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October 19,2001

For meeting of
Committee: Wednesday, October 31,2001
Board: Tuesday, November 13,2001

FROM: The Acting Secretary

Private Sector Development Strategy: Directions for the World Bank Group

Draft Final Report

Attached is a President's Memorandum together with a paper entitled "Private Sector Development Strategy: Directions for the World Bank Group", which will be discussed at a meeting of the Committee on Development Effectiveness scheduled for October 31,2001, prior to Board consideration. It is intended to make this report publicly available after the Board discussion.

Questions on this document may be referred to Mr. Klein (x33293), Mr. Roger (x38720) or Mr. Mahmood (x36856).

Distribution:

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Directors and Department Heads, Bank, IFC and MIGA

The World Bank
Washington, D.C. 20433
U.S.A.

Office of the President

October 15,2001

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Private Sector Development Strategy – Directions for the World Bank Group

The goal of the private sector development strategy is to help deploy private initiative to reduce poverty. The strategy recognizes that private sector development is not a sector, but a cross-cutting issue. It is about a way of doing things that can have relevance for any sector such as energy or agriculture. This strategy thus fits into the web of strategy papers guiding World Bank Group operations.

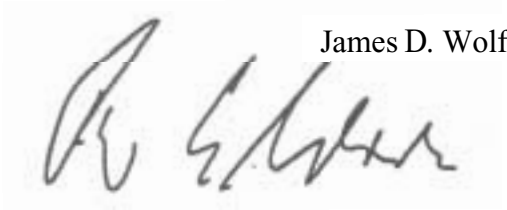
Taking into account the lessons of experience on how best to support private initiative for poverty reduction as well as the plight of taxpayers in poor countries, where past approaches have yielded unsustainable debt, the strategy emphasizes ways for extending the reach of markets to help the poor obtain jobs and better incomes and for improving basic service delivery for the poor. These are done such that performance risks are shifted to private parties, and subsidies are better targeted to the poor.

Additional disciplines are proposed on the World Bank Group based on its comparative advantage. These include systematic analysis of the investment climate over time and across countries, output-based approaches to aid, rate-of-return disciplines on support to the private sector and unbundling subsidies.

The strategy preparation utilized a broad consultation process both inside and outside the World Bank Group. These core themes and key proposals have been discussed with a range of stakeholders, including governments, multilateral agencies, private firms, trade unions and non-governmental organizations.

We look forward to discussing the strategy with you.

James D. Wolfensohn



by Peter Woicke

PRIVATE SECTOR DEVELOPMENT STRATEGY
— DIRECTIONS FOR THE WORLD BANK GROUP —

October 15,2001

PRIVATE SECTOR DEVELOPMENT STRATEGY
DIRECTIONS FOR THE WORLD BANK GROUP

Table of Contents

ANNEXES

FIGURES

TABLE

BOXES

ACRONYMS

AAA	Analytic and Advisory Activity
ARDE	Annual Review of Development Effectiveness
CAS	Country Assistance Strategy
CDF	Comprehensive Development Framework
CEMs	Country Economic Memoranda
DEC	Development Economics
EBRD	European Bank for Reconstruction and Development
FACS	Firms Analysis and Competitiveness Survey
FIAS	Foreign Investment Advisory Service
HD	Human Development
IDA	International Development Association
IFC	International Finance Corporation
IMS	Investment Marketing Service (MIGA)
MIGA	Multilateral Investment Guarantee Agency
OBA	Output-Based Aid
OECD	Organization for Economic and Co-operation and Development
OED	Operations Evaluation Department
OP	Operational Policy
PREM	Poverty Reduction and Economic Management
PRG	Partial Risk Guarantee
PRSP	Poverty Reduction Strategy Paper
PPI	Private Participation in Infrastructure
PPIAF	Public-Private Infrastructure Advisory Facility
PSAS	Private Sector Advisory Services
PSI	Private Sector Development and Infrastructure
RPED	Africa Regional Program on Enterprise Development
SME	Small-Medium Enterprises
WBG	World Bank Group
WBES	World Business Environment Survey
WBI	World Bank Institute

CORE THEMES OF THE PSD STRATEGY

The goal of the Private Sector Development (PSD) strategy is to help deploy private initiative to reduce poverty. Key to poverty reduction is the creation of jobs and the growth of incomes for the poor, in particular the 1.2 billion who live on less than US$1 per day and who work in the private sector in urban and rural areas, many of them in the informal sector. A reasonable investment climate is in turn required to generate more productive and hence better-paying jobs. Critical features of the investment climate include a sensible governance system that allows contracts and property rights to be respected and corruption to be reduced. Equally important is an infrastructure that allows private entrepreneurs and their employees to operate effectively. Competition and, where necessary, regulation are essential to channel private initiative in socially useful directions. A sound financial sector is required to allow firms to enter the market and operate effectively as well as to help restructure failing firms. So much is clear.

To improve work on the investment climate the PSD strategy suggests systematic investment climate surveys and assessments that allow i) better identification of the features of the investment climate that matter most for productivity and hence income growth, ii) tracking of changes in the investment climate within a country, and iii) comparison of countries or regions within countries.

A sound overall investment climate is crucial, but just one part of the puzzle. For poverty reduction, the poor need to benefit from markets that help them find jobs and raise productivity and incomes. At one level, this means ensuring that institutional and policy improvements extend to the areas where the poor live. In particular, programs to reduce bureaucratic obstacles faced by small entrepreneurs and to provide property rights to poor citizens in urban and rural areas are needed. At another level, it is often advocated to complement work on the investment climate with direct support to small and medium firms as well as entrepreneurs in rural and informal settings, for example via micro-finance schemes. Such interventions are meant to provide direct help for people to escape poverty. Yet, the record of public support to such schemes is mixed at best. Subsidized credit and provision of business development services that are not based on market demand have typically failed.

To help improve the performance of public financial and advisory support for private entrepreneurs and for firms of all sizes, the PSD strategy proposes disciplines on the World Bank Group to provide credit on non-subsidized terms, preferably via the IFC so as not to expose domestic taxpayers in poor countries to credit risk. Any subsidies are to be targeted transparently, in ways that are performance-based, to purposes that truly require a subsidy, such as some types of institution- or capacity-building. This model of assistance is based, for example, on lessons of experience from micro-finance.

Next to jobs and income growth, basic service delivery (infrastructure, health and education) is crucial for poverty reduction. Widespread failures in public service delivery have led to experimentation with new types of private participation in

infrastructure. For health and education, many of the poor de facto depend on services by private providers. Private provision of basic services can, if done right, improve access to services and quality. At the same time, it has become clear that indiscriminate privatization has not worked and that subsidies for basic services have often not reached the poor and need to be better targeted. Experience of OECD countries, where transfer payments have come to be a large part of value added, also suggests that funding and provision may in a number of cases best be separated, with public funding supporting social concerns and private initiative providing service delivery.

There is no simple recipe to accomplish better results due to the contracting, regulation and enforcement challenges that surround the delivery of basic services and the targeting of subsidies, whether under public or private modes of provision. However, development institutions can deploy their instruments better to support delivery systems and the targeting of subsidies. To this end, the PSD strategy proposes to pilot "output-based-aid" schemes for the disbursement of public funds backed by donors. Essentially, aid would be disbursed to subsidize poor consumers of services rather than to fund private or public firms that provide the services. In this way, aid funds would help enhance the purchasing power of poor consumers. Services could be free to poor users or available at modest cost depending on the type of service and the resources available. Providers of services including both for-profit and not-for-profit organizations would then take more of the risk of performance under a variety of public-private partnerships. If service providers fail, investors would suffer rather than taxpayers in poor countries. While output-based aid is not always practical, the direction holds promise as shown by a variety of experiments in both low and middle income countries — typically initiated by governments or NGOs — with the goal of getting ever closer to achieve the outcomes that actually matter to citizens.

Altogether, taking into account the lessons of experience on how best to support private initiative for poverty reduction as well as the plight of taxpayers in poor countries, where past approaches have yielded unsustainable debt, the PSD strategy emphasizes ways to

- extend the reach of markets to help the poor obtain jobs and better incomes
- improve basic service delivery for the poor

and to do so in ways that

- shift performance risk to private parties
- target subsidies better to the poor

by imposing disciplines on the World Bank Group based on its comparative advantage, namely

- systematic analysis of the investment climate over time and across countries
- output-based approaches to aid
- rate-of-return disciplines on support to the private sector and unbundling subsidies

PRIVATE SECTOR DEVELOPMENT STRATEGY
— DIRECTIONS FOR THE WORLD BANK GROUP —

I. INTRODUCTION

A. Context for the PSD Strategy

1. **The revolutionary changes of the 1990s introduced market-friendly policies in most parts of the world.** During the 1980s policy-makers in many countries and development institutions became disappointed with the performance of state-owned enterprises and excessive government intervention in market processes. In response, the first private sector development strategy for the World Bank Group (WBG) was developed in the mid- to late 1980s. Yet, at the time, few expected the radical changes in economic systems world-wide. Most central planning regimes were abandoned. A wave of deregulation, liberalization and privatization swept the globe. Even in infrastructure sectors, an unexpected wave of policy changes introduced private participation on a global scale.[1]

2. **Systemic change is giving way to consolidation.** Now the world appears to be entering a phase of consolidation. In some cases, fundamental changes have taken place, but problems persist. In others, real reform has remained elusive. Some of the euphoria of reform has faded. Yet, a review of the existing evidence suggests that the thrust of the PSD strategy, as set out in the early documents of the late 1980s and elaborated later on, remains sound.[2] The deregulation and privatization in sectors like manufacturing, agriculture and the financial sector, where competition can be effective, has typically been beneficial.[3] However, pro-competition policies (free entry, hard budget constraints) were neglected in a number of cases, which led to disappointing outcomes and excessive power of private firms after privatization, for example in some transition countries. Private participation in infrastructure has proven its potential. However, it has become equally clear that such private participation can be ineffective or harmful in the absence of sound regulatory approaches.(4)

3. **Establishing a sound investment climate is the key reform challenge.** The emphasis of policy reform is thus shifting from fundamental regime change to getting policy interventions and institutional development right, which includes governance, the improvement of infrastructure and establishment of a sound financial sector. Among the key questions are what various actors – the public sector, the private for-profit firms and not-for profit organizations – can do best and who is best placed to manage and bear the risks of economic activity. A central issue is no longer the move to a private economy,

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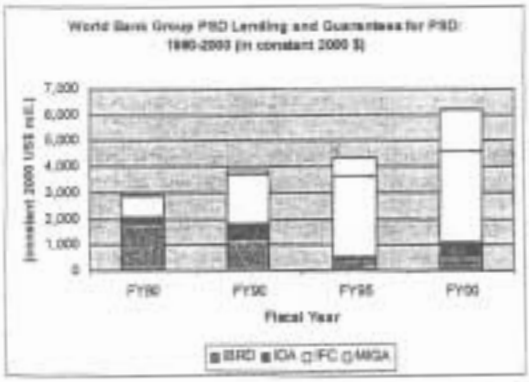
[1] Gray (2001).
[2] World Bank (1989a); World Bank (1991); World Bank (1995); World Bank (1999).
[3] Galal et al. (1994) ; Kikeri (2001); Macedo (2000); Megginson and Netter (2001); Sachs et al. (2000); Sheshiski and Lopez-Calva (1999); Shirley and Walsh (2000); World Bank (2001f).
[4] Gray (2001), Klein (1999).

but the role of competition and regulation including the supporting institutions, and hence the role of policy and the state in creating an investment climate that fosters private initiative while channeling it in socially useful directions. That is what PSD strategy is about, in particular, how to tap the power of market-mechanisms and private initiative to reduce poverty.

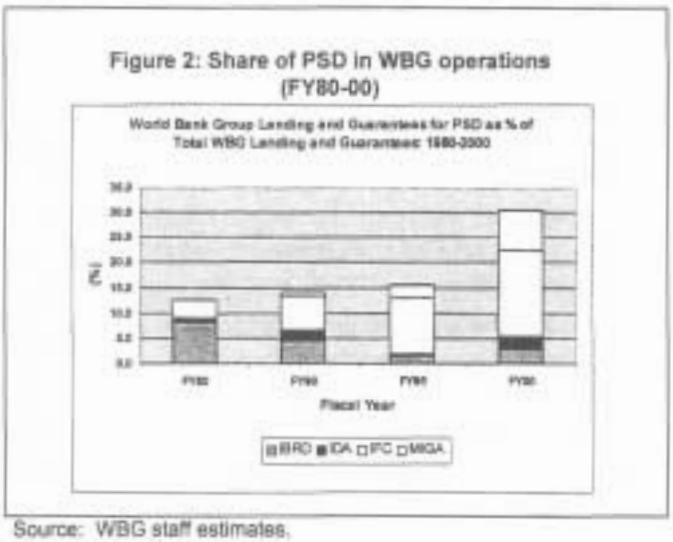
4. World Bank Group activities have supported PSD more and more. During the 1990s, private sector development has taken on greater prominence in development work world-wide, including in the World Bank Group (Figures 1 and 2). Policy advice, capacity-building and policy-based lending have promoted a better environment for existing firms and the increased use of private firms in many sectors of the economy such as manufacturing and agriculture, where open and competitive markets have proven to be effective means of raising productivity, providing jobs and reducing poverty. Driven by an unexpected wave of policy changes in most client countries, private participation in infrastructure also became very prominent during the last decade. State-owned bank restructuring and privatization has become a major element of the Bank's financial sector development work in most regions - with particular emphasis in Central Europe and Latin America.

5. But privatization and direct support to private firms are just a part of PSD. More broadly, the development of an investment climate that supports growth on the basis of private markets is the core of PSD. Policy advice, capacity-building and policy-based lending have become the focus of IDA/IBRD activities in the area of private sector development (Figure 3) rather than the direct support to private firms, which has more exclusively become the domain of IFC and MIGA.

Figure 1: Volume of WBG PSD operations (FY80-00)

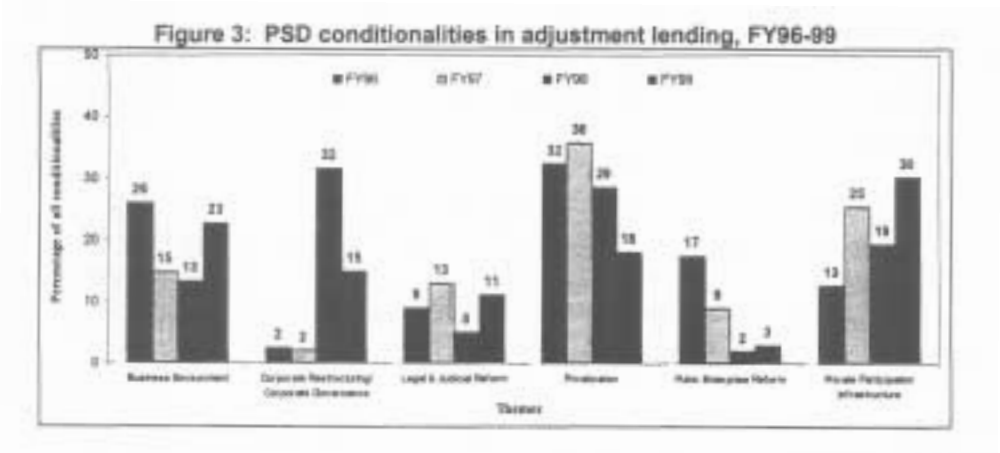


Source: WBG staff estimates.



Source: WBG staff estimates.

6. In FY00, financing for private firms and private projects of IBRD/IDA and the work of IFC and MIGA accounted for about 30 per cent of total annual volume of WBG financial products, compared to about 14 per cent in FY90 (Figure 2). IBRD and IDA have stopped or significantly curtailed lending to public enterprises in sectors that can obtain finance from private sources, such as manufacturing, tourism, agriculture, mining, oil and gas, telecommunications, power generation and railways. IFC and MIGA on the other hand have increasingly helped private investors provide finance to those sectors.



7. In the process, the WBG has helped shift performance risk for projects of all types from domestic taxpayers in client countries to private investors, while supporting governments in focusing on policy measures and institution-building. Annex III provides a review of World Bank Group PSD activities based on a comprehensive staff paper that was submitted to the Executive Directors of the World Bank Group in May 2001.(5)

[5] World Bank (2001d).

B. Strategic directions for PSD

8. **A variety of strategy and policy documents have elaborated on PSD issues throughout the last decade.** Since the mid-1980s, a growing number of documents by the World Bank and other development institutions have explored at length the dimensions of private sector development and its relevance to the development process,(6) including the recent Review of Private Sector Development in IDA 10-12. Most recently, the World Development Reports of 2001 and 2002 have respectively discussed the relationship between private markets and poverty reduction and the role of institutions in a market economy.(7) In developing this strategy document, a number of background papers have been prepared that review extensively the dimensions of PSD and existing evidence on effectiveness. A comprehensive staff paper on the role of entrepreneurship, markets and development was submitted to the Executive Directors of the World Bank Group in May 2001.(8) The main papers underpinning the preparation of this strategy document are listed in Annex I.

9. **The strategy focuses on key directions for the future.** This PSD strategy briefly summarizes key points of strategic relevance, restates many WBG policies on PSD and proposes new approaches and priorities, particularly for deploying instruments of the WBG in ways that better complement private initiative and help improve the division of labor within the WBG. The emphasis of the paper is on strategic directions for the WBG. It does not purport to provide a comprehensive guide to the wide range of WBG interventions in support of PSD, which are discussed in the background papers to the strategy and a series of recent toolkits (Annexes I and VI). By the same token, this strategy does not present multi-year budget and project proposals for the WBG as a whole or for parts thereof. This is left to IFC, MIGA and to IBRD/IDA sector strategy papers on traditional sectors such as transport or rural development. The strategy does, however, set out clear next steps to pursue the various proposals including the translation of the strategic directions for PSD in regional strategies.

10. The strategy recognizes that PSD is not a sector, but a cross-cutting issue. It is closely intertwined with our financial sector work. It is about "a way of doing things" that can have relevance for any sector such as energy or agriculture. It thus fits into the web of strategy papers guiding WBG operations.(9) And the pursuit of private sector development is not a goal but a means to do things better.

11. **The strategy builds on the existing WBG approach to PSD.** This strategy paper is organized in three main sections. The first is about the role of PSD in the development process and the role of development institutions in supporting PSD. There is nothing truly new in this section. A review of past strategy statements and actual

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6 African Development Bank (1997); Asian Development Bank (2000); AusAID (2000); EBRD (1999); IADB (1996); Norway Ministry of Foreign Affairs (1999); OECD (1994); UK-DFID (2000).

7 World Bank (2001a); World Bank (2001i).

8 World Bank (2001~).

9 A background paper summarizing what various WBG sector strategies say about PSD was submitted to the Executive Directors of the World Bank Group in May 2001: World Bank (2001e).

experience suggests that appropriate policy precepts have been in place. For example, previous strategies had highlighted the need for pro-competition policies and sound regulation including the underlying institutions and governance systems, but implementation has not always been in line with strategic precepts. Overall, PSD interventions have been rated as similarly effective as other types of Bank operations.[10] All in all, this would seem to suggest that more effective management rather than radically new approaches to PSD are required. Hence, at the level of approaches to PSD, the strategy summarizes already agreed strategy of IBRD/IDA, IFC and MIGA.[11] A series of toolkits have in recent years been prepared to provide guidance to staff on how to deal with design and implementation issues, including matters of timing and sequencing as well as institution-building, for example for regulatory agencies. Annex VI lists the toolkits and characterizes them briefly. Moreover, the World Development Reports of 2000 and 2001 have discussed out how private markets relate to poverty reduction and what we know about the role of institutions and relevant design issues.

12. Overall, the strategy re-emphasizes the importance of the investment climate for growth and poverty reduction. Beyond this, it highlights two areas. First, it underlines promising options to exploit small-scale infrastructure projects to expand access, particularly to telecommunication, energy and water services in low-income countries. Second, it stresses the de facto dependence of poor people on health and education services provided by private for-profit and not-for-profit organizations. It calls for assessing better the potential for private participation in health and education and for new ways of deploying instruments of the WBG to support such approaches, where appropriate. Existing strategy papers already cover these issues. For example, the 1989 PSD action program already called for more attention to private participation in the social sectors. However, in practice, progress in this area has been limited, because governments have not embraced private participation in the social sectors with the same zeal as in infrastructure due to the political sensitivity of the social services.

13. **The strategy proposes increased selectivity in WBG support to PSD.** The second main section proposes new or stronger disciplines on the WBG. To improve decision-making on programmatic assistance and capacity-building, it is proposed to conduct systematic assessments of the investment climate across countries and over time. To focus assistance in the area of private participation in infiastructure, it is proposed to help develop standards for regulatory regimes governing private participation schemes in infiastructure. The proposals build on the Bank Group's special ability to convene and support global efforts for policy review and standard-setting.

14. For project finance activities, market-type disciplines on the WBG are proposed of a type that the WBG has been recommending to client countries for some time. The proposals are based on arguments about the World Bank Group's comparative advantages. Central to the new proposals are measures to shift performance risk further from domestic taxpayers in developing countries to private parties, where these parties, be they small or large for-profit or not-for-profit organizations appear better able to bear

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10 World Bank (2001d).
11 World Bank (1999); IFC (2001); MIGA (2000).

or manage risk. At the same time, the proposed measures would facilitate the transparent targeting of subsidies embedded in WBG products to intended beneficiaries or purposes. The proposed core measures include:

- output-based aid; and
- "commercial disciplines" on direct support to the private sector.

15. They would enhance selectivity by subjecting project decisions by the WBG to stronger market-type tests and by rendering the allocation of financial flows and subsidies more transparent.

16. The third section deals with coordinating PSD activities within the WBG and other implementation issues, including measurement of results and reporting.

17. **The key proposals have been widely discussed.** The key proposals have been discussed with a range of stakeholders, including governments, multilateral agencies, private firms, trade unions and non-governmental organizations. Annex II describes the extensive external and internal feedback on the key proposals in the proposed strategy, which were made public in a discussion paper dated June 1, following Board discussion on May 23,2001.[12] Annex II summarizes how the comments have been taken into account.

18. **The PSD strategy fits into the core country strategy processes of the WBG.** The proposals contained in this paper provide strategic direction and characterize ways of deploying instruments effectively in pursuit of these objectives. However, at the country or project level, the PSD approaches need to be brought together with other relevant approaches and adapted to country circumstances. This would be done following the CDF principles, in the context of Bank support to countries' efforts to develop their own development strategies (e.g. PRSPs), or in preparing Bank Group Country Assistance Strategies (CASs). This PSD strategy is not a detailed guide on how to design interventions in particular cases. Country typologies are not helpful for this purpose. In parallel, detailed toolkits for program or project preparation are being prepared for the PRSP processes - but they are tools, not immutable recipes or blueprints. However, the disciplines proposed in the paper would constrain the exercise of discretion in WBG interventions at the country level and thus promote selectivity.

II. PSD AND DEVELOPMENT

A. Growth and basic service delivery

19. The potential for rapid economic growth means large-scale poverty reduction is now possible within a human lifespan. A number of developing countries have been able to double per capita incomes within a decade, for example, Botswana, Chile, China and

12 World Bank (2001b).

Thailand. This is a phenomenon of the late 20th century. Before, it took significantly longer for countries to double per capita income. For example, the lead country of the 19th century, Britain, at the time needed some 60 years to double per capita income. Today countries have the potential of adopting best practices already developed elsewhere to enhance productivity growth and thus incomes more rapidly. There is ample evidence that the potential for growth and hence the potential for poverty reduction can best be realized in well functioning private market economies that are open to trade and investment and that allow free entry to economic activity and consumer choice.(13)

20. But the process is neither automatic, nor completely understood. Transition issues, capacity- and institution-building are all critical as discussed most recently in the World Development Report 2002.(14) Yet, simple "engineering" solutions do not exist. The strategy tries to set out the basic features of sound private sector development. How to move towards improved policies and projects varies from case to case. A series of analyses and tool-kits provide guidance to staff, but fundamentally programs have to be developed in dialogue with the countries concerned (Annex VI).

21. **The investment climate.** A reasonable investment climate is required with a policy framework set by governments that provides ample room for entrepreneurs to invest and create jobs in agriculture, industry and most services. Private firms, small and large, operating in competitive markets are the engine for growth and job creation and thus provide the opportunity to escape poverty (Table1).(15)

Table 1: Private firms as a source of job creation
(selected developing countries, 1987-98)

Country	Period	Job Creation (thousands)		Ratio Private to Public Job Creation
		Private	Public	
Mexico	1989-98	12,431.0	143.0	87:1
Costa Rica	1994-98	238.0	12.0	20:1
Turkey	1987-92	1,490.0	91.0	16:1
Kenya	1993-98	173.0	13.0	13:1
Guatemala	1994-98	47.0	4.0	12:1
Bolivia	1994-97	181.0	18.0	10:1
Uruguay	1987-92	127.0	27.0	4.7:1
Gabon	1992-96	4.7	1.3	3.6:1

Note: This table is limited to the few countries for which changes over time in job creation are documented for the entire public sector, including state-owned enterprises.
Source: Pfeffermann (2000).

22. Markets and entrepreneurship arise in many different settings and often in very trying governance environments. Yet, for markets and the private sector to develop their full potential, sound policies and institutions are required. The various strategy papers cited above have discussed at length the key pre-requisites for well functioning markets.

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13 Djankov and Hoekman (2000); Sachs and Warner (1995); Winters (1999).
14 World Bank (2001i).
15 Over several decades many reform programs for state-owned enterprises have been undertaken world-wide, including with World Bank Group support. However, they have typically failed, particularly where competitive markets can work. Hence the shift to support public institutions for purposes where the state has a clear role, for example regulatory institutions.

This includes macro-economic stability as well as a number of institutional pre-requisites, most importantly a reasonable governance system that promotes adequate property rights and security of contract within a framework of regulations that pursue sensible social and environmental goals underpinned by a functioning legal system and curtailment of corruption.(16) All this points to the importance of an effective state (at all levels of government, including central, state and local) in creating the setting for markets and entrepreneurship to flourish.

23. Within the rules set by policy, markets develop their full power when competition is promoted; this implies customer choice, free entry, as well as freedom to fail for private organizations.(17) Competition allows individual firms to experiment and innovate, to adapt to local circumstances and to local knowledge. At the same time competitive forces — on average — limit profits to normal rates of return required to remunerate owners of firms for the risks they take. Productivity growth is also facilitated by an open international trading regime, which helps unleash competitive forces, opens up new markets for developing country products and services and promotes the transfer of know-how and technology to developing economies.

24. Firms not only compete, they also complement each other. Small firms bring new approaches. Large firms tend to be more productive than small ones and support new firms, for example, through subcontracting arrangements and with trade credit. As economies grow richer, the average firm size increases (Figure 4). Firms from developed areas within or outside a country tend to be most productive and are able to bring best practice to new areas. Altogether, an equal playing field for firms of all sizes is most conducive to growth. In particular, barriers to entry to small and medium domestic formal or informal firms or entrepreneurs and to productive firms from developed areas tend to retard growth.[18] When such barriers are not removed comparatively large incumbent firms that are politically well-connected tend to dominate. Competition is thus undermined. The market power of such firms tends to reduce productivity growth. Their political influence tends to protect them against failure when they do not perform, often via preferential access to bank credit. The resulting vicious circle sets back job creation and reduces entrepreneurial opportunities for small entrepreneurs as well as innovation from new foreign firms.

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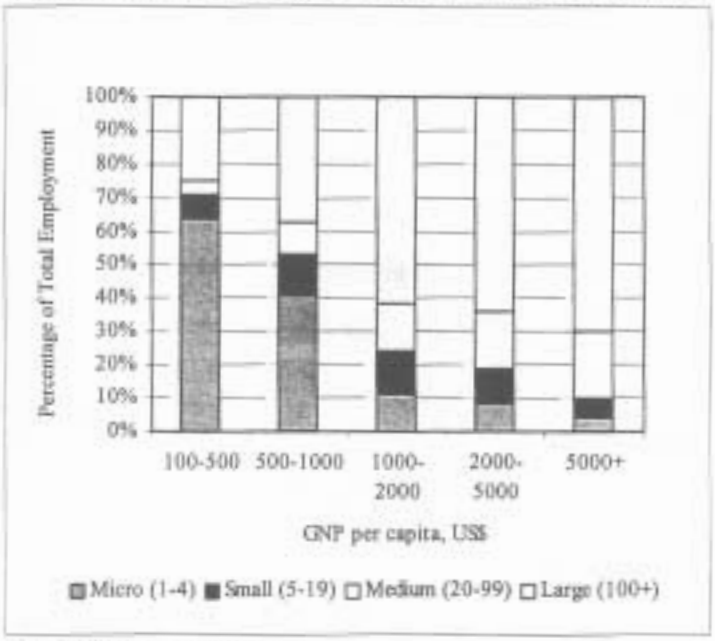
16 World Bank (2000a); World Bank (2001i).

17 Galal et al. (1994); Kikeri (Forthcoming, 2001); Macedo (2000); Megginson and Netter (2001); Sachs et al. (2000); Sheshiski and Lopez-Calva (1999); Shirley and Walsh (2000).

18 Audretsch (1991); Baily et al. (1992); Batra (2001); Caves (1998); Javanovic (1982); Liedholm and Mead (1987); Roberts and Tybout (1996).

Figure 4: Distribution of employment by firm size and GNP level



Source: Snodgrass and Biggs (1996).

25. Both for-profit and not-for-profit organizations form part of the private sector.[19] Both can be subjected to competition, which provides them with the incentive to perform, whether performance means maintaining credibility for an advocacy organization or product quality for a service provider. Hence, they have a strong advantage over state-owned firms that are typically hard to subject to competition even in sectors where that might in theory be possible, because governments tend not to let state-owned firms fail when they do not perform. For-profit firms have more diverse and flexible funding options, but they may not be trusted as much as not-for-profit firms. In sectors where consumers place a premium on trust, for example in health and education services not-for-profit providers may be able to out-perform for-profit firms under competitive conditions. Hence, competition between these different forms of incorporation should, in principle, be allowed.(20)

26. Growth is enhanced when a sound financial sector supports entry of promising firms and reallocates resources away from failing or under-performing firms to more promising ones, a function typically best fulfilled by private financial institutions.(21) A well-functioning financial sector operating at arms-length from political and corporate

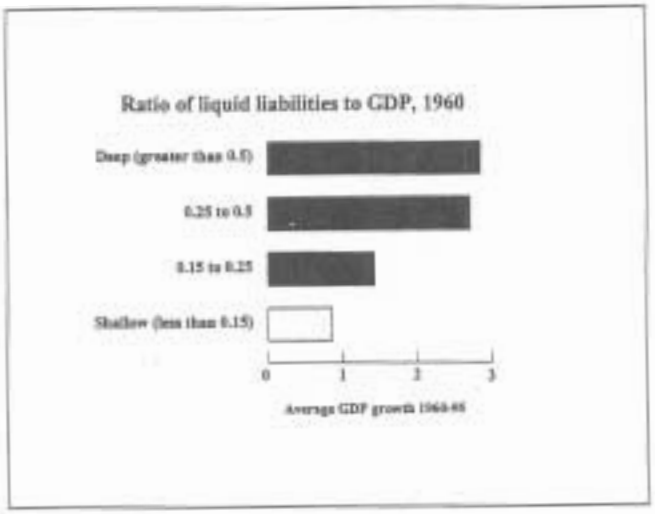
[19] All these organizations form part of a continuum. Many not-for-profit organizations that do not receive donations make profits like any other firm, but they cannot distribute them to arms-length shareholders. The boundary between donations and membership fees is also rather fluid. Within both for-profit and not-for-profit organizations there are many types of very different organizations. Among not-for-profits we find advocacy organizations as well as service providers. A similar spectrum exists among for-profits, which include newspapers with an editorial and opinion-making policy as well as manufacturing firms.

[20] However, it does not follow that not-for-profits should be tax exempt except for parts of their business that is deemed to be of special public value.

[21] World Bank (2001f).

interests is thus part and parcel of pro-competitive policy regimes. Recent studies trace the link between deeper financial sector development and economic growth (Figure 5).

Figure 5: Financial depth generates subsequent growth



27. Development institutions are well placed to support public goods such as the development of good policy, in particular a sound investment climate.(22) Typically, advice on best practice, assistance with capacity-building and policy-based operations would be deployed for the purpose. In addition, development institutions may try to improve the supply response of private firms that can suffer due to political risks and market failures.(23) They may do so by providing financial or business development services to private firms, for example to assist with the development of entrepreneurs for countries in transition to a market economy. Such support to private firms is most likely to succeed, if it is free of market-distorting subsidies and supportive of market forces. Overall, the evidence suggests that such assistance is likely to succeed only if the investment climate is adequate.(24) Sound investment climates not only create the conditions for firms to flourish and to allocate resources effectively, they also deal with information problems that plague markets, in particular the financial markets. Within a sound investment climate, the ecology of large and small firms serves to overcome further market failures, as large firms and subcontracting arrangements can overcome some of the market failures due to information problems.

28. Beyond improving the investment climate, public interventions have tried directly to support private firms and to overcome market failures, particularly for small and medium firms in both urban and rural areas. Where public support to private firms was based on subsidized credit or provision of business development services without aligning them with market demand and supply the results have typically been disappointing. This is equally true for rural credit or extension services, for SME support programs and micro-finance schemes. The evidence suggests that, like in the case of aid

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[22] Stem (2001).
[23] IFC (2001); MIGA (2000).
[24] Batra (2001).

effectiveness overall,(25) the support of private firms in inadequate investment environments tends to lead to waste. Consequently, public support for private entrepreneurs should not be based on subsidized credit and - as laid out in the SMEs strategy of the WBG - any subsidies should be transparently deployed, well targeted to address institutional failures and limited in time.(26)

29. Efficient service delivery in infrastructure and the social services. Under competitive disciplines and adequate regulation, private organizations hold potential to improve the provision of infrastructure services (telecommunications, energy, water and sewerage, transport) as well as that of health and education services.(27) Private provision does not imply that funding needs to be private as well. Funding may well best be provided by the public sector where affordability concerns or public goods considerations are important. Private investors operating at arms-length from governments tend to have strong incentives to invest efficiently. Competitive forces can be deployed to combine freedom of initiative with limits on profit rates. In some sectors, head-to-head competition is feasible as in telecommunications and electricity generation or among health care providers.(28) In areas of natural monopoly, for example, pipeline or electricity transmission networks limited forms of competition for the right to provide a service can be deployed. Government attention can then be focused on remaining critical issues of procurement, regulation and, where justified, subsidies.

30. Lessons of experience exist particularly for infrastructure due to the numerous new schemes introduced during the 1990s all over the world. Well designed schemes have shown that private participation schemes can improve on traditional public provision. Failures of private participation schemes for infrastructure have typically been due to neglect of setting tariffs or public funding schemes at adequate levels as well as to neglect of options for introducing competition and inadequate regulatory schemes. New private participation in the social sectors have not been introduced deliberately by governments as often as in infrastructure during recent years. New private activity has developed more spontaneously in response to failing public systems whether in low income countries or transition economies, where many service professionals started de facto providing private services. Still, in health systems private forms of provision are in any case widespread in many countries. In education some countries have private providers like the Netherlands, where private provision is publicly funded. Several developing countries have introduced private schemes and school choice, notably Chile and Colombia. Existing evidence indicates that private provision can lead to improvements. As in infrastructure, the key is adequate attention to market structure and regulation.

31. Adequate choice of market structure and regulation is critical in infiastructure and the social sectors, as these services tend to be provided in imperfect markets. In

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[25] World Bank (1998a).
[26] World Bank (2000b).
[21] See evaluation of results for PPI schemes in World Bank (2001g); World Bank (1994); Jimenez et al. (1991).
[28] Kessler and McClellan (1999); Newberry and Politt (1997); World Bank (1994); Winston (1993).

infrastructure sectors, for example, natural monopoly segments may require price regulation.(29) In health, socially desirable service coverage may require some restrictions on choice by customers and mandatory insurance. Incentives for excessive expenditure on health care may require some form of price and quantity controls on the providers of health care.(30) Externalities of health care interventions, such as vaccination programs, may require special subsidy or obligatory consumption schemes to enhance demand.(31) In education, concerns about social segmentation may require some restrictions on customer choice.

32. In weak governance environments, regulatory capacity may be limited and ineffective. Hence schemes relying on private participation may not work well. However, this does not imply that in such situations government provision is necessarily preferable. The regulatory functions – setting prices, quality and sometimes quantity - have to be fulfilled regardless of ownership. In many cases, governments have an even harder time to regulate state-owned companies than private ones. Only when the bundling of provision and regulation within government yields special benefits would government provision be preferable to private provision.

33. Development institutions have a role in supporting the development of good policies and institutions, particularly regulatory capacity. To achieve this, they would deploy the same type of financial or advisory instruments to help shape the regulatory regimes for infrastructure and social services that they use to improve the policies and institutional framework for markets in general.

B. Pro-poor design of PSD interventions

34. Growth and poverty reduction. Economic growth remains the main factor that helps reduce poverty. Hence, a healthy private sector that drives economic growth is critical for poverty reduction. Growth in incomes also explains, to a significant degree, improvements in services for the poor. For example, income growth is a major factor behind improvements in health as it provides citizens with the opportunity to obtain cleaner water, sanitation and better health care.

35. Existing experience shows that — on average — economy-wide income growth benefits all income groups in similar proportions.(32) However, in some countries the poor may not benefit much from growth, whereas in others they benefit disproportionately. Why growth translates in different ways into poverty reduction in different countries is not fully understood. Yet, some basic directions for intervention are clear. PSD approaches can contribute by helping to provide jobs and raise incomes as well as by improving access to basic services and their quality.

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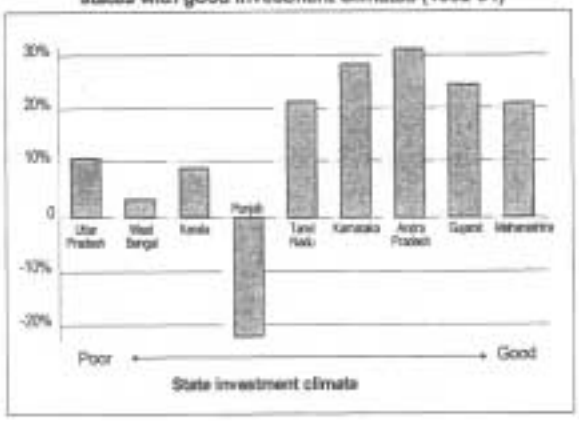
[29] Train (1991).
[30] Saltman et al. (Forthcoming, January 2002).
[31] Smith et al. (2001).
[32] Dollar and Kraay (2001); Ravallion (2001).

36. Extending the reach of markets. A good investment climate that drives growth is an essential feature of poverty reduction strategies. PSD interventions may be designed to enhance benefits for the poor by promoting an investment climate that extends the reach of markets to the poor.(33) Connecting citizens to markets increases the chances that best practice and thus productivity improvements are spread to all citizens providing jobs and lifting their incomes (Figure 6). At the same time, access to markets tends to provide better and more varied goods and services at more advantageous prices. Key interventions to extend the reach of markets are the abolition of detrimental entry barriers to private firms, particularly to domestic small and informal ones and to foreign firms that bring best practice across borders.(34)

Figure 6: Poverty reduction was higher in Indian states with good investment climates (1992-94)



Source: Dollar (2001).

37. Improvements in the financial sector should render credit decisions more efficient and less dependent on whether firms are politically well-connected. This helps provide finance to new and promising firms including small and medium-sized firms and very small ones via micro-finance. In addition, where it does not excessively interfere with incentives to invest, property rights that are uncertain can be allocated to the poor and formalized. For example, rights to land in many rural and urban areas are not well defined and may be allocated to the poor via simple titling schemes.(35) This provides the poor with assets that can eventually be used as collateral to support finance for new investments. This program of opening up opportunity for the poor and empowering them with access to property rights – advocated most prominently by Hernando de Soto – has yet to be pursued vigorously by development institutions. Basic infrastructure, such as rural roads, equally helps connect the poor to markets.

38. As mentioned before, direct support to small entrepreneurs in rural and urban areas including support to micro-finance schemes is best delivered in ways that are aligned with market forces, i.e. without credit subsidies and using demand-side

[33] World Bank (2001h).
[34] Brunetti et al. (1998); Djankov et al. (2001).
[35] de Soto (1989); World Bank (1998b).

performance based subsidies such as matching grant schemes for business development services.

39. **Access to basic services and affordability.** PSD approaches can further help the poor by tapping private initiative to extend access to basic infrastructure and social services and reduce costs. Service coverage targets for private firms can be used to bring about improved access to services, for example water supply. Where modern water systems extend service to additional poor customers, typically in peri-urban areas, prices paid by the poor drop precipitously by factors often or more, as the poor are no longer dependent on expensive private water vendors. More generally, the truly poor are rarely connected to modem infrastructure or health and education systems. They either receive no service or often expensive service from small private providers. In many cases, extending access of modem services to the poor tends to address affordability issues at the same time and helps in particular women, who often bear a disproportionate responsibility for securing water or energy for their household.

40. Complex regulated private provision may, however, not function well everywhere. Where regulatory capacity is weak, it is difficult both to attract large private investors, particularly from abroad and to supervise them sensibly, if they do invest after all. But public provision may also be ineffective in expanding coverage and providing reasonable service. In fact, most poor people in low-income countries are particularly dependent on private forms of health care, education, energy supply, water, transport and communications, precisely because public sector providers are not able to reach them. Such services tend to be provided by small local firms and organizations with low capital requirements and are often costly and inefficient. Yet, they provide access to better service than would otherwise be available (Box 1).

Box 1: Access to services: the role of small-scale providers

For many poor households in developing countries the prospect of access to infrastructure services from formal networks remains distant. The magnitude of the access deficit is often so great that, even with thorough-going reform, universal network access could take many years or even decades. And in many cases the prospects of establishing functioning, credibly independent regulatory systems in the near-term acts as a serious brake on the rapid mobilization of private finance for service expansion. Very often, the best prospects for service improvement in the short and medium term come instead from small-scale service providers.

The poor in developing countries already rely extensively on small-scale provision – buying water from vendors, candles or kerosene from local merchants, urban transport services from combi buses or jeepneys. But these services often operate in the shadows of the black market, at risk to expropriation and mafia-style monopolization that can push up prices and push down quality. Where entry by small-scale providers is permitted and open to competition, experience suggests that better, cheaper services can follow. In Kenya, where the grid reaches

less than 2 percent of the rural population, photovoltaic cells supplied by small local companies have begun bringing electricity to rural households - with more technical and financing options and reduced costs becoming available as the market expands. While per kW costs remain high relative to grid power, they still represent significant per unit savings over alternative energy sources. In Hargeisa, Somalia, private owners of power generators with excess capacity have emerged as key service providers following the destruction of public power facilities during the civil war - supplying around 10,000 households at a flat daily rate of US35 cents per light bulb. In Cambodia, which has one of the lowest electrification rates outside sub-Saharan Africa, hundreds of small private providers offer services ranging from battery recharging sites to fully metered electricity provision for entire communities. These providers now serve an estimated 115,000 customers - more than one-third of all electricity customers nation-wide. In Mogadishu, Somalia, in the absence of any formal telecommunications regulation, active entry and competition has driven down the price of international calls from US$1 .50 per minute to around US$1.00 per minute - a price that remains high, but not out of line for the region as a whole. In Paraguay, small competing water companies called *"aguateros"* have dramatically increased access to piped water by peri-urban households, at prices not significantly higher than local utility prices. The *aguateros* are now being considered as service providers in rural areas, under a proposed least-subsidy bidding scheme to promote rural water access. In Guatemala City, around 20 independent water vendors, many belonging to a formal federation, supply clients with holding tanks, including poor communities that have constructed communal holding tanks. And in Teshie, a suburb of Accra in Ghana, tanker companies have reached a formal arrangement with the local public utility for the purchase of bulk water for distribution to households that currently lack connections. In each case, the effect is to open up better options for those who lack access to conventional utility services.

Sources: Solo (1998) on Paraguay water; Kariuki and Acolor (2000) on Ghana water; Hankins (2000) on Kenya PV; Marchal et al. (2000) on Somalia electricity: and data on Somalia telecommunications and Guatemala city water from Ada Karina Izaguirre.

41. Thus, in countries with heavily constrained regulatory capacity, lightly regulated private provision may still be preferable to ineffective public provision, even though costs may be higher. Furthermore, the advent of new technologies has in many sectors reduced the level of economies of scale, increasing the benefits and justification of small-scale approaches. However, a number of countries prohibit entry of private providers of telecommunication services, electricity distribution, primary education, etc. Such prohibitions in many instances equate to a denial of service. Hence, priority should be given to the removal of unjustified entry barriers. The challenge for development institutions is to promote policy regimes that improve access while helping to upgrade gradually the regulatory interventions so as to allow citizens to benefit eventually from the advantages of well-regulated infrastructure and social service systems. Recent papers provide guidance on how to improve access to services to poor customers and on how to design regulatory interventions in environments with low regulatory capacity.(36)

42. Affordability concerns that cannot be addressed by access to better and cheaper services can in principle be addressed by subsidy schemes. This is compatible with PSD-

[36] See papers presented at PPIAF Conference on "Infrastructure for Development: Private Solutions and the Poor," held in London on May 31-June 2000. The papers are available at http://www.ppiaf.org/conference/newindex.htm. In particular, for graduated approaches to regulation dependent on the state of governance, price and quality/environment, see paper by Warrick Smith (2000); see also Brook et al. (October 2001).

type interventions, wherever performance risk for delivery of the subsidized service(s) can be shifted to private parties, while using public funds to support the poor. Essentially, subsidies then enhance the purchasing power of the poor and the quality and/or cost of the service is improved by using private providers. Competition among private parties for the right to supply the poor limits private profit to normal rates of return and ensures that the subsidy accrues to the customer — not to the private provider. Price regulation is required to achieve this goal, where competition is ineffective.

43. Generally, provision of service is separable from funding of the service. While provision may better be in the hands of private organizations, funding may in a number of cases better be dealt with by public agencies based on tax finance. Funding schemes may involve user fees, for example in the case of electricity service, or they may involve free provision of a service to a whole range of customers, for example for primary education. A whole range of options is available to combine private provision with public funding schemes in ways that marry the objectives of greater service delivery efficiency via private provision and support to the poor so as to render services affordable.

44. Development institutions have a particular mandate to support poverty reduction and thus the design of policies and projects that promise to bring the benefits of PSD to the poor. In part, this means supporting investment climate reforms that extend markets to the poor. In addition, development institutions can improve results by funding or supporting well-designed subsidy schemes that reconcile public financing with the shifting of performance risk to private parties. One promising strategy for achieving this, output-based aid, is discussed in more detail in Part III.

C. PSD and sustainability

45. Private markets may be effective means of generating growth and improving efficiency. However, concerns persist that continued deregulation and privatization may harm the environment and the social fabric. The negative effects of private markets can be dealt with by subjecting private organizations to norms that address health and safety issues, environmental and other social concerns, e.g. labor standards or privacy issues. In fact, such norms qualify and often restrict the property rights held by private parties. Prudential regulation of financial institutions can be deployed to minimize disruptions arising from financial market behavior.

46. Some norms may be followed largely voluntarily, supported by strong underlying ethical beliefs of market participants. Others may more routinely require penalties that enforce regulations or mixes of taxes and subsidies to provide adequate incentives. However, given those adjustments to property rights, the deregulation of prices and market entry remain powerful forces to help exploit the property rights efficiently.

47. Environmental sustainability. The economic growth of recent decades has placed unprecedented strains on the natural environment. At the same time, the innovation supported by private markets has so far been able to cope with a number of

the resulting environmental problems, for example, natural resources scarcity. However, for markets to be effective in coping with environmental problems, there needs to be a framework of sensible regulation protecting the environment and promoting new environmentally-friendly business solutions. Development institutions use safeguard policies to introduce better environmental practices under their operations. Such regulations condition the property rights of private parties. Wherever possible, markets can then bring their innovation powers to bear on finding the best solution to meet the objectives of the regulation. Where economic instruments are used such as taxes and subsidies or tradable property rights that create markets in scarce resources, environmental goals may be achieved at least cost.

48. The disappointing environmental performance of public enterprises, particularly in non-market economies, suggests that regulation of private firms is likely to be more effective in combining economic growth with sensible environmental standards. In particular, private firms may be easier to regulate than public ones due to the arms-length relationship between them and the authorities. They may also have stronger incentives to conform to regulations as the impact of penalties and economic incentives affects the personal wealth of investors.

49. Once again, the key feature of PSD-type approaches is to shift performance risk to private parties within a framework of sensible regulation. The role of development institutions (with regard to PSD) is to support the development of market-based ways to help implement environmental goals effectively. An example is the World Bank Group's attempt to establish a fund for trading rights to emit greenhouse gases, the Prototype Carbon Fund.

50. PSD approaches should be integrated with pro-active approaches to shape the policy environment so as to enhance cost-effective protection of the environment. Reform processes associated with the creation of markets or privatization may in fact hold opportunity to reshape environmental policy. For example, in many cases private investors will require clarification of responsibilities for past environmental liabilities associated with an asset sale and for future environmental impact of operations. More generally, deregulation processes may affect the choice of technology, for example, in the power sector they tend to shift generation from hydro and nuclear towards natural gas. Reform efforts should take such effects into account.

51. **Social sustainability.** There are also concerns about social sustainability engendered by increased use of private markets. A frequent concern is that the use of the profit motive might lead firms to skimp on quality or break rules and regulations. To some degree, competition can be used to counteract this incentive by providing firms with incentives to maintain reputation and hence provide quality to its customers. Interest in maintaining a decent reputation provides the basis for the phenomenon of "corporate responsibility", which drives large visible multinational corporations to adopt global operating standards and practices that exceed legal or regulatory requirements in a number of host countries. Yet, where competition is weak or ineffective in instilling

interest in maintaining reputation the profit motive should, where possible, be balances with regulatory safeguards, for example labor standards.

52. Markets are institutions that combine rule-based and cooperative behavior with competition. Markets only function well when private parties observe some basic rules, most fundamentally respect for contracts and property rights. Property rights in turn are conditioned by rules and regulations on matters of safety, health and the environment. As long as private parties accept the rules they can compete. Competition in turn restricts the market power of private parties and directs them to serve customers. Under competitive conditions profit becomes a signal for customer wants, because only those can make a profit, who offer something that customers want. Through both rules and competition, markets constrain and direct what private parties can do while leaving them scope to experiment and provide new and better services. Market development is not about "laissez faire", but about constraining power, while leaving room to innovate.

53. Most firms actually conform to regulations imposed on them. Monopoly power appears to be a bigger issue than the profit motive per se. For example, it is often hard to impose rules on large public enterprise that act like a state within the state. Equally, some large well-connected private firms may escape effective regulation. Hence, the importance of truly "privatizing the private sector", i.e. to create effective free entry and freedom to fail. Finally, the monopoly powers of the state itself may be abused. After all, self-interested behavior is common to people in all sorts of organizations, not only those that explicitly recognize the profit motive. Markets themselves do not function well when a coalition of well-connected firms and abusive politicians impose their interests on society.

54. Overall, the problem is one of "who guards the guardians". The solutions involve balance of power, which includes competition among firms as well as balance of power within the public sector, and ways for citizens to express their interests effectively, which includes purchasing decisions in markets as well as democratic decision-making in the political realm. Arms-length relations between regulator and the regulated party as well as transparency are critical features of any solution. Competition among firms helps regulators punish those that misbehave and provides incentives for firms to obey the rules.

55. Sensible standards combined with transparency appear able to temper the profit motive and to enhance the quality of growth in time. Development institutions can play a role in helping to develop such standards and mechanisms providing transparency. The particular contribution of this PSD strategy would be to help support mechanisms that strengthen the reputational mechanism that makes companies adopt sound norms voluntarily, including rules for transparency and competition.

III. DEPLOYMENT OF WBG INSTRUMENTS FOR GREATER SELECTIVITY

56. This strategy proposes further to clarify the respective roles of the Bank and IFC, with the Bank leading on policy reform (mainly through programmatic lending as well as funding and provision of advisory services to governments) and IFC and MIGA leading on direct support to private enterprises (whether through loans, equity, guarantees or advisory services). It builds on the well-established track record of the WBG of phasing out support to state-owned enterprises, where markets and the private sector can better deliver goods or services (see examples in Figures 7 and 8). In particular, it proposes an approach to deploying WBG instruments — output-based aid — in ways that would help tap better the efficiency of private organizations for the delivery of a variety of public services. It also proposes disciplines on direct support to private firms that aim at preventing subsidies for substandard projects and subsidies for private firms. Instead subsidies would be targeted to where they are truly required.

Figure 7

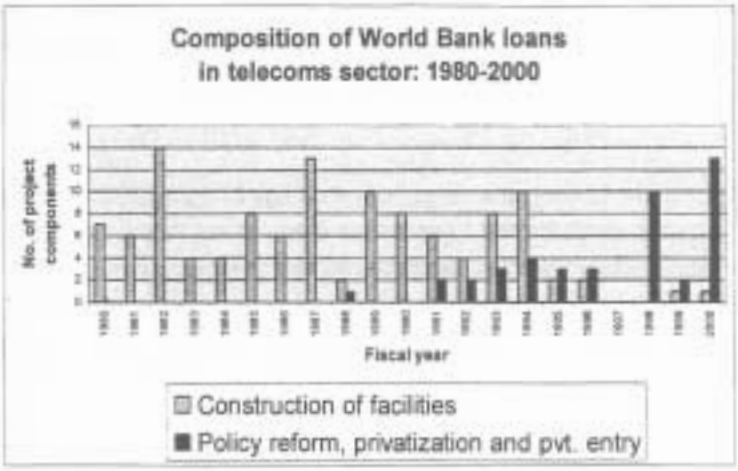
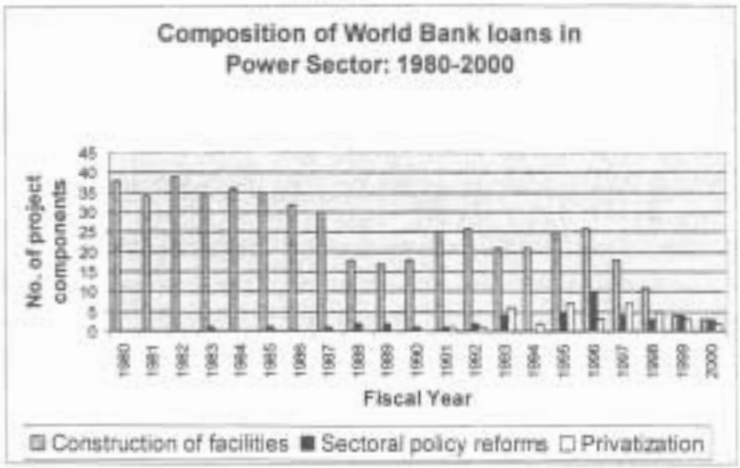


Figure 8



A. Policy development, regulatory frameworks and capacity building for private sector development

57. **The investment climate.** Development institutions have a role to play in supporting policy and institutional development in client countries through provision of advice, capacity-building projects and programmatic assistance. To design an appropriate assistance strategy, an assessment of the investment climate in a country is required that captures key factors driving growth and hence poverty reduction. Such an assessment should link the policy and institutional environment in a country to the performance of firms. Carefully designed survey tools would enable analysis of the differential impact of the investment climate on different types of economic actors, such as poor and non-poor, or male and female entrepreneurs.

58. Regular, standardized surveys would allow the systematic study of how policy changes affect firm performance and hence growth and poverty reduction, which is particularly relevant for IDA countries. Comparisons among countries and tracking changes over time are critical for such systematic study. Over time, this would help improve the design of government policy and supporting assistance programs. Such analyses would be complemented by WBI's work on indicators of the quality of governance.

59. The importance of the investment climate has been acknowledged for some time. Indeed, existing evaluations by the Operations Evaluation Department of the World Bank Group suggest that PSD operations focusing on improvements in the investment climate have had the highest rate of satisfactory outcomes (Annex III). What is, however, lacking is systematic tracking of the quality of investment climates across countries and regions. Past efforts by the WBG during the last decade such as "Private Sector Assessments" have failed to yield systematic results. Funding was driven by country program concerns, which might not value tracking of the investment climate on a regular schedule. Execution was uneven, reflecting idiosyncrasies of task managers and funding sources. Multiple, not comparable survey methodologies were used as part of assessments of the investment climate in different parts of the WBG, for example the FACS survey (DEC), the WBES (IFC, PSAS), the Regional Program for Enterprise Development of the Africa region (RPED) plus several other ad hoc variants of surveys or rating schemes used within the WBG, not to speak of the many other approaches followed by other agencies.(37)

60. In an increasing number of countries, efforts are underway to collect and analyze fim-level data that would allow more effective investment climate assessments. New insights about the process of economic growth and the development of markets and firms have started to be generated from such data sets during the 1990s, starting in OECD

[37] The World Bank has also developed a number of data bases of indices, namely: *The World Bank's World Business Environment Survey (WBES); The World Bank's Competitiveness Indicators;* and the *World Bank Institute's Worldwide Governance Research Indicators Dataset.*

countries and a few developing countries.(38) In a way, there is now an incipient movement to establish micro-economic level statistics and assessments to understand growth processes just as macro-economic statistics were developed after World War II to assess issues of overall economic stability. This is also reflected in private sector efforts to design indicators of the investment climate, which are, however, as yet highly incomplete and judgmental.(39)

61. At the current time, there is an opportunity to promote the design and implementation of a minimum standard survey methodology for the investment climate and to assist client countries in developing their own statistical systems to support it. The global reach of the World Bank Group and the depth and breadth of its expertise provides it with the ability to design and implement such surveys of the investment climate in cooperation with concerned development partners. Such surveys would be equally valuable for other development institutions and could help improve donor co-ordination at the country level.

62. WBG management has established a new joint investment climate unit of the Research Department and the Private Sector Advisory Services Department (PSAS) to spearhead an effort to develop a minimum standard investment climate survey methodology and to help implement it. A balance will have to be struck between a manageable core set of issues to be addressed in all surveys and a broader set of issues reflecting institutional priorities and specificities of country situations. The effort is to be coordinated with other development institutions and among relevant groups in the WBG, including the regional PSD units, SME, FIAS, MIGA, PREM, FSE, IFC and WBI. To anchor this type of donor co-ordination and to provide a regular funding base for a sustained systematic survey effort, a new multi-donor funding scheme could be developed. This would harmonize and leverage existing funding schemes for survey efforts, limit duplication and contribute to the dissemination of information and analysis collected in this way.

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[38] See Caves (1998) for a survey of databases on turnover and mobility of firms in a selection of OECD and developing countries. Iqbal and Urata (Forthcoming) have put together a collection of papers that examine the evolution of small and medium enterprises in East Asia. The Africa Regional Program on Enterprise Development (RPED) consists of several components: (a) collection and analysis of enterprise survey data; (b) in-depth case studies focusing on finance, technological capability and business strategy; and (c) cross-country studies of issues related to firm dynamics. A complete list of RPED studies is available at http://afr/aft2/pvtsect/RPED/listof.htm.

[39] See A.T. Kearney, ***FDI Confidence Index 2001;*** A.T. Kearney, ***Globalization Index 2001;*** The Economist Intelligence Unit (EIU); ***Euromoney,*** "Country Risk Rankings"; The Fraser Institute, ***Index of Economic Freedom;*** Freedom House, ***Country Ratings;*** The Global Economic Forum, ***The Africa Competitiveness Report*** *2000;* The Global Economic Forum, ***The Global Competitiveness Report*** *2000;* The Global Economic Forum, ***The Environmental Sustainability Index 2000;*** The Heritage Foundation, ***Index of Economic Freedom*** *2001;* The International Institute for Management Development (IMD), ***World Competitiveness Yearbook 2001; Institutional Investor,*** "Country Credit Surveys"; Moody's ***Sovereign Ratings List;*** The PRS Group, ***International Country Risk Guide;*** Price Waterhouse Cooper, ***Opacity Index;*** Standard and Poor's ***Sovereign Ratings List;*** Transparency International, ***Corruptions Perception Index*** *2001;* UNDP, ***Human Development Report;*** The Tuck School of Business, ***Emerging Market Access Index.***

63. Investment climate surveys will only be useful if they inform policy and capacity-building operations. Their results need to be integrated into integrative due-diligence ESW products, such as Country Economic Memoranda (CEMs) and programs supported by WBI, and should inform the development of CASs.

Management intends to pursue the following work program to institute a minimum standard system for surveying the investment climate.

- *Note on minimum standard survey methodology by December 2001*
- *Workshop with interested development institutions to discuss common operational and funding approach by Fall 2002*
- *Starting in FY03, results of investment climate surveys to be integrated into core due diligence products such as CEMs and to inform the development of CASs.*

64. **Development of regulatory regimes for infrastructure.** The development of competent and independent regulatory institutions is critical to developing effective and sustainable private participation in infrastructure (PPI). So far, a wide ranging set of activities by the WBG has helped distill best practice and lessons of experience as well as support capacity-building. This includes training programs that have been attended by regulators from most client countries. Policy-based lending and project lending have supported the development of regulatory regimes in client countries. The efforts so far have translated in positive operational results. OED has rated PPI projects as most likely to be sustainable and as having the highest rate of institutional development among PSD interventions. The recent review of IDA 10 –12 rates PPI interventions highest together with micro-finance.

65. Such implementation successes notwithstanding, the most difficult and critical challenge for regulators remains competently to exercise their functions of balancing the interests of consumers and producers while maintaining independence from political interests. Decisions by regulators can easily prompt disputes, which risk undermining sustainable private participation schemes. At the same time, it is typically hard to tell whether regulators' decisions were incompetently made or whether political interference was the reason or whether the private providers were at fault. To help provide incentives for designing and managing regulatory systems effectively, it may be useful to establish a set of standards that allows an independent assessment/certification of quality of the regulatory systems for infrastructure — somewhat similar to certification of organizations under standards like ISO 9000 (quality management processes) or ISO 14000 (environmental management processes).

66. Currently, there are no efforts underway to develop such standards and no specialized international organization is charged with issues of infrastructure regulation or procurement of private participation schemes. Given its track record in the field of PPI, the WBG is well placed to tackle the issue of standards for regulatory systems in this

area. This would need to be an effort involving relevant agencies and policy-makers world-wide and would benefit from the convening power of the WBG.

Management has requested the PSAS department to explore the feasibility of developing standards for regulatory systems in infrastructure by Spring 2002.

67. Private provision of social services. The private sector has played an important role in providing health and education services in a number of countries for many years, and interest in expanding the role of the private sector is growing strongly. IBRD/IDA projects have involved more private organizations in the delivery of social services, particularly not-for-profit organizations. IFC has established a department in April 2000 that supports financing of health and education projects. Nevertheless, progress in these sectors still lags behind the infrastructure sectors, and work in implementing appropriate policy and regulatory frameworks remains at a relatively early stage.

68. The WBG can play an important role in assisting client governments assess the potential role of private sector involvement and to establish appropriate enabling environments. This will involve development of new assessment methodologies; clarification of the strengths and weaknesses of alternative forms of private involvement, market structure arrangements, regulatory approaches, strategies for promoting universal service, and financing approaches. To that effect, the Bank's Human Development Network is preparing detailed toolkits on private participation in health and education and is developing web-based information systems such as Edinvest. Support will also be required for the design and implementation of effective transaction processes. While each sector has its unique features, the WBG can build on the expertise it has developed on similar issues in the infiastructure area.

Management intends to expand its work in identifying and disseminating best practices and to strengthen the Bank Group's advisory capabilities in this area.

To help leverage relevant experience gained in the infrastructure sectors, the HD and PSI networks, in collaboration with IFC, will undertake a co-operative venture in this area supported by a small unit on private participation in the social sectors in PSAS to be established early in 2002.

B. Output-based aid – tapping private initiative for public services

69. Many goods and services in an economy are provided most appropriately through private markets, with consumers meeting the full costs of provision, and any market failures addressed through carefully designed regulation. However, for infrastructure and social services there is a larger role for government, for example through price regulation and public funding to address affordability concerns or, in the case of services with public or merit good features, to ensure an efficient level of service provision.

70. Traditional project finance by development institutions has often focused on financing inputs, for example the construction of a water pipeline or a school. Operation and maintenance of the system were then left to public organizations, which have often suffered from weak incentives to deliver sustained quality service. Contracts that shift the responsibilities for operation and maintenance to private investors (for-profit or not-for-profit) hold significant promise for sustained service improvements. Development institutions can support the shift of performance risk for service delivery to private investors by disbursing funds against achievement of contractually agreed objectives, for example the delivery of water to particular customer groups at agreed quality standards and for agreed prices. In this case, private investors would need to seek financing for the construction, operation and maintenance of a water system.

71. Where financial markets are not well developed to fund such projects, the disbursement schedule for subsidies could be frontloaded somewhat so as to render financing more manageable, while still maintaining adequate financial exposure of the private provider to maintain incentives to perform. Particularly in IDA countries, it would be important credibly to guarantee that subsidies will actually be paid when due. IDA could thus support output funding including through the use of guarantees, while IFC could help fund private providers without government guarantees, leading to a better and new division of labor between the Bank and IFC. Under adequately designed and supervised contracts, investors could then assume the risk of failure as opposed to taxpayers under traditional forms of development finance. Generally, output-based financing schemes provide development institutions a good instrument to support the introduction of private participation in service provision.(40)

72. In particular, output-based forms of project finance could be used to address affordability concerns better. All forms of subsidy schemes could be supported ranging from means-tested targeting of specific customer groups to broad-based subsidies to all consumers of a service that may be bid out on the basis of the least subsidy. Any combination of user fees or tax financing can be supported to establish the necessary cash flow for a project or a whole program of investment as output-based schemes separate decisions on provision and funding of services.

73. The involvement of private firms should rely on competitive disciplines to ensure that subsidies are applied to intended purposes and not to enhance private firms' profits excessively. Disbursements of funds under output-based schemes may still be directly to private firms – just as, for example, IDA funds may currently be disbursed directly to contractors for civil works or equipment. However, competitive disciplines would ensure that the profit margins would be bid down to normal levels and that the subsidy would eventually be reflected in lower prices to customers.

74. Many of the contractual and institutional design issues are challenging, Particularly monitoring arrangements, contracting processes, regulatory oversight and

40 As used in this strategy paper, output-based aid is a contractual discipline for the provision of services and should not be confused with adjustment-type operations where funds are disbursed to borrowers after successful implementation of specified reforms.

financing schemes. Proper attention will need to be given to the legal and regulatory set-up of these schemes. Relevant and useful insights can be gained from experience with similar issues in the context of private infiastructure arrangements. Schemes of this kind are already being used to improve the provision of a wide range of basic services, including rural telecommunications in Peru, road maintenance in Argentina, basic health services in Haiti, public health services in Nicaragua, and education services in Chile (see Box 2). Many of the examples involve small domestic service providers. The experience with attempts to introduce private participation in infiastructure (PPI) in IDA countries during the 1990s suggests that there is considerable scope for successful implementation of contracting and regulatory schemes for private providers. As mentioned before, the recent evaluation of PPI projects under IDA 10-12 ranks them highest among all forms of project intervention at par with micro-finance.

Box 2: Output-based aid

Output-based aid (OBA) is a strategy for improving the delivery of services that depend at least in part on public financing. In contrast to traditional approaches of channeling support to inputs consumed by public sector providers, OBA delegates service delivery to a third parties under contacts that tie payment to the outputs or results actually delivered. The approach thus helps to shift performance risk to the private sector, and in so doing can help to sharpen the targeting of development outcomes, sharpen incentives for efficiency, and mobilize private finance in support of development objectives.

OBA schemes may take many forms. In Peru, a special telecommunications fund subsidizes public pay phones for low income rural communities. The subsidies are offered by the government to private operators through competitive tenders. The obligation is to provide a pay phone for 20 years in each rural locality listed in the tender and the operator requiring the lowest subsidy to do this wins the subsidy. Part of the subsidy is paid out on award of the contract, part once the equipment is installed and the rest in semi-annual installments, contingent on the operator complying with specified service performance standards. In Romania output-based contracts between local health authorities and family doctors combine per-capita payments for their registered patients with capped fees for preventive services. Doctors compete for patients and to get paid they must provide documented evidence of registrations and the volume of fee-based services. The goal is to encourage responsiveness to patients (in contrast with the former system where local hospitals employed family doctors on salary and assigned patients to doctors), and to create incentives for performance related to key public health outcomes (e.g. immunization) and health care access (e.g. more rural services). At the same time these contracts try to avoid the budget problem associated with unconstrained fee-for-service remuneration occurring in some OECD countries.

Variations on these schemes have been applied to a wide range of public services in developing countries, with encouraging results.

75. Pioneering work has been done in defining performance standards, structuring payments in a way to mobilize an adequate supply response, and crafting implementation arrangements to meet local institutional constraints, including in some cases the

contracting out of monitoring functions to NGOs. A review of selected experience and key design challenges has been prepared as background to this strategy paper.(41)

76. The full potential of output-based aid approaches has yet to be explored. The WBG could play an important role in supporting progress in this area. IDA/IBRD could provide the financing for the subsidy payments in the form of loans or grants; assist governments in designing effective schemes; and help to identify and disseminate emerging lessons of experience within and across sectors and regions. IFC can provide financing to private service providers and, when required, various parts of the WBG might offer risk mitigation products.

Management intends to pursue output-based aid projects, with a particular emphasis on those supporting the provision of basic public services. Potential pilot operations are being identified in a variety of sectors (in particular in infrastructure) and regions. For project lending output-based approaches would be considered routinely.

C. Direct support for private firms

77. IFC is the prime vehicle of the WBG for direct financial or advisory support to private firms. It is the only part of the WBG that takes credit risk and thus has the strongest incentives among the component parts of the WBG to evaluate commercial risk effectively. IFC already has in place a number of products to complement private finance, for example B-loans, credit guarantees of various types, loans with extended maturities and so on.(42) While IFC's role within the WBG has increased substantially during the 1990s, IBRD and IDA continue to finance private firms via government-guaranteed on-lending operations that still account for about US$0.5-0.7 billion per year despite a substantial decline since the late 1980s.

78. The Bank's record of support to private firms, including SMEs, has been mixed at best.(43) In particular, subsidized financing terms have not promoted productive investment and operations. Likewise, business development services that do not make use of market-based approaches have typically failed to be cost-effective. The new SME strategy of the WBG recognizes this and is to promote unsubsidized financial operations as well as market-based approaches to business development services. Evaluation results of IFC operations by OEG also suggest that projects with sound developmental impact tend to be financially sound as well, and that subsidized finance does not simply translate into more developmental operations.(44) Based on these evaluation results, it is proposed to unbundle subsidies from IFC financial products that support private firms and to allocate such subsidies more transparently to purposes that merit being supported with

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[41] For a filler discussion of output-based aid approaches, Brook and Smith (October, 2001) and **Annex** IV. See also Cannock (2001); Eicher et al. (2001); Goldstone (2001); Gómez Lobo (2001); Liautaud (2001).
[42] see IFC (2000) and IFC (2001).
[43] Batra (2001) and World Bank (2001d).
[44] World Bank (2001d).

subsidies. Examples fi-om micro-finance show how performance-based subsidies can be deployed to leverage funding (Box 3). In selected cases, IBRD/IDA on-lending to private firms may continue to be a useful instrument for policy dialogue and reform. However, in order to impose tighter financial discipline on these operations, it is proposed that Operational Policy 8.30 be clarified and its application extended to all Bank on-lending to the private sector. In the process of applying such discipline, subsidies would be made more transparent and more clearly targeted to support policy and institutional development.

Box 3: CGAP's performance-based investments

CGAP is a consortium of 29 bilateral and multilateral donors who support microfinance. With a team of microfinance specialists housed in the World Bank, CGAP serves the microfinance industry, donors and microfinance institutions (MFIs) through the three categories of services provided: technical tools and services, training and capacity building, and technical advice and exchange. CGAP also has a small grant facility that provides funding for these activities and for strategic investments in MFIs. A large part of CGAP's mission is to promote "best practice," especially in the way donors support MFIs. Using its grant fund, CGAP has developed an investment-style approach to grant-making that ties tranched funding to institutional performance. The key focus is on the achievement of financial performance measures that will enable the MFI to reach sustainability and thus significant numbers of poor clients.

The performance contract that accompanies CGAP's equity-like funding leaves the use of funds entirely at the discretion of management; reporting, monitoring, and continuation of disbursements are tied to the MFI's fulfillment of a performance thresholds at the institutional level. These thresholds are designed to lead the microfinance institution to "full financial sustainability", the ability to cover all costs including a commercial cost of funds. They generally step up over time and include indicators such as profitability, efficiency (cost per unit of $ lent), portfolio quality, and growth (numbers of clients reached). Because most of a microfinance institution's funding is usually soft, achievement of full financial sustainability implies that it will generate substantial surpluses that will be retained to fund yet more services to poor clients.

CGAP's investment in Compartamos in Mexico illustrates the effect of such leverage. Compartamos works with very poor women in Mexico's most destitute regions. Its early funding consisted mainly of two large grants, US$1 million from a private Mexican banker and US$2 million from CGAP. Six years later, its client base has multiplied five-fold. More than half of its portfolio of 65,000 borrowers is funded, not by grants, but by retained surpluses that it has generated over the period. Now the NGO has invested in a new licensed finance company which will expand the same business. About half of the investment in this finance company came from commercial sources. Under prudential norms, it can leverage the capital of its investors up to five times by selling bonds to the public. Thus, each dollar that CGAP put into Compartamos in 1995 now translates into as much as twenty dollars of microloan service to poor clients. Looked at from this perspective, it becomes clear that it was not important how Compartamos spent CGAP's money (as long as it was legal). Rather, what made this investment successful was that they kept loan repayment at very high levels and stayed on track to financial sustainability, without abandoning their social mission. Thus, CGAP made continued disbursements contingent on their maintaining a specified delinquency rate and a specified improvement in their adjusted return on assets as they grew.

79. Commercial disciplines on commercial operations. Public support for private firms raises a number of issues. These issues include the potential for "crowding out" of private financial sources, support for sub-standard projects, and concerns about "corporate welfare" stemming from provision of subsidies to private firms. Care must be taken to ensure that public entities which support private firms have a clearly defined role, doing things which private financiers cannot, that they do not waste resources on substandard projects, and provision of subsidies is made as transparent as possible. WBG instruments contain elements of subsidy. In the case of IDA credits, the subsidy element is substantial and may be as high as 60 to 70 per cent of the face value of a credit. In the case of IBRD, the subsidy element corresponds to the opportunity cost of the equity capital, free availability of callable capital and tax-exemptions. IFC and MIGA benefit from non-payment for the opportunity cost of capital and tax privileges. In the absence of the financial discipline imposed by traded shares, care must be taken that these advantages are well used.

80. One way to address such concerns is to increase the commercial discipline (45) under which public entities operate. For commercial activities, one would set a target rate of return that covers the actual cost of debt and the opportunity cost of equity capital for the institutions, i.e. the full weighted average cost of capital. As the return on equity is not distributed to shareholders it would then be available explicitly to subsidize purposes that deserve subsidies, such as institution-building, and support for special environmental and social standards. It would also allow IFC to focus its subsidies on appropriate activities in low-income countries, with the IFC continuing to play its risk-mitigation role in middle income countries.

81. Earning a profit equal to the full weighted average cost of capital would not conflict with the developmental mandate of IFC for its loan and equity investments. For such projects, IFC provides political risk comfort to investors, takes special risks that others cannot handle such as extending maturities in emerging markets and play trailblazer with its demonstration projects. In all these cases, IFC would help realize good projects that the private sector by itself might not have undertaken. These projects should return their full cost of capital, because there is no special argument for subsidy involved.

82. IFC would thus operate under three basic disciplines. As in the past, it would continue to avoid crowding out the private sector and to seek additionality in its projects (e.g. positive economic rate of return, compliance with social and environmental safeguards as well as minimum corporate governance standards). In addition, it would need to earn the full risk-adjusted cost of capital on its commercial operations. The latter discipline would prevent the pursuit of substandard projects, and would address the charge made by some critics that the IFC is interested in enhancing corporate welfare rather than the reduction of poverty in member countries. See Annex V for the case for unbundling of IFC products.

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[45] Commercial discipline exists in IFC's operations today in a number of forms, including minimum financial and economic rates of return for projects, and annual corporate profitability objectives.

83. None of this would change in principle the overall financial resources at the disposal of IFC, but it would force more disciplined choice of projects and more clearly justified allocation of subsidies.

Box 4: Why should IFC seek to earn a return on its lending and equity investments comparable to what private financiers achieve?

Some have argued that, as a development institution, there is nothing necessarily wrong with IFC earning a return on its lending and equity investment activities which is less than what private investors expect to achieve. This is confused on several levels: (a) At the level of the specific investment: IFC invests in parallel with other financiers (and the project sponsor), always taking a minority position, and generally only providing 20 to 30% of the financing needed. The returns IFC earns are tied to the returns on the project, with adjustment only for the nature of the risks for our portion of the investment package. The returns B-loan partners earn are tied to the returns IFC earns. To argue that IFC supported projects should earn a return less than what private financiers could earn on 100% private projects would be to argue that either IFC accepts a sub-par portion of the project returns (which is not IFC policy), or the projects supported are sub-par projects. Neither should be the case. (b) Replicability: If the projects do not earn a return equal to what private investors can earn on other investments, the projects IFC is supporting will not be replicated by pure private parties, and nothing sustainable will have been created. (c) From the point of view of the country: There is a loss to society if low return projects are financed rather than those resources being used for the high return projects. (d) At the level of IFC as an institution: Shareholders have entrusted resources to IFC, and these resources come at an opportunity cost to their own societies. While there is an argument for subsidizing certain IFC activities, lending for private projects is not one of them. Thus the return on IFC investment activities should be at least comparable to what private entities require for projects that benefit from IFC's risk mitigation function.

84. IFC is not the only organization facilitating the flow of private capital by addressing political risk and market failures. There is no particular reason to decide ex ante on a division of labor between organizations with a mandate similar to that of IFC. The organization that is best able to mitigate risks or identify and cope with market failures should be able to carry out the job at hand. Competition does and should reveal the comparative advantage of IFC, EBRD and other institutions (multilateral as well as national) providing similar services – on a reasonably even playing field. Such an even playing field would reasonably consist of similar disclosure rules, safeguard policies, and expected rates of return.

IFC management intends to pursue the establishment of practices that would effectively unbundle the subsidy embedded in its products. This may involve

- *accounting separation between commercial and subsidized operations of IFC,*
- *a specific target return for IFC commercial operations ,*
- *a decision-making mechanism to justify and allocate subsidies; and*

- *a timetable to phase in the new disciplines*

IFC would report on progress and implications for the Corporation's business program in IFC's Strategic Directions 2003-2005 paper (scheduled for FY2002, Q4).

IFC management intends to continue to engage other IFIs on harmonizing disclosure rules and safeguard policies and discussions regarding expected rates of returns.

85. Lending to private firms by IBRD/IDA. Currently, both the IBRD/IDA and IFC finance private firms. The IBRD and IDA finance firms backed by government guarantees, whereas the IFC takes the credit risk of its decisions. IBRD/IDA funding of private firms, typically via on-lending through intermediaries (but sometimes also through direct lending to private companies with government guarantee or through Bank-funded government equity contributions to such companies), have over the 1990s lost importance as a result of disappointing performance. Yet, still some US$0.5-0.7 billion per year are on-lent to the private sector, the bulk of it for rural credit schemes and lending to small and medium-sized firms. Most of these operations escape the disciplines of OP 8.30 on financial intermediary lending. IBRD/IDA on-lending can sometimes play a useful role in country dialogue and policy reform. In order to improve their performance with respect to the past, it is proposed to place all such future operations under OP 8.30, including on-lending operations for rural or social development. OP 8.30 requires that on-lending occurs at or near market rates and that operations are aimed at improving policies in the financial sector and institutional development of intermediaries. As on-lending occurs at or near market rates, the subsidy element contained in IBRD or IDA funds is de facto unbundled and typically passed to government.

86. The Vice President for the Financial Sector Network would lead a clarification and revision of OP 8.30, and decide upon the application of OP 8.30, involving IFC in the process. For all such operations, IFC would have first right of refusal, such that on-lending is preferably conducted without exposing domestic taxpayers in client countries to the credit risk of private firms.

The FSE Sector Board would draft appropriate amendments to OP 8.30 for approval by the Spring of 2002.

IV. CO-ORDINATION OF PSD APPROACHES ACROSS THE WBG AND STRATEGY IMPLEMENTATION

A. The division of labor in the WBG

87. **General division of labor between IDA/IBRD and IFC and MIGA.** The basic division of labor in the WBG with regard to PSD is as follows. IBRD/IDA focus on investment climate and related institution building, improvements of governance, legal and regulatory systems, financial sector policies and selected public services, e.g. some

types of infrastructure services, particularly roads and social services. IFC is the only part of the WBG, which takes credit risk for support to private firms. It pursues demonstration projects that promote the credibility of government policies, provides additional financial services in local markets and provides political risk protection to co-financiers. Its strategy is to deploy its instruments such that they support relevant institution building particularly in the financial sector and for small and medium enterprises. MIGA provides focused political risk guarantees, institution-building and investment promotion assistance. Particularly in IDA countries, the proposed strategy could lead to better complementarities between IDA and IFC. IDA could support institution- and capacity-building including through the use of targeted subsidies and guarantees, while IFC could help mobilize private finance without exposing the domestic taxpayer to credit risk. Output-based aid schemes would be particularly suited for such complementary approaches among parts of the World Bank Group.

88. Improvements resulting from main proposals of the proposed PSD strategy. The preceding proposals would further streamline this division of labor. In particular, output-based aid would further focus IDA/IBRD on supporting policy development, programmatic assistance and capacity-building as well as support to public finance and subsidy schemes targeted at public goods and/or the poor. Unbundling of subsidies embedded in IFC products would render interventions more transparent.

89. Co-ordination of WBG guarantee operations. The Executive Directors adopted a joint approach to WBG guarantee products, based on a paper presented to the Board in December 2000:

> "The World Bank guarantee is expected to complement other Bank Group instruments, adhering to the principle of market first, MIGA/IFC instruments second, and Bank guarantees (with the sovereign counter-guarantee) last. This concept of ('Hierarchy of Instruments" has been useful as a general organizing principle, and will continue to be used. However, the application of this concept has been more difficult. Implementation has been complicated by the fact that governments, arrangers and developers have their own views, sometimes strongly held, as to which instruments they prefer for particular deals. At times, the three Bank Group institutions were each independently engaged on the same projects, thereby giving mixed signals to the market regarding the application of the hierarchy of instruments.
>
> Discussions have been held between IFC, MIGA, and the Bank over the last few months with the aim of further clarifying the rules of deployment of Bank Group risk mitigation instruments where there is potential for duplication and competition. These discussions have indicated that the Bank's PRG should be considered for deployment when one or several of its features (explicit counter-guarantee, booking on Bank's balance sheet and specific remedies attached, influence of the Bank, linkage to the Bank's sector dialogue, conditionality) are critical from a risk management and/or market point of view to achieve private financing objectives. Thus, the deployment of PRGs

would generally be considered for transactions where one or several of the following conditions are met:

- Transactions in sectors in early stages of reform, where the risk of reversal is seen as significant;
- Riskier and larger size operations, where booking of the risk on Bank's balance sheet, with remedies attached to Bank operations, is seen as preferable from a risk management perspective; and
- Operations highly dependent on Government support and/or undertakings, where the explicit counter-guarantee and the clout of the Bank are seen as critical to mobilize private financing."(46)

90. **Co-ordination of WBG advisory services.** IFC and the Bank have taken various steps to improve co-ordination of advisory services in the PSD area. Two joint departments focusing on advisory services were established in January 2000, the SME department and the Private Sector Advisory Services Department. The former integrates the central SME unit of the Bank and the IFC SME activities. The latter integrates the former PSD department of the Bank, the Corporate Financial Services Department of IFC and the joint Bank/IFC Foreign Investment Advisory Service (FIAS). Synergies between IFC and the Bank are being developed. Reporting on progress on the implementation of this and other institutional reforms decided on the basis of the 1999 PSD Board report is done as part of a separate process.(47)

91. The relationship between FIAS and MIGA's Investment Marketing Service (IMS) has also been addressed. FIAS provides policy advice to governments on how to attract foreign investors in ways that benefit the host country. MIGA/IMS tends to operate downstream from FIAS helping countries promote investments based on the policy and institutional framework promoted by FIAS. MIGA/IMS and FIAS have developed a new protocol, which entails systematic exchange of client requests for advisory services, agreements on the division of labor (FIAS conducts "upstream" policy work, MIGA advises on investment promotion programs) and regular (quarterly) meetings among managers and key program staff to harmonize work plans and agree on joint activities where appropriate.

B. Implementation

92. **WBG coordination.** Implementation of the PSD strategy across IBRD/IDA and IFC is led and supervised by the Managing Director for PSD of the IBRD/IDA and Executive Vice President of IFC. Co-ordination with MIGA is maintained through multiple mechanisms, including the guarantee committee (for guarantee operations) and the protocol between MIGA and FIAS (for investment promotion activities). The PSD Sector Board — which includes representatives from all Regions, PSAS, SME, Legal,

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[46] World Bank (2000c)
[47] See World Bank (2000d).

WBI and IFC, as well as participation from MIGA — will continue to play an important role in coordinating PSD approaches within IBRD/IDA and across the World Bank Group.

93. Implementation responsibilities. Responsibility for implementation of the main proposals is described in the highlighted sections of this paper and summarized in the attached Implementation Matrix.

94. At the operational level, the core responsibility for integrating the PSD agenda in our country-level dialogue and operations lies with the Regions. Regional PSD units will continue to play a critical role by developing (with inputs from other parts of the WBG) regional articulations of this strategy starting in 2002, as appropriate. These regional strategies will specify, among other issues, how the operational proposals of the PSD Strategy will be implemented, including timetable and countries for investment climate assessments and pilot OBA projects.

95. Regional PSD units will also continue to lead PSD operations and increasingly provide PSD inputs into operations managed by other units such PREM or HD. As the central anchor has been substantially reduced, regional PSD staff will increasingly take the lead in promoting the PSD agenda in a wide range of operations and AAA. PSAS (the anchor unit) will maintain and develop a capacity to provide catalytic operational support to the Regions, primarily in the core areas presented in this strategy.

96. At the country level, country directors and country teams will continue to address PSD issues in the context of the Bank's country assistance strategies (CAS), as well as in their dialogue with clients (including the CDF and PRSP processes), as they tend to be at present. The profile of PSD issues will be reinforced, however, following a relative neglect in the very recent past. Regional management will ensure that the proposals set forth in this strategy are integrated in the strategies, work program agreements and budgets, in particular as regards the investment climate.

97. At the sector level, the PSD dimension will be strengthened in the relevant sector strategy papers, with inputs from the PSD Sector Board and anchor unit (PSAS). This will, in particular, be the case for the sectors highlighted in this strategy, including the social sectors and PREM.

98. The implementation of the PSD strategy will be supported by operationally relevant training programs designed and delivered jointly by WBI and PSI for WBG staff as well as client countries, including new programs focusing on OBA and investment climate issues and facilitation of in-country dialogue with the private sector.

99. The PSD sector board will review, in collaboration with the other sector boards, progress in adopting PSD approaches across all networks, building on the project review conducted in preparation for the PSD strategy.(48) This could form part of the Annual

[48] World Bank (2001d).

Portfolio Review (ARPP) process.(49) More generally, the PSD sector board would work with the other sector boards on promoting PSD approaches in the Bank's work and ensuring consistency between the PSD strategy and the relevant sector strategies. To facilitate WBG consistency and cooperation, IFC and MIGA will continue to participate in PSD sector board meetings.

Regional management will prepare regional PSD strategies and action plans to operationalize this WBG PSD strategy, starting in 2002.

100. **Dialogue with private sector organizations.** More systematic and effective consultations with private firms are required as an input into the WBG work on PSD. In particular, the IFC's knowledge of investment climate issues should be utilized more in Bank operations to improve the policy environment. In line with its existing mandate, the PSD Sector Board would oversee the development of more systematic consultation processes with private sector parties and their application to country-level processes such as CDF and PRSPs. Attention needs to be paid to ensure that consultation captures the views of the broad spectrum of firms in the economy. The PSD Sector Board will also review the WBG's partnerships in the PSD area with a view to identify duplications, synergies and missed opportunities. The Business Partnership and Outreach Group with the help of WBI would lead at the global level and PSD units in the Bank Regions at the regional level, in collaboration with WBI, IFC and MIGA at all levels.

101. **Funding implications.** Most actions proposed are to be covered from existing budgets in IFC, MIGA and the Bank through internal reallocation. This includes reallocation for support to output-based aid schemes, support for work on private participation in the social sectors and the recent creation of a joint DEC/PSI unit for investment climate (see implementation matrix below).

102. The investment climate unit would design, promote and supervise the survey effort, help with investment climate assessment work in the Bank, and discharge the standard "anchor" functions for investment climate work (knowledge management, training, cross-support, quality assurance). Beyond this and going forward, the only special funding issues for the PSD strategy arises fi-om the call for systematic investment climate surveys.

103. During consultations, some donors indicated that such surveys would be a useful basis for their own program decisions and that they would wish to participate in a joint mechanism to develop and finance them. Within the Bank, the regions would be major users of survey work. They would fund assessments and other economic and sector work that makes use of the surveys reflecting specific country demands. Country departments would also be the source of funding for translating survey results into operational activities based on regional strategies, PRSP consultations and the CAS process. To anchor this collaborative effort that spans the interest of the Bank and other

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[49] This PSD strategy paper does not contain detailed multi-year projections of PSD projects by region. This should be done under the relevant sector strategies such as rural development, transport or health.

development institutions, it is proposed to fund the surveys and their interpretation under a special multi-donor funding vehicle with significant regular contributions by the WBG. To start the process in FY02 some 5 to 8 surveys are being started using existing trust funds and special research funds that are currently being solicited and in collaboration with the regions. Survey activities are underway for India and Morocco and are to be started for China, Ethiopia and Nigeria, with Brazil, Serbia and Mozambique being further candidates. From FY03 onwards, it is proposed to consolidate funding possibly as part of a proposed DEC trust fund for investment climate research and taking into account existing donor funded programs such as the Regional Program for Enterprise Development of the Africa region.

104. It is proposed to build up over time to a level of about 20 surveys per year by FY04 to cover some 100 countries on roughly a five-year cycle. Roughly, a survey of the investment climate that links investment climate variables to firm-level productivity would cost about US$250,000 to administer and evaluate. Total costs would thus be in the order of US$5 million annually.

105. Assuming that donors provide US$3 million per year to support these surveys, the Bank's contribution would be US$2 million in additional funding from the Bank's administrative budget. It is proposed to start off with a Bank contribution of US$2 million in FY03 as a sign of commitment to donors and to allow the survey program to expand to some 10 new surveys in FY03. Final agreement on this proposal would be sought as part of the FY03 budget decision. During calendar year 2002, donor funding would be sought and a cost-sharing model with regions would be developed to mainstream and embed the survey work in country programs. Reaching the targeted level of 20 surveys would depend on the level of support from donors.

106. Measuring results — scorecards for PSD projects and programs. All projects with significant PSD components would maintain scorecards as agreed at the time of project or program approval. IFC is implementing a scorecard program under its current strategy, which will reflect financial performance and development impact. IBRD and IDA PSD projects would develop scorecards at the time of project approval and establish baseline information under guidelines approved by the PSD Sector Board. Scorecards may also be prepared for MIGA operations. Typically scorecards would show (where relevant and feasible):

- achieved economic rates of return;
- changes in financial performance of the assisted entity;
- changes in indicators of productivity;
- indicators of changes in access to services provided to low income groups;
- information on charges imposed on low income groups and/or subsidies provided;
- total amount of subsidy provided directly or embedded in financial products; and
- indicators of environmental impact.

In its periodic review of projects with PSD components, the PSD sector Board would review the scorecards and report on overall implementation and results.

107. Measuring results — cost-benefit analyses. By nature, many scorecards will fall short of a full-fledged cost-benefit analysis. To provide a deeper understanding of the results of PSD approaches and to sharpen the interpretation of scorecards, selected cost-benefit analyses based on explicit counterfactuals would be conducted for projects or programs suggested by the PSD sector board in conjunction with DEC/OED. Such cost-benefit analyses would focus on projects/programs supporting basic service delivery including output-based aid schemes as well as SME projects and micro-finance schemes.

A program of cost-benefit analyses for PSD interventions is to be developed between PSD the PSD Sector Board and DEC/OED.

108. Progress report on implementation of PSD strategy. A progress report on the actions set out in this strategy (see summary matrix) will be provided to the Executive Directors periodically, the first one in March 2003.

IMPLEMENTATION MATRIX

INTERVENTION AREA	ACTION	DEADLINE	RESPONSIBLE MD/VP	RESPONSIBLE UNIT	FUNDING IMPLI
Investment climate assessments	▪ Note on minimum standard survey methodology • Workshop with interested development institutions to discuss common operational and funding approach • Incorporation of standard survey results in CAS and core due diligence products	December 2001 Spring 2002 From 2002	Woicke/ Shafik	Regions/PSAS/DEC with SME/ MIGA/ WBI	Design costs cover reallocation of fun PSAS restructurin DEC budget Future costs of sur program (FY03 on about US$2 millio per year, to be fun Bank budget.
Standard setting for regulatory systems in infrastructure	Paper on proposed approach to standard setting	Spring 2002	Woicke/ Shafik	PSAS	Covered by realloc funds under PSAS restructuring
Private participation in the social sectors	Establish advisory unit on private participation in the social services as part of PSAS in co-ordination with HD network and IFC	Early 2002	Woicke/ Ramphele/ Shafik Ritzen	PSAS with HD/IFC	Covered by realloc funds under PSAS restructuring
Output-based aid	Pilot projects for output-based aid focused on basic public services in a variety of sectors and regions	▪ Underway	Woicke/ Shafik	Regions/PSAS/WBI	Covered under cur operational budget reallocation of fun PSAS restructurin
Commercial disciplines for IFC	Review, as part of IFC Strategic Directions paper, of options for unbundling of subsidies, including: • accounting separation between commercial and subsidized operations of IFC; • a specific target return for IFC	End FY02	Woicke	IFC Strategy Department	Covered by IFC fu

IMPLEMENTATION MATRIX

INTERVENTION AREA	ACTION	DEADLINE	RESPONSIBLE MD/VP	RESPONSIBLE UNIT	FUNDING IMPLIC
	commercial operations; • a decision-making mechanism to justify and allocate subsidies; and • a timetable to phase in the new disciplines				
	Continued dialogue with IFIs on consensus terms (disclosure rules, safeguard policies, rate of return policy)	ongoing	Woicke	IFC Strategy Department	Covered by IFC fun
IDA/IBRD on-lending operations	WBG management to revise OP 8.30 so as to cover all on-lending operations incl. rural and social sector operations	Spring 2002	Goldstein, Ramphele, Zhang	FSE	Covered by existing funding
Regional PSD strategies	Regional implementation of this PSD Strategy	Starting in 2002	RVPs	Regions	
Monitoring PSD dimension of Bank operations	• Review by PSD Sector Board of scorecards for projects with significant PSD components • Development of program of cost benefit analysis for PSD interventions	• Annual Review • Spring 2002	Shafik	Regions, PSD Board, BEC, OED, WBI.	Covered by existing operational funding
Progress report on implementation of PSD Strategy	A progress report on the actions set out in this strategy (see summary matrix) will be provided to the Executive Directors periodically	First one in March 2003	Woicke	PSD Board, IFC Strategy Department, MIGA	Covered by existing operational funding

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