



Impact of development capital on poverty reduction

*Tasneem Salam
Independent Consultant
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Question

Which strata of poverty reduction is an instrument like development capital best suited for? (e.g. international poverty line for extreme poverty (US\$1.90/day), lower middle-income (US\$3.20/day), or upper middle-income (5.50/day).) Please provide examples covering investments by DFID, CDC, IFC, Private Equity/Venture Capital/Impact Investors where available, covering the following parameters:

- *What kind of development capital instrument was used – loan, equity, guarantee*
- *Size of investment*
- *Country of investment*
- *Sector of investment*
- *Outcome and impact achieved in terms of: poverty reduction and job creation*
- *How was impact measured (methodology)*

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1. Summary

Evidence from current publicly available literature indicates that development capital has a positive impact on poverty reduction, but that this is achieved through indirect and induced impact rather than through direct impact. International Finance Corporation's (IFC) response to an Independent Evaluation Group evaluation is that "IFC engagements are focused on private sector development, job creation and sustainability and are therefore a means to an end to reduce poverty". Whilst there is quite a lot that has been written about the effectiveness of development capital in improving the lives of people in poverty, none of the literature addresses directly the three different levels of poverty set out in the query.¹ It is perhaps timely for development community to commission or carry out itself a rigorous study of impact of development capital on the three levels of poverty, firstly defining a methodology that could do this effectively. The literature indicates that to date development capital has been more effective in lower middle-income or upper middle-income poverty but is also supportive to reducing extreme income poverty. A part of the reason for this bias is that development capital is not focused on the poorest populations and tends to be directed at middle-income countries. There are examples of development capital that has been effective in reducing extreme poverty when it has been directed at the poorest. For the most part, however, development capital's impact on extreme poverty occurs in an indirect way, for example, when development capital recipients have clients who are from the poorest sections of the population. The link from growth to poverty reduction is, however, not automatic, and deliberate action is often required to incorporate distributional aspects of growth into project design and implementation. A key recommendation from the literature is the need to develop creative products and approaches to facilitate private investment in frontier markets. At the same time, innovative financing needs to be rooted in the overall objective of poverty reduction. It should be noted that where evaluation of programmes do exist, there is negligible information on gender and inclusion in general. Both institution level and project level evaluation exists, but much of this is in-house. There is limited independent review of impact.

Other key findings include:

- The literature tends to speak about lower-income and middle-income countries but not about the poverty lines that might be related to this.
- There is limited evidence of the achievements of outcomes for programmes involving the private sector. A study by the Development Assistance Committee (DAC) found that private sector engagement activities do not focus enough on development results, lack a clear theory of change and have weak monitoring systems (OECD, DAC, 2018).
- International finance institutions (IFIs) such as the International Finance Committee (IFC) pursue poverty reduction through economic growth. The majority of IFC's projects are designed to achieve growth, but the link from growth to poverty reduction is not automatic, particularly in situations where market failures and other inefficiencies limit participation of the poor in growth (IEG, WB IFC, MIGA,2011). Deliberate action is often required to incorporate distributional aspects of growth into project design and implementation.
- A recent evaluation of World Bank Groups (WBG) reinforced the "general lack of evidence of the direct welfare implications of market creation efforts". It recommended a

¹ I.e. international poverty line for extreme poverty (US\$1.90/day), lower middle-income (US\$3.20/day) and upper middle-income (5.50/day)

greater focus on monitoring and evaluation to understand the effects of market creation for the poor (IEG, 2019)

- Ending poverty requires a sustainable and comprehensive approach which will sustain people above the poverty line while also ensuring that they are more resilient to crisis and are able to benefit from opportunity and progress (Development Initiatives, 2014).
- At a country level, investment needs to be better targeted. It is not benefiting the poorest populations nor the countries with the lowest government revenues. Countries left behind receive the least investment in infrastructure and business and low amounts to education, which has an impact on human capital (OECD, DAC, 2018).
- The geographical focus of development finance is also revealed in research (OECD-DAC, 2018) where emerging evidence shows that non-official development finance mobilised through blended finance taken place in mostly middle-income countries and does not target all Sustainable Development Goals (SDG) equally. Part of the reason is the lack of information and knowledge of investors and the negative perception created by the press (CSIS, 2017).
- On the other hand, where projects are designed well, they have the potential to reach out to different levels of poverty. For example, a project by Sida facilitating lending to small and medium enterprises (SMEs) and micro-entrepreneurs in the private health care sector in Uganda by providing portfolio guarantees, showed that many borrowers were small clinics with a large number of customers that can be classified as poor (Sida, 2016). Whilst this might be classified as indirect impact on the poor, there are limited options to provide access to health care and education for the poor without creating the conditions for these facilities to be built and operated. To that extent it might be described as one of the conditions for creating direct impact.
- A key recommendation is the need to develop creative products and approaches to facilitate private investment in frontier markets. At the same time, innovative financing needs to be rooted in the overall objective of reducing poverty.

Overall, there is a lack of focus on monitoring and evaluation that would enable a comprehensive response to posed by DFID (IEG, 2019). From the secondary information available the overall view is that development capital has not had direct impact on the poor but that it has led to poverty reduction in indirect ways. It is perhaps the reason why the IFC has shifted focus to ending extreme poverty by 2030.

This report is structured around the following sections:

2. Financing Modalities: Provides an overview of the range of financing structures available and examples of how some have tried to reduce risk and also reach out to the poor.

3. Experience of bilateral and multi-lateral finance institutions: Explores the use of development capital for poverty reduction and presents evaluations carried out by organisations on specific financing structures.

4. Examples of projects receiving development capital: Presents examples of successful use of development capital in a range of projects and demonstrates the positive impact that can be achieved through targeted engagement.

2. Financing modalities

2.1 Summary of range of financing modalities

Development capital is public investment made in the private sector to achieve development objectives (DFID, 2015). Since public resources alone will not be enough to address the financing needs in developing countries, increasingly the approach is to use public resources to attract private finance, especially to sectors that can make a difference in achieving the SDGs. A range of different types of financing through a combination of public and private, domestic and international are now available and usefully summarised by Ferranti (2016) in Box 1 below.

See: Box 1: Range of public, private and public-private financing modalities, Ferranti (2016: 4), <https://www.brookings.edu/wp-content/uploads/2016/06/20060720deferranti.pdf>

In the arena of purely public sector options, ideas being pursued include new forms of taxation and borrowing against future aid flows. Another set of options attempt to modernise existing bilateral or multilateral lending to make them more responsive to recipient country requirements. Examples include lending in local currencies to reduce currency exchange risks, or greater flexibility in how guarantees are provided. A key concern where the private sector is involved is how to reduce the risks to investors as much as possible in each country specific situation. The private sector often assesses risks to be too high and may seem reluctant to partner with the development co-operation community because of its perceived cumbersome procedures leading to high transaction costs and no obvious advantage to their businesses (OECD-DAC, 2018). Three specific financing options are discussed below to highlight some of the challenges and opportunities faced by development capital.

Results based Sequencing of Loans and Grants

Employed successfully in the polio eradication campaign. Here a coalition with prominent grant funding from the Rotarians and the Bill and Melinda Gates Foundation helped countries pay off (hence “buydown”) debt from loans from the World Bank that were needed by those countries to mount intensive efforts to wipe out polio.

There is also an advanced form of the above with results based conditioning of support on performance; a government and external funder agree a programme of support where a government agrees to reach certain goals by a specified period. The external funder provides the loan. A third party becomes part of the agreement as a grant financier or lender, which commit to provide additional support when and only when the specified target has been met. The challenges include harmonisation between donors and getting grant financiers on board with sufficient funds to achieve significant impact. Despite the early examples of the Rotarians and Gates Foundation, the development world has been slow to follow. Bilateral donors have also been slow to show interest. This is perhaps a missed opportunity where despite demonstration of impact the development community has been slow to follow.

Global Development Bonds

Private foreign investment in developing countries would be larger if risks could be mitigated more effectively. Global development bonds is one way to do this.

Global development bonds is a private-to-private option, where funds flow from the private sector (mainly from developed countries) to private sector projects in developing countries. It does this by essentially packaging low credit rating investments (developing country projects) in ways that result in high rated aggregates that can borrow on favourable terms and pass on savings to poorer clients. The advantage of a private to private sector option is that it can avoid some of the bureaucracy and therefore time taken for additional aid programmes. On the other hand there is still some need for backing from public authorities to facilitate necessary legal and financial action (Ferranti, 2016).

Investing in Grassroots Business Organisations

At the opposite extreme of Global Development Bonds is funding and technical assistance to grassroots businesses. One initiative is the Strengthening Grassroots Business Initiative (SGBI) created by IFC. SGBI provides a package of funding and technical assistance to grassroots businesses, helping them to expand their impact and create opportunities for replication and scaling up. It also supports intermediaries and associations serving multiple grassroots businesses, and facilitates the sharing of experience and lessons learned with clients and partners. For example, Honey Care in Kenya is an enterprise established by local farmers and supported by IFC, expressly to increase the incomes of rural farmers. This programme trains them in commercial beekeeping and buys their honey at a guaranteed price. Honey Care then packages and sells the honey.

3. Experience of bilateral and multilateral finance institutions

Rigorous evaluation of the impact of development finance on reducing poverty is limited, but four different assessments that give an indication of the range of engagement and some of the key issues are discussed below.

3.1 Blending as development capital option

Blending is the strategic use of a limited amount of grants to mobilise larger amounts of financing from partner financial institutions to enhance the development impact of investment projects. Joining of grant money with more commercial sources of financing can be carried out through five different instruments: (i) direct investment grants; (ii) interest subsidy grants; (iii) risk capital; (iv) guarantees; and (v) technical assistance.

In an evaluation carried out by the European Commission, it is argued that the use of blending has enabled an organisation such as the EU to remain involved in and to be a significant development agent in the growing number of middle- and lower middle-income countries (European Commission, 2016). Since 2005, the number of lower-income countries where all grant financing of development projects is justified has reduced while the number of upper and middle middle-income countries has increased. Equally, blending has enabled the EU to increase the flow of development resources to lower-income countries in critical need of development aid, including fragile states. Thus, more than 50% (24 out of 46) of the countries that received blending finance in the period 2007-2014 have been under IMF conditions or poverty reduction and growth trust eligible. On the other hand, the level of funding going to lower-income countries was just 14% of the total amounts of loans of all blending operations included in the inventory.

Blending has also enabled the EU to finance major infrastructure at scale, and therefore enabled it to scale the socio-economic development of beneficiary countries.

The evaluation of EU projects found that until the end of 2013, the design and implementation of blending projects generally did not have a strong pro-poor dimension. For large scale blending projects, poverty alleviation was generally seen as indirect and stemming from economic development in general. There is an assumption that there will be “trickle-down” impact on poverty (European Commission, 2016). It is highlighted that sectors supported, for example that of energy is a global commodity and cornerstone of economic development and therefore has an impact on factors that influence poverty reduction such as employment, generation of incomes for landowners and reduction of rural migration. Some sectors such as water supply and sanitation have a more direct link with economic growth and poverty reduction, especially when focused on deprived areas.

Overall, the evaluation argues that although 72% of blending resources have benefitted lower middle-income (56%) and middle-income (16%) countries, there are large income disparities in those countries and therefore activities can still target the poor. To have a greater impact on poverty reduction will require more blending support to lower-income countries and more targeting of the poor.

3.2 Guarantees for market development and poverty reduction

The use of guarantees is one type of blending that has been popular with different organisations. An evaluation carried out by Sida on the use of guarantees for market development and poverty reduction provides some useful insights (Sida, 2016).

- The effects of guarantees reach the target group of the poor indirectly. Borrowers of banks will most likely not belong to the category of the poorest, but their employees or rural suppliers may be and so may the clients of the health services. Such an impact should not be seen as trickle down because one part of the equation of providing health services to the poor is to provide health care facilities and this can only be done by making that investment attractive to the non-poor.
- On the other hand, in terms of sustainable strengthening of inclusive financial markets, effects were limited. Portfolio guarantees did not result in “crowding in” by other banks, neither are partner banks eager to accept lower collateral once the guarantee agreement has expired. Commercial investment in MFI funding was not forthcoming at the scale expected; neither did a market for bonds emerge as a result of Sida’s intervention.
- The guarantee instrument when it comes to bringing about systemic changes in the financial market, may be a necessary instrument but is definitely not a sufficient tool. It is also not realistic to expect that guarantees, after expiration will change the behaviour of banks in favour of more risky lending to the SME sector, nor would it be desirable, given that banks also have a duty of care in protecting the funds deposited by savers. Thus lending patterns revert to previous practice once the guarantee is no longer available. The demonstration impact of the guarantee instrument does not create a sustainable change.
- Selection of a bank which fits best the expectation and objectives of Sida is the main method to maximise the use of a guarantee. Banks should be selected for co-operation, which can demonstrate access to certain types of clients that fit Sida’s target groups. For example banks with good outreach in poor and rural areas. So in order to maximise

impact on the poor whilst the guarantee is in place, it is helpful if the bank is located in an area with greater access to poor people.

3.3 Growth and poverty focus

IFC is one of the key organisations with a global remit that has focused on development capital to achieve poverty reduction. An evaluation of its achievement in poverty was carried out by the Independent Evaluation Group (IEG) of the World Bank in 2011. The majority of IFC's projects are designed to achieve growth, but the link from growth to poverty reduction is not automatic, particularly in situations where market failures and other inefficiencies limit participation of the poor in growth (IEG, World Bank, IFC Miga , 2011).

The evaluation revealed that although a combination of frontier areas and sectors such as infrastructure, agribusiness, health and financial markets may have a pro-poor orientation, there is still a need for projects to be designed and implemented in ways that actually enhance opportunities and the impact on poor people. It is also necessary to understand who are the poor, where are they located and how can they be reached. Moreover, there is a need to look at some of the non-income dimensions of poverty in providing access to opportunities.

A more recent evaluation by IEG found that creating markets that allows the poor to participate in markets or benefit from such efforts remains a challenge. One of the problems being the lack of monitoring and evaluation to understand the effects of market creation on the poor. The report critiqued the IFC's for lack of measures during project design that identified, targeted or tracked benefits for the poor. There is an overall lack of systematic data (IEG, 2019). The evaluation looked at three sector: financial inclusion. Information communication technology and agribusiness: In terms market access to the poor, it concluded that :

- In financial inclusion reaching the poor requires “patient capital” as it takes time for companies to breakeven.
- In ICT, the case studies showed that efforts to reach the rural poor and expand services beyond what is commercially viable were successful but proved to be difficult in several cases.
- In agribusiness, IFC found it easier to integrate small holders to larger farmers along the value chain. Particularly effective when IFC Advisory Services target capacity constraints along the value chain.

In its response the IFC agreed that there was a need for greater focus of monitoring and evaluation and at the same time highlighted that “IFC engagements are focused on private sector development, job creation and sustainability and are therefore a means to an end to reduce poverty” Moreover some IFC efforts do not immediately reach the poor. For example support to develop mortgage finance markets started with developing the market for higher income groups. Over time as the market developed the IFC was able to shift its focus to lower income segments. (IEG, 2019).

3.4 Impact investing

Impact investing is a particular use of development finance that has been growing in the last decade. It concerns investment funds, which have the aim of not only financial return but also making a measurable contribution to the achievement of social and environmental goals. It is

defined not by type of asset, but by intent. The IFC assesses current preferences for impact investment to be as much as US\$5 trillion in private markets – private debt and equity, real assets, infrastructure, and natural assets – and as much as US\$21 trillion in public markets. Adding development finance institutes to these estimates would increase these levels(IFC, 2018)

One area of debate is whether impact investors should accept commercial or sub-commercial returns from impact investment. Analysis of IFC projects found them to have performed competitively with emerging markets public equities. Thus development capital does not necessarily need to have sub-optimal commercial returns.

Going forward a number of challenges are identified, including developing transparency and discipline. As the word impact investing has grown as a brand, many funds that do not necessarily meet the criteria of investment funding have tried to promote themselves as such. The IFC in collaboration with other financial institutions have recently developed the Operating Principles for Impact Management that looks at (i) strategic content, (ii) origination and structuring, (iii) portfolio management, and (iv) impact at exit. All of which require independent verification. The Principles are intended to be adopted at the fund level, by asset managers (IFC, 2018).

4. Examples of projects receiving development capital

Project specific examples show how different types of development capital can reach out to the poor in diverse ways. It should be noted that these examples are not based on evaluations that have tracked change in individual or groups of beneficiaries and their income levels. Such a study was not identified in the research for this assessment.

Africa Improved Foods

Africa Improved Foods (AIF) is a manufacturer and supplier of high-quality and nutrient rich complementary foods to combat malnutrition for children and pregnant and breastfeeding women in Rwanda and the East African region (<https://www.cdcgroup.com/en/our-investments/investment-stories/>)

Investment: Joint venture public-private partnership to address malnutrition at scale. Commonwealth Development Corporation (CDC) committed US\$10 million of direct equity. Other organisations involved included The Netherlands Development Finance Company - *Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden* (FMO) and IFC. CDC funded the greenfield construction of processing facility in Kigali to service World Food Programme (WFP) and local government contracts as well as commercial retail routes.

Impact: In 2017, WFP products reached 1.7 million children in South Sudan, Uganda, Rwanda and Kenya, whilst the Rwanda Ministry of Health programme reached 74,916 children and 15,344 pregnant women and nursing mothers. In addition, the project has had an impact on the economy through its supply chain. AIF buys its maize and soy from local farmers, and has created a network of rural collection centres where smallholders can sell their produce without having to transport it large distances. As of 2017, nearly 9,000 farmers were included in its supply chain.

This is an example of a project that has been able to reach people in extreme poverty as well as impact on lower- and middle-income poverty through its impact on farmers.

MBIA Insurance Corp: Raising Money for Municipal Upgrades in Mexico.

Although Mexico is an upper-middle income country, the IFIs and DFIs are still active in the country and this project demonstrates an innovative form of development capital support. Following the 2008 financial crisis, Mexico was constrained by weak local capital markets and this left limited funding available for infrastructure projects. The public registry that stores the official records for land and property deeds had suffered from a lack of investment and had archaic and inefficient record keeping system that was susceptible to errors and improper transactions (<https://www.opic.gov>)

Investment: Overseas Private Investment Cooperation (OPIC) provided a loan guaranty of up to US\$250 million in conjunction with MBIA Insurance Corp. to support a local bond issuance that would raise funds to upgrade infrastructure including the public registry. The arrangement was structured for the debt from the bond issuance to be repaid with the future revenues from state's public registry. OPIC's investment guaranty provided the additional support necessary in the uncertain financial climate. The bond issuance was the first in Mexico in the wake of the financial crisis to be backed by property registry fees, and provided local capital market investors with an AAA-rated investment grade, fixed-rate, peso-dominated long term asset.

Impact: US\$315 million raised through the issuance was used to invest in State infrastructure including the upgrade of the public registry. The upgraded registry has introduced new steps to improve efficiency, productivity and reliability as well as to reduce corruption. It contributed to enabling the State of Mexico to launch its economic development programme in which it had identified legal certainty of property ownership as a key component in facilitating long-term growth and economic activity, which would also have an impact on the poor.

Impact Investing by OPIC

OPIC's financing for Impact Programme was launched in 2014 to focus on supporting high impact projects that find it difficult to obtain financing. By considering a portfolio of projects, the intention is to create a situation in which the risk can be evened out and that efficiencies can be gained in underwriting and monitoring (<https://www.opic.gov/opic-in-action/impact-investing>).

An in-house working group has been created comprised of OPIC staff across different departments that meets quarterly to review the pipeline and outstanding projects. US\$50 million has been invested in two years since the launch. Projects have also received financing from social investors including the Calvert Foundation, the Rockefeller Foundation, Omidyar Network, Accion Frontier Investments Group, and Shell Foundation amongst others.

Projects that want to apply for financing under the impact programme must have assets for US\$ 1 million, a scalable business model and meet certain sector based financial ratios.

Sustainable Communities – El Salvador

This is an example of how a development organisation can work with local companies to combat urban crime with job training and business connections. It is part of an initiative led by US. Global Development Lab's Global Partnership Team, where local private sector's expertise, resources and/ or networks play a significant role (USAID, 2015).

Urban crime is a something that affects everyone in El Salvador. Successful businesses are often located in neighbourhoods that can be overtaken by rising violence, with robbery, extortion and other crimes a constant threat. This creates not only human costs but also lowers property values and drives away customers.

USAID decided to partner with Grupo Agrisal, a family-owned business focused on real estate development and hotel management, and also with the Fundación Rafael Meza Ayau, a private non-profit foundation that supports and promotes projects, programmes and institutions focused on health, education and entrepreneurship for vulnerable people.

The partnership has two main activities. First, it provides targeted job training for at-risk youth, some of whom could be categorised as poor. The local NGO implementer draws on its network of member companies to connect these newly trained young people to potential jobs. Second, it promotes the creation of small businesses by running entrepreneurship and business management programmes, creating new economic linkages between the neighbourhoods commercial core and its outlying communities. In 2015, it was reported that the programme had invested US\$200,000 in seed capital (USAID, 2015).

The advantage of working with Grupo Agrisal was that it had deep knowledge of the local context and was able to move quickly as the programme progressed. Whereas multinationals can be highly complex and bureaucratic, local companies in El Salvador are often family-owned, with relatively straight-forward hierarchies and decision-making structures. Moreover, because the connections that the project is fostering between businesses and local communities are market-based ties that benefit all parties, there is an expectation that it will be sustainable.

Agribusiness – Blended Finance and Advisory Services

The Global Agriculture and Food Security Programme (GAFSP) and the IFC co-invests to provide affordable funding on favourable terms to companies partnered with smallholder farmers as a part of their overall value chain. In addition to funds, advisory support is given. For example, in the Solomon Islands, IFC and GAFSP developed a blended finance package of 30 million dollars and Advisory Services to promote best practice.

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Key websites

Commonwealth Development Corporation: <https://www.cdcgroup.com>

Organisation for Economic Cooperation and Development: <http://www.oecd.org>

Overseas Private Investment Corporation: <https://www.opic.gov>

World Bank Open Data: <http://data.worldbank.org/>

Independent Evaluation Group: <https://ieg.worldbankgroup.org>

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