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

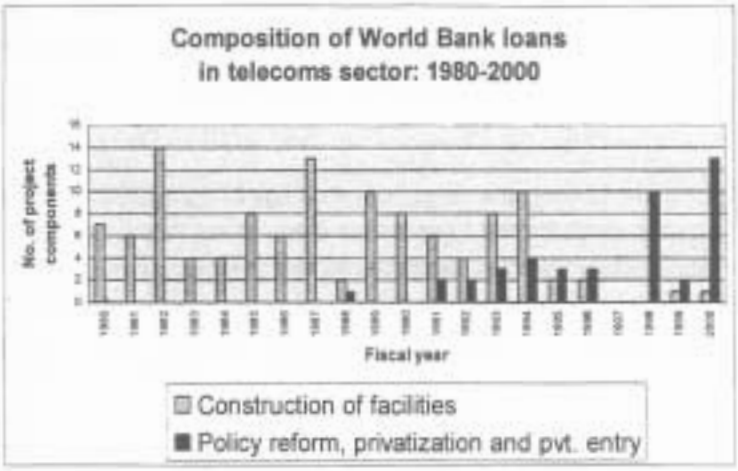
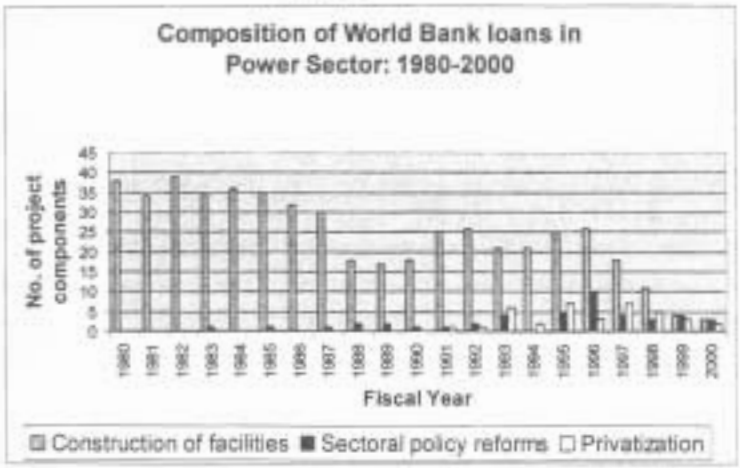


Figure 8



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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