders (see Werhane et al. 2009, 118; Boyle/Boguslaw 2007, 110). They often attempt to tackle problems such as lacking access to infrastructure, water and sanitation, health services etc. A prominent example for a social enterprise is the microfinance institution Grameen Bank founded by Nobel Prize winner Muhammed Yunus with the explicit purpose of reducing poverty among the rural poor in Bangladesh (see ibid). Social enterprises can either be organized as commercial for-profit organizations, as NGOs or as hybrids. While the Grameen Bank is a traditional for-profit venture, one of its spin-off, the Grameen Foundation, a US-based NGO providing assistance to micro-lending start-ups, relies on donations for its financing (see Werhane et al. 2009, 118).

Social enterprises can become models applying best business practices in many ways: creating favorable working conditions for their employees, favoring long-term sustainability over short-term profits, partnering with other public and private institutions in formulating and implementing a comprehensive approach to poverty reduction (see Boyle/Brainard 2007, 117). Their defining characteristic is to generate social change and improvement of social capital⁹ through well-managed business activities (see Werhane et al. 2009, 119).

Another form of social entrepreneurship is community-based business, also known as co-operatives. Such ventures usually originate in communities facing difficult circumstances such as a market collapse, unemployment or environmental disasters with the purpose to improve the situation for the community members through their immediate involvement (see Werhane et al. et al 2009, 119). Constitutive for community-based enterprises is that they are integral to the community since they are essentially created by “(...) *community members acting corporately*” (ibid) to meet their common economic, social, and cultural needs through a jointly-owned and democratically-controlled enterprise (see ICA, 2009, www). Co-operatives are based on the values of self-help, self-responsibility, democracy, equality, equity and solidarity (see ibid). The community of LLocllapampa in Peru has established an

⁹ In this context, “Social capital” refers to the well-being of a community or social ecosystem (see Werhane et al. 2009, 119)

enterprise of such type for its agricultural activities. By working as a unit, the community has been very successful in improving its technology, productivity and technical know-how of its members (see Werhane et al. 2009, 119).

Foundations, such as *Ashoka* or *Avina*, have supported the work of social entrepreneurs through stipends, professional contacts and access to a global network of peers to foster exchange and promote ideas for inclusive private sector development (see Ashoka 2010, www; Avina 2010, www).

2.4.4.2 Public-Private-Partnerships (PPPs)

Public-Private-Partnerships (PPPs) *“(...) can be defined as arrangements whereby private parties participate in, or provide support for, the provision of infrastructure, and a PPP project results in a contract for a private entity to deliver public infrastructure-based services”* (Grimsey/Lewis 2004, 13). *“The role of business is to improve the efficiency of the delivery of public services, while the regulatory role of government is to ensure that efficiency gains are passed on to the public and that access and affordability are maintained for vulnerable sectors of society”* (Reed/Reed 2009, 13)

The Public-Private-Partnership approach thus represents a more traditional form of corporate engagement in poverty reduction as it does not require any specific sense of social responsibility (see Reed/Reed 2009, 13) but can be described as a form of sub-contracting from the government. With economic liberalization as the predominant policy paradigm, this business concept grew increasingly popular in the Global North as well as South during the 1990s (see Reed/Reed 2009, 5) and found implementation in a variety of sectors, ranging from transportation and electricity to telecommunications, health and water (see Grimsey/Lewis 2004, 221). Given the incapacity of governments in the Global South to sufficiently invest in the provision of public goods, development institutions such as the UN, the World Bank and others have increasingly promoted PPPs as a policy alternative (see *ibid*).

However, private investment in developing countries faces much higher institutional risks than in countries in the Global North. Legal and regulatory frameworks are often incomplete or unstable, and payment for the services delivered is not always ensured due to the lack of financial resources (see Grimsey/Lewis 2004, 221). Moreover,

governments in the Global South usually lack the experience with private sector involvement in the provision of public goods and have limited capabilities to deal with MNEs (see *ibid*). Likewise, MNEs often have limited knowledge about the implications for business in the Global South (see Werhane et al. 2009, 107). Due to these obstacles, it is questionable whether PPPs in countries in the Global South have actually met their expectations and significantly contributed to a positive development. In fact, in the corporate world it has been estimated that nearly 50% of all partnerships either underperform or fail (see Brainard 2006, 22). Although, during the past 15 years, PPP arrangements have become increasingly popular for the provision of infrastructure in developing countries, only 20-25 % of total investment has actually been provided by the private sector, drawing upon institutional risks, such as long pay-back periods or difficulties in collecting cost-recovering tariffs (see Reed/Reed 2009, 15). These factors further increase the cost of capital in the Global South which ultimately requires charging the local, poor population more than their counterpart in the Global North (see *ibid*). To ensure that their costs are being covered, corporations have made use of a number of measures, such as prepaid meters, cutting off informal connections, suing defaulters etc. (see *ibid*), which may well have proven effective in cost-recovery, however, even less so in altering living standards for the poor who were deprived of essential services. Likewise, many governments in the Global South have failed to ensure equal access and affordability of services for all segments of society, most notably because of their own shortage of fiscal resources and incapacity to provide adequate subsidies (see *ibid*). It is also not clear if increased involvement of business in the provision of public goods has had an impact on fighting corruption in the public sector (see Reed/Reed 2009, 15), another common expectation from PPPs.

Nonetheless, combined efforts between the public sector, which “(...) *can help corporations gain policy access to governments, provide convening authority, mitigate risk, and share significant accumulated expertise in developing countries*” (Brainard 2006, 22), and private business, characterized by its operational savvy, ability to organize and capability to create value for the poor, can be a promising approach to global poverty reduction if potential partnerships are based on “(...) *open communication, transparency, clarity of roles and ground rules, and regular opportunities for evaluation*” (*ibid*, 23). Yet, the success of PPPs largely depends on

the specific circumstances, which is why critics have argued that, “(...) *while privatization is not necessarily inappropriate in some cases, there is no justification for international bodies to actively promote privatization on the basis that it will improve infrastructure deficiencies in the South*” (Budds 2003 In Reed/Reed 2009, 16).

2.4.4.3 Inclusive business: Bottom-of-the-Pyramid Models

Probably more than any of the approaches mentioned above, the relatively young concept of inclusive business essentially foresees an active, leading role of multinational corporations in poverty alleviation. The improvement of living conditions of the poor is an explicit corporate goal for inclusive businesses and integral part of their value chain (see UNDP 2009, [www](#)).

According to this approach, championed by C.K. Prahalad (2005), the poor are considered as an underserved or untapped market with a huge potential for a win-win situation for business as well as society: By entering into these markets, corporations have an opportunity to generate profits while at the same time improving the living standards of the impoverished through the delivery of goods and services and/or the creation of employment. Moreover, the idea is to use the Bottom of the Pyramid as a source of entrepreneurship and innovation where economic activity can be fostered by corporations from the bottom-up (see Boyle/Boguslaw 2007, 109). The pyramid is used as a metaphor for the income distribution in society, with the top representing the wealthy minority and the bottom representing the population with low incomes, which according to Prahalad (2002) amounts to 4 billion people worldwide (for a detailed discussion of Prahalad’s model and assumptions see chapter III).

Among other goals, BoP models seek to include poor people into the formal labor market (see Karnani 2006), and thus comply with recommendations by the International Labor Organization (ILO) according to which “*creating decent employment opportunities is the best way to take people out of poverty*” (ILO 2009, [www](#)). In many cases, BoP business models also have a strong micro-finance component, in particular with the aim of supporting poor people in their efforts to develop their own business, i.e. micro-enterprise, to make their way out of poverty. The concept of “Microfranchising” as a form of BoP business combines precisely

these two components. According to this approach, microentrepreneurs (microfranchisors), who wish to expand their well-established and profitable business but lack the necessary capital and managerial skills, collaborate with people willing to start a self-employment venture (microfranchisees). In a mutually beneficial partnership, the microfranchisor (typically MNCs, NGOs or independent business persons) gets the opportunity to expand his/her business and at the same time provides operational and ownership opportunities for people with little capital or business experience (see Fairbourne/Gibson/Dyer 2007, 25).

During the past years, inclusive business models have attracted increasing attention from corporate leaders as well as academics. Furthermore, several international organizations such as the World Resources Institute, the United Nations Development Program and the World Business Council for Sustainable Development have launched programs for BoP business development. However, among Multilateral Development Banks, the Inter-American Development Bank is currently the only one with a specific department devoted exclusively to such operations. A detailed discussion of the IADB's engagement in BoP transactions will follow in chapter 4.

3. THE BOTTOM OF THE PYRAMID MODEL

“(...) [T]he only way to spur sustainable growth for the long term is to define a development strategy that focuses on the unmet needs in the developing world itself, the base of the pyramid.” (Hart 2005, 129)

3.1 Origins

Despite large scale development aid provided by public as well as private institutions and well-meant strategies for poverty reduction (see chapter 2), global poverty still prevails. In the attempt of a fresh *“intellectual journey”* (Prahalad 2005, xi), Prahalad thus rejected the mere refining of traditional approaches, such as development aid, subsidies, governmental support, local NGO-based solutions or reliance on deregulation and privatization of public goods and came up with a new idea how to address the problem. Together with his colleague Stuart Hart (2002), he developed an alternative approach to poverty reduction; one that for the first time focused on the

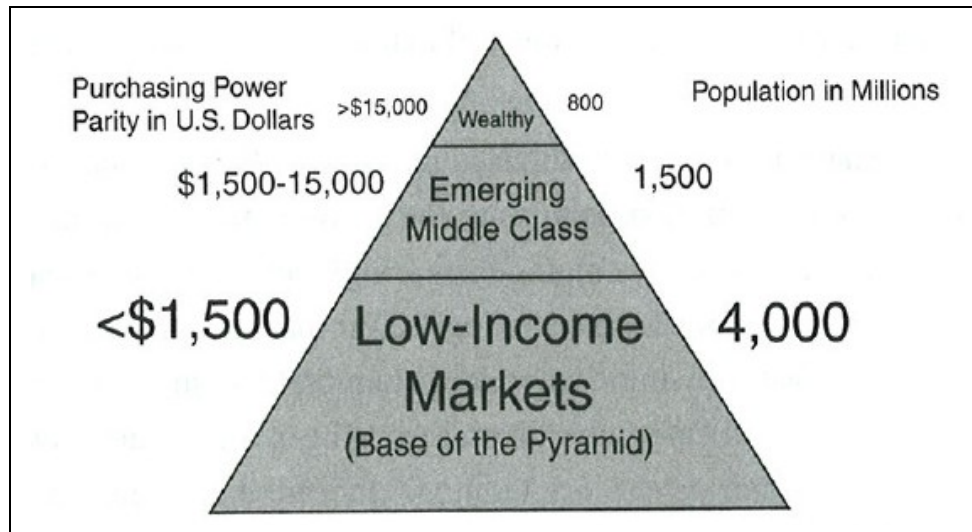
large-scale private sector as the leading actor in development. Their strategy for poverty alleviation does not aim at the mobilization of large sums of development aid but rather on “(...) *partnering with [the poor] to innovate and achieve sustainable win-win scenarios where the poor are actively engaged and, at the same time, the companies providing products and services to them are profitable.*” (Prahalad 2005, 3)

Backed by an evident need for action in combating the rising inequalities and disproportional benefits for the well-educated which are (among other factors) the result of the lower than overall economic growth at the bottom of the income distribution (see Deaton 2004, 10) and increasing support from international high-profile initiatives, such as the United Nations Global Compact, the UNDP’s Growing Inclusive Markets Initiative and the IADB’s Opportunities for the Majority Initiative, Prahalad/Hart’s concept for a leading role of the private sector in development seems to find increasing acceptance among the business community (see Martin, Dana 2009).

3.2 The Model

For the purposes of their model, Prahalad/Hart (2002) use the pyramid as symbol for the global income distribution. The top is represented by the wealthy minority which generates up to US\$ 15,000 per year, while the vast majority is made up by the low-income segment, or the “Bottom-of the-Pyramid” (BoP). When speaking of the BoP, Prahalad (2005) refers to the global population which lives on less than US\$2 per day. He thus uses an income-based measure of poverty (see chapter 2.1.1) for his definition, which does not only include people living in extreme poverty, i.e. on less than US\$1 per day (according to World Bank definitions) but also those facing moderate poverty. According to his estimation, more than 4 billion people worldwide belong to this category (see Prahalad 2005).

Figure 2: The Global Economic Pyramid



Source: Hart (2005)

However, despite being the most impoverished and disadvantaged segment of society, Prahalad/Hart (2002) argue that the BoP can be a powerful source of entrepreneurship and innovation whose potential has barely been recognized by (multinational) companies. In addition, MNCs could profit from transforming the BoP into a new target market for their products and services. Since the BoP is currently largely unserved by businesses, engaging in this untapped market could represent an important growth opportunity for (multinational) corporations.

The core concept of the BoP approach is to create a win-win scenario for both, companies and the poor. Directing profitable business activities at this low-income population and incorporating it into the formal economy is meant to result in gains for the companies and, simultaneously, for the poor who will benefit from enhanced capabilities, a higher standard of living and eventually, the overcoming of poverty.

By placing an emphasis on the profitability of the business activity, the BoP approach essentially differs from models based on corporate social responsibility or philanthropy. The BoP approach recognizes the potential of low-income populations as economic actors in the form of customers as well as producers, and aims at businesses that wish to reach new markets, in contrast to companies seeking to obtain good will from sponsorships or community outreach. Furthermore, it

recognizes people at the BoP as innovators in the market place, capable of developing new approaches and technologies that can open new opportunities and, at the same time, challenge existing business practices (see IADB 2006, 6). A key assumption of the BoP approach is the increasing importance of the low-income market for business growth and innovation in the future (see *ibid*).

Currently, economic activities and employment in low-income markets are largely dominated by the informal economy (see ILO 2002). Economic activities in this sector are characterized by an absence of legal regulation, with regards to taxation as well as labor standards and social security. Due to their informal nature, they are not considered in the determination of a country's GDP, although it is estimated that the informal sector accounts for up to 75 % of economic activity in some developing countries (see *ibid*). Formalizing this sector would generate benefits for the government (through a higher tax return), the BoP population (through regulated employment and labor standards) and businesses for which tapping into the informal sector can be an important opportunity for expansion and growth.

With the BoP approach Prahalad (2005) calls for a reconsideration of traditional assumptions by MNCs such that the poor should not be targeted as customers due to their lacking purchasing power or because they would not have a use for products that are typically provided to higher income markets. It is precisely because of such beliefs that the BoP has remained a largely underserved market. Due to the lacking supply of goods and services tailored to the needs of the BoP, people belonging to this segment often times have no other choice but to resort to offers at high costs, thereby incurring in the so called "poverty penalty" (Prahalad 2005, 11) or "poverty tax" (Hoyt/Jamison 2007, 116). Prahalad associates this phenomenon with the perseverance of local monopolies, inadequate access, poor product distribution and strong traditional intermediaries – circumstances which he would like to see challenged by private-sector corporations (see Prahalad 2005, 11). He thus makes the case for an "inclusive capitalism" with free and transparent private sector competition in the BoP market, allowing the poor to actively participate in the economy. Despite its limited purchasing power, the BoP population can still represent an important market for corporations because of its size. According to Prahalad's assumptions, the BoP population outnumbers the rest by almost two to one. Equally

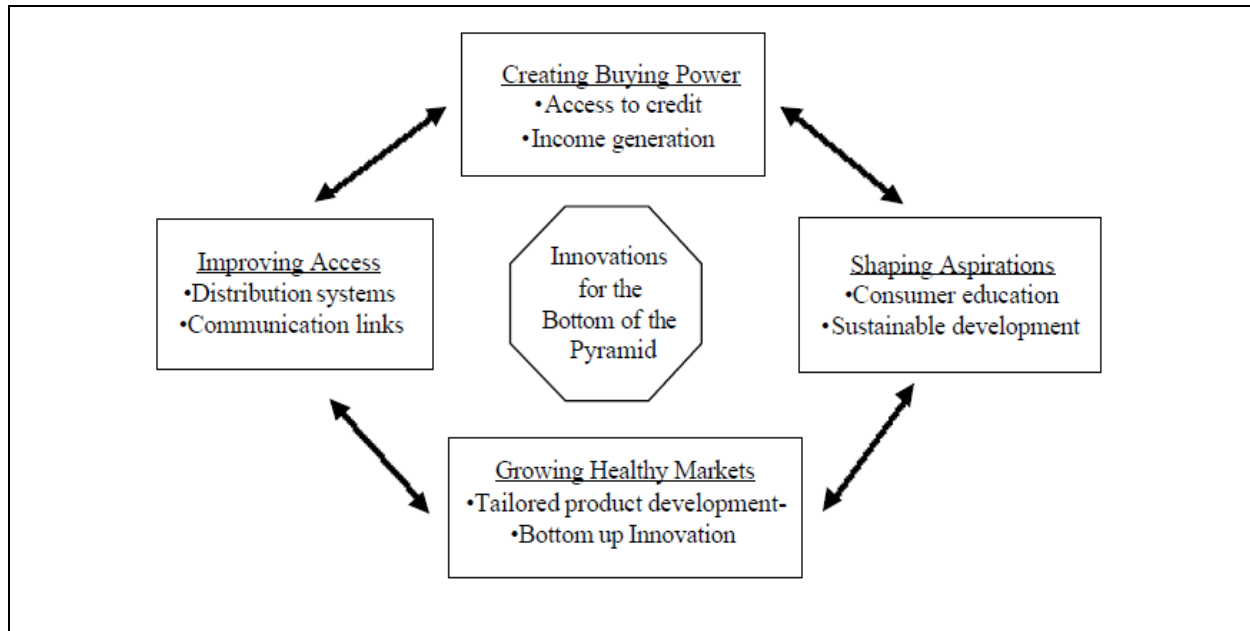
important is the fact, that the majority of the BoP can be characterized as “aspiring poor” (Prahalad/Hart 2002, 4). Thanks to the rapid advance of modern communication technology and increasing media penetration even in the most rural parts of the Global South, the poor are increasingly aware of their misery and ever keener on overcoming it (see Prahalad/Hart 2002, 7).

Moreover, the BoP approach calls for a break with traditional perceptions and attitudes toward private and public institutions. Because of their traditionally non-for-profit orientation and mandate to serve the common good, public institutions are often perceived as “morally purer” (Werhane et al. 2009, 108) than organizations belonging to the private sector which are essentially characterized by their profit seeking nature. Arguably, MNCs must be held accountable for unsustainable business practices which in the past have sometimes exacerbated poverty and exploitation. Likewise, however, public institutions can be accused of inefficient management, misuse of (donor) funds and corruption. Since the BoP approach aims at a strong engagement of the private sector in the provision of social services, which were traditionally provided by public institutions, it is crucial for its success that the traditional black-and-white thinking of the “greedy business” and the purely social welfare oriented public monopoly is overcome (see Werhane et al. 2009, 108). The very concept of the BoP model places an emphasis on precisely the reconciliation of *profitable* business for the *common social benefit*.

3.3 Business Strategies for the BoP

After identifying the BoP population, Prahalad/Hart (2002) lay out the business strategies for targeting this low-income segment. They call upon international business to create an organized market out of this largely informal part of the economy. To this aim, a commercial infrastructure for the BoP (see figure 3) will have to be established in collaboration with a number of public and private actors on the local, national and international level (see Prahalad/Hart 2002, 9).

Figure 3: Commercial Infrastructure for the BoP



Source: Prahalad/Hart (2002)

Firstly, it is necessary to **create buying power among the BoP population**. Half of the world's population lives on less than US\$2 per day and another 20% face extreme poverty, i.e. has to survive on US\$1 per day. In order to break this vicious cycle of poverty, Prahalad/Hart suggest two interventions:

1) Facilitation of access to credit

One way of increasing the purchasing power of the poor is to facilitate their access to credit so they can systematically build their equity and develop into a stable consumer market. Since the poor are usually associated with a higher credit risk and yet are not in the possession of collateral, it is nearly impossible for them to receive credit within the traditional banking system. Consequently, they often resort to local moneylenders who charge exorbitant interest rates¹⁰ on the sums provided, making it impossible for the poor to break out of poverty (see Prahalad/Hart 2002, 10). Essentially in response to this reality, the Grameen Bank of Bangladesh, founded by

¹⁰ In Mumbai, India, for example, local money lenders charge interest rates of up to 20% per day. (see Prahalad/Hart 2002, 10)

Nobel Prize winner Muhammad Yunus in 1983, launched a micro-credit program which later revolutionized approaches to poverty reduction and development. By lending to small groups of women, the bank substituted physical collateral with local knowledge and peer pressure, which has proven even more effective as mitigation of credit risk. Grameen Bank is proud of its 99% repayment rate (see Yunus 1998). The access to micro-credit has not only empowered poor Bangladeshi women and enabled them to start their own micro-enterprise, but also led to a substantial creation of employment and positive transformation of the overall standard of living at the village level (see Prahalad/Hart 2002, 11). In recognition of this successful approach to poverty alleviation, numerous multilateral institutions from the UN to the World Bank, national development agencies as well as commercial banks have engaged in the micro-lending business throughout virtually all countries of the Global South.

2) Creation of opportunities for income generation

In addition to the employment opportunities created through the establishment of micro-enterprises, Prahalad/Hart (2002) argue that MNCs can be important drivers of employment generation. By sourcing raw materials based on sustainable criteria, MNCs such as Nestle or Starbucks can create employment with stable income under conditions complying with international labor standards for hundreds and thousands of small producers in the Global South.

A second priority for MNCs engaging in BoP business activities should be the **shaping of aspirations of the poor**. Thanks to increasing media penetration and ever more widespread use of modern communication technologies and the internet, poor people have better access to information, but may also run the risk of adopting a distorted view of the world. Television and commercials might thus trigger aspirations among the poor to achieve a lifestyle associated with the affluent societies in the Global North. However, a replication of the contemporary consumption patterns of today's richest nations will not be physically possible given the limited natural resources of our planet (see Prahalad/Hart 2002, 13). Consumers at the BoP must thus be educated to form aspirations that are compatible with the concept of sustainable development, which by definition of the UN's Brundtland Commission (1987) refers to *"(...)meeting the needs of the present without compromising the ability of future generations to meet their own needs."* Such

consumer education can be provided in entertaining, yet informative ways through the media or through novel channels, such as sales people who are members of the BoP themselves (see Prahalad/Hart 2002, 13). Thereby new sustainable ways of living can be promoted for the low-income population segments, without repeating the environmental mistakes of the Global North.

Unsustainable business practices during the past decades led to a concentration of power and resources in the hands of a small elite and a growing gap between the rich and the poor. If MNCs truly want to bring about change and shape a sustainable future for all, they must strive to **create healthy markets** which foster local solutions and generate wealth for the masses at the BoP (see Prahalad/Hart 2002, 18). Key to this objective is the development of products and technologies tailored to the specific needs of this population segment. Hindustan Lever Limited (HLL) has been very successful in reaching the BoP in India with single serve packages of detergent (see chapter II.4). For the development of such solutions, consideration of local knowledge is critical: *“To be effective, strategies for the bottom must originate from the bottom of the pyramid”* (Prahalad/Hart 2002, 19). **Bottom-up Innovation** is therefore essential for success.

The fourth element in the commercial infrastructure for the BoP is **improved access** for the poor **to distribution and communication systems**. In many countries of the Global South, poverty is especially prevalent in rural areas. Due to lacking infrastructure people living in those areas neither have access to products and services offered by (multinational) companies, nor do they have the possibility actively participate in the market themselves by selling their own produce to a larger number of clients (see Prahalad/Hart 2002, 15). To be successful, MNCs therefore need to develop effective distribution systems which reach the BoP even in the remotest areas and facilitate their market access. The use of modern communication technologies such as mobile phones and the internet can be key to this endeavor as reflected by the example of Celtel and Celpay in the Democratic Republic of Congo (see chapter 3.4 b)).

3.4 Examples

Since its launch in the early 2000s, Prahalad/Hart's novel approach to business led poverty alleviation has captured increasing interest by a growing number of development institutions. The Dutch Development Agency has partnered with the World Business Council for Sustainable Development to implement projects targeted to the Base of the Pyramid. The United States Agency for International Development and the Canadian Development Agency have also expressed their interest in the BoP concept (see IADB 2006, 2f). In 2006, UNDP launched its "Growing Inclusive Markets" initiative with the aim to share best practices regarding BoP business cases worldwide. The World Bank has also become active in the BoP area, mostly through its private sector organization, the IFC, which runs a special "Grassroots Business Initiative" to develop small businesses in the BOP (see *ibid*). Among the regional Multilateral Development Banks, the IADB currently seems to place the strongest emphasis on promoting the BoP approach. In 2007, it launched the "Opportunities for the Majority" (OMJ) initiative (see chapter 4.7), which exclusively funds private sector BoP business ventures, as one of the core strategies for the term 2007-2011 and created an own department for these operations within its Private Sector Department. However, other regional MDBs, and the IFC in particular, have also demonstrated growing interest in supporting BoP transactions (see Martin, Dana 2009). Thanks to this increasing popularity, more and more "model cases" for successful BoP transactions are put in place. In the following section, I will present two such examples for a better illustration of this approach.

a) Hindustan Lever Limited (HLL): Success through "single servings"

Hindustan Lever Limited (HLL) is the Indian subsidiary of the multinational food company Unilever. Its product line includes food, beverages, personal items and detergents. During the 1940s until the 1980s, when India's economy was strictly regulated and closed to foreign investment, HLL particularly focused on the domestic urban market and evolved as market leader in several product categories, notably soaps and detergents (see Rangan/Sehgal/Rajan 2007, 144). In the 1990s, however, the Indian economy increasingly opened up and restrictions on imports as well as foreign investment were eased. GDP grew at about 6 % annually and was

expected to continue at such pace in light of the increasing global economic integration. These projections promised the development of a sizable middle- and lower income market, especially concentrated in rural India (see *ibid*). As urban markets were increasingly penetrated by foreign competitors, some local firms, such as the detergent manufacturer Nirma, developed a growing interest in the rural low-income market. Nirma introduced a new business model including a new product formulation, low-cost manufacturing process, wide distribution network; small packaging for daily purchasing at a lower price (see Prahalad/Hart 2002). HLL's top management quickly responded to Nirma's growing competition, also recognizing the potential for future growth and expansion at the BoP despite its evident lack of infrastructure, low literacy levels as well as rudimentary commercial infrastructure and poor reach of electronic media. It developed a new detergent brand called "Wheel" with a much lower of water-to-oil-ratio in the product which was especially targeted to the BoP population who often washes their clothes in rivers and other public water systems. Nirma's business was challenged by HLL decentralizing its production, marketing and sales process and revision of the entire cost structure of its detergent business which allowed the introduction of "Wheel" at a low-cost and single-serve basis. Prahalad (2005) finds that single-serve packaging is ideal for the BoP as it is the best marketing response to unpredictable income streams of the poor. While the rich are able to afford purchases in larger quantities, the poor tend to buy only when they have cash available and are shop only what they need for the day. This is why according to the author "(...) *the basic economics of the BoP market are based on small unit packages, low margin per unit, high volume, and high return on capital employed.*" (Prahalad 2005, 24) This represents a stark contrast to business economics of up-scale markets which are characterized by large unit packs and a high margin per unit. Managers must thus realize that the economics of the BoP can still be very profitable, if yet uncommon (see *ibid*). The market size is key. While rural India itself represents a huge BoP market which contributed substantially to HLL's annual growth rates of 25% (see Prahalad/Hart 2002), Unilever leveraged its multinational corporate presence to take the business model from India to BoP markets in Brazil, Indonesia and China, increasing its returns and at the same time, expanding opportunities for millions of poor people by providing quality products to meet their basic needs.

b) Celtel and Celpay: ICT solutions for post-war Congo

Celtel International is a subsidiary of the Kuwait-based leading pan-African mobile telecom company MTC. It launched operations in the Democratic Republic of Congo (DRC) in 2000, during highly difficult circumstances related to the ongoing civil war. Despite enormous challenges regarding the uncertain political and regulatory environment, the lack of security and infrastructure, widespread poverty and illiteracy and absence of a country-wide banking network, Celtel realized the promising potential for BoP business in the DCR, which is one of the fastest growing African economies (see de Catheu 2007, 4). The company understood that telecommunications could help building up the lacking infrastructure, which is particularly important for the rural poor engaging in subsistence agriculture (which accounted for 49% of GDP in 2006) and informal activities (see de Catheu 2007, 6). Furthermore, telecom services can play an important role in the reunification of separated families and communities and in accessing information related to health, education and business. Celtel's business model essentially focuses on the selling of cheap (second hand-) handsets operated with pre-paid cards of a value from US\$3 to US\$50 to low-income populations. The use of shared handsets, either within a family or through a small community business led by a local woman, is especially encouraged (see *ibid*). With this innovative approach, Celtel has gained two million customers during 2000-2006 and expects further growth through intensive upscaling in DRC and neighboring countries. By 2010, the company intends to serve 10 million customers. Due to the low penetration of landlines (10.000 for a population of approx. 55 million in 2002) and mobile phones (10.000 users) at the time of Celtel's entry into the Congolese market (see de Catheu 2002, 8), the company's revenues per customer in DCR significantly exceed the ones in more developed markets (see *ibid*). In addition to the provision of traditional mobile telecommunication services, Celtel established a subsidiary, Celpay, the first phone banking operator in DRC (*ibid*). Customers can manage their bank account by mobile phone and/or the internet and money transfers as well as payments (e.g. for pre-paid phone minutes) can be made via encrypted SMS. Given the absence of a sound banking system in DRC, Celpay fulfils an important role as provider of such services in a non-traditional way. In 2006, the number of accounts managed by the company was 20.000 (see *ibid*). Since mobile banking and phone banking are inter-

operable; they generate economies of scale and the client base of one activity can be leveraged for the other, promising further growth opportunities in the country and the region where capital investment and large scale job creation at the BoP are urgently needed.

3.5 Points of critique

With the introduction of the BoP Model by Prahalad/Hart did not only come praise but also much criticism by academics, business leaders and civil society representatives. In the following chapter, I will try to provide a summary of the most important points of critique on the Bottom of the Pyramid model.

a) Narrow definition of poverty and development

A fundamental weakness of Prahalad/Hart's model is their one-dimensional definition of poverty, which is exclusively based on personal monetary income. It thereby promotes to a normative understanding of poverty as a purely economic problem (see Werhane et al. 2009, 47). However, as has been discussed in substantial detail in chapter I, most scholars nowadays concur that poverty cannot be defined solely in economic terms. Quality of life and real opportunities of people are influenced by many more variables than income (see Sen, 1999). However, since the BoP model defines poverty exclusively on the basis of a person's purchasing power, it neglects all other potential aspects of poverty and is by definition unable to directly contribute to their amelioration. *"The BoP proposition focuses on companies, marketing and prosperity; it sees the social, cultural, and political benefits at best as by-products of economic gains."* (Karnani 2007, 106) Thereby the BoP model does not encompass all degrees of poverty and essentially fails to address its root causes and the structures which keep people poor (see Boyle/Boguslaw 2007, 113). Instead of a narrow focus on the provision of goods or creation of jobs for the BoP population on the individual firm level, critics therefore rather propose a more holistic, systemic and better coordinated approach to poverty reduction, including wealth and opportunity (see *ibid*).

b) Over-estimation of the BOP market size

Prahalad/Hart (2002) claim that the potential market size for the Bottom of the Pyramid segment amounts to USD 13 trillion PPP. Critics, however, have raised serious doubts about this calculation, finding it “*grossly over-estimated*” (Karnani 2007, 91) and wrong. According to them, Prahalad overestimates not only the size of the BoP population but also its purchasing power. While Prahalad based his BoP model on a population of 4 billion in this segment, researchers at the World Bank estimated the number of people living on less than 2 \$/day at only 2.7 billion in 2001 (see *ibid*). Moreover, Prahalad’s calculations do not account for the fact that the poor do not spend their entire budget every day, but that their average daily consumption is much lower, at 1.25 \$ (see *ibid*). Applying these numbers, the potential market size at the BoP amounts to US\$ 1.2 trillion PPP (in 2002), a fraction of Prahalad’s assumption. Moreover, critics, such as Karnani (2007) have pointed out that multi-national companies based in rich countries usually repatriate profits from developing countries not at PPP rates, but rather at financial market exchange rates. Taking this into account, the global BOP market size shrinks to less than US\$ 0.3 trillion (see Karnani 2007, 91). An additional challenge to Prahalad’s argument about the “fortune at the BoP” are the high marketing costs involved with doing business in areas lacking infrastructure and/or safety regulations, which may reduce potential profits for MNCs even more.

c) MNCs are not suitable for BOP business

Multinational corporations are the principal actors in poverty alleviation in the BoP approach according to Prahalad/Hart (2005). However, critics have pointed out that these organizations are not in the position to successfully reduce global poverty, either due to institutional constraints or because of a mere lack of commitment.

The perhaps most important incompatibility between strategies for business and large-scale social investments, such as poverty alleviation is the required time frame. While efforts to reduce poverty require strategic long-term investment, “[c]orporations, pressed for measurement and outcome reports,

find broadly framed investments in poverty reduction do not fit neatly into business strategies focused on short-term cost-benefit analyses” (Boyle/Boguslaw 2007, 103). In many cases, *“current market liberal business realities continue to elevate company shareholders [and their interests] over all other stakeholders”* (McFalls 2007, 90). The notion remains that the only social responsibility of business is to increase profits. McFalls examined in her research on BoP business that there exists a *“general lack of commitment in pursuing pro-poor projects that may not yield quick returns for shareholders; the propensity to minimize not only resources, but also time dedicated to pursuing the public good that inclusive capitalism may offer; and the pressure to withhold social learning in order to find a profit in intellectual property”* (ibid). In that way, MNCs might actually contribute more to the problem of poverty than to its solution. It is possible that MNCs establish entry barriers and monopolistic market structures which drive smaller entrepreneurs out of the market, diminish gains in consumer welfare and threaten local jobs and incomes (see Warnholz 2007, 4). Some scholars even argue that despite the lack of goods and services provided to the BoP by international companies, this sector is not actually underserved. Instead, local small and medium-sized enterprises as well as a thriving informal sector has catered to the needs of this population and arguably, might be in a better position to do so given their profound knowledge about the local culture and context (see Warnholz 2007, 6; Boyle/Boguslaw 2007). Werhane et al. (2009, 107) also observes that MNEs often lack the knowledge, access, relationships and other resources necessary to play a significant role in poverty reduction, unless they partner with a public or other noncommercial organization with proven experience in the field. Jaiswal (2007, 96) thus concludes that MNCs probably have a reason for not yet having invested in the BoP. Local small and medium sized enterprises seem to have a competitive advantage over MNCs in serving the BoP and in fact, have been doing it for decades. Given that local SMEs and micro-enterprises are closer to the people on the ground, they are easier to hold accountable for potential harms caused to the society or the environment and they may also be in a better position to contribute to a more participatory, people-centered development, which for the top-down management practices

inherent in large global corporations seems nearly impossible (see McFalls 2007).

d) Exploitation of the poor

Another key point of critique at the BoP concept is the notion of it implying an unethical exploitation of the poor, which instead of bettering their living conditions results in the complete opposite to the sole benefit of MNCs based in the Global North.

The underlying idea of the BoP concept is to raise the standard of living of the poor by increasing the consumption choices available to them through the provision of goods and services especially targeted to them (see Prahalad 2005). However, although economic theory associates a wider choice with higher levels of welfare, Karnani (2007, 97) states that “(...) *this increase in choice is unlikely to result in a significant change in [the] poverty situation [since] a poor person is far more constrained by lack of income than by lack of variety of goods and services offered in the market.*” The critic further argues that a BoP endeavor might even have the opposite of its desired effect and worsen the situation for the poor if it encourages them to spend their little money unwisely on luxury goods instead of investing in health or education (see *ibid*). Prahalad rejects such thoughts as patronizing and arrogant, complying with core liberal market ideology according to which the consumers themselves know best how to maximize their utility (see *ibid*). Reality is different from theory, however, and it is a fact that in many cases, the population at the Bottom of the Pyramid lacks education as well as sufficient information about certain products and services, making it an easy target for exploitative business activity. Empirical data has shown that the poor do not spend their entire budget on nutrition, health and education as would be in their best interest in the long term, but they rather spend considerable amounts on intoxicants and entertainment (see Banerjee/Duflo 2007). Such behavior clearly proves Prahalad’s neoliberal assumption of the rational perfectly informed consumer wrong. Like richer consumers, people at the BoP lack self-control, yield to temptation and spend to keep up with their neighbors (see Banerjee/Duflo 2007). However, since the consequences of unwise

choices are more severe for the poor than for the rich (ibid), public action in the field of poverty reduction may seem rather justified than patronizing. Unilever's efforts to sell facial whitening cream in small packages to women at the BoP in India clearly resulted in financial gains for the company; the welfare benefits for society are not so obvious however. In India, fair skin is associated with a higher social status and more economic possibilities, asserting certain inferiority to people with darker skin. By using controversial advertisements for its whitening cream, Unilever not only contributed to the prevalence of such prejudices but also took advantage of poor women's aspirations to market a product whose benefits are not even scientifically proven (see Karnani 2007a, 1353). As shown by this case, defining the BoP as a profitable market may entice MNCs to implement unethical marketing strategies for luxury goods which do not necessarily enhance the wellbeing of the poor but rather lead to a misplacing of their priorities and unwise allocation of their scarce resources (see Jaiswal 2007, 17). However, *"the problem with the consumer-focused BOP approach is that it does not differentiate between priority and non-priority areas"* (Jaiswal 2007, 17) Thus, it also happens that the BoP population is fatally excluded from marketing activities for certain products which would enhance their welfare, such as medicines (ibid). In this context, McFalls (2007) points out the imperative to resolve normative issues concerning intellectual property rights in the BoP model discourse.

A more fundamental point of critique at Prahalad/Hart's BoP model is has been raised by Karnani (2007) who claims that the only way to alleviate poverty is to raise the real income of the poor, either by reducing the cost of the products sold to them or by raising their incomes. A cost reduction can be achieved either by a reduction of profits or costs of production. Although the BoP is sometimes characterized by inefficient monopolistic market structures, Karnani (2007) finds that this is rather the exception. He therefore concludes that the only way to reduce product prices is by cutting the costs of production. This often implies lowering the quality of the product offered (see ibid). Unlike Prahalad (2005) who insists on the delivery of high-quality products to the BoP, disregarding the provision of low-quality products to the poor as disrespectful and potentially dangerous (see ibid), Karnani (2007, 102) claims

that “selling inexpensive, low-quality products does not hurt the poor (as long as they understand [the] tradeoffs related to safety)” because their understanding of quality is relatively lower than it is for the rich.

Much critique has also been raised about the nature of inclusion of the poor in the economy which the BoP model promotes. As Prahalad/Hart (2002, 8) write: “*The primary task is to create a consumer market out of the poor (...)*” However, simply providing a larger offer of goods and services to the BoP population, does not necessarily improve their standard of living if their income level remains the same (see Karnani 2007). Furthermore, the perception of the poor as passive participants in the (global) economy warrants some criticism from an ethical point of view. Such an approach strongly suggests a top-down implementation of policies for poverty reduction rather than a participatory people-centered development which allows the poor to play their part in the improvement of their own fate (see McFalls 2007, 92). Alternative propositions for the BoP model thus pledge for an inclusion of the poor not only as consumers, but most importantly as producers (see Karnani 2007, 102). Microcredit may offer a promising solution for small and micro-entrepreneurs at the BoP; however, critics doubt the long term viability of such businesses, since “*(...) the vast majority of microcredit clients are caught in subsistence activities with no prospect of competitive advantage*” (Karnani 2007, 104). This situation can be changed if effective mechanisms are created which allow the poor to access powerful markets with their products (see Jaiswal 2007, 20), generating sufficient profits and allowing the microenterprise to grow and expand its reach to a larger number of small producers. Ideally organized in the form of cooperatives, the positive impact of such businesses can be significant on the lives of the poor (see *ibid*). Nonetheless, some still argue that a better way for eradicating poverty is by creating opportunities for steady decent employment (see *ibid*). Although microcredit and micro-entrepreneurship have certainly produced some positive effects on the improvement of living conditions of poor people (see Yunus 1999), the majority of new jobs created must be attributed to small and medium sized enterprises, not micro-entrepreneurs (see Karnani 2007, 106). Thus, the role of government is essential in the implementation of appropriate

policies which facilitate the creation and growth of private enterprises (see *ibid*).

e) Detracting from the imperative to correct government failures

With its heavy emphasis on private sector led development strategies, the BoP model as designed by Prahalad/Hart (2002) avoids any strong government intervention in the field of poverty reduction. It thereby fails to acknowledge the important role of governments in the creation of a favorable business climate which is a prerequisite for successful BoP business activities. Appropriate economic policies, basic infrastructure and functioning institutions form the necessary framework for private sector activities which must be set by the government (see Karnani 2007, 106). However, Prahalad/Hart's theory clearly de-emphasizes the role of the state as provider of basic services and infrastructure (see Karnani 2007, 108). By arguing that goods and services can be more efficiently provided by private firms, they detract from the government's obligation to provide public goods, such as infrastructure (i.e. roads and ports), health and education systems, stripping it of one of its core functions. In the case of the Mexican city of Reynosa, for example, the municipality contracted the multinational cement manufacturer CEMEX to pave roads in low-income neighborhoods, instead of providing the works directly via government-run companies (see OMJ 2009, [www](#)). Somewhat controversially, the affected BoP population was even required to contribute to the cost of the street paving with resources they evidently did not possess and had to take out microloans for (see *ibid*). A similar model has been implemented regarding the access to natural gas pipelines for households in the low-income neighborhoods of Buenos Aires (see Fundacion Pro Vivienda Social 2009, [www](#)).

Despite the largely successful delivery of services in the examples mentioned, critics still request that, “[p]rivatization should be treated as a means of increasing efficiency and not as a way of reducing or undermining the role of the state.” (von Weizsaecker et al. 2005, 360). Especially governments in the Global South often lack the political power and experience to effectively negotiate with multinational corporations, which can eventually lead to

inadequate regulations for investments and a concentration of power in the hands of a few powerful enterprises (see *ibid*). *“Companies often use political connections, pressure or bribery to secure regulatory decisions to their liking. In extreme cases, they can threaten to terminate supply contracts altogether, a strategy that is tantamount to blackmail”* (see *ibid*) Not uncommonly, MNCs demand a guaranteed rate of return in their contracts, thereby shifting all risks related to currency and demand to the often ill-prepared government. Moreover, *“[p]rivatization can divide [especially unequal] societies into ‘haves’ and ‘have nots’, with large differences in the access to, or quality of, the services (e.g. education, police protection, and clean drinking water, electricity and recreation facilities) available to the two groups. In many cases, after privatization the poor have to spend a much higher proportion of their income to satisfy such ‘basic needs’”* (*ibid*, 355). Privatization can also be problematic regarding democratic practices and common public ownership of goods. Notably in countries in the Global South, where public services are perceived as part of a process of democratic nation-building (see von Weizsaecker et al., 357), state supervision of privatized utilities, esp. when provided by MNCs whose decision-making processes are rarely transparent for the local population, often appear rather abstract and do not allow for democratic participation (*ibid*). Since eventually, such practices might lead to less democratic participation and alienation from government (see *ibid*), critics of privatization have argued that instead of replacing the public provision of goods by privatization, government failures should be identified and corrected through civil society action from the bottom-up (see Karnani 2007, 108).

f) Scope of activities and targeting of LLDCs insufficient

Critics have raised substantial doubts about the potential of the BoP model to really contribute to the eradication of extreme poverty. As Jaiswal (2007, 4) argues, *“[p]eople’s basic needs must be fulfilled before anyone can look at them as profitable BOP markets”*. This clearly excludes populations of the world’s poorest countries (or Least Developed Countries, LLDCs) where most of the people live on less than US\$ 1 per day, who would be in greatest need of any poverty reduction efforts. Furthermore, a number of additional factors,

e.g. inefficient regulation, widespread corruption, lack of basic infrastructure and weak financial and banking systems may discourage MNCs to do business in LLDCs. However, since the world's population living in extreme poverty amounts to more than one billion (see World Bank 2006 in Jaiswal 2007), Prahalad/Hart's approach would be limited to the remaining three of the suggested four billion at the Bottom of the Pyramid, i.e. the people living in moderate poverty (on less than US\$ 2 per day but more than US\$ 1 per day) which are largely concentrated on Middle Income Countries, such as Brazil, India and Mexico. Indeed, most of the successful BoP business cases were observed in these countries, supporting the assumption that private sector involvement can only be viable and fruitful once a certain level of economic development has been attained (see Jaiswal 2007, 5). This reality is also observed by Boyle/Boguslaw (2007, 106) who find that "(...) *business involvement and leadership is of greatest importance with regard to moderate and relative poverty reduction (...)*". However, if the approach is indeed only feasible in Middle Income Countries, i.e. limited to the alleviation of moderate poverty, its merits for contributing to the achievement of the MDGs and especially the eradication of extreme poverty must be subject to question.

g) Lack of a macroeconomic analysis

Another weakness of Prahalad's theory is its lack of a macroeconomic analysis. Although the concept intentionally places a stronger emphasis on a micro-oriented approach (see Prahalad 2005, xi) , a discussion of implications for macro-variables would have been important to complete the picture. Prahalad's theory goes barely beyond the definition of the BoP population/market size and concepts for MNCs to engage in BoP business. No attention whatsoever is devoted to the question which policies or institutional framework would be needed to encourage firms to enter the BoP space (see Boyer 2003, 13). Given that the legal environment could be critical in addressing challenges such as high transaction costs, the scaling of small economies and the overcoming of cultural and organizational barriers to BoP business (see *ibid*), a sound academic discussion could have complemented Prahalad's theory in a valuable way. Moreover, suggestions about how broader alliances among BoP stakeholders could be incentivized as well as a

discussion about the influence of geopolitics on BoP activities would have been of interest (see *ibid*). Even more important from a macro point of view are questions about the potential for BoP business to induce global systemic change and the possible effects of new ideas from the bottom up on traditional industry structures (see *ibid*). However, Prahalad has not taken up any of these questions and essentially fails to include a macro-perspective into his theories.

3.6 Interim Results

After explaining the BoP model with its origins and theory and summarizing the most important points of critique at the concept, I will now, at the end of the theoretical part of this thesis, revisit the respective research hypotheses of chapter 1 and try to verify/falsify them.

- The BoP approach represents a novel strategy for poverty reduction and can be clearly differentiated from traditional public or private sector led approaches.

Prahalad's theory is clearly different from poverty reduction strategies based on the provision of development aid, be it by the public (through bi- or multilateral aid) or the private sector (through corporate philanthropy or CSR). While the idea of selling products to low-income individuals for profit is not necessarily novel (as it has been common practice for many local SMEs in the Global South), it is new in the context of a poverty reduction strategy. Moreover, the emphasis on MNEs as implementers of BoP business represents an innovation. This offers the advantage of reaching a large number of poor people on a global level; however, also implies many challenges for these organizations whose primary goals are usually not related to development.

- C.K. Prahalad's BoP model can be criticized for a number of theoretical weaknesses, such as a too narrow definition of poverty and development, an over-estimation of the BoP market size, insufficient targeting of Least Developed Countries, the inadequacy of MNCs as actors in development and the detraction from the imperative to correct government failures which altogether may eventually lead to exploitation of the poor.

As has been shown above, critique at Prahalad's theory of BoP business is indeed justified in many cases. Thus, it is questionable if the model – if implemented completely according to theory – would yield the expected positive development impacts. In order to answer this question, I will, in following chapter, study the practical implementation of the BoP approach by the Inter-American Development Bank. Particular emphasis will be placed on its compliance with Prahalad's theory as well as the consequences for poverty reduction.

4. THE INTER-AMERICAN DEVELOPMENT BANK AND PRIVATE SECTOR LED POVERTY REDUCTION

4.1 History and Mission of the IADB

The origins of the Inter-American Development Bank date back to the late 19th century, when the idea of a development bank for Latin America was first brought up at the First Pan-American Conference. However, the creation of this institution did not happen until 1959, proposed by President Juscelino Kubitschek of Brazil and formally adopted by the Organization of American States (OAS). Nonetheless, the IADB is not a OAS organ because it grants membership also to non-American countries that are members of the International Monetary Fund (see OAS 2009, [www](#) and IADB 1996, 6). (A list of the borrowing as well as the non-borrowing member states will be provided in paragraph 4.2). One of the main reasons for the IADB's foundation was the discontent of many Latin American countries with the structures and practices of the Bretton Woods Institutions, the World Bank and the International Monetary Fund, and the attempt to create an institution which would serve the specific interests of those countries. Although the IADB consequently refers to its independence from the Bretton Woods Institutions, it is a fact that the two institutions maintain a close relationship in practice, as do other multilateral regional development banks and the World Bank (see AfDB 2009, [www](#)).

According to its constitution, the mission of the Bank is to “*contribute to the acceleration of the process of economic and social development of the regional developing member countries*” (IADB 1996, 5). To achieve this goal, the bank provides financial assistance in the form of loans and grants as well as technical

assistance to governments, civil society organizations and private enterprises in countries of Latin America and the Caribbean (see IADB 2009, [www](#)).

Together with the Multilateral Investment Fund (MIF) and the Inter-American Investment Corporation (IIC), which both aim at the support of private sector entities and the promotion of private sector development in Latin America and the Caribbean, the IADB forms the IADB Group. A more detailed description of the MIF and the IIC will follow in section 4.6.

4.2 The member countries of the IADB

The IADB is owned by 48 sovereign states, which can be divided into a group of borrowing and non-borrowing member states (see IADB 2009, [www](#)).

The group of borrowing member states is comprised of 26 countries, all of them in Latin America and the Caribbean: Bahamas, Barbados, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru and Suriname, Trinidad and Tobago, Uruguay and Venezuela.

Collectively, the borrowing countries hold 50.02 % of the IADB's shares and voting rights (see chapter 4.4 and figure 4 for details about the distribution of voting rights).

The remaining 22 member countries form the group of non-borrowing member states, all of them are non-regional: Austria, Belgium, Canada, China, Croatia, Denmark, Finland, France, Germany, Israel, Italy, Japan, the Netherlands, Norway, Portugal, the Republic of Korea, Slovenia, Spain, Sweden, Switzerland, United Kingdom and the USA.

4.3 Capitalization of the IADB

The IADB raises its funds through the issuing of bonds on the international financial markets. These bonds are backed by the sum of capital subscriptions paid in by the Bank's 47 member countries, plus the sum of callable capital subscriptions pledged by the Bank's 22 non-borrowing member countries. Together these constitute the Bank's ordinary capital, which after the last capital increase in 1994 amounts to US\$

101 billion. Of this amount, 4.3 % is paid in, while the remaining 95.7 % is callable. The callable capital pledged by the 22 non-borrowing members, which include the world's wealthiest developed countries, functions as a guarantee for the bonds that the IDB sells. This arrangement ensures that the IDB maintains a triple-A credit ranking, and, as a result, can make loans to its borrowing member countries at interest rates similar to those that commercial banks charge their largest corporate borrowers (see, IADB 2009, [www](#)). It enjoys preferred creditor status, meaning that outstanding debt payments must be met with the IADB first before serving other (private) lenders. During the last years, the IADB had an annual lending volume of approx. US\$ 8 billion. Given the size of the institution, the conditions of the financial markets and the development progress of the region, this amount seemed appropriate. In the wake of the recent financial crisis unfolding in 2008, however, the Bank has faced a growing demand for finance from its Latin American and Caribbean borrowers. As a result, the IADB approved \$11.2 billion in operations in 2008 and further increased its lending volume to a record of to \$15.9 billion in 2009 (see IADB 2009, [www](#)). In light of these events, the IADB is currently in the process of its ninth general capital increase. The governors of the IADB have agreed to provide an additional US\$ 70 billion, which effectively represents a 70% increase of the IADB's current lending volume (see IADB 2010, 1). The process is expected to be completed with the subscription of shares of the member countries, after several critical issues concerning the role and specific mandate of the Bank as well as lending policies have been resolved. A public consultation with NGOs and other representatives of civil society, which is also part of the process, has already been held (see IADB 2009, [www](#)).

4.4 Governance and Distribution of voting rights within the IADB

The highest authority of the IADB is the Board of Governors, which is comprised of the finance ministers or presidents of the member countries' central banks. The Board of Governors is responsible for the major policy decisions and strategic planning of the institution and meets once a year (see IADB 2009, [www](#)).

Day-to-day business, however, is carried out by the IADB's Board of Executive Directors which is its supreme unit of decision making, on projects as well as policy matters. The Board consists of 14 Executive Directors, each with an Alternate

Executive Director, sharing among them the representation of all the member countries. Voting power of each Executive Director is determined by the respective country's shareholdings, i.e. its subscription to the IADB's ordinary capital (see Annex 1). The United States is the single largest non-borrowing shareholder, with approximately 30 percent of the voting power, followed by Japan (5%) and Canada (4%). The 26 Latin American and Caribbean borrowing members collectively control 50.02 % of the IDB's shares (with Argentina, Brazil and Mexico being the largest shareholders) (see *ibid*).

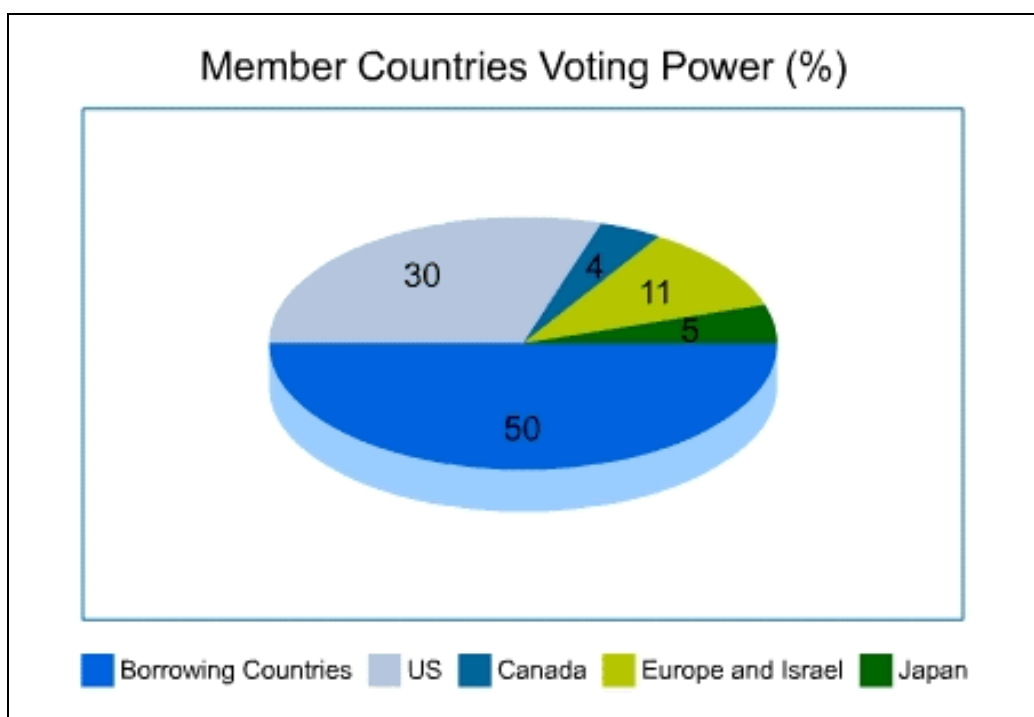


Figure 4: Voting Power of IADB Member Countries (2010)

Source: IADB 2010, www

4.5 The IADB and Private Sector Development

Recognizing the important role of the private sector in the generation of economic growth, employment and investment, which are all key aspects in the development process of a country and its society, the IADB in recent years has placed an increasing emphasis on the promotion of private sector activities in the region. This strategy has been reflected in the IADB's lending practices, which during the past two decades, have increasingly focused on the promotion of private sector development through investment and policy reform loans to foster competitiveness, the

modernization of the state, financial and capital market development and small and medium enterprises (SMEs) (see IADB 2004, 1). With policy-based lending to the public sector, the Bank seeks to promote reform concerning structural issues that affect the private sector in the LAC region, such as (see IADB 2004, 11): (i) strengthening the legal and institutional framework in which financial systems operate, (ii) developing financial regulatory agencies, (iii) strengthening capital markets, (iv) strengthening property rights over assets (particularly the assets of the poor) such as land and housing, and (v) developing microfinance systems and other alternative institutions to expand access to credit. The overarching goal of these operations is the creation of an enabling business environment, which allows the private sector to thrive and yet, to find “(...) *a good balance between the complementary functions of the state and the private sector*” (IADB 2004, 5).

Besides providing finance to public entities (through so called loans with sovereign guarantee), the IADB also lends directly to private sector organizations to meet their long-term financing needs (so called loans without sovereign guarantee) (see IADB 2004, 14). Additionally, the IADB offers fee-based consultancy services to enterprises on matters such as restructuring, financial engineering and the search of joint partners (see IADB 2004, 15). The target of the IADB's private sector activities are micro-, small-, medium- and large-scale businesses in all sectors. The bank either lends to them directly or indirectly through local financial institutions which are in the position to better accommodate the needs of the client (e.g. provide funds in local currency) thanks to guarantees on credit or political risk offered by the IADB (see *ibid*). Reflecting the increasing emphasis on private sector development, the maximum lending volume to the private sector was augmented from a 5 % of total lending volume to 10% in 2001 (see IADB 2001, 1). At the 2010 annual meeting of the Board of Governors, the limit has once more been altered to 20% through 2012 (see IADB 2010, 3). After this date, private sector operations will be subject to the IADB's new Non-Sovereign-Guaranteed lending strategy and capital adequacy policy (see *ibid*).

During the last twenty years, the IADB Group has also created a number of specialized institutions and organizational units with the particular mission to promote private sector development.

4.5.1 Structured and Corporate Finance (SCF) Department

The SCF Department is responsible for the IDB Group's financing of large banks and private sector investments Latin America and the Caribbean. It also supports the development of international trade through a special Trade Finance Facilitation program. The loans provided by SCF are "A" Loans, i.e. they are funded by the IADB's own resources. However, SCF also collaborates with banks and institutional investors to participate in co-financing through loan participations, or "B Loans". Loans granted by the SCF department are usually for the long term (i.e. 5-30 years) and cover for example greenfield projects, increases in production capacity, growth as well as refinancing of liabilities (see IADB 2009, [www](#)). An important SCF project approved in 2008 is, for instance, the US\$ 400 million loan to support the largest infrastructure project currently underway in the LAC region, expansion of the Panama Canal (see *ibid*). Another project of similar importance is the US\$ 200 million loan granted to the biggest producer of slab steel in LAC, the Gerdau Acominas steel mill of Brazil, for the purpose of modernization and productivity increase of two of its steel mills in the southeast of the country (see *ibid*). The IADB's Sustainable Energy and Climate Change Initiative (SECCI) contributes to the project with an energy efficiency and carbon footprint assessment of the mill's operations.

Major investment activities were also effectuated with public and private utility providers, such as the Basic Sanitation Company of Sao Paulo, which provides water and wastewater services to the 26 million inhabitants of this Brazilian state, and Costa Rica's state-owned energy and telecommunications provider.

In 2009, the approved SCF operations amounted to a total of US\$ 919 million (see IADB 2010, 23). Projects covered 17 countries in LAC and focused on innovative financing of "green" investments, i.e. financing of renewable energy, energy efficiency and recycling projects. Thereby, the IADB hopes to create a demonstration effect for other investors and contribute to the promotion of investments in environmentally sustainability projects and industries (see *ibid*).

Moreover, SCF provides partial credit and political risk guarantees and can work with clients to mobilize non-reimbursable resources for project preparation (see IADB 2009, [www](#)).

4.5.2 The Inter-American Investment Corporation (IIC)

The Inter-American Investment Corporation (IIC) was established by the Board of Governors of the IADB in 1986 with the purpose to promote the economic development in Latin America and the Caribbean by encouraging the establishment, expansion, and modernization of private small and medium sized enterprises (SMEs) in supplementation to the activities of the Inter-American Development Bank (see IADB 2009, 2). To fulfill its mission, the IIC provides financing as well as access to private and public domestic and foreign capital to such enterprises. In order to facilitate this process, the IIC has developed a special tool (called FINPYME) to assess the performance and financial capacity of SMEs which are often underserved by the banking sector (see FINPYME 2010, [www](http://www.finpyme.org)) . The transfer of technology and technical and managerial know-how are also fostered by the institution. Additionally, the IIC seeks to stimulate the development and expansion of public and private investment opportunities in the Latin American region. The loans granted by the IIC are entirely without sovereign guarantee. The initial authorized capital stock of the IIC was US \$ 200 million. Over the years, it has been increased several times, ultimately in 2008, when it amounted to about US \$ 700 million (see IIC 2009, 77).

The IIC is formally independent of the IADB and has its own bodies of governance. However, since the IIC is part of the IADB Group and closely collaborates with the IADB, the member countries of the two institutions are the same (with the exception of a few countries that are members of the IADB but not of the IIC) and the positions of Governors and Executive Directors of the IIC are held by the same persons who represent their countries in the IADB. Furthermore, the President of the IADB is ex-officio Chairman of the Board of Executive Directors of the IIC. He presides over meetings of the Board of Executive Directors; however, he has no voting right except in the event of a tie. He may also participate in meetings of the Board of Governors, but has no right to vote whatsoever (see IIC 2010, 59). The distribution of voting rights of the IIC is similar to the IADB's (see *ibid*).

Unlike the private sector windows of the IADB, the IIC is legally enabled to provide capital to private sector borrowers in the function of a shareholder. It can do so even in cases where public institutions are also shareholders. Although it cannot intervene

in the management, it is represented in the general assembly. Later, it can sell its quota.

In 2009, the IIC approved 40 projects amounting to US\$ 299 million in direct loans and investments and an additional US\$ 342 million in co-financing operations (see IIC 2010, 42). The IIC's investment portfolio in 2009 consisted of 203 projects with a total amount of loans outstanding of US\$ 889.8 million (see *ibid*, 36). The majority of investments (63%) last year were made in the financial service sector and about 12% in agriculture and agribusiness (see *ibid*). Other investment projects were distributed among various industries, from general manufacturing, oil and mining to food and beverages (see *ibid*). The 2009 investment activity by the region reflects the regional distribution of the IIC's total investment portfolio, with 20-35% of projects in each the Southern Cone, Andean and Central American (including Mexico) region. Regional and Caribbean projects account only for a minor proportion of investment activity (up to 10%) (see *ibid*).

4.5.3 The Multilateral Investment Fund (MIF)

The Multilateral Investment Fund (MIF) is a US\$ 1.3 billion-dollar grant and investment facility administered by the Inter-American Development Bank. The MIF complements the private-sector development activities of the IADB and the IIC, but has a distinct function within the IADB Group. Its projects promote innovation, testing new approaches to strengthen competitiveness, demonstrate possibilities to commercial markets, and advance difficult reform issues. Another focus of MIF activities is the promotion of joint investments (such as public-private-partnerships) with local partners in the project country (see MIF 2010, [www](#)). The idea is that the MIF then leverages its impact by sharing the results of its experience so that successful approaches can be replicated (see IADB, 2005). The MIF's general mandate is to encourage policy reforms toward an improvement of the investment climate for the domestic and foreign private sector in Latin America and the Caribbean (see IADB, 1992, 3). Special emphasis is placed on fostering the development of medium and small enterprises as well as micro-entrepreneurs (see *ibid*). The operations of the Fund are managed through three facilities (see IADB, 1992, 5ff):

a) The Technical Cooperation Facility

This facility seeks to finance diagnostic studies to identify investment constraints, including legislative, financial and regulatory impediments to investment, policy reform plans, advice on the design and implementation of privatization programs and assistance on the development of financial systems.

b) The Human Resources Facility

This facility provides grants to government agencies and educational institutions for Human Resource development and training necessary for increased finance and investment and an expanded private sector.

c) The Small Enterprise Development Facility

The aim of this facility is to provide direct or indirect financing to local micro-enterprises and small businesses in Latin America and the Caribbean. Thereby, their financial and business practices shall be improved so the businesses become self-sustaining and their capabilities to identify business opportunities and sources of financing shall be strengthened.

The MIF was initially established for a period of 10 years and the agreement of its establishment was renewed once until the end of 2007. However, in 2005, a MIF II Facility was agreed upon by the member states of the IADB, with essentially the same mandate and use of funds (see IADB, 2005).

In 2009, MIF operations amounted to a total of US\$ 115.7 million with 114 grants and 20 investment projects approved (see IADB 2010, 23). More than 40 % of these operations cover the smaller and relatively poorer C and D countries (see chapter 4.6.5, Table 3). The projects target a wide range of sectors and beneficiaries, ranging from the implementation of a sustainable model for micro-insurance in Central America to the facilitation of access to capital markets for SMEs and innovative programs to combat youth unemployment (see MIF 2010, [www](http://www.mif.org)).

In addition, the MIF hosted a number of conferences in 2009, such as the twelfth Inter-American Forum on Microenterprise and the seventh Inter-American Conference on Corporate Social Responsibility, among others.

With this brief overview of the IADB's traditional private sector windows, my intention was to highlight the wide range of the Bank's private sector activities. With its three private sector lending institutions, the SCF, IIC and the MIF, which all have a distinct focus in terms of project type (loans or grants), size and borrowers, the IADB has numerous opportunities and tools available to foster private sector development activities in the LAC region. While SCF provides long-term financing to big companies and banks for large-scale infrastructure or financial operations, the MIF lends small amounts to SMEs and micro-entrepreneurs and focuses rather on the fostering of innovation, advocacy and business development through non-reimbursable investments. The IIC, however, as a strong focus on investments in financial services and its formally independent status put in a better position to fulfill this mandate.

4.6 The Opportunities for the Majority Initiative

In what follows I will give a detailed description of the OMJ Initiative of the Inter-American Development Bank, its history and activities. Special attention is devoted to this private sector window of the IADB as the OMJ office provides advice and funds exclusively for private sector BoP operations in Latin America and the Caribbean. It can thus be regarded as a catalyst of implementation for C.K. Prahalad's BoP model. Applying the theory elaborated in chapter 3, I will, at the end of this chapter, assess two OMJ project examples according to the points of critique raised earlier and try to draw a conclusion for the activities of the office and its future.

4.6.1 Background and History

When Luis Alberto Moreno took office as president of the IADB in 2005, he *"(...)* came to the bank with a reform agenda. He was looking for a way to shake up the institution, (...) to revitalize it and to make it relevant to today's Latin America (...)" (Martin, Dana 2009). As a consequence, he launched a comprehensive institutional re-alignment. Within this process of restructuring, the IADB's non-sovereign

guaranteed lending was reinforced by the creation of the vice-presidency for private sector additional to the already existing private sector lending arms of the IADB Group, the MIF and the IIC. Moreover, Moreno's newly assumed presidency and institutional re-alignment coincided with the development of an innovative approach for private sector led poverty reduction strategies in the Base of the Pyramid by academics such as C.K. Prahalad and Stuart Hart. Spurred by personal interest and an institutional strategy to foster private sector development, President Moreno installed an interdisciplinary working group consisting of bank officials from different public as well as private departments to explore the opportunities and feasibility for this new academic approach in the context of the IADB. *"(...) [T]he question was: What could a MDB bring to this process to try to help the private sector enter as a more prominent player in development in the region?"* (Martin, Dana 2009)

To answer this question and to learn about the prominent players in the BoP market in LAC and its characteristics, a number of studies (e.g. *"The Next Four Billion"* in cooperation with the World Resources Institute) and market analyses of different sectors in different countries were conducted. These studies proved the existence of a market worth US\$ 500 billion and made up by 350 million people who earn less than US\$ 300 per month in the region. Moreover, they revealed the willingness of these low-income populations to pay private sector providers for the delivery of goods and services which should be provided by the government if there is a better value-proposition. As already mentioned in chapter 3, due to a lack of consumer options the poor are often forced to pay a "poverty penalty" or face high opportunity costs because of long waiting times for the delivery of public goods.

The results of these studies were presented in a publication and conference with prominent speakers, such as Bill Clinton, Hernando de Soto and Luis Alberto Moreno and paved the way for the creation of the Opportunities for the Majority office by the IADB's Board of Governors in 2006. Thereby the IADB was the first MDB to establish a special institutional unit for BoP operations. Although the other members of the IADB Group, the MIF and the IIC, also focus on private sector operations, neither of these financing windows has an exclusive focus on low-income markets (Martin, Dana 2009), thus justifying the creation of OMJ to serve this need. The IADB's Board of Governors acknowledged that the majority of the population in LAC has been

empowered politically, but nevertheless been excluded from full participation in economic life by weak institutions, inadequate policies, boom-and-bust cycles and other constraints (see IADB 2006, 1). A missing link between macroeconomic growth and improved living conditions for the entire or majority population has been identified and explained primarily by an insufficient economic empowerment of these people. Aim of the OMJ Initiative is thus to foster the entrepreneurial spirit among these people and develop new approaches and business models, essentially driven by the private sector, which seek to improve the economic opportunities for the majority of the population in LAC (see *ibid*). By establishing the OMJ Initiative, the IADB recognized that traditional development approaches, which rely on a single sector or actor, are insufficient, and that there is a need for new strategic partnerships between the private sector, civil society and community stakeholders are necessary for economic development (see *ibid*). Special emphasis, however, is placed on “(...) *the private sector as a partner in development, to complement the efforts already under way by the Bank working with the public sector and to extend its support of private sector actions that embrace the majority*” (IADB 2007, 2). It is expected that “(...) *financial partnerships with the Bank will allow [private firms] to deepen their involvement, particularly focusing on the incorporation of [the BoP] into the economic mainstream, creating a virtuous circle of development and business prosperity*” (*ibid*).

4.6.2 The Majority

“The Majority”, i.e. the target of the IADB’s OMJ Initiative has been defined as the population generating annual earnings of approximately US\$3,260 or less, which in the region of Latin America and the Caribbean comprises 360 million people or 70 % of the total population (see IADB 2006: 1). This figure includes the roughly 25% of Latin America’s 512 million people living on less than US\$ 2 per day (see World Bank 2007, www) as well as low-income consumer segments and thus, essentially represents the population at the “Bottom-of-the-Pyramid” according to C.K. Prahalad’s theory (see chapter 3). When compared to other regions in the Global South, such as South Asia or Sub-Saharan Africa, it is evident that the majority of countries in Latin America and the Caribbean classify as Middle Income Countries (i.e. generating a GNI p.c. of US\$ 976 to US\$ 11,905 according to World Bank

definitions) where a relatively large part of the population belongs to the middle-class consumer segment. These people are poor, yet not destitute and therefore account for a significant share of spending in the region (see D'Andrea/Herrero 2006, 26). This fact seems to attract significant private sector interest and thus characterizes the LAC region as a particularly attractive place for BoP transactions.

4.6.3 Activities

The OMJ Initiative reflects a new strategy for the IADB, shifting from a primarily macroeconomic approach to poverty reduction to a microeconomic focus (see IADB 2006, 1). With this microeconomic emphasis, the IADB seeks to improve the living conditions of the majority population through specifically targeted small-scale investments in local or international private enterprises for the development and execution of business endeavors that engage with the population at the bottom of the socioeconomic pyramid. However, the projects should have the potential to be scaled up for the achievement of more ambitious development goals in the medium and long run (see IADB 2006, 2). Perfectly in line with C.K. Prahalad's theory, OMJ requires its models to be directly linked to a company's profitability or competitiveness, clearly distinguishing it from CSR or philanthropic activities (see IADB 2006, 6). It thereby claims to recognize the BoP population's potential as economic actors (consumers as well as producers) and intends to foster the majority's entrepreneurial spirit (see *ibid*). Furthermore, the OMJ Initiative seeks to help position the BoP market as an emerging market for the future which can be an important source for growth and innovation for businesses (see *ibid*).

The OM Facility was created by the IADB with an initial budget of US\$250 million for the period 2007-2011 with the possibility to be increased depending on the initiative's results achieved during the first two years of operations (see IADB 2006, 18). The OMJ operations are part of the IADB's non-sovereign-guaranteed operations whose limit is set at 10 % of total lending volume by the Bank's Board of Governors (see *ibid*).

OMJ investments are not limited to a specific sector. On the contrary, they comply with the recommendation of the UN Millennium Project (2005), according to which “[p]olicies to promote economic and human development need to focus not only on

income but also on factors such as social services, infrastructure development, human security, and democratic political participation. This includes targeted and sustainable improvements in health, education, nutrition, access to basic water, sanitation and transport, and increased and equal opportunities for marginalized groups in society.” Nevertheless, six target areas have been identified which are perceived as key *“to overcome bottlenecks that have limited inclusive growth”* (IADB 2006, 1) and thus represent a particular focus of OMJ investments. The OMJ Target Areas with respective quantitatively measurable goals have been defined as follows:

Table 2: OMJ Target Areas

OMJ Target Area	Quantitative Goals
Citizen identification	- Decrease by 50% the percentage of children under age 5 without legal identity (from 15% in 2005 to 7.5%).
Financial Democracy	- Double the number of Majority households with savings accounts (from 15% to 30%) - Triple the number of micro enterprises with access to formal credit (from 5 to 15 million) - Decrease by 50% the transaction costs of sending remittances to the region (from 6% to below 3%)
Employment Generation and Entrepreneurship	- Decrease by 50% the time required to register a company (from average of 63 days to 30 days) - Increase by 25% the percentage of Majority workers under the age of 65 included in a social security or pension program (from 24% to 30%) - Cut by one-fourth the percentage of workers earning "poverty" wages
Basic Infrastructure Services	- By 2016, decrease by 11 million the number Majority people without access to piped water; by 5 million the people without access to improved sanitation services; by 1 million the people without access to reliable electricity; and improve transportation for 53 million persons
Information and Communication Technology	- Increase Internet access in the region by 200% from 15% to 45% - Increase access to personal computers in the Region (measured as PCs per 100 inhabitants) by 200% from 8% to 24% - Increase by 60% access of Majority households to telephone services (either fixed line or cellular service), increasing access from 37% of the Majority population to 59%
Housing	- Double the annual production of new housing solutions by the private sector in the region, from 1 million to 2 million solutions per year - Reduce by 15% the proportion of the Majority that lives in overcrowded homes (from 33% to 28% of the persons in the first seven deciles of the income distribution) - Reduce by 35% the proportion of the Majority that lives in dwellings with dirt or sand floors (from 28% to 18%).

Source: IADB 2006

Although acknowledging that the selected fields of concentration represent only a few of the many sectors and activities needed to promote sustainable and equitable development in the region, the IADB is convinced of the potential of these particular areas for creating synergies with the private sector as an actor in development and poverty alleviation (see IADB 2006, 1). Moreover, among all organizations active in BoP investment, the IADB is the only institution to adopt a strategic approach focusing on specific target areas for these transactions (see IADB 2006, 2f).

Additional to covering one of the six OMJ Target Areas, potential projects must fulfill a number of other criteria to be eligible for OMJ financing of which the most distinct are the following (see IADB 2007, Annex 1: A): Potential OMJ projects must be innovative, in the sense that they develop new ways of doing business with the BoP population through the engagement of a private sector entity using a hybrid or novel business model or partnership with a BoP community organization, NGO or the public sector for the benefit of the poor. Moreover, they must be “scalable”, i.e. have the potential to be replicated or adapted to reach a larger group of people in the same country and beyond. Of particular importance is the project’s development impact on the BoP population. It is therefore required that OMJ projects provide measurable and verifiable evidence of their positive economic and social impact on the poor through regular evaluation and performance measurement (see IADB 2007, Annex 1: C). Additionally, every OM project has to comply with the IADB’s strategy for the respective country in which it is intended to be executed as well as with the Bank’s policies concerning environmental and social impacts and corporate governance.

In terms of investment size, individual projects financed by the OM Facility, either through loans or partial credit guarantees, must not exceed US\$10 million, and the majority of projects approved to date range from US\$ 5 million to US\$ 10 million in investment size (see OMJ 2009 and IADB 2010, [www](http://www.iadb.org)).

OMJ projects are also subject to particular operational criteria (see IADB 2007, Annex 1: B): These include, for example, pricing for the loan or guarantee which is determined on a case-by-case basis with market rates as benchmarks reflecting the

operation's corresponding risk profile. Likewise, tenor, grace period and other financial terms are determined specifically for each transaction.

Often times OMJ loans and guarantees are accompanied by "technical cooperation" (TC) projects which seek to strengthen the structure of the loan and the capacity of the low-income, beneficiary community to receive and maximize benefits (see OMJ 2009, [www](#)). Such TCs can be the conduct of a market analysis, for example, or a training program for the BoP population involved in an investment project, and they are always financed through grants, i.e. non-reimbursable funds. Given the office's own limited budget for such projects, a strategic fund has been established with the aim to raise funds with a variety of public and private donors who wish to promote market-based solutions to address the needs of low income populations (see *ibid*).

Apart from grant and investment projects, the OMJ Initiative also engages in research on the BoP in Latin America. In partnership with national development agencies from donor countries and NGOs such as the World Resources Institute, OMJ conducted research on market characteristics of the majority population, identified potential private sector stakeholders and developed innovative business models targeting the BoP in a mutually beneficial way for the companies as well as the poor (see IADB 2007, [www](#)).

Initially, there was some confusion about the need for OMJ and its activities (see Dana M) as well as concerns raised by the Board of Governors. Existing units of the bank claimed that their work was already covering the improvement of living conditions for the majority of low-income people in LAC (Dana M) and bank leaders feared running *"(...) the risk of engaging firms that only see the majority as a market to be served and not a society to be developed"* (IADB 2007, 3). However, OMJ justified its additionality with its focus on investments targeted exclusively at private organizations with the aim of fostering the creation of employment for the majority in microenterprises, SMEs and MNEs for which a clear "business case" can be shown (*ibid*). At any rate, OMJ operations were meant to complement and not substitute any of the already existing IADB activities in the public or the private sector (see Martin, Dana 2009). Moreover, in order to increase its accountability and prove the positive contribution to development of its projects, OMJ has developed a special tool for the systematic assessment of the development impact of its projects: The OMJ

Development Effectiveness Matrix (DEM)¹¹ (see Annex 3). This table provides a rating of the development outcomes of an OMJ project as well as of the IADB's role (or "additionality") in the operation. The development outcomes are measured by four area ratings: project or company business performance, environmental & social effects, private sector development and IADB strategic development objectives. The Bank's additionality is assessed by its financial and non-financial contribution. Each of these area ratings is composed of 2-6 assessments of single project properties, such as the financial rate of return (for the business performance), facilitation of market expansion and competition (for private sector development) or the participation of the target population in the project design and implementation (for the IADB strategic development objectives). Already at project design, OMJ investment officers and project leaders are responsible for rating the 23 assessment criteria according to 5 categories (excellent, good, satisfactory, partly unsatisfactory and unsatisfactory) on the basis of assessment guidelines and specific project information. The single ratings are subsequently aggregated to the area ratings and ultimately, to the overall comprehensive rating of the project. After completion of the project, the ratings are verified by the IADB's independent Office of Evaluation and Oversight (OVE) which directly reports to the Board of Governors (see IADB 2008, 4). The Development Effectiveness Matrix has thus become an important evaluation tool for the implementation of accountable and results-based operations (see *ibid*).

After the positive assessment and approval of OMJ's first projects, support for the office's activities was growing, among the Board of Governors as well as on an institutional level with the MIF and SCF department engaging in co-financing of a number of OMJ projects (see Martin, Dana 2009).

During its first year of operation, the OMJ Initiative completed one operation, a US \$ 25,000,000 investment in a newly established venture capital fund for early stage and growth companies in LAC whose business activities are targeted at low-income populations. The fund (IGNIA) shares the same mission as OMJ and in particular, also targets investments in sectors such as healthcare, housing, education, nutrition and basic utilities to benefit people at the BoP (IADB 2008). By the end of 2009, however, the Initiative counted no less than 13 projects approved, with a total

¹¹ However, a similar tool is used for the assessment of other IADB projects, including sovereign guaranteed loans (see IADB 2008, 13).

investment volume of about US\$ 1.2 billion and nine eligible investment projects in the pipeline for 2010 (see OMJ 2009 and IADB 2010, [www](#)).

4.6.4 Project Examples

In the following chapter, I will present two examples of OMJ projects. It is important to understand, however, that due to the ample variety of economic sectors and industries as well as the large number of countries in which OMJ operates, the chosen projects can by no means be labeled representative. I deliberately chose to present the project “La Riojana” because of its extraordinarily inclusive design and high degree of inclusion of local beneficiaries and the “Social Financing Program EPM-UNE” because of its certain controversy. Following the description of each of the projects, I will, in the next chapter, attempt to assess them applying the points of critique explained in chapter 3. Although I am aware that single case studies cannot serve to validate or discredit a development model, I will use these specific cases to point out strengths and weaknesses in the practice of the BoP approach. Eventually, I will try to come to a conclusion about the benefits and caveats of market based solutions for poverty alleviation for the BoP population as executed by the IADB’s Opportunities for the Majority Initiative.

a) La Riojana

This project intends to provide financial support for the strengthening and expansion of business operations of the agricultural cooperative “La Riojana” in La Rioja, Argentina. “La Riojana” is a cooperative of small low-income wine producers, established in 1940. Inherent to this form of organization, it is entirely owned by its members and governed according to democratic principles. With almost 500 members, the cooperative unites more than 80% of all small producers of the region, which with almost 27% of households living below the poverty line, is the second poorest of the country. For these people at the bottom of the pyramid, wine production has not only traditionally been the primary source of income, but is also deeply rooted in their cultural life. “La Riojana” has been highly successful in the past, receiving numerous national and international awards for its products, which are elaborated according to internationally recognized environmental and fair trade standards. However, given the significant changes in the wine market during the

last years, investments in the wine business are urgently needed. To remain competitive and guarantee that the vine cultivation remain a viable source of income for future generations, the cooperative needs to adapt its production to the domestic and international demand, which has increasingly shifted to red instead of the traditionally cultivated white wine. Since vine naturally needs several years to grow and produce fruits, the cooperative is essentially in need of long-term financing which, esp. in the aftermath of the Argentine currency crisis in 1999 and in the wake of the current unfavorable financial conditions, is difficult for it to obtain as an organization and impossible for its individual members who, as members of the BoP, do usually not have access to conventional forms of finance. “La Riojana” has thus approached the IADB, and more specifically OMJ, in request for funds. Together with officials from the Initiative, an investment project has been developed to support the cooperative’s business and its owners. OMJ intends to contribute 50% of the total investment cost of the project, which is expected to amount to US\$ 5.8 million. The remaining amount will be provided by the cooperative itself, the regional public authority and parts of a different IDB loan to the Argentine Viticulture Corporation, a parafiscal body promoting the sustainable development of the wine sector in Argentina. With these resources, a microcredit fund will be established allowing the small producers to access the needed means for financing new technical equipment and machinery and meet their working capital needs. Moreover, the investment project will be accompanied by a “technical cooperation” (i.e. non-reimbursable investment) from the Argentine government which seeks to facilitate the market access for the cooperative’s products and strengthen its institutional structures to better accommodate its members interests. The medium- and long-term objective of the project is to strengthen the existing production chains involving small wine producers for further export of their products to the world market which is expected to result in the generation of higher and stable incomes for the BoP population in La Rioja.

Source: Project Concept Document “La Riojana” AR-L1096

b) Social Financing Program EPM

The objective of this project is to increase the access to banking to previously “unbanked” low income populations in Colombia, by leveraging the billing information and payment histories of EPM’s customer base. Nearly 45 % of the Colombian adult population has no access to any formal financial service and is thus forced to recur to friends, family or informal money lenders as credit sources, who often charge significantly higher interest rates. The “unbanked” population in Colombia is especially at risk because of factors such as poor education and high unemployment, often resulting in subsistence activities in the informal sector. Access to finance has also proven to have a positive effect on firm creation, pro-poor economic growth and the reduction of inequalities. Furthermore, it can be a safety net for families suffering from a temporary shock due to income reduction or instability.

The goal of this OMJ project is thus: (i) to improve access to cheaper credit services at competitive market rates to low income populations; (ii) to improve their quality of life by providing access to home improvement finance and new and more efficient appliances as well as other goods and services; and (iii) to reduce the consumption of energy by giving the beneficiaries the possibility to replace old appliances with more-energy efficient ones. In addition, it will facilitate their access to a second credit or savings account.

A US\$ 10 million loan will be provided to *Empresas Públicas de Medellín* (EPM), the municipally-owned provider of electric, natural gas and water distribution services of Medellín, who will use the funds to set up a trust which will provide revolving credit lines for the purchase of domestic appliances (such as washing machines, refrigerators, microwaves, air conditioners etc.), technology goods (such as computers and telephones), video and audio equipment (such as TVs, digital cameras, DVD and home theater systems etc) and home improvement materials (such as flooring materials, baths and kitchens) for low-income customers. EPM itself will contribute another US\$ 30 million to the trust. The company has established a comprehensive network of allied retail distribution stores where the borrowers will be able to purchase the goods using specially issued credit cards. Billing and payment for the purchases, however, will be done through regular EPM

utility invoices. The Project follows the example of *Codensa*, the local energy distributor in Bogotá, who implemented a similar program with highly positive effects on the living standards of the poor as well as on the financial returns to the company. EMP will provide revolving lines of credit primarily to approx. 150.000 low-income households through 2015 who have demonstrated a good payment record. By leveraging this information, the project solves one of the most relevant market failures in BoP markets: the lack of reliable data on credit histories of low-income individuals which can potentially be used for future BoP transactions (such as microinsurance etc.). Furthermore, the project uses an existing commercial platform – utility services – to provide previously unavailable services to this population segment.

The project's development impact will be measured by outcome targets specified in the respective Development Effectiveness Matrix. These are, in particular, the percentage of previously unbanked BoP clients who, after participating in the project, have access to multiple financial services, the amount of reduction in annual interest rates for those populations as well as the increase in tenors available to them. Ex-ante assessments of all these indicators have been rated "excellent".

Source: Project Profile "Social Financing Program EPM-UNE" CO-L1080

4.6.5 Evaluation of OMJ Project Examples: Applying the points of BoP critique

After introducing two important OMJ projects in the previous chapter, I will now continue with a systematic assessment thereof. Using the points of critique outlined in the theoretical chapter 3 of this thesis as a framework, my goal is to find out if or to what extent they apply to these OMJ projects, which exemplify the implementation of Prahalad's BoP model by the Inter-American Development Bank.

a. Narrow definition of poverty and development

Although the IADB recognizes the multiple facets of poverty, including the lack of access to food, clean water, education, health services and personal safety (see IADB 1997, 1), its poverty reduction efforts are nevertheless primarily focused on the eradication of monetary poverty and the raising of income for the poor.

This is based on the assumption that “(...) *income provides the means to guarantee adequate levels of all the other basic necessities*” (ibid). In this matter, the IADB is completely aligned with the policies of the World Bank and the IMF. The Opportunities for the Majority Office is no exception and, just like any other department or office of the IADB, it primarily aims to alter the standard of living of poor people by targeting the improvement of their monetary welfare.

Karnani’s critique at the narrow definition of poverty in Prahalad’s BoP model is therefore directly applicable also to the activities of OMJ and the IADB (as well as the other IFIs) in general.

b. Over-estimation of the BOP market size

This point of critique cannot be directly applied to OMJ projects because the IADB does not work on a global level, but only in the LAC region. Moreover, it does not rely on Prahalad’s estimation of BoP market size but together with NGOs and national development organizations conducted extensive market research and prepared its own studies as a basis for its projects and interventions (see Martin, Dana 2009). These studies showed the existence of a market worth US\$ 500 billion consisting of 350 million people who earn less than US\$ 300 per month in the region. These numbers seem to make a case for the potential of private sector involvement in poverty reduction strategies which also yield profits for the companies.

c. MNCs are not suitable for BOP business

C.K. Prahalad originally envisioned MNCs as primary actors intervening on a large scale in the global BoP market. Critics, however, have doubted the feasibility as well as the positive contributions to (local) economic development of this idea (see chapter 3). Similar concerns have also been raised by the IADB’s Board of Governors when establishing the OMJ Initiative: *“While some firms share the goals stated above and may see the overriding need to operate in successful societies, financial considerations may temper their willingness and capacity to enter into ventures whose profitability is in the longer term or is uncertain. The overriding goal for all private firms is profitability and, from a solid*

basis of profitability, firms could engage in activities that promote the welfare of the majority. Unless proper incentives are in place, we run the risk of engaging firms that only see the majority as a market to be served and not a society to be developed” (IADB 2007, 3).

Although the BoP approach developed by C.K. Prahalad provides the theoretical foundation for the IADB’s OMJ Initiative, the practical implementation of the model by the office seems to differ with regard to the role of MNCs. While OMJ has collaborated with MNCs in some projects (e.g. street paving with CEMEX, see chapter 3), in the vast majority of cases, it has supported local enterprises, mostly SMEs or microenterprises (see IADB 2009: OMJ annual report). However, this must not be understood as undesirable incompliance with Prahalad’s theory, but rather as part of OMJ’s mission, which among other things includes *“(...) creating and strengthening microenterprises and small and medium sized businesses and to promote sources of employment and income for the Majority, in particular taking advantage of the operation of new and existing clusters and the opportunities to involve those businesses in the value chain of larger enterprises” (IADB 2007, 3).*

The case studies presented in the previous chapter reflect this practice.

“La Riojana” is a prime example of a local medium sized enterprise, which, thanks to its exceptional organization as cooperative, contributes to inclusive development essentially driven by its owners who are indigenous micro entrepreneurs. Thanks to democratic ownership and government structures, cooperatives are also regarded as a form of social business (see chapter 2). The downside of working with local SMEs as opposed to large MNCs, however, is the shorter reach of beneficiaries, which is limited to the viticulturists and their families.

The second case of “EPM-UNE” does not have such a strong focus on Bottom-up development. In this project, the local BoP population is involved only in the role of consumers of credit as well as designated consumer goods delivered by the fairly large company EPM. Although EPM is not a Multinational Enterprise, it is a major economic player in the project region as it is the provider of utility

services to 1.7 million customers in the city of Medellín (see PP CO-L1080, 18). Thanks to such a large client base, the number of beneficiaries of “Social Financing EPM-UNE” reaches 150.000. This is in stark contrast to the 500 micro-entrepreneurs benefiting from the project “La Riojana” and clearly demonstrates the frequent trade-off between the reach of an intervention and participation by local beneficiaries. Nevertheless, another important difference between Prahalad’s theory and the OMJ project “Social Financing EPM-UNE” is that the company is publicly owned; thus implying a strong collaboration with the public sector and at least an indirect participation of the people through municipal elections.

These aspects of the project are also captured in the Development Effectiveness Matrix for “Social Financing EPM-UNE” (see PP CO-L1080, Annex). While the project’s targeting of Majority populations and potential for scale have been rated as “excellent”, the role of the target population in the project has been identified as merely “satisfactory”. However, the DEM acknowledges OMJ’s collaboration with a publicly owned company and awards a “good” rating for the project’s alliances with other stakeholders. In addition, by leveraging the billing information of a utility provider for other large-scale development interventions, the project’s potential for replication in the LAC region has been given an “excellent” assessment.

d. Exploitation of the poor

One of the most important points of critique at the BoP concept is its perception as unethical exploitation of the poor, which instead of bettering their living conditions results in the complete opposite to the sole benefit of MNCs based in the Global North. Such criticism is especially directed at business models with a main focus on merely selling products to the poor, which include the BoP population only as passive consumers but not producers. It has been argued that such interventions may actually worsen living conditions for the poor if they result in a misplacement of priorities and unwise allocation of their scarce resources (see chapter 3).

In terms of the two OMJ project examples described above, such critique may be warranted in the case of “Social Financing EPM-UNE”. Though not directly *selling* products to the poor, objective of the business model is to stimulate low-income people’s consumption through the issuing of microcredit. While this practice does not imply negative effects per se – after all, microfinance has proven to be a powerful tool for the start-up of microenterprises or the investment in education, health or energy services (see Yunus 1998) – the focus of the program run by EPM appears suspicious. Instead of encouraging investments in human capital (such as education or health) or productive investments in microenterprises, the use of microloans awarded by the company is limited to the purchase of designated goods, many of which classify as luxury goods. Clients may use the loan to acquire materials for an improvement of their housing situation (such as floors, baths and kitchens) as well as durable consumer goods (such as washing machines and refrigerators) but they may also opt for a laptop, TV or digital camera. Whether these restrictions on the use of the microloan are indeed the most effective in terms of developmental impact should be subject to question. Given that over 90% of the target population already owns a refrigerator and more than 60 % are in the possession of a washing machine (see PP CO-L1080, 13), it is possible that many will use the microloan for investments in luxury goods instead of home improvement materials. Even though it is yet too early to predict outcomes, the project concept alone may warrant some criticism.

The OMJ case study of “La Riojana”, however, takes into account important remarks made by Prahalad’s critics concerning the use of microcredit in the BoP context. According to Karnani (2007), the only way to alleviate poverty is to raise the real income of the poor, and one way of doing this is by raising their incomes. This is essentially the objective of the OMJ project “La Riojana”. By awarding microloans to the owners of the viticulture cooperative for investment in new plants and production technologies, the enterprise is strengthened in its competitiveness domestically and abroad. Jaiswal (2007) also suggests this implementation of microcredit, which enables the poor to access powerful markets with their products, generating sufficient profits and allowing the microenterprise to grow and expand its reach to a larger number of small producers. Additionally, “La Riojana” being organized as a cooperative,

guarantees a democratic governance and distribution of profits of the business. In this sense, it represents an ideal example of a bottom-up driven social business model which includes the BoP population as consumers as well as producers of goods. By participating in the project, their standard of living is altered through higher incomes, stable employment as well as access to previously unavailable goods and services.

These positive outcomes are also reflected in the ratings in the Development Effectiveness Matrix. The DEM for “La Riojana” acknowledges the “excellent” targeting of Majority populations as well as their active contribution in the project (see PP AR-L1096, 12). Given that this is mainly thanks to “La Riojana”’s organization as a cooperative, the successful collaboration with such a type of business is rather innovative and has an important potential for future replication in Argentina and other LAC countries for the IADB (see *ibid*). Top rankings were also given to the OMJ project’s contribution to market expansion, technology & know-how transfer and alliances with multiple stakeholders, among others (see *ibid*).

e. Detracting from the imperative to correct government failures

Another controversial aspect of Prahalad’s theory is the complete neglect of the public sector’s role in poverty reduction. Thereby, the model ignores the fact that appropriate economic policies, basic infrastructure and functioning institutions – which form the necessary framework for any private sector activities – must be set by the government (see Karnani 2007, 106).

In the context of OMJ projects, however, a more positive and collaborative attitude toward the public sector can be identified.

In the case of “La Riojana”, public sector involvement is strong given that a substantial part of the project funds is contributed by the regional public authority and the Argentine Viticulture Corporation, a parafiscal body promoting the sustainable development of the wine sector in Argentina. Furthermore, the Argentine government supports the project with a grant for technical assistance

aiming at the facilitation of market access for the cooperative's products and strengthening of its institutional structures.

The project "Social Financing EPM-UNE" also demonstrates cooperation with the public sector as the principal actor in the operation, the company *Empresas Públicas de Medellín* (EPM), is the municipally-owned provider of electric, natural gas and water distribution services in the city of Medellín. In fact, it is precisely thanks to the collaboration with this public entity that valuable information about the credit history of the BoP population can be accessed and potentially used for future operations. By using the commercial platform of (public) utility services, the reach of the project is also remarkable.

As is evident from the two OMJ project examples, the office clearly values the contribution and collaboration with the public sector if it supports a market-based solution to poverty reduction. Deviating from Prahalad's original theory, OMJ does not seek to substitute or compete with public policies aiming at the reduction of poverty, but rather intends to forge creative partnerships with a variety of stakeholders, among which the public sector is one (see IADB 2007, Annex 1: A). Thus, this is also one of the 23 criteria for the assessment of a project's development effectiveness according the DEM. For both project examples the rating has been "excellent".

f. Scope of activities and targeting of LLDCs insufficient

Critics have raised doubts about the feasibility and effectiveness of BoP transactions in Least Developed Countries (LLDCs) (see chapter 3). Targeting primarily the population living on less than US\$ 2 per day, the focus of Prahalad's model indeed seems to be the alleviation of moderate rather than absolute poverty. However, given the level of economic development of the majority of the countries in Latin America and the Caribbean, the BoP approach seems quite appropriate for addressing the challenge of poverty in this region. Most countries in LAC belong to the group of Middle-Income countries (see World Bank 2010, www) and the percentage of population living in absolute poverty is relatively low compared to other geographical regions in the Global South. Except for Haiti, which classifies not only as Low-Income country (see World Bank 2010, www)

but also as LLDC (see UN-OHRLLS 2010, [www](#)), all 42 countries in the region belong to the category of Middle-Income countries, including emerging markets such as Argentina, Chile, Mexico and Brazil. These countries have experienced tremendous progress in development and poverty reduction during the last years and though not yet fully eradicated, absolute poverty has decreased sharply. Nonetheless, differences exist between Upper- and Lower-Middle Income countries; to the latter belonging Belize, Bolivia, El Salvador, Guatemala, Guyana, Honduras, Nicaragua, Paraguay and São Tomé and Príncipe (see World Bank 2010, [www](#)). The IADB distinguishes accordingly and classifies the countries according to the level of economic development and respective lending capacity in categories A-D. Category A comprises the borrowing member countries with the highest GDP and best creditworthiness, whereas the countries with the relatively lowest national income belong to category D. The criteria for lending is adapted to the four categories, so that C and D countries enjoy more favorable loan conditions than the countries belonging to group A and B. Approximately 35 % of the IADB's total lending volume is channeled to countries belonging to the lending categories C and D (see IADB 2010, [www](#)).

Table 3: IADB Lending Categories

A	B	C	D
Argentina	Chile	Bahamas	Belize
Brazil	Colombia	Barbados	Bolivia
Mexico	Peru	Costa Rica	Dominican Republic
Venezuela		Jamaica	Ecuador
		Panama	El Salvador
		Suriname	Guatemala
		Trinidad&Tobago	Guyana
		Uruguay	Haiti
			Honduras
			Nicaragua
			Paraguay

Source: IADB 1974

Up to date, the OMJ office has supported more than 20 country specific projects (loans, guarantees and grants for Technical Assistance) in over 8 different member countries, additional to several regional projects (see IADB 2009, OMJ Annual Report). Promoting BoP business models throughout the whole LAC region, it does not prioritize according to the project location.

Concerning the scope of activities, however, it is evident that the number of beneficiaries reached through BoP projects supported by OMJ up to date is limited. This is mainly due to the fact that the BoP idea and OMJ as an institution are very young and respective projects just started.. Nevertheless, OMJ is striving to grow in size, expand the reach of its operations to a larger number of beneficiaries and promote the BoP concept (Martin, Dana 2009). If eventually, BoP business can be transformed into an industry, as has happened with microfinance initiated by M. Yunus' Grameen Bank, the potential reach and

scope of BoP activities could indeed be extensive in LAC and other world regions.

g. Lack of a macroeconomic analysis

Since the OMJ Initiative has its theoretical foundation in C.K. Prahalad's theory of the BoP, it also emphasizes a micro-economic approach to poverty reduction (see IADB 2006, 1). However, unlike Prahalad's thinking, OMJ activities cannot be blamed for lacking a component of macroeconomic analysis. After all, OMJ is still a part of the IADB, an institution whose primary approach to development has been from a macro-level (see *ibid*). In fact, precisely because of its micro-economic focus, the implementation of the BoP model through OMJ represents a new development approach for the IADB, justified in part by the identification of a missing link between macroeconomic growth and the positive impact on overall society (see *ibid*). Nonetheless, even though OMJ projects operate mostly on the micro-level, they are always required to comply with the overall IADB country strategy (see IADB 2006, 5), which essentially outlines the medium- and long-term macroeconomic development objectives for the particular project country.

5. CONCLUSION AND OUTLOOK

5.1 Main findings and conclusion

Despite many years of efforts and development interventions global poverty, defined in monetary, biometrical or capability terms, still prevails. Traditional aid-based strategies, mostly driven by the public sector, have not produced the desired results and chances of meeting the first Millennium Development Goal of halving global poverty by the year 2015 are small. Given this reality, some academics have turned toward the private sector as an actor in development. Its capacity to innovate and efficiently use resources, increasing importance in our globalized society and its financial means seem to make it a promising player in the fight against poverty. Indeed, corporations have engaged in this endeavor for several reasons and in different ways, such as policy dialogue, Corporate Social Responsibility programs or social business models. Out of this rationale, C.K. Prahalad and Stuart Hart developed the Bottom-of-the-Pyramid approach, which intends to achieve the

alleviation of poverty by directing profitable business activities at low-income populations and incorporating them into the formal economy. The pyramid is used as a metaphor for the income distribution in society, with the top representing the wealthy minority and the bottom representing the population with low incomes. Despite much criticism for dubious assumptions and the potential risk of exploiting the poor, Prahalad's theory enjoyed high acceptance among international development institutions. The Inter-American Development Bank has demonstrated particular interest and founded the Opportunities for the Majority Initiative dedicated exclusively to the support of BoP business solutions. The intention of my thesis was to provide a critical assessment of the activities of OMJ, i.e. the practical implementation of Prahalad's BoP model in order to make a statement about the feasibility and effectiveness of this poverty reduction strategy. For this reason, I will revisit the research hypotheses concerning the activities of OMJ, which I initially outlaid in chapter 1, and try to verify/falsify them.

- The OMJ office of the IADB supports projects which fit C.K. Prahalad's BoP business concept; yet not all of its projects fully comply with Prahalad's theory.

Although drawing upon Prahalad's theory in its founding articles (see IADB 2006), the projects implemented by the Opportunities for the Majority office of the IADB do not always fully comply with Prahalad's theoretical model as has been demonstrated in the case studies "La Riojana" and "Social Financing EMP-UNE". Major differences are the support of local companies rather than MNCs and the significant involvement of the public sector in project funding as well as execution. These deviations from the theory are due to practical reasons as well as OMJ's explicit mandate to forge creative partnerships with multiple stakeholders (see IADB 2006) in order to ensuring the benefit of the BoP population from market based solutions for poverty reduction.

- The points of critique raised at the theoretical concept of Prahalad's BoP model also apply to its implementation through OMJ projects, except in cases where a deviation from Prahalad's model has been adopted.

The assessment of the case studies "La Riojana" and "Social Financing EPM-UNE" have shown that some of the critique raised at Prahalad's theory is also warranted for the practice. In adopting the narrow definition of poverty based on purely monetary

terms, the projects supported by OMJ primarily neglect all other potential aspects of poverty and are by definition unable to directly contribute to the improvement of any other facets of poverty than the lack of income. Just like Prahalad's theory, OMJ projects thereby run the risk of failing to address the root causes of poverty and the structures which prevent people from overcoming it.

The accusation of MNCs exploiting low-income individuals by incorporating them into the value chain only as consumers (not producers or vendors) of goods which might not even enhance their welfare must also be considered in practice. Although "Social Financing EPM-UNE" involves a public company instead of a MNC, the project nonetheless focuses on selling goods, many of which classify as luxury goods, to BoP populations without incorporating them productively into the value chain.

Such critique does not apply to the case of "La Riojana"; however, this project differs considerably by having as main actor not a MNC but a local cooperative. It is tempting to conclude from the comparison of these two case studies that MNCs are not suited for BoP business which truly benefits the poor as much as the company in general. Nevertheless, I would like to warn of such unfounded conclusions and rather emphasize once more the limitations of my research project which only examined two selected projects in a specific context. In order to make valid general statements about the BoP model and OMJ activities much more research will be necessary.

5.2 Outlook and further thoughts

Despite initial confusion and certain criticism, recognition and support for the BoP approach has strongly increased in recent years. National development agencies, NGOs, Multilateral Development Banks and the United Nations have all become active in the identification and support of projects which seek to eradicate poverty through profits. Some have clearly expressed the aim of expanding activities in this field (see Martin, Dana 2009). Likewise, the business community is showing increasing interest in business models with the potential of a win-win scenario for both the company and the poor (ibid).

Similarly, internal support for the Opportunities for the Majority Initiative has grown within the Inter-American Development Bank. Conditional on successful operations

and continued support by the Board of Governors as well as the President of the Bank, the OMJ office aims to grow in budget size and staff headcount after the renewal of its initial lending facility in 2012 (ibid).

In light of these developments, it is likely that the approach championed by C.K. Prahalad and Stuart Hart will become much more prominent in the future. If, in the long run, projects increase in number as well as reach and create an *industry* of BoP business, the vision is to minimize market failures for the poor and “[i]nstead of being left out in informal processes where they are paying these poverty penalties they [will be] brought in into the mainstream markets and the markets are really working for them, both in terms of job creation and in the provision of quality goods and services” (Martin, Dana 2009). Once we see this happen, we might find that poverty reduction for profit is possible.

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http://www.wto.org/english/thewto_e/whatis_e/tif_e/dev3_e.htm (May 12, 2010)

Other Sources:

Interview with Mr. Dana Martin, private sector specialist in the Opportunities for the Majority office at the Inter-American Development Bank in Washington, DC on December 15th 2009

The interview was conducted personally by the author of this thesis and audio visually recorded. The entire footage is in possession of the author.

7. ANNEX

Annex1: IADB CAPITAL STOCK AND VOTING POWER

Borrowing members	Shares	Votes	% of total votes (1)
Argentina	900,154	900,289	10.751
Bahamas	17,398	17,533	0.209
Barbados	10,767	10,902	0.130
Belize	9,178	9,313	0.111
Bolivia	72,258	72,393	0.865
Brazil	900,154	900,289	10.751
Chile	247,163	247,298	2.953
Colombia	247,163	247,298	2.953
Costa Rica	36,121	36,256	0.433
Dominican Republic	48,220	48,355	0.577
Ecuador	48,220	48,355	0.577
El Salvador	36,121	36,256	0.433
Guatemala	48,220	48,355	0.577
Guyana	13,393	13,528	0.162
Haiti	36,121	36,256	0.433
Honduras	36,121	36,256	0.433
Jamaica	48,220	48,355	0.577
Mexico	578,632	578,767	6.912
Nicaragua	36,121	36,256	0.433
Panama	36,121	36,256	0.433
Paraguay	36,121	36,256	0.433
Peru	120,445	120,580	1.440
Suriname	7,342	7,477	0.089
Trinidad and Tobago	36,121	36,256	0.433
Uruguay	96,507	96,642	1.154
Venezuela	482,267	482,402	5.761
Subtotal borrowing members	4,184,669	4,188,179	50.015
Regional nonborrowing members			
Canada	334,887	335,022	4.001
United States	2,512,529	2,512,664	30.006
Subtotal regional nonborrowing members	2,847,416	2,847,686	34.007
Nonregional Nonborrowing members			
Austria	13,312	13,447	0.161
Belgium	27,438	27,573	0.329
China, People's Republic of	184	319	0.004
Croatia	4,018	4,153	0.050
Denmark	14,157	14,292	0.171
Finland	13,312	13,447	0.161
France	158,638	158,773	1.896
Germany	158,638	158,773	1.896
Israel	13,126	13,261	0.158
Italy	158,638	158,773	1.896
Japan	418,642	418,777	5.001
Korea, Republic of	184	319	0.004
Netherlands	28,207	28,342	0.338
Norway	14,157	14,292	0.171
Portugal	4,474	4,609	0.055
Slovenia	2,434	2,569	0.031
Spain	158,638	158,773	1.896
Sweden	27,268	27,403	0.327
Switzerland	39,347	39,482	0.471
United Kingdom	80,551	80,686	0.964
Subtotal nonregional nonborrowing members	1,335,363	1,338,063	15.979
TOTAL	8,367,448	8,373,928	100.000

Annex 2:

Partial transcript of the Interview of December 15th 2009 with Mr. Dana Martin, Senior Investment Officer at the IADB's Opportunities for the Majority office.

E: I was curious about the origins of OMJ. Can you tell me more about how this initiative evolved?

D: Well, the Bank has been involved in both Public and Private Sector Development in Latin America obviously for the past 50 years and the private sector work of the Bank has evolved during that time. And a few years ago...um...well, at the time the new president came to the Bank, Luis Alberto Moreno, it coincided with the publication of several leading texts on...on this "business idea" that came up in business schools, largely led by C.K. Prahalad but by other writers as well like Stuart Hart, about doing business in the Base of the Pyramid. And the interesting part about it was the question of what could a Multilateral Development Bank bring to this process to try to help the private sector enter as a more prominent player in development in the region. And so we had a conference...ah...we had several prominent speakers come to that conference and we prepared a book on the occasion at that time to make an argument for what the opportunity was in Latin America. Ah, at the conference we had Bill Clinton, ah with our new president, Luis Alberto Moreno, and we also had several other prominent speakers, like Hernando de Soto, and Carlos Slim from Mexico and...and several others. And we explored what this...this opportunity might be in the region and...and how the...a bank like the IDB could be involved in that process. Following that we came up with a...or first of all, the president appointed a working group, it was an inter-disciplinary working group made up from people from throughout the Bank, both in the public and the private sector. (...) In the end the decision was made to launch this initiative in a 2-step process. The first would be to have a learning period where we would go out and we would try to understand what are the major players that are working in this area, especially private sector businesses in Latin America, but then also try to get an idea of what the market looks like. What is this group that we had identified? Let me go back for a minute and mention the study that we did with the World Resources Institute. As a result of that study, which is...it's called "The Next Billion"...or "The Next Four Billion". In that study they identified that within Latin America there's a market of 350 million people or better...expressed, there is a group of people in Latin America, the "Majority" as we call them, which have annual earnings of less than 300 dollars a month. And that comprises 70 % of the entire region. And we also became aware that this same group represents a purchasing power of 500 billion dollars. (...) So we went out and we did these studies, we did segmentation studies of the housing market in Peru, we did...ah...basic market surveys in the telecommunications sector in Brazil and in Mexico. We also did market surveys in the health sector...in El Salvador and in Colombia. (...) We went back to our Board of Directors with the results of the study, they...they agreed that there was an opportunity...they decided that we should take a private sector focus and so they

created the Opportunities for the Majority...ah...Facility, which is a 250 dollar lending facility exclusively for Non-Sovereign-Guaranteed Operations, or operations with private sector businesses.(...)

E: How would you explain the strong support for OMJ by president Moreno?

D: I think...ah...president Moreno came to the Bank with a reform agenda. He was looking for a way to...to shake up the institution and...and to revitalize it and make it relevant to today's...ah...Latin America and the needs of the region. And...I...I think part of it was the overall institutional realignment that...that he led for the Bank, which was a restructuring of the entire bank. Within that process, he created or...or under his leadership was created the Vice-Presidency for Private Sector, which had not existed before. There were three windows in the private sector in the Bank at that time: there was the Inter-American Investment Corporation, there's the Multilateral Investment Fund, which are both...they both have their own charters...uhm...and governance structures even though they are part of the IDB Group. And then within the Bank, there was the old Private Sector which became the Structured and Corporate Finance Department. But of those three windows, none of them had an exclusive focus on low-income markets and on solutions for...on market based solutions for low income markets. (...) I think he just brought a personal, academic ah...and...and informed interest in this area (...). And by the way, this is the first Multilateral Development Bank that has a full-time...ah...team dedicated exclusively to this with an exclusive focus on market-based solutions for low-income communities.

E: You already mentioned the MIF and the IIC. Since they're both focusing on private sector operations as well, are there any...institutional interests with those members of the IDB Group (...)? Is there internal competition with those private sector arms of the IDB which may hinder the OMJ Office of the IDB?

D: (...) I think initially (...) there was a lot of confusion about what the initiative was really about and...and fears that...of competition because I think that every department within the Bank is dedicated to working in Latin American Development and every department of the bank, almost every official in the Bank would say that they are in some way engaged in this process of working not only with development but of also helping ah...ah...the majority in Latin America or the low-income communities, either directly or indirectly through their work . (...) But I think when it finally became clear to people that first of all, we're working only with Non-Sovereign-Guaranteed Operations, that we're trying to bring the private sector into the space, we're looking for market-based initiatives, that this in no way substitutes for all the important work that has been done and must continue to be done with the public sector areas. (...) We're really not competing with the MIF or the SCF or the IIC (...) I think the level of cooperation has been building...ahm...over the last year and a half with the other windows and as you know, we now have parallel financing on a lot of our operations (...)

D: I mentioned earlier that we did these studies in the...in the health sector in a couple of countries. We're finding the same thing there: that there's a willingness by low-income people to pay...ah...for private services even when they reportedly should be provided by the public sector. But because of a lack of resources and the quality of the services, if the private sector can come in with a better...better value proposition than that can be very valuable in terms of the well-being of...of the families.

E: So what are your future expectations for OMJ? What's going to happen after 2011?

D: We hope that we have made...and believe we have a compelling case for what can be done...uhm...with...by bringing the private sector into developing these...these...these ah, these market-based solutions for low-income communities. We see that that's really resonating outside the Bank (...) and we also see the same thing happening inside the Bank. That gradually, as understanding builds of what we're doing, the more comfortable people are with it and the more compelling the case is to try to...to keep moving forward and...and to build this...and...and make it an ongoing part of...of the Bank. (...) I think there's going to be strong institutional support to move forward with this and...and keep it going. (...) My guess is that there will continue to be a dedicated tea...ah working on this, that that team will...ah...will...will...will grow and...and this is gonna remain and become an increasingly important area of...of the many tools that the Bank has to...to serve our member countries in Latin America.

E: Do you know of any other MDBs that are currently interested in forming institutions, departments similar to what OMJ is doing?

D: (...) IFC has been very interested in what we're doing. In fact, they're developing gradually a similar program of their own. I...I don't know they will necessarily have a separate institutional structure. It may be mainstreamed within their operations. (...) But I think it's an important point here to add what Michael Chew has said, you know, one of our strong supporters and...and actually one of our clients, professor at Harvard University and former CEO of Accion International but...but he talks a lot about the need for an industry. It's not enough to just have individual business models. (...) What would the ultimate vision of success be in what we're trying to do? (...) That you'd find that markets in Latin America are working for low-income people, that there instead of being left out in informal processes where they're paying these "poverty penalties" they've been brought into the mainstream markets and the markets are really working for them, both in terms of job creation and the provision of...of quality goods and services. But if you're gonna make that happen, you can't do it with a 250 million dollar facility and 25 operations in a team of 10 people even if you repeat that every year...or now we're about 20 people really. So...it's important that other players come into this space and...and it's important to emphasize within

our dialogue what we've tried to do there. We've created this new website as well, you know, Majority Markets. The idea is that this is not just an IDB space. We wanted to move it off our own website to show that this is a...a...an honest open dialogue of everyone who wants to help in this (...) So if...if IFC wants to come into this and if the...you know the CAF and the...the a Central American Bank for Economic Integration and the AfDB and the ADB...you know, if all those players wanna come into this space, that would be fabulous and I would only hope that we have a small role in inspiring them to do so.

Annex 3: OMJ Development Effectiveness Matrix (DEM)

OMJ Development Effectiveness Matrix (“DEM”)			
Development Outcomes 5 Rating categories: Excellent, Good, Satisfactory, Partly Unsatisfactory, Unsatisfactory	Indicator Expected Results	Indicator Rating	Performance Area Rating
Project or Company Business Performance			Area rating
(1) FRR/ROIC	Number	Rating	
(1-1) Sector specific indicator – Revenue growth	Number	Rating	
(1-2) Sector specific indicator – New clients	Number	Rating	
(1-3) Sector specific indicator – Other	Number	Rating	
Contribution to Economic Development			Area rating
(2) ERR/EROIC	Number	Rating	
(2-1) Sector specific indicator (e.g., # people with new services)	Number	Rating	
(2-2) Sector specific indicator (e.g., improved living standards)	Number	Rating	
(2-3) Sector specific indicator - Other	Number	Rating	
Environmental & Social Effects			Area rating
(3) IDB Policy Compliance		Rating	
Private Sector Development			Area rating
(4) Competition		Rating	
(5) Market Expansion		Rating	
(6) Private Ownership & Entrepreneurship		Rating	
(7) Technology & Know-How Transfer		Rating	
(8) Higher Standards of Corporate Governance		Rating	
(9) Changes in Legal Regulatory Framework		Rating	
(10) Impact on physical or financial market infrastructure		Rating	
IDB Strategic Development Objectives			Area rating
(11) Country Diversification -C& D Country		Rating	
(12) Relevance to Country/Regional and/or Sector Strategy		Rating	
(13) Targeting of Majority Populations		Rating	
(14) Role of Majority in Project Company		Rating	
(15) Demonstration Effect /Potential for Replication		Rating	
(16) Potential for Scale		Rating	
(17) Alliances with stakeholders		Rating	
IDB’s Role – Additionality			
Financial Additionality			Area rating
(18) Provision of amounts, tenors and/or key terms & conditions not available in marketplace		Rating	
(19) Resource mobilization		Rating	
Non-Financial Additionality			Area rating
(20) Improvement in project structure/ risk allocation through financial engineering or innovative financial instruments.		Rating	
(21) Improvement in the context of the project (e.g. regulatory environment) through use of TC or other intervention.		Rating	
(22) Improvement of Corporate Governance		Rating	
(23) Improvement of Environmental/Social standards		Rating	
Comprehensive Rating			Overall rating

Source: IADB 2008

Source: IADB 2010, www



ABSTRACT

The present thesis deals with a critical assessment of the „Bottom of the Pyramid (BoP)” Model for Poverty Reduction and its implementation by the “Opportunities for the Majority (OMJ)”-Initiative of the Inter-American Development Bank.

Despite many years of efforts and development interventions global poverty still prevails. Traditional aid-based strategies, mostly driven by the public sector, have not produced the desired results and chances of meeting the first Millennium Development Goal of halving global poverty by the year 2015 are small. Given this reality, some academics have turned toward the private sector as an actor in development. Its capacity to innovate and efficiently use resources, increasing importance in our globalized society and its financial means seem to make it a promising player in the fight against poverty. Indeed, corporations have engaged in poverty reduction for several reasons and in different ways, such as policy dialogue, Corporate Social Responsibility programs or social business models. Out of this rationale, C.K. Prahalad and Stuart Hart developed the Bottom-of-the-Pyramid approach, which intends to achieve the alleviation of poverty by directing profitable business activities at low-income populations and incorporating them into the formal economy. The pyramid is used as a metaphor for the income distribution in society, with the top representing the wealthy minority and the bottom representing the population with low incomes. The analysis of this approach, including its origins and points of critique, is at the core of this thesis. Despite much criticism for dubious assumptions and the potential risk of exploiting the poor, Prahalad’s theory enjoys high acceptance among international development institutions. The Inter-American Development Bank has demonstrated particular interest and founded the “Opportunities for the Majority”-Initiative in 2006, which is dedicated exclusively to the support of BoP business solutions in Latin America. A critical assessment of the activities of OMJ constitutes the second, empirical part of this thesis. The feasibility and impact of the BoP approach are evaluated by applying the points of critique raised at the theory to two selected OMJ project examples.

Although some criticism seems warranted, the popularity of the BoP theory is increasing among international public and private organizations alike. Hence, prospects for the OMJ-Office are highly positive.

ZUSAMMENFASSUNG

Das Erkenntnisinteresse dieser Diplomarbeit liegt in einer kritischen Analyse der „Bottom-of-the-Pyramid (BoP)“-Theorie zur Armutsbekämpfung und ihrer Umsetzung durch die „Opportunities for the Majority“-Initiative der Interamerikanischen Entwicklungsbank.

Nach einem einleitenden Überblick über verschiedene Definitionen von Armut werden traditionelle Strategien zur Armutsbekämpfung, die in erster Linie auf Spendengeldern basieren, skizziert und der Beitrag privater Unternehmen zur globalen Armutsbekämpfung analysiert. Die Motive für Unternehmen, sich in diesem Bereich zu engagieren werden ebenso untersucht, wie die Möglichkeiten konkreter Beteiligung. Neben Public-Private-Partnerships und Social Entrepreneurships bietet das „Bottom-of-the-Pyramid“-Modell eine Möglichkeit, Armutsbekämpfung als integralen Teil in die Geschäftsidee eines Unternehmens einzubinden. Ziel dieses Modells, welches von C.K. Prahalad und Stuart Hart entwickelt wurde, ist es, niedrige sozio-ökonomische Schichten in den formellen Wirtschaftssektor zu integrieren und so zur globalen Armutsbekämpfung beizutragen. Die Pyramide dient als Metapher für die Einkommensverteilung in der Bevölkerung. Während an der Spitze eine kleine Minderheit von Reichen steht, bildet die Bevölkerung mit niedrigem Einkommen die Basis der Pyramide. Die Analyse der BoP-Theorie, welche in gleichem Masse Vorteile für Firmen und Arme verspricht, stellt, unter Berücksichtigung ihrer Entstehung und Kritik, den Kern der Diplomarbeit dar.

Die Interamerikanische Entwicklungsbank zählt zu den wichtigsten Anhängern dieser Theorie. Im Jahr 2006 etablierte sie mit der „Opportunities for the Majority (OMJ)“-Initiative eine eigene institutionelle Einheit zur Entwicklung und Finanzierung von BoP-Geschäftsmodellen in Lateinamerika. Die Analyse dieser Abteilung mit ihrer Entstehungsgeschichte und Positionierung innerhalb der Organisation ist Inhalt des zweiten, empirischen Teils der Diplomarbeit. Anhand zweier konkreter Fallbeispiele werden die Aktivitäten der IADB im BoP-Bereich aufgezeigt und anschließend auf die Kritikpunkte des Theorieteils untersucht. Fazit ist, dass sich die BoP-Theorie trotz teils gerechtfertigter Kritik international sowohl im öffentlichen als auch privaten Sektor zunehmender Beliebtheit erfreut. Entsprechend positiv sind die Zukunftsaussichten für „Opportunities for the Majority“.

CURRICULUM VITAE

PERSONAL DATA

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Summer School on Thai Cultural Studies through the UMAP Thailand Scholarship June – July 2008

Universidad Gabriela Mistral Santiago, Chile
Study Abroad through the Joint Study Scholarship Program July – December 2007

Austrian Study Centre for Peace and Conflict Resolution Schlaining, Austria
Participation in the International Summer Academy on
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RELATED WORKING EXPERIENCE

Internship at the Infant and Young Child Nutrition Program Geneva, Switzerland
The Global Alliance for Improved Nutrition March– June 2010

Research Fellow at the Opportunities for the Majority Office Washington DC, USA
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Internship at the Washington DC, USA
Austrian Trade Commission May – June 2009

Internship at the Peace Library Schlaining, Austria
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Internship at the Santiago, Chile
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Internship at the Peace Library Schlaining, Austria
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LANGUAGES

GERMAN: Mother tongue
ENGLISH: Fluent; Cambridge First Certificate of English (ALTE B2), grade A
SPANISH: Fluent; DELE Intermedio (ALTE B2), grade A
FRENCH: Very good knowledge; Diplôme de Langue - Alliance Française (ALTE B2), grade B
PORTUGUESE: Basic knowledge