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The politics behind economic development

A global political economy perspective on challenge funds



Abstract

This study explores the economic development mechanism *challenge funds* through the lens of critical development theories. The challenge fund mechanism was established to present an alternative to traditional top-down development approaches, but with most previous research coming from a new institutional economic perspective, they have seldom been problematised from the perspective of critical development theories such as dependency theory, postcolonial theory and post-development theory. Using evidence from eight semi-structured interviews with stakeholders working with Sida-funded challenge funds or grantees of the funds in Kenya, the study has found that challenge funds (1) have helped professionalise and mature businesses and the business environment, (2) has decolonising aspects and moving beyond conventional development, and (3) presents a combination of market solutions and a post-development approach in development cooperation. From this, it argues that challenge funds have incorporated critical development perspectives into a liberal market solution and are utilising the market-based approach to facilitate bottom-up development. This includes working to reduce North-South economic dependency and placing agency in development cooperation onto local stakeholders, while improving efficiency in development funding.

Keywords

Private sector development; challenge funds; economic development; inclusive business; inclusive finance; social impact; sustainable development; postcolonial; post-development.

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Abbreviations

PSD - Private Sector Development

PPP - public-private partnerships

SMEs - small and medium sized enterprises

1 Introduction

Since the 1990s, there has been an increase of private investments to developing countries, which has led to an expansion of new forms of partnerships and collaboration with the private sector within development cooperation (de Silva, Kokko and Norberg, 2015, pp. 13–14). This expansion is justified by the Swedish international development cooperation agency, Sida, through the argument that functioning markets are considered an essential part of providing people living in poverty with basic goods and jobs, since small and medium sized enterprises (SMEs) provide 50% of the world's jobs according to Sida (2024b). However, partnerships with the private sector within development cooperation is a disputed topic. While proponents argue for the opportunities of generating more effective aid, the opposing side worries that there is a fundamental conflict between business interests and development objectives, and that development funding should not be used to enhance private corporations (de Silva, Kokko and Norberg, 2015, pp. 13–14). Yet, collaboration with and support to development of the private sector is a central part of contemporary development assistance. In the 2023 reform agenda for Swedish development assistance, *Development Assistance for a New Era*, the Swedish government highlights the private sector, trade and stimulation of economic growth as key factors to lift people out of poverty and emphasise the need to generate synergies between trade and development assistance policies (Government Offices of Sweden, 2023, pp. 9–10).

Sida works with the private sector in two main areas: by partnering with large companies and organisations that contribute to sustainable development; and by targeting private sector development (PSD) directly through support to SMEs, inclusive value chains, reforms of the business environment, and improved access to business development services (Sida, 2024b). The approach is based on the principle of utilising collaboration to generate better results by improving social and environmental responsibility, creating sustainable results and systemic change, and catalysing resources such as knowledge and innovation capacity (Sida, 2021). To achieve these results, Sida uses a set of economic development mechanisms that approach private sector development in different ways. One such mechanism is *Challenge Funds* (CF), which focuses on contributing to the development of SMEs in the Global South. Sida describes that they use challenge funds to overcome the systemic lack of commercial capital in developing markets and support innovation while addressing a specific development issue (Sida, 2024a). They argue that due to the high levels of risk and uncertainty in the markets where the businesses are operating, commercial investors tend to not invest in them, and so, the challenge funds are

intended to bridge the gap of investment opportunities for SMEs seeking to scale their business or test an innovation on the market (Sida, 2024a).

The emergence of challenge funds as a mechanism can be linked to the debate over development problems being addressed through top-down approaches or "hierarchically coordinated [...] blue prints" that are commonly found in traditional development theories (Copestake and O'Riordan, 2015, p. 1). challenge funds were thus developed to present a decentralised, flexible and adaptive private-public partnership alternative that addresses the complexity of development issues. This paper will further develop the knowledge around whether this is the case and they do present an alternative to top-down development, or whether they continue to reinforce the existing hierarchies in development cooperation. Building greater understanding of them can help us to better understand the modern development agenda, or the so-called 'post-Washington consensus', as described by Copestake and O'Riordan (2015, p. 12).

Although quite common in development strategies today, challenge funds have been subjected to relatively little research and comprehensive evaluations (Copestake and O'Riordan, 2015, p. 1), specifically in regards to their theoretical positioning and whether they actually present an alternative to the top-down approaches. Previous research has mainly focused on the power dynamics between a government donor and private sector recipient of funding, leaning on new institutional economics and the principal-agent theory (Poulton and Macartney, 2012; Copestake and O'Riordan, 2015; Moore and Vining, 2023). The discussion has therefore been concerned with balancing the allocation of risk and power between the government and private actors to find the most efficient collaboration. While presenting important insights into how to build efficient principal-agent relationships, the long-term perspectives of development are limited. Little to no research has been conducted from the perspective of development theories. This lacking perspective is highlighted in the literature as an obstacle to making informed judgement on their combined impact in relation to other development mechanisms, approaches and theoretical understanding (Copestake and O'Riordan, 2015, p. 11; de Silva, Kokko and Norberg, 2015, pp. 13–14). Copestake and O'Riordan (2015, p.11–12) argue that this problem could be solved by more theoretical exploration of the social, political and economic dimensions of challenge funds operations, to gain understanding of their long-term impact.

Positioned in the intersection of global political economy, economic history, and development studies, the study uses a lens of critical global political economy and development theories to present a perspective on challenge funds stemming from development theories. The

thesis starts by placing challenge funds in the history of economic development and explores the political and economic trends connected to the post-Washington Consensus going back to the 1990s, before investigating whether challenge funds represent a continuation of top-down and Eurocentric approaches to development. This contributes to the knowledge of private sector development as a development strategy and how bottom-up development is pursued in the modern development agenda. Before the aim and research questions are presented, a background of the challenge fund mechanism at Sida will be briefly described.

1.1 The challenge fund mechanism in international development and Sida

Challenge funds have been used since the late 1990s, with the British Department for International Development (DFID) taking the lead, followed by CGAP, Australian Aid, Canadian Aid, USAid and Sida in the 2000s (Sida, 2013, p. 2). Copestake and O'Riordan (2015, p. 1) argue that their establishment can be linked to the critique towards the linearity in "hierarchically coordinated 'grand plans' and blue prints" of development strategies, and how these are undermined by the complexity of many development issues. challenge funds were thus developed to present a decentralised, flexible and adaptive private-public partnership (PPPs) alternative that addresses the complexity of development issues (Copestake and O'Riordan, 2015, p. 1). In the form of open competition, challenge funds encourage small businesses to produce innovative solutions to solve a particular development issue and develop a proposal for how to scale and spread the solution (Foley, 1999, pp. 815–816; Copestake and O'Riordan, 2015, p. 2). Internationally, the interest for challenge funds among development agencies arose from several factors, including: the ambition to engage more actors, particularly the private sector, without creating market distortions; the increased reliance on innovation and competition as a driver for innovation; and the focus on the desired outcome rather than the process of achieving them, allowing flexibility and diversity in how the outcomes are accomplished (Sida, 2013, p. 2). Sida started supporting challenge funds in 2007 following changes in the development policy set by the newly elected centre-right government Alliance for Sweden, which encouraged engagement with the private sector (IPE Triple Line, 2018, p. 15). The focus on the private sector was further scaled up in 2011 when Sida was tasked with developing new and innovative ways of working with development assistance, leading to increased use of the innovative challenge fund mechanism (IPE Triple Line, 2018, p. 15).

Sida defines challenge funds as a "financing mechanism to allocate (donor) funds for specific purposes, using competition among organisations as the lead principle" (IPE Triple Line, 2018, p. 12). They are used to finance entrepreneurs and innovators with a commitment to economic, environmental and social sustainability in market contexts where commercial capital is lacking (Sida, 2024a). Through the investments via the challenge fund, Sida takes on some of the risk facing business start-ups or entrepreneurs scaling their projects or business ventures, thus giving the business a chance to test their innovation and become self-sustaining (Sida, 2024a). Such an opening of investment opportunities is meant to trigger innovative and cost-effective solutions to development challenges that are otherwise not addressed by the market (IPE Triple Line, 2018, p. 5).

This approach is a part of a larger development plan to improve accessibility to financial services for businesses in emerging markets. While challenge funds operate to de-risk innovations and support small and medium sized enterprises (SMEs) in their quest to scale, Sida also uses other instruments to cover other stages of business ventures. One such example is the *guarantee* instrument, which is used to support companies when they are taking out a loan with a commercial bank. Commercial banks require a security deposit to grant a loan, and the company may not have the capital to cover such a security deposit. With the guarantee instrument, Sida provides the lender with the insurance that they will be paid back, even if the borrower would not be able to repay the debt, thus giving companies that face a lot of financial barriers the possibility to access commercial capital (Sida, 2024c). The combination of challenge funds and guarantees creates a so-called *Systems Approach for Inclusive and Sustainable Market Development* that can address underlying causes of unstable markets to make them more inclusive and accessible for people living in poverty (Sida, 2024b).

Sida currently supports several challenge funds operating on global and regional levels, and these are operated by fund managers. The fund managers identify a key development issue within a targeted field, and small companies in the field are then invited to submit project proposals on how to tackle the specific issue (Sida, 2013, pp. 1–2; IPE Triple Line, 2018, p. 5). Through a competitive selection process, the best project proposals are then selected by the fund manager and the grant is then distributed from the fund manager to the grantee or investee, i.e. the business receiving the grant. This study focuses specifically on Sida-funded challenge funds operating in and out of Kenya, and includes perspectives from all three levels of the funding chain: Sida, fund managers, and grantees.

1.2 Problem statement

With the increasing interest for public-private interaction and private sector development within international development cooperation, the importance of improving our understanding of the long-term impact of such development increases as well. As presented above, challenge funds were established to present an alternative to traditional top-down development approaches, and they exemplify the complexity of public-private development relationships. While there is a lot of research from a new institutional economics perspective investigating efficiency of these relationships, perspectives based on development theories are scarce. This means that the academic discussions have mainly focused on economic efficiency, and little to no research has been conducted problematising the approach through development theories such as dependency, postcolonial and post-development theories. The discussion and evidence regarding whether challenge funds actually presents an alternative to top-down development in practice is therefore weak, which is argued in previous research to restrain a full understanding of the broader impact they have on development cooperation.

1.3 Aim, purpose and research questions

The aim of this study is twofold. One overarching aim is to provide insight into whether challenge funds represent an alternative to top-down development, i.e. bottom-up development. Are they a continuation of top-down and Eurocentric approaches remaining from the Washington Consensus, or can they be considered a combination in which top-down market solutions are utilised to enable innovative bottom-up development?

The second aim is to provide insights into how relationships between public and private partners in development cooperation can be built to ensure efficiency while striving to not reinforce dependency and colonial legacies. The study uses aspects of principal-agent theory to analyse the relationships between Sida, the challenge funds and the grantees to better understand how power asymmetries between donors and recipients in development cooperation are addressed in these partnerships.

Using a combination of arguments from theoretical perspectives and the experiences of local stakeholders (i.e. fund managers and grantees) working with challenge funds in Kenya, the experienced effects on local economic structures and power relations between donors and recipients are investigated, contributing to the knowledge about the role of local entrepreneurs and innovators in the modern development agenda. In this, the study offers new perspectives on

how critiques towards top-down development are approached in the challenge fund mechanism, such as concerns of economic dependency on external funding and lacking agency of local stakeholders.

To achieve these aims, they have been operationalised by posing the following research questions:

1. *How can we understand challenge funds as a development mechanism in relation to the critiques towards top-down development and as an alternative to top-down development?*
2. *How can we understand the relationships between donors and recipients in challenge funding, particularly in relation to efficiency and local stakeholders' agency?*

This thesis starts with placing challenge funds in the broader historical scope of economic development and their underlying theoretical foundations. By building understanding of the rise of the private sector as an active partner in development cooperation and its connected critiques, the literature review lays the foundation for the context in which challenge funds operate and describes key aspects of the mechanism. Next, the theoretical framework is presented, starting with development theories criticising the colonial legacy and inequality in mainstream Eurocentric top-down development approaches, namely dependency theory, postcolonial theory and post-development theory. Following this critical approach, the institutional economics' principal-agent theory is presented, before going into the methodology, including the research design, semi-structured interviews, operationalisation, thematic analysis and ethical considerations. Next, the analysis and findings of the study are presented in three themes identified during the thematic analysis. And finally, the concluding discussion will answer the research questions and summarise key findings.

2 Literature review[1]

Despite the relatively small amount of research on the topic of challenge funds, there are a few researchers who have delved into them. Significant previous research has also been conducted on the closely related topics of private-public partnerships (PPPs) and private sector development (PSD) within development cooperation. This section reviews the existing literature, identifies key themes to be considered in this study, and will further develop the arguments about the research gaps. The review will position the study within the existing knowledge about economic development mechanisms and provide valuable insights into the background of liberal market solutions in development cooperation. This presents a necessary background to better understand the critique towards linear top-down development and the evolution of development cooperation, private sector development and challenge funding. The review therefore builds understanding of the influences that global political and economic dynamics, such as international development agendas and economic trends, have had on the design and implementation of challenge funds as a development mechanism. The first section will present the emergence of the post-Washington Consensus and introduction of the private sector as an active partner in development cooperation. The second section goes deeper into what the focus on entrepreneurship and the private sector of the post-Washington Consensus means in development cooperation. The third section then reviews the core concepts of additionality and innovation. Finally, the last section summarises some key take-aways from the literature review.

2.1 Global economic and political trends in international development cooperation

During the 1990s, the neoliberal development policies of the Washington Consensus were getting criticised by leading economists (Lopes, 2012, p. 71). The failures of structural adjustment and macroeconomic stabilisation programmes were becoming clear, and it is now well known that these programmes caused severe harm to social policies and poverty levels in many countries. Lopes (2012, pp. 71–72) describe that African countries took the hardest hit, with stagnating economic growth and declining investments interrupting poverty alleviation. Critics argued that

[1] Declaration of use of AI tools in literature review: NotebookLM was used to help sort through the literature and find specific sections in the literature again. Undermind.ai and SciSpace.com was used to initially find and get inspiration on research articles on specific topics and to sort through the literature available.

the market liberalisation policies and drawbacks of state interventions negatively impacted productivity and contributed to indebtedness, while also disproportionately favoring donor countries. This led to an establishment of an unequal donor-recipient relationship within development cooperation, in which technical expertise and strategic capability in implementing countries was undermined and the public sector was drastically weakened, according to Lopes (2012, p. 72). Meanwhile the markets of donor countries remained behind protectionist walls (Mawdsley *et al.*, 2018, p. 28), creating a global trade regime which obstructed African economies' comparative advantage and directly blocked their ability to use export revenue to diversify production and grow to their full potential (Lopes, 2012, p. 72).

These issues led to a moderate shift in the aid regime during the 2000s in which neostructuralist ideas of good governance and social sustainability complemented the still strong neoliberal agenda, marking the beginning of the post-Washington Consensus era (Güven, 2018, p. 393; Mawdsley *et al.*, 2018, pp. 28–30). The structural adjustment programmes were abandoned and poverty alleviation became the dominant objective of aid programmes. However, the trust in the potential of trickle-down effects of globalisation, free trade and economic growth remained. Güven (2018, p. 394–396) therefore argues that the post-Washington Consensus is a paradigm *expansion* rather than a paradigm *shift*, building on from the previous agenda while also incorporating new ideas. This expansion is conceptualised in the economic development programmes such as microfinance and slum improvement programmes, as described by Mawdsley *et al* (2018, pp. 28–30), which emphasised the possibilities of focusing development on the entrepreneurship and consumer markets of people living in poverty. These programmes were built on free-market foundations, but highlighted the potential of making the market working for people living in poverty and notions of 'bottom billion' capitalism (Mawdsley *et al.*, 2018, pp. 28–30).

This meant that the structural issues of the Washington Consensus policies largely remained, and the full extent of their problems became unfortunately evident during the financial crash of 2008 which sent the world into the worst financial crisis since the Great Depression (Wade, 2009, pp. 14–15; Lopes, 2012, p. 73). As a result, reformation of the financial system and development agendas were proposed and considered a necessity by many critics. Instead of following the Washington Consensus linear 'one size fits all' model of market development, a dynamic, flexible and holistic approach of adapting to each specific context was adopted (Lopes, 2012, pp. 82–83). The manner of how this shift came about is debated. On the one hand, Lopes

(2012, pp. 82–83) argues that this marked the decline of Western ideologies' domination in global policies, and that critiques of these ideologies, particularly deriving from postcolonial theories, would instead rise to a more central position (Lopes, 2012, pp. 82–83). On the other hand, the rationalist scholarship following the principal-agent model, points to the changes being driven by shareholder interests, particularly the largest Western shareholders (Güven, 2018, p. 407). Güven (2018, pp. 407–411), however, argues that the shift was not due to ideological changes nor major shareholder interests, but was instead driven by operational directives and changes in policy practice. This means, according to Güven (2018, pp. 407–411), that while policies may have stayed largely the same, the major change in the global financial structure after the 2008 crash was in the way policies were implemented.

Despite the changes in policy implementation and the wide consensus that a larger reformation of the financial system to account for the structural inequalities was a necessity after the crash of 2008, it is commonly argued that the crisis rather reinforced the existing power imbalance between the Global North and the Global South (Wade, 2009, pp. 14–16; Lopes, 2012, pp. 82–83; Milanovic, 2016, pp. 31–32). Due to the structure of global economics and the central positioning of the US dollar, such a reform of the financial system was interrupted (Wade, 2009, pp. 14–16; Lopes, 2012, pp. 82–83; Milanovic, 2016, pp. 31–32), and according to Mawdsley et al (2018, pp. 29–32), the regime following the financial crisis of 2008 turned back towards the neoliberal regime, but also incorporated elements of classical liberalism into a regime of 'retroliberalism'. In this regime, the state exists to facilitate economic growth and support the private sector, and aims to tie aid to domestic strategies. Concepts such as 'aid for trade' and 'sustainable economic growth' became central in this 'beyond aid' agenda (Mawdsley *et al.*, 2018, pp. 29–32), and are noticeable in the 2023 reform agenda for Swedish development assistance (see Government Offices of Sweden, 2023).

With the focus on outputs rather than inputs within challenge fund strategies (Foley, 1999, p. 813), the establishment of challenge funds can be considered a representation of the shift in policy practice that emerged in the 'retroliberal' development regime. In other words, development strategies started focusing on achievements of development cooperation projects as the control measurements instead of looking at the activities and processes that are put in place to achieve the desired results. Using open competition and pushing the businesses to develop a solid business plan for how to scale and increase the distribution of their innovation, the challenge fund model has been argued to make the grantees take ownership of both their solutions and the

addressed development problem (Foley, 1999, pp. 816–817). As a result, challenge funds represents the turn away from the Washington Consensus and the 'blueprint' approach for achieving development by following the same steps of economic development as the Global North, and instead encourage local groups to solve local problems with the support of the donor organisation (Foley, 1999, p. 819).

What this review of the past 35 years of development cooperation trends tells us, is that despite changes in the ruling ideologies and claims of creating 'new' development regimes, the trust in the market-driven economy remains as a guiding concept. This has presented a valuable background of liberalism's role in development regimes and agendas leading up to contemporary development cooperation. This is further represented in the increased support to private sector development which is covered in the next section.

2.2 Entrepreneurship and the private sector in international development cooperation

While the aim shifted from poverty alleviation to sustainable development, and a more dynamic and flexible approach to economic development was becoming central, private sector actors were formally established as 'active development partners' at the High Level Forum on Aid Effectiveness in Busan in 2011 (IPE Triple Line, 2018, p. 15; Mawdsley *et al.*, 2018, p. 32). To fully understand this establishment and the critique towards it, we must first understand how private detector development (PSD) is justified by policy makers.

2.2.1 Justification of private sector development in development cooperation

In general, private sector development (PSD) is argued by its proponents to play a crucial role in promoting inclusive and sustainable economic growth (Boer *et al.*, 2024, p. 1). In a 2015 report for the Expert Group for Aid Studies (EBA) on public-private partnerships (PPPs) within Swedish development, de Silva, Kokko and Norberg (2015, pp. 13–15) writes that partnerships with the private sector can be the basis for significant synergies that can create more effective development cooperation. This is argued to be the standpoint for development agencies for a few reasons. First of all, the private sector holds a large capital of both innovative and financial capacity that PPPs aim to leverage for the sake of sustainable development. For example, partnerships with the private sector can provide opportunities for mobilising new sources of finance and knowledge for development (de Silva, Kokko and Norberg, 2015, pp. 13–15). Second of all, since the majority of jobs in low-income countries are found in the private sector,

a focus on creating better jobs and higher salaries in the private sector is described as essential to reduce poverty (de Silva, Kokko and Norberg, 2015, p. 23).

Scientific articles, however, indicate that the reasons are not always so altruistic, with some arguing that there is significant amounts of self-interest acting behind the justification of the public sector entering partnerships with the private sector. Moore and Vining (2023) and Langan (2011) both claim that political self-interest is a common justification for the implementation of PSD. They argue that politicians may take advantage of the structure of a partnership with the private sector to make a project appear more efficient to enhance their political career. Such choices can neglect the long-term perspectives and stability that are needed for successful development cooperation. Copestake, O'Riordan and Telford (2016, p. 166) also saw similar trends in the development financing of small NGOs' innovative projects in the UK through challenge funding being justified mainly by political expediency.

Additionally, Langan (2011, pp. 93–98) argues that the PSD strategy of 'making markets work for the poor' is a discourse used by donor countries to justify a 'moralisation of liberalisation'. He claims that by seeing PSD in the broader structure and reflecting on the realities of trade agendas between donor countries and recipient countries, projects following the PSD strategy are in fact vehicles for the donor countries to pursue their own economic and political interests (Langan, 2011, pp. 93–98). This raises the concern that projects may not be designed in the most effective way as they may reflect the political interests rather than what the project needs. This is discussed further in the next section.

2.2.2 Concerns towards private sector development

As was described in chapter 2.1, critics towards the neoliberal influences in the development regime argue that the opportunities presented by PSD still operate within a flawed structure which rests on remaining global power imbalances. Using the example of the EU's trade relations with African, Caribbean and Pacific states, Langan (2011) discusses the problems with this structure. Langan (2011, pp. 106–108) argues that PSD is used as a discourse in EU policies to legitimise aligning trade liberalisation with equitable development outcomes. Narratives such as integrating low-income countries smoothly and gradually into globalised markets, and discourses of private sector wealth trickling down 'fairly' from businesses to vulnerable workers and communities, are commonly used by the EU to legitimise trade liberalisation policies as development. Through this discussion, Langan (2011, pp. 106–108) argues that the PSD discourse both neglects the structural inequalities of the global trade system and constructs the

strategic illusion that otherwise questionable trade deals are equitable. In other words, Langan (2011) claims the PSD policies are used more as a publicity stunt than a vehicle for delivering purposeful assistance to engage the private sector in socially beneficial activities and human development. This discourse tends to reinforce the inequalities of the global market according to Langan (2011, pp. 106–108).

Building on this, de Silva, Kokko and Norberg (2015, pp. 13, 36–40) describe that there is a concern over the risk of increased dependency on donor funding, ineffectiveness in certain areas of development, and the conflict between the private sector's commercial interests and the long-term concerns of the development aid agenda. While development aid focuses on objectives such as increasing local ownership and untying aid from donor countries' commercial interests, private sector corporations are designed to maximise profit. Boer and Anastasi (2024, p. 9) argues that without proper regulation, there is a risk that their profit maximisation comes at the expense of social and environmental benefits. This leads us into principal-agent issues in public-private partnerships (PPPs) and private sector development (PSD).

2.2.3 Principal-agent issues in public-private partnerships and private sector development

Related to the concerns over conflicting interests between public and private actors, the most recurring concern highlighted in the literature, is the concern over principal-agent issues emerging when working with the private sector in development cooperation. The principal-agent model deals with the relationship between two actors in which one actor (the principal) delegates resources to the other actor (the agent)[2] (Braun and Guston, 2003, p. 303). The model stems from new institutional economics which assumes that rational actors strive to maximise their personal gains (Braun and Guston, 2003, p. 303). In relation to public-private partnerships (PPPs), Moore and Vining (2023, pp. 271–273) writes that the relationship between a public principal and a private agent always includes some combination and balancing of costs for monitoring, cost for reduced effort, and additional social cost as compensation for the risk taken by the private agent. They explain that lacking monitoring of the agent can raise costs if the agent pursues their own goals, leading to inefficiency towards the principal's goals. Some costs must therefore go to

[2] The theoretical implications and how this framework will be used in this study is described in section 3.2.

adequate monitoring or strong incentives to maximise effort, but such a solution imposes risk onto the agent as it reduces the level of control the agent has over the project (Moore and Vining, 2023, pp. 271–273).

Based on this understanding of the dynamic between a donor principal and private sector agent, the literature on challenge funds emphasises the importance of finding agents whose interests align with those of the donor. Copestake and O'Riordan (2015, p. 8) writes that when goals and interests align, the partnership becomes more reliant on cooperation instead of supervision, leading to less spending on monitoring. Such alignment can also allow the agent the autonomy needed to best utilise their context-based knowledge and generate synergies with other activities (Copestake and O'Riordan, 2015, p. 8). According to Poulton and Macartney (2012, p. 105), PPPs themselves constitute a method for public actors to align incentives of the private sector with public policy goals. To achieve the best social and cost-effective outcomes, they argue that context-based knowledge and familiarity with the business environment of the private agents is essential when designing PPP contracts (Poulton and Macartney, 2012, p. 105). This leads us into the focus on ensuring *additionality* and fostering innovation in the local business environment within challenge funds.

2.3 Additionality and innovation

One major concern found in the evaluations of challenge funds is the question of whether the contribution from the challenge fund was essential for the proposed projects to proceed or if they could have gone on without the support from public development funding. This concept is called *additionality*, which refers to whether the "intervention will lead, or has led, to effects which would not have occurred without the intervention", as defined by Winckler Andersen, Hansen and Rand (2021, p. 9) in a OECD Development Co-operation Working Paper aiming to clarify the concept. Additionality is then generally understood in two distinctions: *financial additionality* and *development additionality* (Attridge and Engen, 2019, p. 18). Financial additionality refers specifically to the mobilisation of capital and investment that was made possible through the contribution, and development additionality refers to the generation of expected or unexpected impacts on a development issue that would otherwise not have occurred (Winckler Andersen, Hansen and Rand, 2021, p. 9). Given that the purpose of challenge funds is to generate and invest in innovative development ideas in markets with systemically lacking investment capital, both financial and development additionality are central aspects of challenge funding.

In an article drawing from years of experience working with challenge funds, Scott (2020) highlights four key aspects to consider when selecting projects to achieve the largest possible impact: innovation and commercial motivation; selecting business ideas that have the potential to be copied and replicated by others; purposively selecting business ideas that face legal and regulatory constraints; and selecting groups of business ideas in the same sector or region. While not specifically calling these characteristics *additionality*, the description of what phenomenon he refers to aligns with the concept as outlined above. Scott (2020, p. 4) argues that innovation and commercial motivation are two of the main characteristics behind business ideas that have a high potential of bringing large scale impact. This potential is described by Scott (2020, p. 4) to be dependent on whether the innovation's impact is limited to the single business, may be replicated by other businesses or change the way other businesses operate. In other words, Scott's (2020) arguments emphasise the importance of finding businesses that will bring both financial and development additionality.

One example of such an innovation funded through a challenge fund in Kenya is M-Kopa, a solar home power system with the disruptive innovation of the pay-as-you-go system that allowed households to acquire an off-grid electricity system for a small down payment followed by small daily fees paid through mobile money. This system allowed relatively poor households to gain access to electricity and the introduction of the pay-as-you-go model opened up the market for more innovations increasing the accessibility of products and services for people living in poverty. The innovation has also been replicated by other solar home system suppliers, creating a diversified market while avoiding monopolisation (Scott, 2020, pp. 4–5).

This discussion highlights the central role that innovation holds in the private sector development framework. De Silva, Kokko and Norberg (2015, pp. 13, 81) argue that this growing interest is coming from the idea that there is significant potential to be unlocked in the expansion to new and broader partnerships that are needed for further development. In the case of challenge funds, innovation is particularly considered an essential feature, according to Stawicki (2016, p. 49). Innovation as a concept is defined by Stawicki (2016, p. 44) as 'something new' and therefore perceived as risky by investors. The purpose of the challenge fund is then to de-risk the innovation and provide the innovator with the opportunity to test the innovation on the market (Copestake and O'Riordan, 2015, p. 9).

The focus on fostering innovation in development cooperation can also be linked to trends within the private sector. Anand *et al* (2021, p. 546) argues that multinational enterprises (MNEs)

have played a critical role in facilitating innovation in emerging economies. Similar to the reasoning for why the development agenda is turning away from the 'one size fits all' model of the Washington Consensus, Anand *et al* (2021, p. 546) argues that corporations operating in the Global South cannot simply copy the technologies and organisational models from the Global North. They need to adapt these capabilities to the context, and innovation in the Global South is therefore characterised by the process of filling gaps in the adaptation (Anand *et al.*, 2021, p. 546; Friz, 2024, pp. 138–139). While Anand *et al*'s (2021) study highlights specifically the role of MNEs and not small scale businesses that are the focus of challenge funds, the understanding of how the private sector has influenced innovation in the Global South is a relevant insight. It provides the background of how innovation as a development tool was introduced to international development agencies and is therefore relevant for the study as it indicates why the connection between private sector development and innovation is utilised to such an extent within development cooperation. An important note to add, however, is that while Anand *et al*'s (2021) paper presents the importance of MNEs in facilitating innovation in emerging economies, it is generally known that the presence of MNEs have negatively impacted economies in the form of contributing to rising inequalities. This discussion, however, falls outside the scope of this paper.

2.4 Take-aways from previous research

This literature review has presented the background of how private sector development rose to the position it has in contemporary development cooperation. It has described how development regimes over the past 35 years, despite claiming to renew itself, is still leaning on the market-driven economy. The main changes in the development agenda have instead been seen in the practical implementation of projects, which has moved away from the traditional top-down approach to focus on flexible and locally based solutions. In this, the private sector has been introduced as an active partner, and despite concerns over conflicting interests and principal-agent issues between profit-seeking companies and governmental development agencies there has been a consensus that there is potential in the private sector that can benefit the larger development agenda. With the focus on additionality and triggering disruptive innovation, the role of the private sector to achieve development goals has increasingly come to light. One key source arising from the literature review is Copestake and O'Riordan (2015), which will be revisited throughout the thesis.

This background provides the study with the background of liberal market solutions in development cooperation and the critique towards top-down development which has been significant when addressing the first aim of this study of providing insight into whether challenge funds represent an alternative to top-down development. It has also introduced research on challenge funds using the principal-agent theory, which will be used to address the second aim of understanding the relationships between public and private partners in development cooperation. This theoretical framework will be developed further in the following chapter.

3 Theoretical framework

This chapter presents the theoretical framework used in this study. To answer the first research question and aim concerning the representation of challenge funds as an alternative to top-down development, challenge funding will be situated in a critical theoretical framework to expose underlying assumptions in the challenge fund mechanism and provide insight into the power dynamics of challenge funds as a market-based economic development tool. The critical theories used to inform this framework are dependency theory, postcolonial theory and post-development theory. To answer the second research question and aim about understanding the relationships between donors and recipients in relation to efficiency and local stakeholders' agency, principal-agent theory will be used. Along with examples from the previous research, this theory provides a framework helping to understand the relationships between public and private actors in development cooperation, and how to make them efficient and sustainable.

3.1 Critical development theories: Dependency theory, postcolonial theory, and post-development theory

The three critical theories informing this study are dependency theory, postcolonial theory, and post-development theory. These theories represent the outset from which the critique towards top-down approaches towards development and therefore play a central role in the way the material is analysed and the presentation of challenge funds as an alternative to top-down approaches are understood.

From the outset, important aspects can be highlighted through the lens of dependency theory. Placing challenge funds in the broader critique of dependency theory, the study can question whether using challenge funds are mitigating or reinforcing dependency on external

funding, international investment and exporting. Dependency theory evolved out of Marxism as a criticism towards the systematic inequalities and exploitative nature in capitalist practices and theories of development and international relations (Dunn, 2010, p. 80), and argues that "contemporary capitalism [has] led to dependent forms of capitalism in the periphery" (Jäger, 2022, p. 258). Dependency theory sees capitalism as a continuation of colonialism, and claims that the 'underdevelopment' of countries – usually previous colonies – is directly linked to the development of countries – previous colonisers (Hopper, 2018, p. 24). The role of development aid in this systematically unequal order has been deeply debated within development studies, with some arguing that aid simply contributes to the political and economic power imbalances between the Global North and the Global South, as it creates a relation of dependency of the recipients on their donors, distorts markets and remains 'unhelpfully top-down' (Gardner and Lewis, 2015, p. 17). So, while evaluations of challenge funds through a liberal and capitalist lens might give an image of success, they may be considered counterproductive through the lens of dependency theory that emphasises the unjust nature of global capitalism. As such, they are not addressing the root cause of global inequality and poverty from this point of view. Therefore, this perspective will add an important critical standpoint that will emphasise the impact of challenge funds in particular, and private-public economic development partnerships in general, on tackling inequality on a global scale. This will provide a critical basis for the study to understand how challenge funds have impacted local politics and economic structures.

Postcolonial theory adds another layer to the dependency critique. Given that development policies and practices can be traced back to colonial development agendas (Hopper, 2018, p. 2), the perspective of postcolonialism is essential for any study regarding development cooperation. Postcolonialism adds a critique towards the eurocentrism in the development discourse that is left out of dependency theory (Kapoor, 2008, p. 10). While dependency and postcolonial theory share the same 'enemy' (liberal modernity and capitalism), postcolonial theorists argue that dependency theory reproduces binaries from the colonial past, such as 'underdeveloped-developed' and 'centre-periphery', and the uneven power structures between them. Despite attempting to shift focus towards the perspective of the 'underdeveloped', dependency still uses Europe as the universal model in its critique of the binaries. In this, the West remains as the dominant in the hierarchy and the point of reference – the standard – while

colonies and ex-colonies, or the 'underdeveloped' continue to be discursively subordinated and 'peripheralised' as the 'Other' (Kapoor, 2008, pp. 10–11).[3]

As a concept with its roots in colonial history, it is essential for development aid cooperation (including research concerning it) to recognise the perspectives of structural injustice that are highlighted in postcolonial theory to move forward towards a more equal world order. Postcolonial theory highlights the culture and politics of representation (Kapoor, 2008, p. 10), and will bring light to the aspect of representation in the challenge fund mechanism in this study. This perspective will therefore create a basis for analysing the underlying power structures of challenge funds, which will provide insight into how they have influenced local political and economic structures.

Finally, the last theory informing this study is post-development theory. Like postcolonial theory, post-development theory also builds on dependency theory and thus also critiques the mainstream theories of development, but instead of solely explaining global inequality by critiquing the capitalist world order, it aims to build a *pluriverse* of alternatives to the mainstream development agenda (Acosta and Cajas-Guijarro, 2022, pp. 292–293). Post-development calls for continued rethinking and reconstruction of economic, political and ecological interactions to step away from capitalism (Acosta and Cajas-Guijarro, 2022, p. 299). It incorporates a plethora of alternatives to the traditional development agenda, which Kothari et al (2019) in their book has categorised into *reformist solutions* and *transformative initiatives*. Reformist solutions refers to development initiatives that attempt to adapt the current world order to become more environmentally sustainable, just and equal, but from the post-development perspectives, these are unlikely to be successful in the long run due to its remaining ties to capitalism (Kothari *et al.*, 2019, pp. xviii–xix). Some examples of reformist solutions include sustainable development, circular economy, and ecomodernism. Transformative initiatives however, address the root causes of global injustice and the climate crisis, i.e. the core features of the development discourse, including economic growth, markets, and sexism, and suggests to abandon the current world order entirely (Kothari *et al.*, 2019, p. xxix). Some examples labelled transformative in Kothari *et al*'s (2019) book include human rights, degrowth and ecofeminism, as well as buen

[3] The discussion on what terms to use when talking about development of countries is extensive and they all have their pros and cons. Yet, for the purpose of clarity, the use of a variety of categorical terms such as 'emerging markets', 'the Global South', and 'Western countries', are needed in this paper in lack of better alternatives.

vivir and ubuntu. In the context of post-development, challenge funding as a concept falls into the reformist solution category as a market solution.

Ultimately, the post-development approach provides a perspective that highlights the importance of plurality in development approaches as it critiques the eurocentric linearity that dominates the development discourse. This perspective will therefore be helpful in understanding the emphasis on flexibility and diversity in the modern development agenda that have informed the establishment of challenge funds. With the approach that development requires a *pluriverse* of development alternatives, combined with the critique towards eurocentrism coming from dependency and postcolonial theory, the theoretical positioning for this thesis is that development projects must be bottom-up and created for and of the local context. The question that remains in this critical lens is how that can be done practically when the funding still comes from the Global North.

The critical theories outlined here constitute a framework useful for understanding the full context of development cooperation in which challenge funds operate. These theories provide a critical lens that helps us understand the underlying power dynamics inherent to development cooperation.

3.2 Understanding donor-recipient relationships: principal-agent theory

To understand the relationships between donors and recipients in development cooperation, the study used the principal-agent theory. Principal-agent theory deals with the social relation of two actors that are involved in delegation and an exchange of resources and occurs when there is one actor – the principal – delegating resources to another – the agent (Braun and Guston, 2003, p. 303). The theory was developed from the new institutional economics framework and assumes that rational actors seek 'opportunism' and to maximise their personal welfare. Shrestha *et al* (2019, p. 2) argues that while both actors together aim to deliver a successful outcome of the project, each actor will also seek ways to extract gains from the other actor and from the project, according to the principal-agent theory. Braun and Guston (2003, pp. 303–304) describe that in this search to maximise their personal gains, actors may act in a manner that can be described as devious or dishonest for the sake of their self-interest.

These issues may occur due to 'information asymmetries' between the agent and the principal. There are two problems associated with information asymmetry, as described by Braun and Guston (2003, pp. 303–304). The first problem is called the 'moral hazard', which describes

issues related to the information advantage that the agent holds over the principal because the principal cannot know exactly what the agent will do with the delegated resources. The second problem is called 'adverse selection' and refers to the insufficient information the principal has on the abilities of the agent to complete the task delegated to them (Braun and Guston, 2003, pp. 303–304).

As a result, the theory assumes that agents acting in self-interest may hide such information from the principal or share a forecast of higher earnings and lower risk-related expenses to secure the contract or reduce their workload and risk, thus making the principal carry most of the risk (Wang and Liu, 2015, p. 1320; Shrestha *et al.*, 2019, p. 2). Meanwhile, the principal acting in self-interest may withhold information about their incentives to deliver all the resources and 'shirk' the agent, meaning they would not provide the agreed upon resources to them (Shrestha *et al.*, 2019, pp. 2–3). These issues in turn can result in the delegated project not reaching its full potential (Braun and Guston, 2003, p. 304; Wang and Liu, 2015, p. 1320).

The literature discussing these issues in the context of government principals and private sector agents present a framework of how to reduce the risk of running into them. Based on the concerns of information asymmetry highlighted above, Shrestha *et al* (2019, p. 3) argues that one of the most important challenges for partnerships with the private sector in development cooperation is to balance the allocation of risk between the agent and the principal. They argue that it is the sub-optimal allocation of risk, when the agent takes advantage of the moral hazard and adverse selection or the principal is not incentivised to deliver the resources and 'shirk', that is the primary cause of failures of private-public partnerships. When the risk is balanced and the partnership is designed so that the private corporation is involved in both the implementation process and the following operational stage of the project, it is likely to outperform conventionally procured projects, according to Shrestha *et al* (2019, pp. 2–3). Since both the private corporation and public donor is then involved throughout the full lifetime of the project, they are incentivised to deliver high quality in all stages (Shrestha *et al.*, 2019, pp. 2–3). The risk of 'shirking' can also be reduced by creating a market-like structure in the procurement of the agent, making it so there are several agents present in the project (Braun and Guston, 2003, p. 304). Finally, aligning interests between the principal and the agent is pointed out as a key way to reduce the risks associated with information asymmetries and costs of monitoring (Poulton and Macartney, 2012, p. 105; Copestake and O'Riordan, 2015, p. 8).

In projects involving government principals and private sector agents, it is common that there are different levels of delegation, making some actors both principals and agents. This is discussed by Moore and Vining (2023, p. 268) as they argue that while governments are commonly seen as a single *principal* aiming to maximise social-welfare, in a democratic country it is in fact an *agent* implementing the work delegated to them by the citizens. Moreover, governments are not a single entity, but consist of multiple agents working on different levels to implement the delegated tasks. What this discussion means is that there are levels of principals and agents acting in government funded operations. In this study, three levels of delegation have been observed and defined. First, Sida is defined as the head principal as the source agency from which resources are delegated to other actors – challenge funds in this case – with the task of implementing projects supporting the achievement of Sida's strategic goals. Second is the fund managers running the challenge funds, which are agents to Sida because they have received the resources to manage projects that contribute to Sida's strategic goals, but also principals of the grantees to which they delegate those resources to implement the projects that will contribute to the strategic goals of both the challenge fund and Sida. And finally, the grantees are the implementing agents utilising the resources that have been delegated to them from the fund managers to implement projects that make them achieve their own strategic goals while also contributing to the strategic goals of the challenge funds and Sida.

While the principal-agent theory at its core is concerned with information asymmetries and generally describes a relationship of distrust in a partnership with delegation of resources, the framework of conditions that can foster efficiency in principal-agent relationships presented in the literature are central for this study. Particularly the discussions on balancing the allocation of risk, ensuring the presence of several agents, and finding aligning interests has informed the empirical analysis. These concepts and their operationalisation will therefore be presented further in the methods chapter (see section 4.3).

3.3 Reflections on theoretical framework

The theoretical framework combining a critical framework of dependency theory, postcolonial theory and post-development theory with the principal-agent theory provides a broad lens for the analysis. While critical development theories are problematising the traditional development agenda and global economic order, the principal-agent theory addresses ways to approach issues of efficiency that may arise when large sums of money is involved. The aspects of distrust

particularly towards the agents that are described in the principal-agent theory can certainly be seen as a contradiction towards postcolonial theory, which highlights the systematic injustice of belittling actors and ideas coming from the Global South. This contrast has however been used in this study with the intention of finding a way forward for the collaborations between the public and private sector to address these systematic injustices by building trust to ensure efficiency.

4 Method and methodology

This chapter will outline the methods for data collection and analysis that will be used to answer the research questions. First, I will discuss the use of a single case study as the research strategy, followed by a presentation of the semi-structured interviews as the method for data collection. Next, the process of thematic analysis that is used for the analysis of the data will be presented, and the final section will discuss the ethical considerations and limitations of the study.

4.1 Research design and strategy

This study is conducted as a single case study of Sida-funded regional and global challenge funds operating in Kenya. The case study research design is suitable for the study given the focus on a specific phenomenon: Sida-funded challenge funds operating in Kenya. The case study is of explanatory nature, as it seeks to understand challenge funds in relation to the critiques towards top-down development and the relationships between public and private partners in development cooperation (Priya, 2020, p. 96). Using an abductive research strategy, the study searches for answers to the research problem by moving back and forth between the theory and empirical material, allowing them to inform each other throughout the study (Clark *et al.*, 2021, p. 116). Additionally, Clark *et al* (2021, p. 116) writes that the abductive approach to research acknowledges that the conclusions drawn are not certain, but inferences of the best explanation. This means that while the explanation to the observed puzzle is concluded to be the most likely in the case of this particular study, it cannot confirm that this is the only explanation (Clark *et al.*, 2021, p. 116). For this study, this approach is used to acknowledge that since the conclusions are grounded in individual experiences and social perspectives, it cannot draw generalisable conclusions on its own.

4.2 Data collection: semi-structured interviews

The empirical data for the thesis was collected through semi-structured interviews with one programme manager at Sida, five fund managers of Sida-funded regional and global challenge funds, and two representatives from grantees (grant recipients) of the challenge funds. The interviews took place in Nairobi, Kenya, in the offices of the interviewees' organisations, and via online video calls. Nairobi was chosen for this field study because of the density of organisations working with challenge funds that are residing there, including fund management offices and the Swedish Embassy in Nairobi, as well as the large number of grantees in Kenya.

The method of semi-structured interviews was chosen because it will allow for a degree of steering the conversation while simultaneously encouraging a variety of perspectives to come forth. The method provides the possibility to systematically explore the research area to find patterns and themes within the data and identify hidden variables of interest for the study (Schensul and LeCompte, 2013, pp. 171–172). The topics that were covered during the interviews were: the political and economic environment for small businesses to gain understanding of the setting in which the challenge funds and grantees are operating and how they handle the different contexts and associated risks; the rationale of using challenge funding as the resource distribution method, and the experiences of applying for and working with challenge funds to implement the business proposal; and, the role of innovation and entrepreneurship in development cooperation (see Appendix 1 for full interview guide). These topics provided responses relating to the concerns with risk in principal-agent theory, and approaches to avoid continued dependency and colonial legacies as well as signs of post-development approaches.

The selection of the participants was done through a combination of generic purposive sampling and snowball sampling. The initial selection of the participants was purposive to include different perspectives from people in distinct positions along the line of donor funding. Purposive sampling is used to make a deliberate selection of participants on the basis of the information that they can provide and allows the study to gather as much information-rich data as possible about the particular phenomena of interest (Clark *et al.*, 2021, pp. 1241–1243). Using generic purposive sampling involves drawing up a set of criteria that the participants must fit into (Clark *et al.*, 2021, pp. 1260–1261). For this study, the criteria were that the participants must have worked with or for a challenge fund or grantee, and they should be in a position through which they would have insight into the application process and local business environment. The

selection was done strategically based on the knowledge and experience that these participants have on the subject that will help answer the research questions. By having participants from Sida, fund managers, and grantees, the selection incorporated the experiences from different levels along the line of donor funding. This has given the study a nuanced understanding of underlying politics and power dynamics within development financing in general and challenge funds in particular.

As the initial conversations and contacts with this sample of participants were taking place, new suggestions for people who could provide good insights for the study were introduced. Since these suggestions were coming from experts on the topic of the thesis during our interviews, it was clear that the study would benefit from the perspectives they would bring. Because of this, snowball sampling was utilised as well. Clark *et al* (2021, p. 1278) writes that such a combination of purposive and snowball sampling is quite common. Because the process of snowball sampling initially starts with a purposive sample from which the snowball effect then unfolds, the two are naturally connected (Clark *et al.*, 2021, p. 1278). In this study, the main sampling method was purposive, with snowball sampling as a valuable complement.

4.3 Operationalisation of theories

The three critical development theories of dependency, postcolonial and post-development theory present a critical theoretical framework that has an overarching informing role in this study as they are placing challenge funds in relation to the history of development cooperation. The presentation of the theories in the theoretical framework chapter describes this lens which is used in this study to understand challenge funds as an alternative to top-down development. The operationalisation of the principal-agent theory was instead informed by the previous literature. The literature on the principal-agent theory in the context of development partnerships between the private and public sector presents a framework of conditions that foster efficiency in such partnerships. Three of these aspects are utilised in the analysis of this study: (1) balancing the allocation of risk between the agent and principal; (2) having multiple agents involved, creating a market-like structure; and (3) finding aligning interests between the agent and principal to reduce the resources going towards monitoring. These aspects mainly address the relationships between donor and recipients in challenge funding, but still contribute to the discussion concerning the first aim about challenge funds representing an alternative to top-down development.

Balance allocation of risk

The risk of the principal 'shirking' the agent due to lacking incentive to deliver the resources is reduced by ensuring that there is a balanced risk between the agent and the principal (Shrestha *et al.*, 2019, pp. 2–3). Balancing the risk accurately means that the principal is just as incentivised as the agent to deliver good results in the project, and therefore has a lot to lose by not providing the resources. Naturally, balancing the risk then also incentives the agent to deliver good results in the implementation of the project, as they would also have a lot to lose by not doing so (Shrestha *et al.*, 2019, pp. 2–3). This study has therefore searched for indications of how the challenge funds are working to balance the risk taken by them and the grantees, as well as how it is balanced towards Sida as the head principal.

Having multiple agents present in the project

Braun and Guston (2003, p. 304) also describes that the risk of 'shirking' is reduced when there are multiple agents present, creating a market-like structure in the design of the project. Features such as the use of open competition and calls for proposals, which aims to attract as many agents as possible to the project and follow a market-like structure, can therefore be considered a safe-guard towards 'shirking' (Braun and Guston, 2003, p. 304). Given the competition based approach of challenge funds, such a market-like structure is built into the mechanism. The study has consequently searched for more evidence on how the challenge funds ensure attracting and working with multiple agents.

Aligning interests to reduce costs

As has been discussed in the literature review, a principal-agent relationship involving public and private actors always includes some combination and balancing of *costs for monitoring* and the additional *social costs* that emerge as the private agent takes on more risk (Moore and Vining, 2023, pp. 271–273). According to principal-agent theory, insufficient monitoring can lead to lower productivity towards the principal's goals, while excessive monitoring reduces the control the agent has over the project's performance measures and therefore increases the agent's risk which they are compensated for by the principal (Moore and Vining, 2023, pp. 271–273). Copestake and O'Riordan (2015, p. 8) describe that aligning interests between the principal and agent is key when balancing and reducing these costs. Meanwhile, Poulton and Macartney (2012, p. 105) argue that the process of contracting private actors is already a method to align their

interests with public policy goals. This aspect is used in the analysis to highlight the different approaches to aligning interests and balancing costs that are used in challenge funding.

4.4 Data analysis: thematic analysis

To analyse the data collected in the interviews, a thematic analysis using Braun and Clarke's six stage process of thematic analysis was used (Clark *et al.*, 2021, p. 1770). Braun and Clarke's general method follows a process of six clearly defined stages: (1) *familiarisation*, which involves the transcription of the interviews; (2) *initial coding* following the general steps of qualitative coding; (3) *identifying themes* and elaborate on the ideas from the initial coding; (4) *reviewing themes* and reordering them into higher ranking themes as well as finding sub-themes; (5) *defining themes* involving the development of descriptions of the themes and their properties; and finally, (6) *evidencing themes* during which the evidence from the coding is linked to the wider literature (Clark *et al.*, 2021, pp. 1770–1771). A deeper explanation of each stage is described below.

The analysis was initiated with the *familiarisation* stage. This stage is conducted during the transcription of the interviews with the purpose of getting to know the material and finding first interpretations and ideas about the themes (Clark *et al.*, 2021, p. 1770). After each interview was transcribed, a few general notes about key take-aways from the interview were written down. Certain patterns in the material started to emerge as the process went along and a few initial ideas of themes and patterns were therefore also noted. This process of noting ideas of themes was continuously performed throughout the analysis (Braun and Clarke, 2006, p. 86).

After getting familiar with the material, the next stage of *initial coding* was started. The purpose of this stage is to organise the material by condensing the responses into meaningful groups which in the next stage will be interpreted through the lens of the theoretical framework to identify themes (Braun and Clarke, 2006, p. 88). The focus in this stage was therefore on finding key words and significant observations that identify features of the data that are relevant to the analysis (Braun and Clarke, 2006, p. 88). This stage was approached using 'open' coding with a broad mind of the features and potential themes to be identified and to capture all interesting insights emerging from the material (Clark *et al.*, 2021, p. 1770), with the initial ideas from the familiarisation stage lightly guiding the process.

The approach for this study was data-driven, meaning that the themes were developed from the data and not approached with a set of questions or outcomes already in mind to which

the data would be coded into (Braun and Clarke, 2006, pp. 88–89). Interesting quotes were highlighted and copied into a spreadsheet, and a few key words, themes or features of the extract (the codes) were noted next to it. In this process, thematic patterns started to emerge, and theoretical concepts became relevant. This built the foundation for developing the themes that will be tied to the research questions and theoretical framework, which was done in the next stage.

The third stage was to *identify the themes*. During this stage, the analysis focuses on finding the broader themes as well as sub-themes in the coded data by thinking about the relationships between codes and potential themes that emerged (Braun and Clarke, 2006, p. 89). The codes were combined, contrasted and sorted into overarching potential themes and sub-themes in a mind map (Braun and Clarke, 2006, pp. 89–90). The data was also placed in the context of the theoretical concepts of interest in this stage, initiating the process of tying the data to the theoretical framework (Clark *et al.*, 2021, p. 1770). Like the initial coding, this stage of the analysis process was also kept open, with some themes appearing more significant, others forming sub-themes, and some codes not fitting into any themes. All these themes were then reviewed and refined in the next stage.

In the fourth stage, *reviewing themes*, the themes identified in the first three stages were reviewed and reordered into larger, overarching themes with sub-themes (Clark *et al.*, 2021, p. 1770). First, a review of the thematic map was conducted, and the themes were sorted into three overarching themes and a total of seven sub-themes (see thematic map in figure 1). Next, the extracts connected to each theme were revisited and reviewed with consideration to whether they form a coherent pattern fitting the theme (Braun and Clarke, 2006, pp. 91–92). This review led to some extracts being re-coded and re-sorted to fit into the potential themes and, more importantly, to ensure that the themes accurately reflect the evidence in the data. Certain key quotes relating to the themes were also highlighted in preparation for the final two stages of the analysis.

The fifth and sixth stages were worked on simultaneously, since they involved producing the text that ultimately presented the analysis and results of the study (see chapter 5). The fifth stage, *defining the themes*, consisted of defining the potential themes and sub-themes (see figure 1) by finding the ‘essence’ of the themes and developing of a narrative clearly describing and determining the properties and aspects captured in each theme (Braun and Clarke, 2006, pp. 92–93; Clark *et al.*, 2021, p. 1771). In the sixth and final stage, *evidencing themes*, the narratives and

arguments developed during stage five were grounded in evidence from the codes. Through these stages, the findings were linked to the wider literature and theoretical framework (Clark *et al.*, 2021, p. 1771).

4.5 Ethical considerations

There are several ethical considerations to acknowledge regarding this study. First is the ethics of using interviews as a method for data collection. And second is regarding my positionality and background going into the study.

All participants in the study were provided with a sheet of information about the study and what their participation would mean prior to the interview. The information sheet included the aim and theoretical perspective of the study; a presentation of what participation would entail and what would be generally covered in the interview; what the information they give will be used for; where they will be able to find the final thesis and where to turn if they had questions regarding participation; and that participation is fully voluntary and that they can withdraw their consent at any time without question. This information was also presented to the participants before the start of the interviews. The participants were asked to sign the sheet to confirm their consent to participating in the study, but despite having acquired this written consent, verbal consent of their participation was also requested at the beginning of the interview and ensured during the interview.

One essential ethical consideration in this study is my positionality in the study. Since I have had an internship with Sida where I worked with challenge funds, I have a professional connection to the topic that is being investigated. Additionally, I received a Minor Field Study grant which allowed me to go to Kenya and conduct this study. This grant was given out via Stockholm University, but funded by Sida. This placed me in the complicated position of investigating elements of the organisation that is funding my research, even though the funding was delegated through a third party (Stockholm University). Consequently, to ensure that this relationship and my positionality would not lead to any conflict of interest or biases in the study, the thesis heavily relies on the theoretical analytical framework to make its arguments. Also, since I have visited fund managers and grantees that are receiving development funding from Sweden and I am doing the research with the support of the Swedish Embassy and Sida, I have indirectly been a representative from a donor. It has therefore been essential for me to state my position as a master student that is not under employment from the Embassy or Sida, and that the

research is done completely independent of their influence, but that they have supported the study by providing contacts with participants and that the final thesis will be shared with them. To ensure that no harm was or will be done to the participants, I have ensured the confidentiality and anonymity of the participants and assured them of this during the interviews. I also made it clear that the thesis will not state the names of the persons or the organisations that I have talked to.

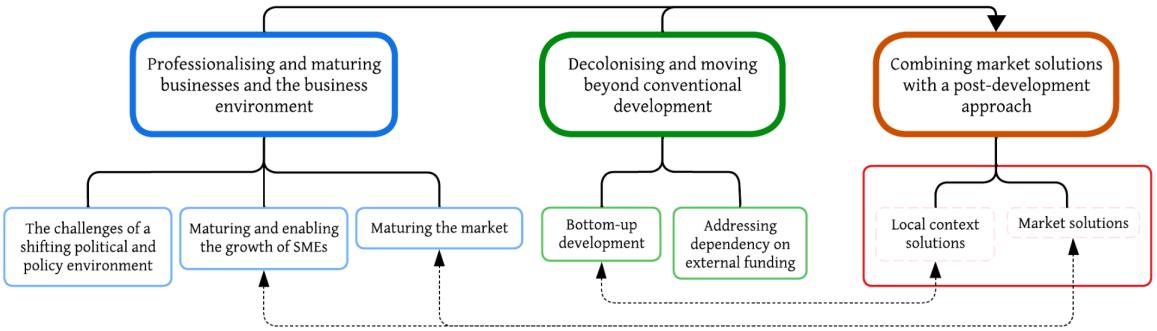


Figure 1. Thematic map

5 Empirical analysis and findings: Thematic understandings of challenge funding

The following chapter presents the empirical analysis and findings which indicates that the challenge fund mechanism can be seen as a combination of top-down and bottom-up development in which market solutions are being used to enable bottom-up development and how this is achieved by building relationships based on trust, leading to more efficient partnerships. The analysis has identified three themes, with the first two feeding into the third one (see figure 1). The first theme, *professionalising and maturing businesses and the business environment*, presents results showing how the challenge fund mechanism is helping innovators and SMEs to remain in business in a tough and volatile business environment and how there are signs that this is leading to the maturing of the market with companies in the challenge funds getting support to formalise their business model. The second theme, *decolonising and moving beyond conventional development*, presents how innovation and the growth of SMEs, and the maturing of the market, can be interpreted through the lens of critical development theories as a process of decolonising the market and addressing dependency issues. Finally, the third theme,

combining market solutions with a post-development approach, further highlights how this kind of liberal market solution is supporting local groups' solutions to local development problems, thus enforcing the critiques towards development in dependency theory, postcolonial theory and post-development theory. The chapter is divided into sections according to the three themes identified in the analysis. Each section will present excerpts from the interviews as evidence to the theme while discussing connections to the theoretical framework and previous research.

5.1 Theme 1: Professionalising and maturing businesses and the business environment

The theme that most prominently appeared in the empirical data was the professionalising and maturing of businesses and the business environment. This theme reflects the liberal market side of challenge funds as an economic development mechanism and discusses the way the critiques towards top-down market solutions are being handled in this approach. In addition to challenge funds helping the small and medium sized enterprises (SMEs) with accessible funding to scale their business, the analysis shows that challenge funds have had a significant influence in helping local SMEs mature as businesses and provide the capacity building needed to enhance the agency of local stakeholders. The analysis indicates that these skills are enabling the SMEs to act on more equal terms on the local as well as global market. Embedded in this approach is a close collaboration between the fund managers and the grantees to ensure efficiency in the partnership. The experiences presented in the interviews suggest that this has led to the business environment for SMEs becoming more formalised and professionalised. Drawing from the data, three sub-themes have been found: the challenges of a shifting political and policy environment; maturing and enabling the growth of SMEs; and maturing the market.

5.1.1 The challenges of a shifting political and policy environment

Several interviews described that the business environment is tough and complex for small businesses seeking to launch their innovations on the market, mainly in terms of lacking access to capital, but also due to other financial obstacles connected to the emerging stage of a market such as inadequate infrastructure or ability to rent equipment.

> So, [the business environment] is tough. A lot because money is so expensive. I mean, it is expensive for these companies to access capital and a lot of capital is required since there is no structure of being able to rent equipment or lease stuff. You have to build it up. You have to purchase everything that you need and own it. And the costs for loans are very high, which makes the financial situation challenging. (Interview 1, Sida, author's translation)

These economic obstacles were argued to be closely connected to the challenges of a shifting political environment, which was repeated as a main reason as to why there are still large barriers for SMEs to overcome in these markets. Each interviewee described political instability as the main reason as to why commercial investments are not accessible on these markets. The interviewees described that because of the uncertainty regarding the permanency of policies and shifting political decisions, as well as instances of conflict or political unrest, most commercial investors and banks consider the markets too risky. As a result, the commercial capital coming in is very expensive, with interest rates starting from 13%-17% at the biggest banks in Kenya (Equity Bank, 2023; Co-Operative Bank of Kenya, no date; National Bank of Kenya, no date). Access to credit and loans is therefore described as extremely tough for SMEs. One fund manager described that this is a trend that has become worse in the last years, stating that the interest rates were single digit approximately 20 years ago, while today it is almost exclusively double digits. It is also described that this is a trend across the continent.

> Access to credits is extremely tough across the continent. So that's where we also come in [...] because the interest rates 20 years ago were single digit, now it's double digit. It's 20% across many African countries. Yeah, so different things have become worse or better. Access to credit, taxation, business environment [...] are becoming challenges. Political uncertainty, I think it's just always there, it just varies with different seasons. (Interview 5, fund manager)

In this context, the fund manager describes that this is why challenge funds are needed, because they can provide a vehicle with 'cheaper' financing opportunities to fill that gap left by the commercial capital. It is also stated that political uncertainty is always there, but it varies, so the challenge fund can present some level of security and stability for the SMEs with their so-called 'patient capital' which allows for more flexibility in repaying the loans. Several fund managers talked about the stability that patient capital brings to the SMEs and how it allows the SMEs to operate despite the challenges presented by the political uncertainty. Seeing this in the broader sense of long-term development, that access to stability for small businesses can be a shock absorber for volatile markets in times of uncertainty that in the long-term helps them continue to grow or maintain its position in global trade in unpredictable times. For example, one fund manager described that, during the Covid-19 lockdowns, they implemented a specific relief fund to save jobs and ensure that companies with potential to generate high development impacts would not disappear. They described that the lockdowns caused limitations for companies dependent on going around and selling the product, which would have led to devastating losses

to some companies. The fund would therefore cover the loss of revenue associated with the restrictions so these companies would survive the economic downturn.

A grantee also talks about the importance of bringing some level of stability to the SMEs in these environments. In their statement, they express that while fully stabilising the political environment will take time, some arrangements could be done to provide businesses with the stability they need to make long-term plans and commitments. This could, for example, be done through long-term agreements between the state and the private sector to account for the potential political shifts.

> The private commercial capital is very also risk adverse because the risk is basically being driven by the political uncertainty of the market. So if you stabilise the political environment, or at least bring some level of stabilisation either by long-term agreements with companies or some sort of offtake agreements for example, or some sort of guarantees or a better policy that's levelling the playing field for all of the company. (Interview 3, grantee)

The grantee explains that this will allow financial institutions to better understand the environment in which they are investing. This in turn, is argued to help level the playing field, meaning such arrangements would make the market fairer as SMEs would be able to compete on more equal terms when success is not as dependent on buffer capital. This example frames the positive impact that bringing flexible and adaptable patient capital can have for SMEs in these environments since it brings that level of stability. It also highlights the value in investing in lobbying resources for better conditions for the SMEs and mature the market (a subtheme that we will return to in section 5.1.3).

The same grantee also describes that it is not only local or regional politics that affect this uncertainty. Shifts in global policies and regulation also contribute to the volatility of the economy in which the SMEs operate, due to the interconnectedness of global trade and dependency on international development funding. Operating in the carbon market, the grantee expressed concern over the challenges in planning and projecting how to invest in long-term projects because of the shifting financial climate both on the local and global level.

> I think the biggest challenge in the business environment is the stability of the policy environment. [...] The policy environment is changing where we don't have a lot of certainty when it comes to the fiscal policy and we still have a lot of fiscal barriers that we need to catch. And even on the carbon market, the carbon regulation and carbon policy, there's still a lot of moving pieces. So it's hard for a business to project and invest with that much uncertainty. (Interview 3, grantee)

The experienced struggles of planning for long-term projects of course also affects the ability to generate long-term impact since companies then do not have the incentives to try out new and

innovative ideas relying on these policies that may not generate revenue until a few years down the line. Connecting this to the concerns of the principal-agent theory, such uncertain environments may cause issues of information asymmetry and risk imbalance since the agents may present a better projection of the project's impacts than is realistic in the current environment.

One way in which challenge funds account for this issue is through localisation. One fund manager described that it is central for their operations residing in Nairobi because this allows them to stay alert to the local dynamics and really know the market and situation that they are operating in. Similarly, Poulton and Macartney (2012, p. 105) argues that deep knowledge of the market is fundamental for development projects collaborating with the private sector. The fund manager's knowledge of the business environment is essential both in the sense that it prevents information asymmetries, and that it makes the fund manager more knowledgeable in regards to what specific support each grantee needs to mature and grow their business. One fund manager described that "it really requires, I think, case to case understanding of the business environment and the key risks, and for [the challenge fund] to be able to take those smart, very smart, but very calculated risks – if it makes sense" (Interview 7, fund manager).

5.1.2 Maturing and enabling the growth of SMEs

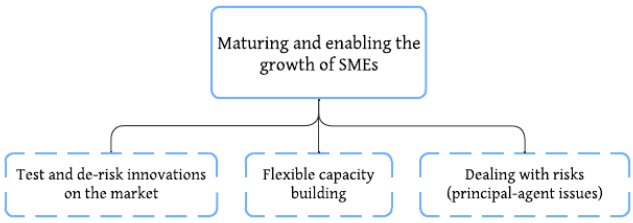


Figure 2. Sub-themes in Maturing and enabling the growth of SMEs.

As described above, SMEs in volatile economies face a lot of challenges, not the least regarding the lack of accessible capital. The challenge funds then step in to fill the gap of flexible and patient capital, and help the SMEs mature and grow by *de-risking*, providing *flexible capacity building*, while *dealing with the risks* associated with these kinds of principal-agent relationships (see figure 2). The flexibility in the approach is described to encourage the entrepreneurs to focus

on their innovativeness and creativity in solving development issues, which promotes further evolution of adaptable and context-based development projects.

> [challenge funds] give you room, they are not strict, "do this do this". You know, like it's not a static, like from A to B. [...] And innovation gives us room to be creative. And the creativeness is what makes us being on the ground [...]. So the [challenge funds] are creating and are really helpful, making sure every day is a learning lesson, adjusting to the current environment. (Interview 6, grantee)

This combination of flexibility in the grant funding and patient capital becomes an effective de-risking tool for testing the innovation on the market. Patient capital is explained by the fund managers as a flexible financial support with a lower interest rate that can be adapted for unsuspected obstacles and changes in the market conditions. This capital enables the entrepreneurs to test their innovations on the market, even in the markets that are considered high risk and where conditions may change rapidly. It was explained that without the access to this kind of funding, the entrepreneurs would likely not have been able to launch their solution.

One key thing connected to this search for innovations to test and de-risk is additionality – to bring development impact beyond the direct outcomes of the business growing. The challenge funds seek to finance disruptive innovations that bring basic services to people living in poverty, such as M-Kopa, the solar home system that introduced the pay-as-you-go system, delivering off-grid electricity systems to people living in poverty for small down payments and daily fees (see section 2.3). Similar to the pay-as-you-go system, the fund managers highlight that 'innovation' does not have to be a product. It might be a new business model, such as the pay-as-you-go model which a couple of the fund managers mentioned as a groundbreaking solution. It can also be to find new way of using a product and giving more value to that product through a new business model, as one grantee presented in their use of ethanol for clean cooking:

> I think ethanol for cooking has always been used historically as a fuel because of the high caloric value of Ethanol, but it has never been used at scale for economic purposes because it was always more, let's say attractive for Ethanol producers, for example, to sell the Ethanol to beverage companies because alcohol will be more expensive and then it's a higher economic value for them than to sell it cheaper for cooking purposes. So the carbon markets really enable us to bridge that gap and bring the Ethanol at scale to households to be able to cook with it. (Interview 3, grantee)

This example shows how the innovators have been able to leverage the carbon market mechanism to make their solution sustainable in the market. What the challenge fund grant in this case did was to support the expansion of the business to a new underserved area, which the grantee described would have taken several years longer without the support from the challenge fund. In

this case, the challenge fund supported the solution by sharing the risk of the expansion with the grantee. This is called 'sharing the risk' because challenge funds have a match-funding component integrated in the mechanism, meaning the grantee is required to go in with the same amount as the grant in a project, which balances the risk between the fund manager and the grantee. Considering the issues that principal-agent theory contends may occur in instances of imbalanced risk, the match-funding component is an important part to prevent issues of information asymmetries since both parties will be incentivised to make the best out of the project.

Furthermore, one essential component of the challenge fund approach is found in the non-monetary support where, in addition to the financing, the fund manager will work with the grantee throughout the different stages of the grant period. challenge funds operate out of the premise that it is not only the lack of capital that is withholding SMEs in their mission to grow. Entering the market as a small business also means dealing with complex bureaucracy. In addition to the financial support, the fund managers therefore work a lot with so-called technical assistance which involves capacity building and helping grantees formalise their business. This kind of support can begin already in the application stages, as presented by one fund manager:

> Some [applications] are very early stage still at R&D – very good ideas – but then they are not yet at the challenge fund state where they can compete. But then you can support them to test the good ideas, their new products in the market. (Interview 4, fund manager)

And, it commonly extends until after the grant period is finished to ensure that the SMEs are commercially sustainable, as explained by another fund manager:

> So through our grant funding, we de-risk these projects, using patient grant capital. We do not take out any equity. And we manage the projects over one and a half years, slightly more, and we try and ensure they are commercially sustainable so that after the grant period ends, they can continue. It doesn't work out all the time, because these are real startups in the real business environment, but that's our goal. And then two years after the projects have ended, we still monitor on a quarterly basis, the progress of the startups to just ensure that they're doing well. (Interview 5, fund manager)

The fund manager here also explained that the projects sometimes do not work out, because they are operating in the real world where business ventures sometimes fall through. They explained that at one point, a grantee who had previously failed their implementation came back after a few years having fixed the technical issue they were struggling with. Because it was still a unique innovation, it was granted the support again and they were able to scale to 10 markets according to the fund manager. The fund manager argued that the use of patient capital made that possible.

The description from the fund manager also implied that there is a level of engagement in the innovations and care for their development outcome in this kind of funding that is commonly rejected in conventional commercial capital (eg. via banks) seeking quick returns of their investments. Furthermore, one fund manager described that SMEs entering these markets "requires someone who not only works as a funder, but works as a critical friend. So it's about providing advisory coming back when mistakes have been made and figuring out how do we forge this further ahead" (Interview 7, fund manager). The technical assistance is described as an absolute necessity and is considered the strength of the challenge fund model. It can be achieved either through a close dialogue between the fund manager and the grantee in which they establish what tools, stakeholders, partnerships and skillsets the grantee would require to scale the business, or the fund manager requests

> a very robust needs assessment done by a third party who does not know you or doesn't care about you, to be able to look at all the aspects of your business and identify, "okay, you need to strengthen your legal, you need to strengthen your product development or how you reach customers [...]" and they try and improve that. (Interview 5, fund manager)

The fund manager also explained that this part of the support has been strengthened in the last years, saying that today "ten percent [of an investment] has to go to technical assistance" (Interview 5, fund manager). The structure and type of technical assistance going into a project is however assessed on a case-by-case basis to ensure the support is tailor-made for each business's needs.

This approach was in a few interviews labelled as an element of 'co-creation', in which "you're helping [the businesses] think about the business models, their scale models, trying to scale them in a certain direction, of course leveraging on our own experience at our own portfolios" (Interview 7, fund manager). This element of 'co-creation' can be considered a way of working on aligning interests between the fund managers and the grantees, which has been identified in the previous literature as a good measurement to prevent information asymmetry issues and assist the balancing of costs between monitoring, reduced efforts and additional social costs in these kinds of partnerships (see operationalisation in section 4.3). It indicates a strong focus on cooperation between the fund manager and grantee to achieve the best possible outcome, a measure that Copestake and O'Riordan (2015, p. 8) argued will reduce the costs of monitoring and supervision, thus increasing the efficiency of the project since more resources are instead put towards reaching the objectives of the project. This question of dealing with the balancing of risks to achieve the most efficient partnership was described by the fund managers to primarily

be handled by really getting to know the organisation of the grantee. It was described that it was essential for them to know the organisation, know the business environment and know the risks they are taking together, and all this is best achieved through localisation and close collaboration.

However, while the fund managers may experience these processes as efficient and an important step to reduce information asymmetry risks, responses from grantees indicate that the application and reporting process is time consuming. This is explained to be an administrative burden across all grant mechanisms, not just challenge funds. In combination with the uncertainty of the market, the planning to invest so much time in the application can be challenging and sometimes not worth it.

> Because it's a lot of time where the business is actually still focused on doing the application, providing input, doing the due diligence. And so it's a lot of investment which is not always worth it. So I think the timeline is probably where they're all similar and one where there's an opportunity I think for improvement (Interview 3, grantee)

Some funding providers are described to be better than others at alleviating the administrative burden from the grantees, but this excerpt indicates that there may be a trend of imbalance in the allocation of risk in regards to the administrative burden between the fund manager and the grantee in most funding opportunities for SMEs. Because of rigorous application and reporting processes, the grantees may be considered to take on more risk in the form of administrative resources allocated to the project. This example highlights an issue that may have been slightly overlooked in the challenge fund models approach to balanced risk allocation, namely to account for the balancing of non-monetary resource allocation. However, with only one example pointing to this in this study, such a conclusion cannot be drawn with absolute certainty.

Yet, the collaborative support is considered essential to make the businesses investment ready and able to act and compete on the global market alongside already established and experienced companies and investors. In their advisory role, the fund managers can help the SMEs to be ready for the complexity of the global market and understand what they are getting into. As more private capital, particularly international private capital, is entering the scene in which these SMEs are operating, the more complex the market and contracts within the market are getting. The challenge fund therefore needs to act as an insurance and safeguard for the SMEs to prevent them from entering exploitative partnerships.

> There needs to be someone to help guide these organisations to get into contracts that they don't understand. [...] Our nonprofit organisations never even have lawyers to look at the contracts. Our for profit organisations or Western based implementers [...] you know, in the US. They'll come

> with an army of lawyers and they'll negotiate each and every word of that contract. So you tell me that sending this nonprofit organisation that never has a lawyer to negotiate with some commercial business based in San Francisco. They don't understand what they're signing off, what rights they're signing off, what intellectual properties they're signing off – and that's the business model. So, we have to be a bit careful. (Interview 7, fund manager)

Based on the experiences of the interviewees in this study, this form of support and capacity building has contributed to the success of numerous SMEs scaling their solutions and providing basic services to people living in poverty. As a result, the interviews have indicated that challenge funds are experienced to have promoted the maturing of the entire markets, as will be discussed in the following sub-theme.

5.1.3 Maturing the market

As demonstrated above, technical assistance is being increasingly recognised as a necessity for sustainable private sector development. The interviews have indicated that the support for SMEs to develop their business models and policies have led to the entire business environment maturing and formalising.

> The business environment has been more professionalised I think. Because to get into the challenge model essentially, you have to have your documents in order, you have to have all these policies in place, you know, financial structures, boards, governance, all these things need to be in place. So the businesses are like "listen, so then we can tap these resources if we professionalise." (Interview 2, fund manager)

Achieving such long-term impacts is engrained in the broader private sector development approach, which aims to bring about systemic change in the market. In interview 1, it was explained that many of Sida's contributions have sub-goals of lobbying for improved conditions for businesses in the economic and political climate, meaning that the fund managers are tasked with working with the local governments to create a better environment for the SMEs. Responses from both fund managers and grantees confirmed that such work has been conducted, and it was indicated that the achievements were connected to the evidence-based advocacy work grounded in the challenge funds' networks of SMEs.

> If we don't have an effective regulatory body or an association that can do that sort of advocacy for you, it becomes hard. But a challenge fund that has, you know, 10 companies in your country or has deployed 10 million is able to say, "listen, we have this issue that is really affecting how effective we can be in our grant." (Interview 2, fund manager)

It is not only the fund managers that are conducting the advocacy work. One grantee also explained how women educated in their programme have been able to sit down with the president

of Kenya to describe their work conditions and how it can be improved through political decisions. The grantee explained that this was unprecedented, because there has previously not been women in these 'middle' positions in this particular sector. Women involved in this sector have previously been either in highly educated positions or unskilled and informal work. "But you see, now we produce women who are skilled" (Interview 6, grantee), the grantee explained, and because of this "the support of this fund could look very small, but it is not very small [...] the fund has really helped on the advocacy bit of it" (Interview 6, grantee).

The same grantee also described that the advocacy opportunities was one of the reasons they turned to the challenge fund for their funding. They saw the advocacy opportunities in working with the challenge fund as a key part of their project and to leverage their knowledge of empowering women in this sector. As a result, they described that they have seen changes in the business environment since they started their programme, with other training programmes in the sector following their lead and more contractors turning to them to employ the women in their projects. The grantee also explained that the contractors have started seeing the value in the female employees, for example in the women's way of caring for the finished look of a project, which indicates the beginnings of a changing mindset in an otherwise tough industry.

Advocacy and the leveraging of networks created through the challenge funds was highlighted as a key feature in the interviews by the fund managers and grantees. They explain that besides the opportunity for strong advocacy, the networks are used to enhance capacity building through collaboration between grantees and different challenge funds. One fund manager explained that, through their networks, they can introduce new partnerships that help grantees achieve their goals, and that they host forums during which grantees can network and learn from each other. Another fund manager described that they use their network to find

> co-investment opportunities or for us to check up something that has come from an early stage funder, that is ready to come to a scale funder like ourselves [...] so we really catalyse the impact of this solution. (Interview 7, fund manager)

This approach of leveraging the skills and knowledge that emerge in the challenge funds and their networks highlights the long-term goals of the private sector development approach coming out of the 'retroliberal' development regime – to create inclusive and sustainable economic growth, leveraging the innovative and financial capacity of the private sector for sustainable development, and advocating for improved working conditions (de Silva, Kokko and Norberg, 2015, pp. 13–15; Boer *et al.*, 2024, p. 1). Responses from one fund manager in particular, shows

further signs of a maturing market as a result, as the fund manager explained that they are seeing an opportunity in extending their technical assistance outside of the portfolio.

> We're now even doing it for businesses that are outside our portfolio, just because it's so necessary and not to many people are doing it as effectively. So we've sort of like figured, "okay, we can't wait for someone else to build it out" we need to build it with ourselves and it's an absolutely crucial a part of what we do. (Interview 2, fund manager)

Comparing this to the process of growing a business in a mature market, the technical assistance provided by the challenge funds can be likened to that of a consultancy firm. The SMEs and innovators are the experts in the product or service that they have produced, while the fund managers can provide the organisational expertise. One fund manager explained that they see a strength in such collaboration, since it allows the grantees to focus on developing the solution while the fund manager can provide the organisational expertise to ensure they can scale the solution efficiently. They explained that they encourage the innovators to spend most of their time on their solution, because "if someone understands the problem and understands the solution they're trying to solve, then you can help them alone figure out organisational aspects" (Interview 7, fund manager). In one interview, a fund manager projected that challenge funds will likely evolve into consultancy firms as the market matures:

> Maybe in another 10-20 years, we are like "this challenge fund was able to capacitate this, we now have industries that are doing something similar". So you won't have technical assistance, you'd have consultancy firms. You won't have the fundraising element, you'd have lots of funding entities that you've built out. From the pipelines, you'll now have a pool of businesses that are growing and proliferating. So that for me is where I think the challenge funds will be evolved to. (Interview 2, fund manager)

These aims, projections and signs of challenge funds contributing to the maturing of the market indicate achievements towards the mainstream 'retroliberal' development agenda of facilitating economic growth. However, through the lens of postcolonial theory, this focus on 'maturing the market' highlights the eurocentric ideas in development agendas and the continuation of reproducing binaries from the colonial past. In this, the Western markets are presented as the universal model for a mature market which an 'emerging market' should strive to achieve. From a postcolonial perspective, this reproduction of binaries presents a continuation of discursively subordinating previous colonies by using terms that hierarchically sorts Western markets as the dominant and the 'standard' (see Kapoor, 2008, 2023 and Bhambra, 2014 for postcolonial problematisation of the Eurocentric discourse).

Yet, the study found elements of decolonising the economy in the experiences of moving towards a more mature market. As argued by one fund manager, the steps towards a more 'Western' approach towards investing has provided the market with more long-term perspectives and opportunities that reduce the dependency on foreign aid.

> The one thing that you can see in the last five to ten years in Africa is that we've taken up more of the more Western approach towards investing. We have more venture capitalism. More non traditional forms of financing are coming to play. We have private equity going in. [...] We can also see a bit of movement from direct aid to more of this kind of investing or more trying to tackle long-term kind of sustainability approaches. [...] It's no longer the usual aid, which is more reactive, but it's more of an anticipatory kind of development in place. (Interview 8, fund manager)

This leads into the second theme that emerged in the analysis: decolonising and moving beyond conventional development.

5.2 Theme 2: Decolonising and moving beyond conventional development

As was presented in theme 1, there are many aspects of the challenge fund mechanism feeding into the liberal side of economic development. The interviews did however also indicate some aspects breaking from conventional development and the integration of postcolonial and post-development ideas and approaches into the development strategy, in other words, presenting a step away from top-down development, and a focus on supporting the agency of local stakeholders. This is identified as the second theme identified in the analysis, building on two sub-themes: the encouragement of bottom-up development and local context solutions; and ways of addressing issues of dependency on external funding.

5.2.1 Bottom-up development

One major theme appearing in the interviews regarding the decolonial aspects of challenge funding was found in the way the challenge funds are working to facilitate bottom-up development. A key feature of the challenge fund mechanism is to surface solutions to development issues coming from the communities themselves. As described in the literature review of this study, challenge funds were developed out of the critique towards top-down 'blueprint' development approaches, with their purpose being to encourage local innovative solutions. This foundation of the mechanism was reflected in the experiences of the interviewees as they described how the challenge fund approach "is essentially the community or the innovators themselves [coming] up with ideas [saying] 'this is what we want to be funded for. We think this has high impact'" (Interview 8, fund manager).

Intertwined with this bottom-up approach to development and the understanding that the most effective and efficient solutions come from local actors, is the importance of localisation of the challenge fund, similar to what was discussed in theme 1. The fund managers placed significant emphasis on this aspect as they explained that, in their experience, it has been critical to be located and present in the context in which they are operating. One fund manager explained because of their localisation, they

> know where the shoe pinches, and the fact that our team is very decentralised. So we're not just all cooped up inside Nairobi, we are really in the thick of things in the different context we operate in. (Interview 2, fund manager)

Because of this, the innovations, projects and subsequent impact are 'Africa led', as described by the fund manager, which they also see as the motivation behind their challenge fund. Another fund manager explained that the localisation and presence in the local contexts helps with ensuring efficiency, sustainability, effective use of resources and monitoring the implementation of a project. Additionally, by being in the right circles and keeping their finger on the pulse in regards to changes in the political and economic environment, they are able to be more accessible to the local innovators and identify disruptive and impactful innovations. Moreover, the interview indicates that the main point as to why localisation is so essential in their operations, is the postcolonial aspects connected to localisation.

> Let me put it like this: you come from the traditional development factor that is very Western led. We still use Western theories, economics of scale and all those things. So there's a role for funds like [challenge fund] to work with local innovators to help them translate these things. And perhaps once the development sector as a whole will reach that place where we've really shifted the mindset, shifted the foundations around how development is done. Then maybe more people like us can close shops and go home. (Interview 7, fund manager)

The fund manager described that as a financier, their localisation in Kenya and having people in the staff who have previously worked as implementers has helped bridge the gap between donors and local innovators. Though not stated directly, there were connotations at different instances in the interview that the localisation has contributed to increased trust between them as financiers and the innovators as recipients, including the explanation that they've "seen more really local innovators come to us and speak to us about their ideas" and that "localisation does come from the trust based philanthropy world, where it's all about give them the money, let them figure out how to do it" (Interview 7, fund manager).

Building on from this, the fund manager continued by explaining that they must incorporate accountability mechanisms to another degree as a publicly funded project in comparison to philanthropic projects, but that such mechanisms must not "perpetuate those colonial systems – to be honest – that have really kept local organisations away from having autonomy and having more resources able to do the work that they need to do effectively" (Interview 7, fund manager). This statement emphasises one of the main critiques towards top-down development approaches: the lacking agency and trust given to local actors in development cooperation. With the application of postcolonial theory, the experiences described above present how knowledge emerging from the Global South has been subordinated in global development to the degree that it may have hindered valuable partnerships. Another fund manager also indicates that such issues have been prevalent in development cooperation while arguing that challenge funds are efficient because they present a way of finding implementers that are invested in the project due to genuine interest and trust in the solution.

> Cause challenge funds are then allowing to get people who are willing partners, who are willing participants. So they know what they're getting into, they know the implications because you have to be quite specific on the outset. (Interview 2, fund manager)

This also addresses the problems of moral hazard and adverse selection of information asymmetry that were raised in the principal-agent theory. These problems refer to the insufficient information the principal has about the agent's intentions with the resources, and the abilities of the agent to complete the task delegated to them. In contrast to the aims of the postcolonial theory, these problems based in new institutional economics assumes the agent will seek to maximise their personal gains, thus presuming a distrust towards the agent. Yet, since the resources involved are coming from public funding, these concerns must still be addressed to ensure that the resources go towards its overarching purpose. In this, the importance of localisation can once again be emphasised. With the challenge funds operating in proximity to the context of the grantees and working in close collaboration with them by contributing with more than financial support through the technical assistance and working with 'willing partners', the interests of the principal and agent are more likely to align. Following Copestake and O'Riordan's (2015) argument regarding aligning interests, it can be argued that the risk of information asymmetries is reduced.

Another angle illustrating the bottom-up development approach in challenge funds is the additionality aspect. In the mission to find innovations by local groups to solve local development

problems that can be scaled, replicated and adapted to reach beyond the immediate impact, the interviews have presented examples of development and financial additionality.

> The aim of the [challenge fund] is to support promising innovations that will result in impact, but socioeconomic impact to millions and millions of people. So our way of looking at innovations, because we fund innovations is that this could translate into hundreds of millions, actually, of people being impacted. (Interview 8, fund manager)

While both providing development and financial additionality in reaching unforeseen impact, the challenge funds were also explained to generate evidence that demonstrate the investment opportunities in bottom-up development. One fund manager therefore explained that they tend to search for two or three variations of a solution to invest in, so that they can demonstrate what works best. This also helps with avoiding monopolisation of the product, creating a diversified market, and preventing the principal-agent issue of the principal "shirking" the agent – meaning that the principal would not provide the agreed-upon resources – given that the diversification and competition model attracts multiple agents to the programme.

Furthermore, the benefits of localisation were once again emphasised with possibilities of the fund managers and grantees to utilise their local networks to achieve additionality, which in the long term can contribute to the emergence of more opportunities for bottom-up development in relation to the arguments made on networks in the sub-theme of maturing the market. The same grantee that described that they have been able to see changes in the construction industry since they started their training programme also explained that their achievements are related to them working closely with their partners in the industry and key stakeholders to make sure that the behavioural changes ingrained in their project would be rooted in the community.

> The community can involve NGO partners. The like-minded NGOs. We have community based groups, and then we have the governments. The government is also a key stakeholder in our training program, and then we have community leaders. These all one way or another, they support the training program, be it to coming together, mentorship services, be it referrals for them, meeting women who come to the programme. (Interview 6, grantee)

The establishment and nurturing of such networks can also further address issues raised in dependency theory.

5.2.2 Addressing dependency on external development funding

The focus on enabling bottom-up development can also be seen as a way of addressing issues connected to dependency on external development funding. As was described in section 3.1, dependency theory highlights the systematic inequalities of the capitalist global economic system in which 'developing' countries are in a state of dependency towards 'developed' countries in regards to funding, investments and exporting. In this, developmental aid has been argued to simply reinforce these imbalanced economic and political power relations between donor and recipients. While the aim of private sector development to strengthen the market can be seen as a way to raise countries out of the state of dependency, the concern over contributing to continued dependency on external funding were discussed in the interviews, particularly in relation to ensuring the grantees move on from development aid funding.

> One needs to work to ensure that companies are not continuing to depend on aid funding, but reach commercially viability. There are companies that manage to mature, but also companies that are recognized in various aid-funded programs over a long time without reaching commercially viability. (Interview 1, Sida)

It was explained that some organisations have made it their niche to be financed through development grants, labelled 'grantpreneurs', and they have learnt how to write a good proposal for these grants. Looking at this phenomenon through the lens of principal-agent theory, one can argue that the grantpreneurs make use of the information asymmetry in that they have the advantage of knowing what the funders want to hear. This may cause the 'moral hazard' issue of the funder not knowing exactly what the entrepreneur will do with the funding, since it may be masked behind the language. More significantly, this disrupts the whole competition based idea behind challenge funds that the best innovation will receive the grant, since it may depend more on the writing of the proposal. The purpose of maturing the businesses to make them investment ready on the commercial market is therefore weakened.

> You'll find that the current challenge in this market is that the same companies are getting funded. So maybe there is supposed to be innovation on the challenge fund model to be able to still reach those who are underserved, because everybody wants to not take the risk. So you'll find that companies have become, we call them "grantpreneurs" now. They've mastered the act of writing good proposals. They've known what language to use. And so in the end, you are missing the original idea of surfacing, you know, those diamonds in the rough, as we say, yes. (Interview 4, fund manager)

Once again, the approach of working closely with the grantees can in relation to the principal-agent theory be considered an attempt to reduce such biases, since this allows applicants to

develop their project together with the fund manager. Yet, as described in the statement above, fund managers raise concerns over the remaining issues of dependency and the implications of this problem, especially since it may interrupt the mission of finding those highly impactful disruptive innovations. The analysis has identified some measurements taken to address these issues, for example, the de-risking tool of match-funding that was presented earlier can be considered an approach to avoid dependency. The match-funding component ensures that the SME is not completely dependent on the funding from the donor, since they are required to insert their own funding into the project as well.

This can of course also present other obstacles in terms of limiting for example start-ups that are still in the 'idea phase' and may not have the finances to match the funding. In the interview with a programme manager at Sida, it was however explained that they have assessed that there already are a lot of other funds granting seed money to innovations in these early stages, for example innovation labs at universities, meaning that the opportunities for funding in those stages are already extensive. In this, the contribution is working to reduce dependency issues by avoiding the crowding out of other forms of financing and investment actors. With this approach, another part of dependency theory's critique towards developmental aid is also addressed, namely that aid always distorts the market. The assessments made to prevent crowding out existing financiers and other forms of funding as well as reduce the level of market distortion can be seen as a preventative measure to avoid dependency.

> There are other programmes in the world, globally, where you give support to lower the price of the product itself. But we have chosen not to do so to not distort the market. [...] And well, there is always the question of what is distorting the market or not. This entire structure is distorting the market in a way, that the West comes in and pays (Interview 1, Sida, author's translation)

Furthermore, the issues of dependency stretch beyond the concerns within the challenge fund's scope. As described earlier, dependency theory argues that the entire economic system is flawed and these issues must therefore be considered on a systematic level. It is therefore important to see challenge funds as one part of a broader theory of change in relation to other forms of financing. "The entire Theory of Change is built on being able to support companies from the early stages until they can take commercial loans" (Interview 1, Sida, author's translation), and

> you have to see this entire landscape of financing opportunities where challenge funds become a seedbed for companies. And I think bringing this all together will be important when you look at different forms of support – what you have as the purpose with the support form apart from like energy or CO2 reduction and such if you look at the longer perspective. That, I think, you will need to carry with you when you compare different financing forms. (Interview 1, Sida, author's translation)

5.3 Theme 3: Combining market solutions with a post-development approach

The third and final theme identified in the analysis is the combination of using market solutions to enhance a post-development approach to development cooperation. This final theme can be seen as the result of theme 1 and 2 overlapping, and consists of two sub-themes reflecting theme 1 and 2. The sub-themes are *local context solutions*, relating to theme 2, and *market solutions*, relating to theme 1 (see figure 1), which are integrated and discussed together.

The empirical material shows both the market aspects and the decolonial aspects of challenge funds. Situating this within the historical context of development cooperation and the previous top-down approaches, this study further emphasises the need to shift towards bottom-up approaches of postcolonial and post-development theory into development cooperation. By critiquing the Eurocentric linearity in mainstream top-down development and emphasising the need to celebrate the diversity of cultures and contexts around the globe, post-development theory argues that there needs to be a *pluriverse* of alternatives to development. With development cooperation touching down in a variety of these different contexts, post-development theory is needed, and simultaneously in the context of economic development, innovation is needed. This combination is exemplified by one fund manager:

> Looking at the African market, you cannot use one approach because of the difference into context, even within one country. So then entrepreneurs have to innovate, to be able to reach the last mile[4] [...]. And I think that is what is driving the innovation. It is the market and also the competition. [...] So if you don't innovate, then you are going to be obsolete. Because then as you see, I've seen many companies come and go. So if you don't innovate in terms of product, in terms of business model, then the market will sweep you out. (Interview 4, fund manager)

[4] The term "last mile" refers to reaching the most marginalised and underserved households and communities. See UNCDF (2016) *Reaching the last mile: the role of innovative finance in meeting the SDGs*. Available at: https://www.uncdf.org/article/1624/reaching-the-last-mile-the-role-of-innovative-finance-in-meeting-the-sdgs-migration

This excerpt emphasises the need for innovation from the perspective of the liberal market, while also illustrating the connection between innovation and the fundamental idea behind post-development theory that development approaches must be dynamic and nonlinear. One grantee similarly explained that they "found out we can't be static because of the changing environment. [...] So innovation even [in] the way they do the technical training, we noted ours shouldn't be like any other" (Interview 6, grantee). The grantee then explained that this is because they are working with women entering a male dominated sector, meaning that their training cannot be the same as others because it must include aspects of preparing the women for that environment, including having to work extra hard to prove themselves, standing up for their rights and handle sexual harassment.

Furthermore, several fund managers described that innovations tend to emerge when problems arise, indicating that innovation is triggered by the emergence of issues that need solving and by the structure of the market where companies need to evolve to remain relevant. It was explained that innovations present "breakthroughs in problem solving" (Interview 5, fund manager) and come "naturally when things are not working" (Interview 7, fund manager). One fund manager even described that

> we want you to go beyond your business-as-usual, where it's working is not of interest to us, figure out where you're not present, where there is need for your particular products, but there's nothing there. And rationalise that. (Interview 2, fund manager)

Following this line of thought, challenge funds can be seen as a vehicle to introduce and raise awareness of certain development problems through their programmes, hoping this will trigger that nature of innovativeness and lead to breakthroughs in problem solving that they can support. One example where this increased awareness combined with new market opportunities emerged was in the previously described example of the grantee introducing ethanol-fuelled stoves as part of a clean cooking programme of a challenge fund (see section 5.1.2). The grantee described that there were two key drivers behind the establishment of the business. First was the increased awareness and recognition of issues connected to deforestation, including the health and social impacts brought about by deforestation. The second thing was the emergence of the carbon market mechanism, which "provided the financial tool and the financial subsidy really brought together the two core elements to build a business in this market" (Interview 3, grantee).

This example highlights how the awareness of the problems with using charcoal and firewood for cooking – such as issues of deforestation, health complications connected to using

firewood and charcoal for cooking, and gender aspects given that women usually cook and collect the wood – combined with the introduction of the financing opportunities of the carbon market, made it possible for this innovation to emerge and be deployed on the market. This case presents an example of how the combination of increased acknowledgement of a specific development issue and a market-based financing mechanism triggered innovation.

In relation to this, the fund managers have experienced that the challenge fund model opens the possibilities to surface innovations, describing that

> solutions around impact are essentially out there. So you needed to find a better way of getting access to the solutions *or* those people working to solve some of these problems around poverty. (Interview 8, fund manager)

One fund manager specifically explained that challenge funds has a special ability to

> surface [...] the diamonds in the rough. You know if you just go cherry picking then you might miss opportunities for companies who are not known. Some companies might not even be having a website or such, so they are not known, but they are very good ideas. They are deep down in communities and allowing companies to emerge on their own using the challenge fund I think is a good way of surfacing those companies that are not known. (Interview 4, fund manager)

The market-based approach of the challenge funds is presented here as a tool to surface bottom-up development. This builds on to the discussion made in the literature review around Anand *et al*'s (2021) arguments highlighting the role of the private sector in facilitating innovation in emerging economies, presenting the role of the market-based development approach as a facilitator of bottom-up development.

However, conclusions like these, advocating the opportunities of the market and private sector, are drawn with considerable caution. As was discussed in the literature review (section 2.2.2) and following the principal-agent theory, rational private actors will seek to maximise profits. In this, there is a risk that the profit maximisation comes at the expense of social and environmental benefits when proper regulation is not in place (Boer and Anastasi, 2024, p. 9). It is therefore important to highlight that while the private sector and commercial capital have a role to play in facilitating innovation, the most essential feature of the combination of market solutions and bottom-up development is the long-term objectives of development, including increasing local ownership and untying aid from donor countries' commercial interests that underscores every decision made. One fund manager expressed that because of the complexity of development issues, it is essential to be mindful and make sure commercial capital and interests coming in are understanding of this complexity.

> The commercial money or the commercial investments that are coming in do have a role, but we need to be very careful in setting up frameworks and thinking about the viability of commercial capital, especially within very complex social issues. (Interview 7, fund manager)

Copestake and O'Riordan (2015, p. 1) argued that one key issue with top-down development was the neglecting and undermining of the complexity of development issues. This statement from the fund manager can therefore be considered a representation of how the challenge fund model is moving away from the top-down approaches and presents the important task – and challenge – of the challenge funds to introduce aspects such as the post-development pluralism and postcolonial criticism to the liberal market. This illustrates another way in which the knowledge and values coming from critical development theories are sought to be integrated into liberal market solutions to development. Additionally, in relation to principal-agent theory, this statement also strengthens the argument of the importance of aligning interests between stakeholders to ensure efficiency in reaching the development objectives set out by the principal while the agents remain in control of their project.

Another example of this combination of how the post-development ideas can be integrated into market solutions was presented by the other grantee. The grantee's business model consists of a training programme for women to get qualified work in the construction sector with a fair wage. Through this programme, they have been able to open up opportunities for women coming from vulnerable situations to work in the construction sector for a fair wage. Furthermore, the grantee described that their training programme also encourages the women to start their own businesses and workshops, leading to the additionality of further job creation as the women can employ more people in their businesses.

> So we realised some women as much as they are employed in the construction sector, others are moving ahead, much ahead than the rest. They will take some of the opportunities that they can grasp, like taking work as contractors. That one will view it as business, where they come like they can look at this room if she's a painter and she'll quote [the work that needs to be done]. Then she will go back and write a business idea for that project. She will source people. And sourcing people, it can be also looking for female trainees or artisan or other, mingle with other. So she picks that. We've noted they pick that as business. (Interview 6, grantee)

Using the lens of critical development theories, this example can be seen as a way of rejecting the trickle-down hypothesis of top-down development approaches and modernisation theory that was common in the Washington Consensus. As described by Langan (2011) in section 2.2.2, the common narrative of development aid directed at private sector development and trade liberalisation is that the benefits of improved private sector wealth will 'trickle-down' to

vulnerable populations. This example, however, presents how rather than working to strengthen the market by providing resources to the top and hoping the benefits will reach vulnerable populations, this grantee works directly with strengthening and empowering vulnerable women who can enter the workforce and strengthen the market from its base, i.e. working bottom-up. From this, they have been able to see changes in the sector with other construction firms following their lead.

The results presented in this analysis indicate that focusing on providing support to small scale innovation has the potential to increase bottom-up development and contribute to the creation of the post-development *pluriverse*.

> And one of the reasons my thinking is that it will be important to have a challenge based kind of approach because it will lead to a sort of, let me say, co-creation or a more natural way of providing solutions. So it would be coming from the down to us, so the solutions come from the innovators. (Interview 8, fund manager)

6 Concluding discussion

This thesis has addressed two aims. First, to provide insight into whether challenge funds represent an alternative to top-down development as presented in their establishment, the study has sought an answer to the first research question: *how can we understand challenge funds as a development mechanism in relation to critiques towards top-down development and as an alternative to top-down development?* In regards to this, the analysis has shown that challenge funds can be seen as a market solution that is enabling innovative bottom-up development, and can therefore be considered a combination of top-down market solutions and the bottom-up post-development approach. As a liberal market solution with the aim to mature the market, the challenge fund mechanism still incorporates some elements of top-down development in the eurocentrism of still using the 'West' as the point of reference. It is however rejecting the idea of the 'one size fits all' that development solutions can be copy-pasted into any context and is working to bring local solutions to local issues into the market while seeking to make the market fairer for small businesses in emerging and unstable markets. The experiences found in this study indicates that the raised awareness of development problems is a key driver of innovation, suggesting that challenge funds can take on another role in bringing attention to problems that can encourage innovativeness.

The analysis indicates that challenge funds are working to reduce North-South economic dependency through their long-term objective of maturing and diversifying the market. This is done on two levels: professionalising and scaling the SMEs, and advocating for an improved business environment. By supporting the SMEs with both financial support and technical assistance for capacity building, the analysis has shown signs of the market becoming more professionalised and growing from the 'bottom', for example through grantees providing people from a vulnerable group with the skills to start their own businesses. Integrated in this is also the findings of extensive advocacy work to improve the economic conditions for small businesses. This advocacy work is also described to come from the grantees and the networks of SMEs created by the challenge funds, once again showing signs of the evidence for the advocacy coming from the 'bottom'. In this, the analysis has presented the incorporation of the post-development approach and postcolonial understanding into the challenge fund mechanism, specifically with the descriptions of seeking a variety of unique solutions or 'diamonds in the rough' to support, and the strength of solutions being 'Africa-led'.

The second aim was to provide insights into how relationships between public and private partners in development cooperation can be built to ensure efficiency while striving to not reinforce dependency and colonial legacies, the analysis has explored the second research question: *how can we understand the relationships between donors and recipients in challenge funding, particularly in relation to efficiency and local stakeholders' agency?* The analysis has presented that an efficient relationship between stakeholders that supports the agency of local stakeholders is well connected to localisation and close collaboration. The localisation of the fund managers in the context of proximity to their grantees is highlighted in the analysis as a necessity to provide efficient and decolonising support. Furthermore, this is presenting a shift in development cooperation where the centre for decision making about development is moved from the Global North to the Global South, providing agency to the people working on the ground. With the approach of surfacing locally based solutions and providing both financial support and technical assistance to build capacity within the SMEs, the challenge funds are actively working to support the agency of the SMEs. As a result, local stakeholders are empowered with agency both through the localisation of the challenge funds and through the holistic work with the SMEs.

Meanwhile, this localisation is also allowing for smoother handling of concerns of efficiency related to issues of information asymmetry lifted in the principal-agent theory. The

analysis shows that there are several measures at work to prevent the occurrence of principal-agent issues, including close collaboration to align interests and match-funding to balance the allocation of risk. However, one aspect that this study has found that may have been overlooked regarding the balance of risk is that the risk-sharing seems to be directly connected to the monetary resources put in. With one grantee explaining that there are high administrative burdens connected to grant funding, meaning that the grantees put in a lot of resources and risk in the time spent on applications. While it is not possible to draw a defining conclusion on this from this study alone, this indicates that there may be an imbalance in risk allocation when including non-monetary resources. Regardless, further research on this is needed to make an informed judgement on what possible issues this may entail.

While the study has found that challenge funds are working to reduce dependency on external funding through capacity building and making the SMEs investment ready, the interviews have also indicated that some companies keep looping back to grant funding – the so-called 'grantpreneurs'. In relation to this, it was expressed that reforms of the challenge fund model may be needed. Based on the results of this study, such reforms should focus on strengthening the advocacy work, networking elements, and the collaborative relationship between fund managers and grantees.

Finally, this study has contributed to the knowledge of private sector development and challenge funding by investigating them through the perspective of development theories in contrast to studies of new institutional economics looking at efficiency. In this, the study has found that the knowledge of critical development theories has been integrated in the challenge fund model, and that this has contributed to efficiency in the relationships between donors and recipients while providing local stakeholders with agency.

7 Reference list

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8 Appendices

8.1 Appendix 1: Interview guide

Abbreviations:

Grantee = challenge fund grant recipient

FM = fund manager

PM = programme manager

CF = challenge fund

Initial questions

1. **ALL:** Could you start by telling me a bit about your business/CF?

    1.1. What is your business philosophy/aim of your CF?

2. **ALL:** Could you tell me more about the motivation and inspiration behind the start of the business/CF? Why was the business/CF started?

    2.1. Were there any specific things that inspired the establishment? What were these?

Deepening questions - focus on challenge funds

3. **a) For grantees:** And you have applied for and received a challenge fund grant for a project, could you tell me about the project that you received the grant for?

    3.1. What inspired you to develop this project?

    b) For FM/PM: Could you tell me a bit more about the projects that you have funded? Why did you choose these and what does that process look like?

    3.2. What are the most important criteria that you focus on when picking a project for the grant?

    3.3. Are you involved in the project and give them more than financial support? How does that work?

4. **a) For grantees:** Could you describe more why you chose to apply to this particular challenge fund?

4.1. Were there other financiers, grants or loans that you applied for but did not receive for this particular project? How was that process in comparison?

4.2. Have you previously received grants or cooperated with other financiers or development agencies in different projects or for the business in general? Could you describe that experience in comparison to challenge funds?

b) For FM/PM: When you established the challenge fund, could you describe more why the mechanism of challenge funding was chosen and why it was the most appropriate mechanism for this development issue?

4.3. In what ways does this design differ from other grants, loans or financing in your opinion?

5. **ALL:** Building on from this, I would like to go deeper into the role that CFs have in the business environment of your field from your experience. So, based on your experiences, how would you describe the business environment in your field (and in the geographical area)?

5.1. How is the economic situation for small businesses?

5.2. Has this changed over time in any way? Are there more or less opportunities for small business now than previously?

5.3. What about politics, how would you describe the influences that political decisions have had on the business environment in your field?

6. **ALL:** Also based on your experiences, how do you think challenge funds influence the business environment in your field?

6.1. Have you noticed any particular differences in the business environment since the challenge fund was started?

7. **ALL:** Finally, there is a lot of focus on innovation and entrepreneurship in CFs, where do you think this focus comes from?

Closing questions

8. **ALL:** Is there anything else you would like to share about your experiences working with challenge funds?

8.2 Appendix 2: Interview participants

Interview	**Role**	**Date**
Interview 1	Sida	18 February 2025
Interview 2	Fund manager	21 February 2025
Interview 3	Grantee	28 February 2025
Interview 4	Fund manager	5 March 2025
Interview 5	Fund manager	17 March 2025
Interview 6	Grantee	18 March 2025
Interview 7	Fund manager	26 March 2025
Interview 8	Fund manager	26 March 2025