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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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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.

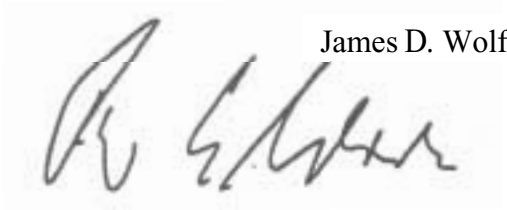
Taking into account the lessons of experience on how best to support private initiative for poverty reduction as well as the plight of taxpayers in poor countries, where past approaches have yielded unsustainable debt, the strategy emphasizes ways for extending the reach of markets to help the poor obtain 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

Core Themes of the PSD Strategy ..... **i**
I. Introduction 1
A. Context for the PSD Strategy 1
B. Strategic directions for PSD 4
II. PSD and Development 6
A. Growth and basic service delivery 6
B. Pro-poor design of PSD interventions 12
C. PSD and sustainability 16
III. Deployment of WBG Instruments for Greater Selectivity 19
A. Policy development. regulatory frameworks and capacity building for private sector development 20
B. Output-based aid – tapping private initiative for public services 23
C. Direct support for private firms 26
IV. Co-ordination of PSD Approaches Across the WBG and Strategy Implementation **30**
A. The division of labor in the WBG 30
B. Implementation 32
Implementation matrix **37**
Bibliography **39**

ANNEXES

I Background Papers Prepared for PSD Strategy Paper
II Consultation Report
III Private Sector Development Activities of the World Bank Group
IV Output-Based Aid
V Commercial Disciplines for Development Institutions Providing Direct Financial Support to the Private Sector
VI Toolkits and Practical Guides for Policy Design and Implementation
VII Environmental and Social Safeguard Policies of the World Bank Group

FIGURES

1 Volume of WBG PSD operations (FY80-00)
2 Share of PSD in WBG operations (FY80-00)
3 PSD conditionalities in adjustment lending, FY96-99
4 Distribution of employment by firm size and GNP level
5 Financial depth generates subsequent growth
6 Poverty reduction was higher in Indian states with good investment climates (1992-94)
7 Composition of World Bank loans in telecom sector: 1980-2000
8 Composition of World Bank loans in power sector: 1980-2000

TABLE

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

BOXES

1 Access to services: the role of small-scale providers
2 Output-based aid
3 CGAP's performance-based investment
4 Why should IFC seek to earn a return of its lending and equity investments comparable to what private financiers achieve?

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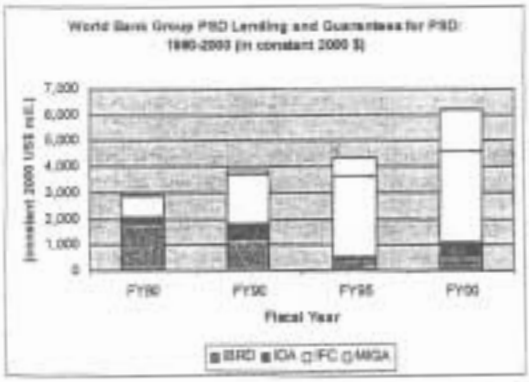
[1] Gray (2001).
[2] World Bank (1989a); World Bank (1991); World Bank (1995); World Bank (1999).
[3] Galal et al. (1994) ; Kikeri (2001); Macedo (2000); Megginson and Netter (2001); Sachs et al. (2000); Sheshiski and Lopez-Calva (1999); Shirley and Walsh (2000); World Bank (2001f).
[4] Gray (2001),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

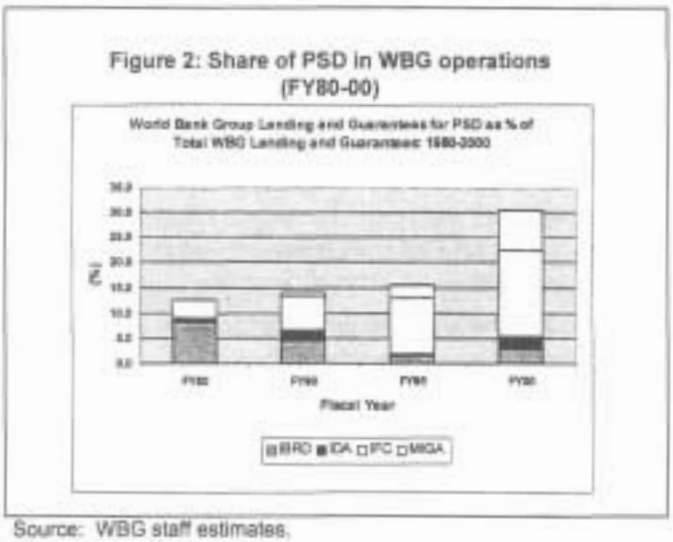
4. World Bank Group activities have supported PSD more and more. During the 1990s, private sector development has taken on greater prominence in development work world-wide, including in the World Bank Group (Figures 1 and 2). Policy advice, capacity-building and policy-based lending have promoted a 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)

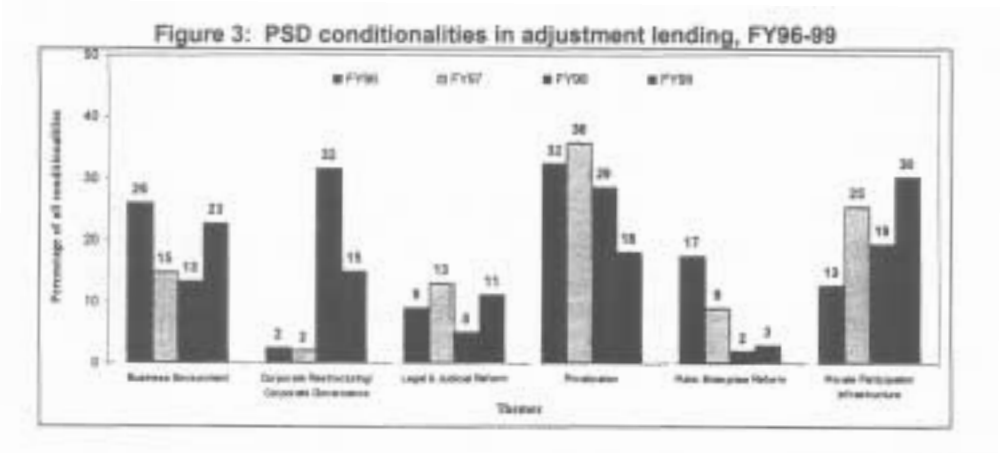


Source: WBG staff estimates.



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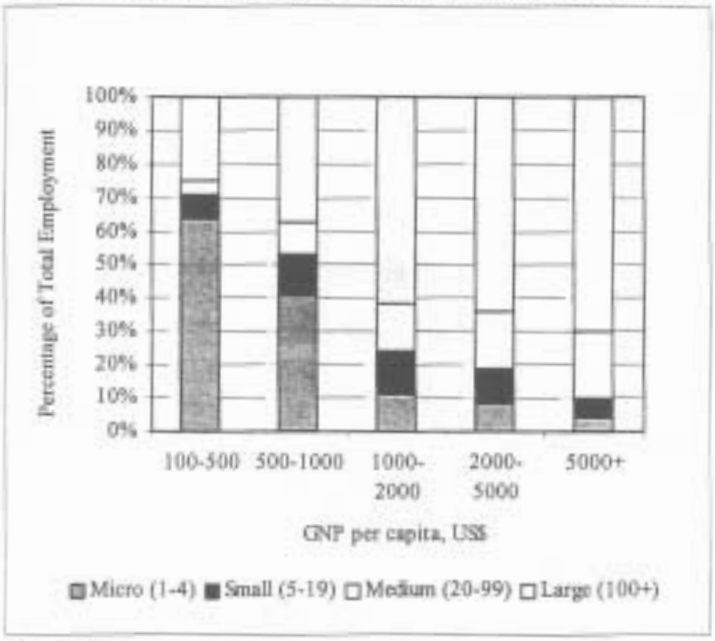
16 World Bank (2000a); World Bank (2001i).

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

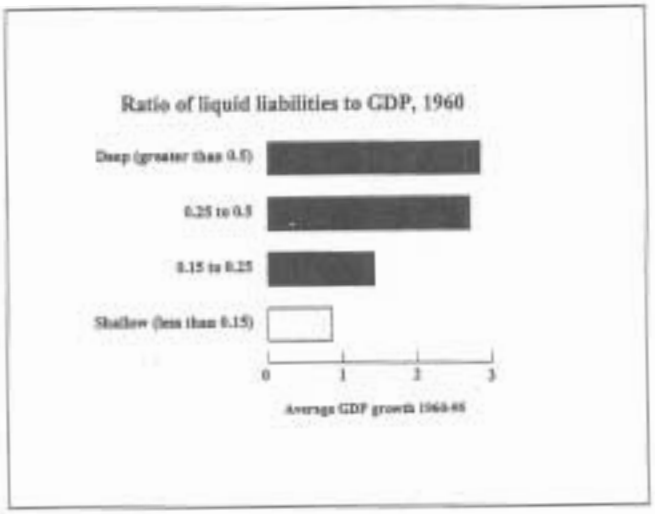
[19] All these organizations form part of a continuum. Many not-for-profit organizations that do not receive donations make profits like any other firm, but they cannot distribute them to arms-length shareholders. The boundary between donations and membership fees is also rather fluid. Within both for-profit 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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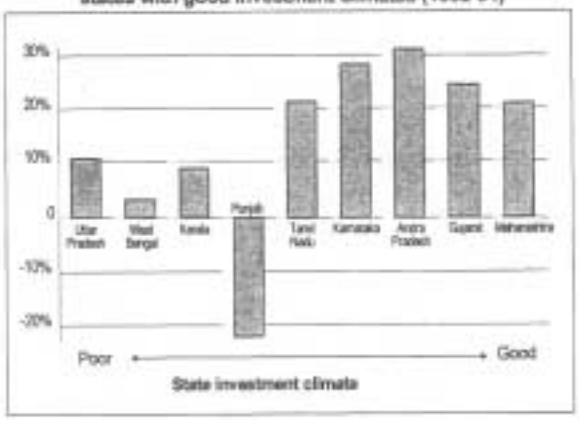
[29] Train (1991).
[30] Saltman et al. (Forthcoming, January 2002).
[31] Smith et al. (2001).
[32] Dollar and Kraay (2001); Ravallion (2001).

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.