Wealth of the Poor

Eliminating Poverty through Market and Private Sector Development

BY CLAES LINDAHL

Wealth is created by people, both poor and rich, on different types of markets. Claes Lindahl shows how development cooperation can influence international, national and local systems and institutions to provide incentives that unleash the creativity and enterprise of the poor – and that benefit the poor. Donors need, much more than in the past, to ponder how markets and the private sector can contribute to achieve the ultimate objective of development: a better life for people.

Lindahl discusses key factors behind successful pro-poor market and private sector development which include equitable distribution, gender equality, human rights, and environmental considerations. He also shows various ways of assessing the potential of different countries to achieve development of this type, and methods for assessing their present performance.

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Sida studies

Foreword by Sida

For several decades of Swedish development cooperation there has been no specific policy for Swedish support to Private Sector Development (PSD). The underlying reason may be debated, but there is no doubt that the formal decision made by Sida's Director General in October 2003 to adopt "Policy Guidelines for Support to Private Sector Development" marked the start of a new way of looking at PSD.

Central to this new thinking is the realisation that pro-poor growth and poverty-focused PSD have crucial roles to play in the international fight against poverty, and that support to PSD is not just about "getting the prices right" – as envisaged by the international finance institutions during the 1980s, or about providing direct support to private firms – as many thought during the 1990s. The main feature of the new thinking is that strategic government interventions, supported by actors in the private sector and in civil society, may make market institutions and market outcomes more beneficial to the poor.

The decision to adopt the PSD Policy Guidelines was preceded by a fruitful policy-making process which involved all the major departments at Sida. The policy was also shaped by a series of external consultations that involved a great number of persons representing many different aspects of knowledge of PSD. The response and engagement of all the people that contributed during these consultations were overwhelming. This clearly demonstrates that Market and Private Sector Development is a matter of great interest and relevance to Swedish development cooperation.

As a part of the policy process, a background paper was prepared by Claes Lindahl from Management Perspectives International (MPI). The paper, "Making Markets Work for the Poor, Challenges to Sida's Support to Private Sector Development", Provisional Edition, October 2003, contributed in a number of ways to highlighting the important policy issues and to paving the way for consensus-building at Sida. The paper has received considerable interest at Sida, in Sweden and internationally.

In order to spread Claes Lindahl's work to an even wider audience, Sida has decided to re-edit the study and to publish it in the series "Sida Studies". The study has been restructured and now focuses less on specific Swedish and Sida aspects and more on general features of donor support to Private Sector Development. The report presents and analyses key issues at the heart of private sector development, incorporating related issues such as growth, human rights, distribution and gender equality. It discusses the problems and details connected with support to private sector development and, throughout, it suggests the roles of donors in this context. It should be noted, however, that while the problems and issues are of central concern to Sida, the opinions and recommendations expressed in this report are those of the author. In the Sida Studies series, issues of relevance to Sida's policies and practices are reflected, but each report in the series expresses the views and findings of its writer(s).

The report adopts a broad, holistic approach to private sector development, encompassing basically all areas of development co-operation. It is our hope that the report will stimulate discussion at Sida, with our partner organisations in Sweden, with partners in our partner countries, and in international and bilateral organisations.

Sida Stockholm, April 2005

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Contents

Executive Summary

This report discusses pro-poor market and private sector development (PSD), and ways in which donors can provide effective assistance for such development. The thrust of the report is to:

- Provide a holistic approach to market and private sector development, identifying broad factors in society which are essential determinants of dynamic and socially beneficial market development.

- Place markets and private sector development in a historical context, summarising how values and ideologies have provided different approaches to market development over time.

- Focus on conditions which make markets and private sector development pro-poor in the sense that the systems contribute to effective poverty reduction.

- Be practical, by suggesting potential action by donors throughout the report.

The key conclusions of the report are:

- market and private sector development is not an end in itself. It should always be seen as a tool for higher objectives, i.e. human development and welfare, freedom, democracy and poverty reduction. The effectiveness of the market and the private sector in promoting such ends depends on society, the incentives and disincentives established by governments and civil society. Donors can interact in such processes.

- incentives for economic activities in society are critical, especially those embedded in political stability; freedom from war and conflict; well trained people in good health; positive attitudes in society to entrepreneurship and innovation; non-corrupt governments; good quality infrastructure, and transparent regulations.

- there is no inherent conflict between equality and pursuit of human development on the one hand, and economic growth on the other. Equal distribution of income and wealth, investments in people's health and education, and respect for human rights, are highly compatible with market and private sector development for economic growth.

- promotion of markets and private sector development is, in essence, nothing new for development assistance. What is required is rather a different perspective on much of what donors have been involved in since the birth of official development assistance.

- donors need, much more than in the past, to interact with and take into consideration the market players and the private sector, both domestically in recipient countries, and internationally on a global scale. A dialogue of this type should not be considered a "sell-out to the market", but a means to make commercial forces work for the poor most effective.

- as donors have scarce resources in both finance and manpower, there is a need for a careful analysis of the types of donor interventions which can have a strong leverage in changing the business climate towards pro-poor growth in recipient countries. An analysis of this type needs to be country-specific, targeted at the real constraints and opportunities, and not based on blueprints applicable across nations.

The Reasons for Market and Private Sector Development

Today market and private sector development has a high position on donor agency agendas. This is reflected in many recent policy and strategy documents guiding development assistance. A number of factors have triggered this interest: the global dominance of the market-economy system after the end of the Cold War and the parallel process of globalisation have not only made participation in international trade critical in almost all countries' economies, but have also unleashed major flows of private capital to developing countries, dwarfing official development assistance. There is an increasing recognition of the importance of economic growth for poverty reduction, and the critical role that markets and the private sector play as engines of growth. For reasons that are partly pragmatic and partly ideological, markets and private sector operators are moving into fields that, in the past, were almost exclusively the domain of the public sector, such as basic social services and infrastructure.

The market and the private sector are concepts which are closely linked, and often used synonymously. A market economy is defined as an economic system in which decisions on the allocation of resources are made on the basis of prices established by decentralised and voluntary exchanges of goods and services between producers, consumers, workers and owners of factors of production. Markets depend on private sector players, and well-functioning markets are crucial for private sector development. However, markets and the private sector also depend on the state, which establishes most of the rules of the game, providing institutions and the overall environment. In addition, civil society – in the sense of non-profit, non-governmental organisations – makes up a third crucial element that determines market and private sector development by influencing values, public opinion and political actions.

Market and PSD is not limited to a sector in the conventional sense, but encompasses agriculture, manufacturing and services, including trade, and increasingly also infrastructure and social services. It also includes all types of market players, from the self-employed in the informal economy, and small, medium and large enterprises, to transnational companies. Market and PSD is the interplay between the state as the formulator of the 'rules of the game', the 'players in the private sector', and civil society. These interact in dynamic processes. Understanding the dynamics of such a system is critical for promoting development from the outside.

Markets in a Historical Context

The market – as an instrument for exchange and allocation of resources in society – is as old as the first civilisations. However, throughout history the market mechanism has been the subject of criticism, and sometimes replaced by other forms of exchange. The form of the organisation of economic activities in society is an essential element of contemporary politics, which also has an impact on donors. The donor community has changed its approach to market and the private sector along with broader shifts in dominating political ideologies. Thus, until the 1980s, donors tended not to have strong views on types of economies, but supported both planned economies, with a marginal role for the private sector, to more laissez-faire style economies. From the 1980s, structural adjustment, based on the so-called Washington Consensus and influenced by neo-liberal economic theory, dominated the donor agenda, with strong views on the different roles of the state, the market and the private sector, especially after the end of the Cold War. More recently, not least due to the considerable criticism of the Washington Consensus, there seems to be a movement in the donor community towards a mixed economy with a stronger view of the role of the state, and greater concern for distribution, similar to what might be called a "Scandinavian model".

The Focus on Poverty

Poverty eradication is at the centre of donor agencies' work. Poverty is generally defined as multidimensional, and includes not only material poverty but also poor health, lack of education, lack of freedom, etc. The Millennium Development Goals (MDGs), with the overriding objective of halving poverty by 2015, are a powerful demonstration of the commitment by the donors to poverty eradication. Market and private sector development is crucial to the MDGs in several ways: most importantly, without private sector and market-driven rapid growth, poverty reduction on a scale envisaged by the MDGs would not be possible. Secondly, the goals of improving health and educational standards can only be attained through the mobilisation of local resources for which the private sector is a key engine. The private sector can also, under the right conditions, contribute to providing the essential services needed to fulfil the MDGs.

The concept of pro-poor growth implies that, while growth is a necessary condition for poverty eradication, such growth can vary in its effectiveness in reducing poverty. Pro-poor growth is determined by three factors: the pace of growth, the distribution of income and wealth in a society at the outset, and the changes in such distribution during growth. The equitable distribution of income and wealth in society is to a great extent a political issue, and hence dependent on political action, and not a result of market forces as such. However, market and private sector development benefits from equitable distribution. Thus, the inclusion of the poor in the economy contributes to growth in several ways: by diversifying the economy and the production base; by broadening domestic markets; and by unleashing the creative and entrepreneurial forces of poor people. In short, there is strong evidence that equality is beneficial for growth.

The Fundaments of Effective Markets

Four fundaments are essential for effective markets for pro-poor growth:

- Competitive markets, characterised by fair competition, free entry of new enterprises and efficient systems for the exit of failing enterprises. In these markets, so-called market failures should be minimised. This means that the benefits to society should not be less than the private benefits. For example, private operators should pay for negative impacts on the environment resulting from their actions. The incentive structure of such markets should favour inclusion of the poor.

- Entrepreneurship: the human creative action in the commercial sphere which triggers innovation and structural change, and drives the creation of new enterprises, as well as the development of large ones. It is a critical ingredient for making markets dynamic, evolutionary, and not just competitive.

- Fair, non-discriminatory and effective property rights: essential for entrepreneurs and other private sector operators to make them willing to take commercial risks and invest. Non-existent, unclear and poorly formulated or implemented property and tenure rights are claimed by some researchers to be the most significant factor for explaining 'under-development'. Clear and fair property rights are essential for the assets of the poor.

- Decent work conditions and sustainable use of the environment help to ensure that a fair share of the benefits provided by the market forces goes to the poor; and prevents exploitation of the environment which will impact negatively on current and future generations.

Donors have a variety of means available to them to assist countries to develop competitive markets which work for the poor. They can promote entrepreneurship, which make such markets dynamic. They can promote an institution of property rights that is effective for the private sector and for the poor, and ensure decent working conditions and sustainable use of the environment by the private sector. Market and PSD requires broad-based development: human development and skills development; establishment and improvement of policies, laws, regulations and other basic institutions of society; and quality and efficiency in physical capital in the form of infrastructure, creating a suitable environment for the private sector. It means, in particular, addressing these various elements from a systematic poverty, gender and ecological perspective.

Traditional Markets of the Poor

The agricultural sector is generally the most important source of livelihood for the poor in developing countries. Agriculture, including fisheries, livestock and forestry, often employs over half of the total labour force in developing countries, mostly as smallholders, tenants and agricultural labourers. In some of the poorest nations in sub-Saharan Africa, the ratio is over 90%. Smallholder agriculture must be considered an essential part of the private sector for the poor and, in particular, for poor women.

The informal economy, defined as non-registered self-employed persons or micro enterprises outside agriculture, is another major source of livelihood for the poor, often employing 50–80% of the non-agricultural work force in developing countries. Women also tend to be over-represented in the informal economy. Poverty-reducing private sector development with a gender focus must pay strong attention to these business ventures of the poor.

In the past, both agriculture and the informal economy have been discriminated against by governments in many countries. In relative terms, they have also been given less attention by donors. Agriculture lends itself well to donor country support, from efforts to change the highly distorted trade environment for agricultural products in OECD countries, and promoting technological development and the diffusion of technologies that benefit poor producers, to assisting countries to reform and finance supportive infrastructure, devising effective credit schemes, and developing property rights and land reforms. The informal economy, on the other hand, is more complex as a field for donor assistance in view of its 'informality'. Yet, efforts can be directed to assist countries to modernise their legal and policy frameworks for business in general as a means of reducing dualism in the economy. Support for specialised programmes such as micro finance and entrepreneurship training has proven to be a powerful instrument.

While smallholder agriculture and the non-agricultural informal economy are prime targets of pro-poor private sector development, it must be realised that none of these economic activities will provide the long-term solution for poverty eradication on a global scale. The modernisation of developing country economies requires the movement of poor people out of low-productive, smallholder agriculture and out of the informal economy in order to achieve such poverty eradication. The degree to which agriculture is a pro-poor development strategy or not, is highly dependent on land holdings. Ownership of land, or other forms of rights to land, is critical for pro-poor growth.

Key Determinants of Market and Private Sector Development

Donor support aimed at addressing poverty is not a question of a narrow sector approach, with efforts limited to those sectors where the poor are engaged, or to various instruments to support the private sector operators directly. It has to do with the environment in which the private sector operates, and the incentive structures and qualities embedded in policies, institutions and resources. As donors are marginal players and external agents of change, they need to make careful assessments, prioritising and sequencing their efforts in order to contribute to the overriding objectives. The key to donor effectiveness is assuming the role of an agent of change.

The functioning of the private sector depends on a number of broad conditions in society, which establish an 'enabling environment' in general. It is also the character of the environment which determines how effective the private sector is in its contribution to a poverty-free and egalitarian world. For the purpose of analysing this environment, and the potential role of a donor, the following structure is applied:

- the meta system, or the international environment;
- the macro system, meaning 'institutions' or 'rules of the game' in a specific country;
- the meso system, here defined as resources required for business operators.

These systems impact on the micro level in a specific country, i.e. on all types of commercial enterprises in the formal and informal economy.

Meta Level Determinants – the International System

The major determinants at the international level discussed in this document are:

- Technology development and innovations provide both opportunities for 'leap-frog' development and threats to many traditional markets and producers. They have allowed some countries to modernise and reduce poverty at an unprecedented rate in recent decades. The private sector is the key instrument for applying and adapting such technologies. Of specific importance today is the application of information technology.

- International trade, critical for economic development, has increased dramatically in the past three decades. Integrating into, and tapping the global trade environment, is critical for rapid economic growth, requiring a host of changes, ranging from making the global trade environment fair and free from distortions, to enhancing the competitiveness of poor countries.

- Global capital movements are today by far the most significant source of external capital for investment in developing countries. However, Foreign Direct Investment (FDI) is selective: only a limited number of countries have benefited substantially.

- Universal institutions, expressed in international conventions and declarations ratified by a large number of countries, usually under the umbrella of the United Nations, contribute to steering private sector development in a socially positive direction. Civil society groups, Corporate Social Responsibility codes, the UN's Global Compact and other arrangements contribute to their influence. International commitments to deal with what are called global public goods, such as systems to create global financial instability, are increasingly common. Such commitments and agreements have an impact on the environment in which the private sector works.

Donor countries can assist developing countries to address these 'meta' systems with a variety of means. They can impact on the systems as they are formulated at the international level, for example by increasing the transparency of ways in which trade distortions in OECD countries affect the poor. Donor agencies can assist developing countries by strengthening the capacity of the private sector to benefit from global technology and innovations, international trade and FDI. Donor countries can strengthen the power of the universal institutions to have an impact on the private sector.

Macro Level Determinants – Policies and Institutions

The major determinants of the performance of the private sector at the macro level in developing countries discussed in this document are basic institutions embedded in norms, rules, policies, and values governing a society. For example:

- War, conflict and civil strife are the most serious negative factors for economic growth. Peace building, conflict resolution and private sector development are mutually reinforcing. Thus, peace and stability are critical preconditions for healthy and effective private sector development, and the latter contributes to the former.

- Sound macro economic policies, manifested in low inflation, a realistic exchange rate, and low budget deficits are today well-established principles for both developed and developing market economies and a basis for an 'enabling environment', critical for effective Market and PSD. They are also a precondition for pro-poor growth, as the major victims of poor macro economic policies tend not to be the rich, but the poor.

- The legal and regulatory framework is critical for healthy market and private sector development, as it determines the willingness of local and foreign investors to invest, what they are willing to invest in, and their behaviour in the market place. A culture of rule-of-law is a critical ingredient in a conducive business environment. There are essential specific regulations governing the market and the private sector, the most important being commercial laws, property laws and contract laws, essential for the 'cost of doing business', and for the interplay between business, government and the civil society.

- Good governance is critical as an element of the general environment for business. Of particular importance are the accountability, fairness, honesty and effectiveness of such government functions as taxation, customs, business licensing authorities and bank inspections, as well as authorities operating infrastructure such as harbours. Such functions determine transaction costs, predictability, and the overall business culture. Corruption is a major cause of distortion of markets, leading generally to sub-optimal resource allocations based on cronyism and political connections rather than on efficiency of operation.

Creating a macro and institutional environment which is conducive to poverty-reducing private sector development is a long, labour-intensive process involving capacity building and dealing with vested interests in society. The donor community, led by the World Bank and the IMF, is already very active, especially in macro economic policy reform, but the process needs complementary capacity building. One of the greatest challenges is how to accomplish such a process in conflict scenarios or in countries that have recently emerged from conflicts. Using the private sector for a virtuous circle of peace and growth is a major challenge.

Meso Level Determinants – Resources

The determinants at the meso level are various forms of resources for Market and PSD. It should be stressed that these are, to a large and increasing extent, commercial markets themselves. Those discussed here are:

- Financial capital, including risk capital, bank loans, bonds and insurance, provides much of the 'blood' of business development. The depth and diversity of the financial markets are closely related to economic performance. Of particular importance to the financial needs of the poor are NGO-innovated microfinance schemes.

- Physical capital in the form of transport systems, energy, water and sanitation, and telecommunications, are all key determinants of an effective private sector and can also be effective pro-poor instruments. For example, physical access to markets through good roads is one of the greatest determining factors of returns to smallholders and the informal economy.

- “Human resources” are the most critical of all resources for economic development. While human development through education and health is obviously an end in itself – as development is all about people and improving their welfare – there are also strong interdependencies between such development and PSD:
  - Human resource development is a critical, and perhaps the most significant determinant of an effective, dynamic and competitive private sector and of long-term growth.

- The private sector in many developing countries is an increasingly important supplier of health services and education, partly due to “government failures”, partly by design.
- The private sector is the prime engine for generating finance for investments in human resources through health care and education, and thus critical for countries to be able to make long-term investments in the development of human resources.

• The poor depend to a large extent on employment, in both the informal and formal sectors, and their way out of poverty will be determined by the ability of formal businesses to absorb labourers: wage levels and working conditions are of paramount importance for the poor. The role of labour markets for PSD is determined by both supply and demand factors, and by the regulatory framework for them. Social and occupational mobility and labour market flexibility are critical for efficient labour markets.

Micro level – Direct Support to Businesses

Development assistance aimed directly at the market players is a common donor approach for enhancing competence at the market level. There are two kinds: 1) assistance to public or private business support organisations such as export processing zones, trade promotion organisations, chambers of commerce and business development services; and 2) direct assistance to market players, such as matching grant schemes. While such micro level assistance is a hands-on type of development assistance, often providing visible and practical results, such assistance runs the risk of causing various types of market distortions. To reduce the risk of such distortions, donors need to:

• avoid capital subsidies to commercial operators, unless there are very clear cases of positive externalities and, in such cases, only for higher-risk, pioneering efforts. Donors must particularly avoid distorting capital markets by providing subsidised credits to specific financial intermediaries;

• carefully review direct public-financed PSD support, which risks retarding and preventing the development of markets, for example for business services or micro finance.

In such cases, donors should promote the development of such markets, rather than compete with them through subsidised schemes;

- be highly restrictive in direct forms of PSD support that bypass domestic organisational structures. In funding such structures, preference should be given to private sector organisations, especially in fields where there are no compelling arguments for government interventions.

In general, donors should aim at providing support which addresses constraints in the business environment, rather than providing direct support for commercial players. The latter should be confined to interventions which indirectly address the constraints in the environment through a demonstration effect.

Integrating Market and Private Sector Assistance with Overall Donor Support

A main theme of this report is that Market and Private Sector Development touches upon many aspects of what donors already do, and that Market and PSD should therefore not been treated as another subject requiring its own organisational structures. What is required is rather a different perspective on much of what donors traditionally have been involved in and to see how such assistance can be modified to be more effective in supporting markets and the private sector for poverty eradication. To ensure that this takes place, Market and PSD must be treated with a cross-sector approach, with an on-going dialogue between different organisational units in donor agencies, and competence development of what constitutes an enabling environment for effective private sector development and pro-poor growth. The integration of a genuine market and private sector development approach into existing analytical and strategic instruments used by donors, such as the Poverty Reduction Strategy papers, is critical. For the latter to be effective, they should include genuine participation of different kinds of market and private sector players.

Introduction

CHAPTER 1

1.1 Background

Over the last few years many donor agencies have shown a considerable interest in markets and the private sector. Various policy and strategy documents have been drawn up by these agencies to guide new projects and programmes. For example, in 2004 the United Nations issued a report by the Commission on the Private Sector and Development entitled: "Unleashing Entrepreneurship – Making Business Work for the Poor" (UN 2004a). The World Bank's World Development Report for 2005 is entitled "A Better Investment Climate for Everybody", and deals largely with the same subject (World Bank 2004a). The Bank derives many of its conclusions from two recent major research undertakings that look into private sector conditions in different countries: "Doing Business" (World Bank 2004c), which assesses barriers to business around the world and is updated annually, and a series of Investment Climate Surveys (for details, see World Bank 2004a). British DFID is currently working on updating its report "Making Markets Work Better for the Poor", which was first issued in the year 2000 (DFID 2000), and has prepared a number of background documents for this purpose. OECD/DAC issued a paper in 2004 in its POVNET Agenda called "Accelerating Pro-Poor Growth Through Support for Private Sector Development"(DAC 2004). Among bilateral donors, Sida issued a Private Sector Development Policy in 2003 (Sida 2003b). The list can be expanded.

This donor interest is manifested in various projects and programmes aiming at market and private sector development: from broad-based policy interventions to provide 'enabling' environments for market operations, to specific assistance to enterprises and their organisations. Yet, development agencies are still in a learning process where the constituents of effective market private sector development are concerned.

In addition to the increasing interest being shown by donor agencies in market and private sector development for poverty eradication, there also seems to be an increasing interest in ways in which business can assist in that process in the international business community. An interesting example of this is the best selling book by the international business guru, C.K. Prahalad, *The fortune at the bottom of the pyramid. Eradicating poverty through profits* (Prahalad 2005). His argument is that the poor of the world is a very substantial market that is missed by international business, and that efforts to address this market are good, not only for the enterprises, but also for the poor.

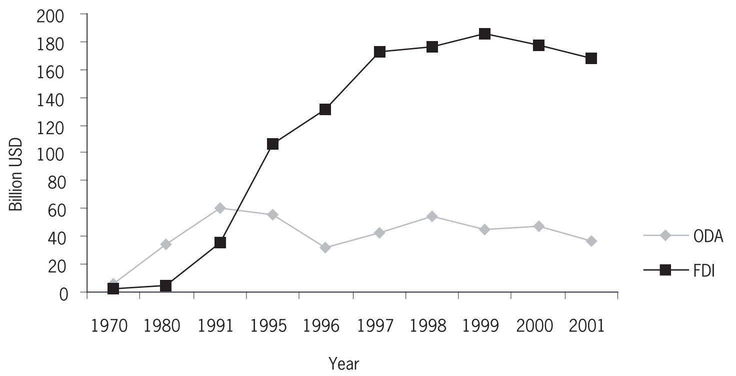
1.2 A Changed Environment and its Consequences for Donor Assistance

A number of broad events and changes in the world lie behind the increasing interest shown by donor agencies in market and private sector development. These events also have profound consequences for donors' strategies and activities as outlined below:

Since the fall of the Soviet Union in 1991, the market has been the undisputed principle for the organisation of economic activities, applied today by all nations of the world – with a few remaining exceptions such as North Korea (where the centrally planned economy is also on the verge of collapse). Russia's reform towards democracy and a market economy ended the credibility of the centrally planned economy where the supply of goods and services was determined by political and administrative decisions. However, centrally planned communist states, such as Vietnam and China, had already begun to reform their economies towards a market system in the 1980s. In the early 1980s the donor community, led by the World Bank, began a process of forcing and cajoling their clients towards market reforms focusing on macro economic policy.

The end of the Cold War also meant a strong impetus for globalisation. Private capital increasingly began moving across borders, facilitated by financial liberalisation and changes in communication technology. As import-substitution was replaced by export-orientation in many developing countries, inspired by the economic successes of the Newly Industrialised Countries (NICs) such as South Korea, Singapore and Taiwan, the opportunity for trade and foreign direct investments (FDI) further triggered the international flow of capital also to the developing world. Today, Official Development Assistance (ODA) as a form of capital transfer is dwarfed by private capital flows to developing countries (see figure 1, below). Increasingly, donors have to interact with and support such private flows in order to make development assistance effective. The current interest in Public-Private-Partnership (PPP) is a reflection of this. However, ways and means in which ODA should interact with private capital flows in order to achieve effective poverty eradication still need to be developed.

Figure 1. Net Flows of ODA and FDI to Developing Countries 1970–2001



Source: Mistry and Olesen 2003

The poor derive their income as small-scale producers, entrepreneurs and labourers almost exclusively within the private sector and from market-related activities. As consumers they depend on the market and the private sector for their essential goods and services. The value and usefulness of their limited investments, for example in land and housing, are determined by market forces. Making markets work better for the poor is therefore a rationale and necessary strategy for donors interested in poverty reduction. It has also been recognised for quite some time now that poverty is only reduced in poor countries through sustained economic growth, and that such growth is dependent on well-functioning markets and a dynamic private sector (see, for example Ravallion and Chen 1997; Dollar and Kraay 2003). The donor community is searching for instruments to support such growth processes, and, in particular, for so-called pro-poor growth strategies.

The market and the private sector have expanded into new areas such as infrastructure, utilities and social services, traditionally the domain of the public sector also in most market-oriented countries. This process has been triggered by: 1) massive government failures in delivering basic services in many developing countries; 2) technological innovations allowing competition in areas where natural monopolies existed such as in telecommunications and power generation; and, not least, 3) ideological reasons for expanding the role of the private sector into former government monopolies. Private solutions for basic social services and infrastructure are still very much a trial and error process. In some cases considerable backlashes have occurred, for example in the form of political uprisings due to increased prices, as a consequence of privatised services. Donors need to learn which models work and which do not.

In summary, donors must take Market and PSD to heart, and their ability to effectively address the issues embedded in markets and private sector development will determine the extent to which they will play a critical role in world development.

1.3 Purpose of the Report

This study is an update, expansion and considerable revision of a paper (Sida 2003a) prepared by the author for Sida as background material for Sida's PSD policy (Sida 2003b). Its purpose is to complement other reports by:

- focusing on conditions which make markets and private sector development "pro-poor" in the sense that the systems contribute to effective poverty reduction.

- taking a holistic approach to market and private sector development, identifying broad factors in society which are essential determinants of dynamic and socially beneficial market development.

- placing markets and private sector development in a historical context, summarising how values and ideologies have provided different approaches to market development over time. Thus, market and private sector development is closely linked to politics and political choices, a factor usually not much discussed in donor policy papers or assistance. Effective poverty-reducing Market and PSD is not just a technical issue, but one of politics and political choice.

- being practical throughout the report by suggesting potential actions by donors.

This report has six key essential principles for effective, pro-poor market and private sector development. These are:

First, market and private sector development is not an end in itself. It should always be seen as a tool for higher objectives, i.e. human development and welfare, freedom, democracy and poverty reduction. The effectiveness of the market and the private sector in promoting such ends depends on society, and the incentives and disincentives established by governments and civil society. Donors can interact in such processes.

Second, the incentives for economic activities in society are critical. Conventional business incentives, such as low taxes and a low burden of regulation, are important but still dwarfed by the incentives that are embedded in political stability and freedom from war and conflict, as well as other factors such as well-trained people in good health; positive attitudes in society to entrepreneurship and innovation; non-corrupt governments; good quality infrastructure, and transparent regulations.

Third, there is no inherent conflict between equality, pursuit of human development and democracy on the one hand, and economic growth on the other, as has sometimes been argued. Egalitarian distribution of income and wealth, investments in people's health and education and respect for human rights and democracy go hand-in-hand with market and private sector development for economic growth. These factors tend to mutually reinforce one another.

Fourth, promotion of markets and private sector development is, in essence, nothing new for development assistance. What is required is rather a different perspective on much of what donors have been involved in since the birth of official development assistance. The priority is not to add another subject to the already long agenda of donors, and/or new units in their organisational structures. Rather, for effective pro-poor market and private sector development, donors need to look at on-going efforts with new spectacles, to see how existing projects and programmes can be modified to be more effective in supporting markets and the private sector for poverty eradication and other higher objectives of society. Donors also need to ponder how markets and the private sector can be used as means of achieving the ultimate objective of development: a better life for people.

Fifth, much more than in the past, donors need to interact with and take into consideration the market players and the private sector, both domestically in recipient countries, and the players operating on a global scale. Donors, which generally have little experience of business, should not second-guess what business thrives on, but need to maintain a dialogue with the market players, for example in their formulation of donor strategies, programmes and projects. Such a dialogue should not be considered a "sell-out to the market", but a means to make commercial forces work most effectively for the poor.

Sixth, as donors have scarce resources in both finance and manpower, there is a need for a careful analysis of the types of donor interventions that can have a strong leverage effect in changing the business climate towards pro-poor growth in recipient countries. An analysis of this type needs to be country-specific, targeted at the real constraints and opportunities, and not based on blueprints applied across nations.

1.4 Methodology

This report is based on a review of the rapidly expanding literature on market and private sector development. It includes both literature which, in a historical perspective, tries to explain the emergence of today's rich industrialised countrie s, and literature of a more normative type on ways in which developing countries can improve their economic performance through market-led development. The report also draws upon the author's own experience from development assistance over the last 30 years, in his work with numerous bilateral and multilateral organisations in a large number of countries across the world.

1.5 Structure of the Report

The report is structured the following way:

In *chapter 2*, the concepts of market and of private sector development are defined, indicating their scope and dynamics, and the essential interplay between the state, the private sector and civil society.

In *chapter 3*, market development is placed in a historical and ideological context, and donors' interpretations of such ideologies over time are described.

In *chapter 4*, donor visions concerning poverty eradication and the role of growth to achieve this are discussed, including the linkage between the Millennium Development Goals (MDGs) and Pro-Poor Growth on the one hand, and the market and private sector on the other.

In *chapter 5*, the fundaments of effective markets and private sector development are discussed, identifying features such as creating a level playing field, dealing with market failures, and stimulating entrepreneurship and innovation.

In *chapter 6*, two key markets or sectors for the poor, agriculture and the informal economy, are discussed, and actions suggested for their integration into a pro-poor market and private sector strategy.

In *chapter 7*, a systems framework is outlined for analysing how donors can address different types of determinants for effective, pro-poor market and private sector development.

Chapters 8–10 discuss such determinants and potential donor actions in detail.

Chapter 11 analyses different types of direct donor interventions at the market place, and the pros and cons of such interventions.

Chapter 12, finally, places the various actions for pro-poor market and private sector development into a general donor strategy framework.

Annex 1 offers a tool for assessment of the quality of the market and private sector as part of the diagnosis for action on country level. The quality and trends in a particular country and/or region are assessed through the use of a number of public sources, against key indicators and benchmarks for the general development of the private sector, and in terms of the inclusion of the poor and, specifically, of women.

Annex 2 lists the Millennium Development Goals and Targets.

What is Market and Private Sector Development?

CHAPTER 2

2.1 Defining Markets

A market economy is defined as an economic system in which decisions on the allocation of resources are made on the basis of prices established by decentralised and voluntary exchanges of goods and services between producers, consumers, workers and owners of factors of production. In a market economy decision-making is decentralised and performed independently by groups and people. A market economy consists of a very large number of partly interdependent markets, shifting over time in the sense that markets are born and markets also die. Markets might be local, regional, national or international in scope. Markets might be physical where buyers and sellers meet (market places), or virtual (for example a stock exchange).

Box 1. Formal Definition of a Market

> "A market exists when buyers wishing to exchange money for a good or service are in contact with sellers wishing to exchange goods or services for money. Thus a market is defined in terms of the fundamental forces of supply and demand, and is not necessarily confined to any particular geographical location. "

Penguin Dictionary of Economics, 1971.

2.2 Defining Private Sector Development

Private sector development is a term commonly used by donors. It is closely related to the concept of market economies in the sense that a market economy and well-functioning markets are necessary conditions for PSD. At the same time a market economy requires private players. Nevertheless, PSD is to some extent a semantic misnomer. While the principle of private ownership of the productive means in society is one element, the role of the public sector is equally important. Firstly, a market economy might consist of both private and public players[1]. Secondly, the public sector is critical as it establishes the rules of the game for the market.

Often the terms market development and private sector development are used synonymously. This report applies the term Market and Private Sector Development, or Market and PSD.

Box 2. Definitions of PSD

The OECD (DAC) defines private sector development as a basic organising principle for economic activity where private ownership is an important factor, where markets and competition drive production and where private initiatives and risk-taking set activities in motion. (DAC 1995).

The World Bank defines PSD not as a sector, but as a cross-cutting issue. It is about 'a way of doing things' that can have relevance for any sector such as energy or agriculture. And the pursuit of private sector development is not a goal but a means of doing things better.
(World Bank 2002a).

2.3 The Scope of Market and Private Sector Development

Market and private sector development concerns agriculture, manufacturing and services, including trade, and increasingly also infrastructure and social services. It also includes all types of market players, including the self-employed in the informal economy, small, medium and large enterprises, and transnational companies. Thus, private sector development is not a sector in the conventional sense of the term.

The market principle can apply to a wide or narrow segment of the total production of goods and services in a society. Outside the market are, for example, household production and the subsistence economy. Also the production of various public goods and social services is often excluded from the market. With economic development, an increasing share of the production of services and products in a society becomes subject to market principles as subsistence and household production shift to production for markets. This allows economies of scale and the division of labour in society, enhancing overall productivity and growth. A significant share of production taking place for subsistence purposes or in the household is a manifestation of a weak, undeveloped economy.

[1] The participants in the market place might not only be private for-profit operators, but also government-owned enterprises, and other non-governmental operators such as co-operatives etc., operating under the conditions of the market and in competition with other enterprises.

However, also in advanced market economies, non-market solutions are common in the commercial private sector: business organisations are to a large extent established on a principle of internal exchange that is not based on market mechanisms, but on administrative decisions. As enterprises grow in size into multinational firms, such administrative exchange mechanisms across borders are globalised and often replace trade[2]. This type of exchange is important in the sense that it indicates that market mechanisms should not be assumed to be superior to other mechanisms of exchange in all situations (Coase 1937). See further chapter 5.

2.4 State, Market and Civil Society

Market and Private Sector Development comprises the interplay between the 'rules of the game' and 'its players'. The 'rules' are institutions in the sense of policies, laws, regulations, norms etc. These rules can be formal and informal, established by governments on the basis of customs or social norms, or by the market players themselves. Together, they create the environment in which the private sector operates. It is a dynamic system in the sense that neither the institutions and the public organisations, nor the private operators are fixed over time, but change as a result of interaction and interdependencies. Governments establish the mandatory rules and create organisations to enforce these rules. However, the private sector players also greatly influence the rules. Institutions, including policies, are often created as a response to private sector behaviour. Understanding the dynamics of such an interactive system is critical to being able to promote development from the outside.

An important third element of the dynamic state-market system is 'civil society'. This includes various types of non-profit, non-governmental organisations, including labour unions and consumer unions, issue-oriented NGOs such as human right groups and environmentalists, and various forms of democratic organisations, including political parties. Just as markets are being globalised, civil society is also becoming globalised in many ways. Civil society groups in industrialised countries are linking up with sister groups in developing countries, facilitated by the Internet. Political organisations form cross-national links. Increasingly powerful forces that provide checks and balances for multinational enterprises in developing countries are civil society groups engaged in 'fair trade', protection of the environment, human rights, child labour, etc. Such groups have stimulated the development of rules of conduct and other forms of ethi-

[2] Obviously not all intra-firm exchange takes place in the form of administrative allocations. Market mechanisms do apply as well, sometimes manifested in concepts such as profit-centres.

cal standards. In a global process to ensure development based on human rights, forces of this type are essential.

In summary, effective pro-poor market and private sector development requires that donors are prepared to interact with all three of these players.

The Market in a Historical Perspective

CHAPTER 3

3.1 An Ancient Institution

The market – as an institution for the exchange of goods and services - is almost as old as mankind. Records from the earliest civilisations show that trading in both local and foreign markets was a part of life in the first city-states. The earliest forms of markets were based on barter. The introduction in 6th century BC of money as a commonly accepted measure of value was a major innovation, that dramatically reduced the transaction costs of exchanges, and thus expanded trade. Most towns and cities of the world have emerged as a result of trade and market activities, located at places where trade was facilitated, for example on convenient water-ways. Urbanisation has been, and continues to be, intimately linked to trade and commerce.

3.1.1 A controversial institution

Throughout history, the market as an institution has been controversial, disputed, heavily regulated and, in some cases, replaced by other mechanisms for exchange and as the basis of the prevailing economic system. Morals, and what money and the pursuit of money does to morals, have been one reason for the controversy in Western thinking, which traces its roots back to ancient Greek civilisation. In the words of Aristotle, "in the most finely governed cities, the citizens should not live a vulgar or a merchant's way of life, as such a life is ignoble and contrary to virtue" (Muller 2002, p.5). Aristotle saw engagement in moneymaking as leading to pleonexia, greediness, a deplorable state of mind in ancient Greece. Consequently, the merchants, bankers and moneylenders in the Greek cities were outsiders and denied citizenship (Muller 2002).

The Christian church echoed similar sentiments, proclaiming an unavoidable conflict between virtue in the form of devotion to God and money making. The Gospels proclaimed that people could not serve both God and Mammon, and that, in the words of Jesus: "it is easier for a camel to go through the eye of a needle, than for a rich man to enter the kingdom of God" (New Testament, Mark 10:25). Especially banking, or making money out of money, was considered contradictory to Christian values (see Box 3). The Protestant Church also pursued the same values, and Martin Luther – contrary to common belief – was largely hostile to commerce and trade (Muller 2002).

Box 3. The Moral Hazard of Banking

The opposition of the Church in Medieval Europe to money-making was particularly strong in respect of 'making money out of money', i.e. banking. Many European governments forbade their Christian citizens to be involved in banking, and brought in Jews to play the role of moneylenders and bankers. This not only contributed to the subsequent strong position of Jews in business and banking in Europe, but also sowed seeds of anti-Semitism.

The ancient debate on the vices of money making and the market has strands into these days, which also have an impact on development agencies. Market and private sector development is an agenda which many agencies have emulated late and, where some of them are concerned, with a certain reluctance. Not only is the market and the private sector unfamiliar terrain in comparison to government systems, merchants and industrialists are little known partners compared to the conventional government bureaucrats. There is also a perceived moral dilemma in organisations which have made the poor their champions, in dealing with people who are often far from poor, having moneymaking as their occupation, and where donor action can often be interpreted as making them even richer.

3.1.2 Adam Smith: From zero sum to win-win

One reason for the historically negative perception of the market and money-making was the belief in economies as a zero-sum game, i.e. if someone won from an exchange, someone else would lose, a belief propagated as science by the mercantilists in the 16th and 17th centuries. It was not until the 18th century that this belief was revised, and thinkers like Adam Smith (1723–1790) began arguing that wealth of nations could increase without anyone losing. Poverty was not necessarily the destiny of mankind, but wealth for the majority was possible. Commerce was also seen by philosophers of the Age of Enlightenment, such as Montesquieu and Voltaire, as a means to counteract the despotic rule of kings of the time, and an instrument to civilise societies and, as such, a forerunner of democracy.

3.2 Alternatives to the Market: from Feudalism to Command Economies

Throughout history the market has competed with other systems for transactions of goods and services. In medieval times, feudalism was a dominant system of this type in many parts of the world, not least in Europe. Feudalism was based on a patron-client relationship, where serfs or peasants delivered labour and goods to the lord, who (himself in a similar relationship to the king) in turn provided land, inputs and protection. The exchange was founded on a rigid and compulsory system based on customs and class structures, primarily in self-sufficient enclaves. The feudal system was a product of a highly uneven society, a fragmented world after the collapse of the Roman Empire, and a value system (supported by religion) in which every person was rigidly destined to have a specific position in society. The feudal system broke down in Europe in the 16th century as a result of changes in military technology (the supply of manpower for wars by the lords became insufficient, hence the power bases of the lords were changed), population growth, increased mobility and, not least, the emergence of markets based on voluntary exchange rather than compulsory contracts. (Rosenberg and Birdzell 1986).

In the 19th century, the perceived lack of social justice in prevailing market systems provided justification for another type of non-market allocation mechanism. Instrumental to this was Karl Marx (1818–1883). In a similar way to Adam Smith, he had a strong belief in the dynamic forces of the market, the forces of productivity, and the innovative capacity of the capitalist system. However, the outcome of these forces would, in his view, eventually become so unjust and unacceptable to the workers, the exploited classes, reinforced by violent shifts in demand and supply, that the system would eventually collapse and be replaced by the dictatorship of the proletariat, paving the way for the classless society in which everyone would prosper. Marx never articulated a model to replace the market as a means for exchange. However, Marxism did trigger the creation of central planning in the Soviet Union. It also exerted an influence on a large number of developing countries, especially in sub-Saharan Africa and Asia as these countries became independent from colonial rule in the 1950s and 1960s. Based on the Soviet Union's unquestionably rapid economic development and scientific achievements in the first part of the 20th century, state planning and considerable involvement by the state in the economy seemed a rational strategy for developing countries in their efforts to catch up through fast industrialisation. In the era after liberation from colonialism, the belief in a strong state, interventionist government and detailed planning of the economy was shared by almost all governments in the developing countries and by many development agencies (Ljunggren 1992).

3.3 Mixed Economies and Neo-liberalism

The mixed market economies emerged in the early part of the 20th century as a compromise or blend of Adam Smith's laissez-faire economy and Marxist-inspired planned economies. Mixed economies use the private sector market mechanism as the main form of exchange and resource allocation mechanism, but with considerable state intervention for distribution purposes, often with public ownership of key sectors such as banking and housing. The Marxist theories inspired the social democratic movements at the beginning of the 20th century, for example in Scandinavia, which were based on the idea of an inherent conflict between workers and owners of capital, in which the objective was to put the means of production in the hands of the people, not through revolution, but through reformism and democratic actions. A theoretical (non-socialist) basis for the mixed economy was provided by the British economist, John Maynard Keynes (1883–1946), in the 1920s and 1930s, showing the role governments can play in evening out the cyclical patterns of business for the benefit of society as a whole.

3.4 From the Chicago School to the Scandinavian Model

3.4.1 The revival of neo-liberalism

In the 1980s the interventionist theories of Keynes were replaced by neo-liberalism, of which Milton Friedman of the Chicago school is a well-known advocate. The neo-liberal theories, with the strong belief that markets would take care of themselves, and that the state should reduce its role to a minimum, influenced not only the governments of United States and Britain under Reagan and Thatcher, but also major multinational organisations such as the World Bank. The ideology has also been promoted from a broader philosophical perspective, for example by Hayek who saw it as the fundament for human freedom and the basis for Western civilisation (Hayek 1959).

The donor community, including the World Bank, worked to a large extent in the 1960s and 1970s on the premise that economic policy was the prerogative of governments in client countries, and that development was on 'the terms of the countries themselves'. Thus, the donors fully supported both the Marxist economic experiments of many countries in

Africa and Asia as well as liberal market economies. However, a change took place in the 1980s, led by the World Bank. Thus, the World Bank, which had happily underwritten much of Tanzania's socialism and that of other similar interventionist states through major credits in the 1960s and 1970s, innovated structural adjustment lending in the early 1980s, largely using conditionalities based on neo-liberalism as principles to enforce reforms. Most bilateral donors followed suit, supporting the World Bank's and IMF's work, even those which followed quite a different ideology at home, such as the Scandinavian donors (de Vylder 2002). A major reason for this incoherence in (Scandinavian) policy was probably that so much micro-focused development assistance had gone so badly wrong in countries with highly unconducive macro environments. Neo-liberalism with its straightforward message seemed right in the prevailing environment of failed government interventions. However, the shift in approach by many donors from support of state-interventionist economies to free market systems was by no means easy, often leading to considerable soul-searching (Lindahl and Catterson 1999).

3.4.2 Mixed results of neo-liberalism

Over the last 15–20 years, the market reform process has paid good dividends on a global scale in the form of both economic growth and reduction of poverty. Some countries, such as China and Vietnam, which have gradually changed their planned economies to marked-based economies with private incentives, have experienced very high and sustained economic growth rates since the 1990s, resulting in a dramatic reduction of poverty. Similarly, the reform in India, from a closed, state-directed strategy towards liberalism and openness in the mid-1990s, has also triggered high growth and reduced poverty. Taken together, India and China – with almost 40% of the world's population – have made considerable strides towards (material) poverty reduction on a considerable scale. However, it is important to note that, in these countries with high growth and rapid poverty reduction, the model for economic development was far from laissez-faire economics or neo-liberalism. It was a more gradual economic liberalisation with considerable state involvement. Furthermore, in none of the mentioned countries has donor assistance had much of a role to play.

Notwithstanding the clear successes, the benefits of market reforms and private sector development have been unevenly distributed in the world. Discounting the good performance of China and India, and Asia more generally, the situation in other parts of the world is much less promising. In many developing countries, the private sector and free markets have failed to play a dynamic role. Foreign investments have not emerged as anticipated, and growth and poverty reduction have not taken place. Many countries experienced economic decline during the 1990s, the majority in Africa. According to the UN, 54 countries were poorer in the early years of 2000 than they were in 1990 (UNDP 2003). Furthermore, global economic progress has not translated into a comparable level of poverty reduction measured as a reduction of poor educational standards, poor health or other aspects of poverty (UN 2004a).

Agriculture, one of the most highly controlled sectors in almost all countries in the past, has been liberalised in most developing countries, but the dividends have been uneven, especially between different groups of farmers. In some countries, the market reforms have had serious dysfunctional effects, resulting in Mafia-style economies. In sectors such as health and education, governments strapped for financial resources and pursuing economic liberalisation have paved the way for an unregulated supply of services by private providers, which has often had detrimental effects on the health and educational standards of the populations. As a result, in many former planned economies, such as the former Soviet Union, earlier achievements in human development have deteriorated.

3.4.3 Renewal of the mixed economy?

A search beyond the initial set of neo-liberal inspired reforms was started in the 1990s by the donor community. One lesson learned was that the market-driven, private sector development agenda was more complex than initially anticipated. While the initial reforms proposed the rolling back of the state to the most basic functions of law and order, the contemporary view stresses the importance of the state both as a nurturer and a regulator of the private sector and markets. A well-functioning private sector requires a well-functioning state, just as the state needs a well-functioning private sector. An important driver of the change process that took place inside the World Bank in the 1990s was Joe Stiglitz, the Bank's chief economist at that time, who over time became a strong critic of the Bank's and IMF's structural adjustment agenda (Stiglitz 2002).

Another agent of change in development thinking has been the 'discovery' by economists such as Douglass North of institutions - in the sense of formal and informal rules of the game - and their role as determinants of the growth of Western wealth (see, for example North 1990; North and Thomas 1973). The learning of the donor community is reflected in the current revisions of what is usually called the Washington Consensus, which formed the basis of the first phase of structural adjustment reforms. Concepts such as good governance, institutions and transparency have entered the development vocabulary (see Box 4).

Box. 4 Beyond the Washington Consensus

The agenda of structural adjustment of the 1980s: fiscal discipline, liberalisation, privatisation, openness to trade and foreign investments, market-determined exchange and interest rates, protection of property rights, public expenditure focusing in health, education and infrastructure, tax reform…
The added agenda of the 1990s: good governance, effective institutions, empowerment of the poor, democratic representation, country ownership.

From the neo-liberal agenda, leading donor agencies now seem to be moving towards the mixed economy model. A recent World Bank document uses the concept of a 'New Swedish Model' to indicate a desired model based on a "combination of vigorous competition in the productive sectors with regulatory frameworks that safeguard social and environmental standards" (Klein and Hadjimichael 2003). Also, Jeffrey Sachs of the United Nations, a world-renowned economist, seems to have a special liking for the Scandinavian Model (see Box 5).

Box 5. The Scandinavian Model

In recent years the Scandinavian countries have been placed at the top in a number of international surveys and indexes, ranging from well-being and human development, and honesty in government and society, to competitiveness and investment climate.
In a Newsweek article in mid 2004, UN economist Jeffrey Sachs summarized these factors and ranked the Nordic countries as 'the best countries in the world'. He identified three reasons why the Nordic countries had achieved this: 1) prioritising education and science; 2) social insurance in the form of public health care, public education and pensions – leaving no one behind; and 3) a vigorous private sector, with "an enviable record of not just innovation but of profits of high-tech breakthroughs".
(Sachs, Newsweek, 26 July, 2004.)

3.5 An Alternative Approach: Asian Developmentalism

Other development thinkers point to the experience of the highly successful Newly Industrialised Countries in East Asia. In their view, countries such as Japan, South Korea, Taiwan, Singapore, and more recently China, are neither laissez-faire, nor planned or mixed economies, but economies in which the governments, in close co-operation with the private sector, drive economic development towards the objective of growth, using market mechanisms. However, governments are also ready to intervene selectively in markets with fairly 'non-liberal methods' if this supports their desire to drive the market and the economy towards higher growth (Ohno 2003). 'Capitalist developmental state' is a term that has been used for this type of system (Wade 1990). It is different from the traditional mixed economies of the West in the sense that the economic system is not perceived to be based on an inherent conflict between workers and owners of capital, but more of a public-private partnership with common objectives. The Asian developmentalism is controversial in the donor community and the World Bank, for example, tends to be sceptical of the ability of governments to 'pick winners' (World Bank 2004a).

The Ultimate Objective: Poverty Reduction

CHAPTER 4

4.1 What is Poverty?

4.1.1 Poverty is multidimensional

Poverty has been defined by the poor themselves (World Bank 2000a) and by most development agencies, in relation to several dimensions of human life such as hunger, poor material standards, no assets, poor health, lack of education, insecurity, lack of freedom, abuse of human rights, and no voice and power in decision-making (Sida 1996; UNDP 1997). Thus, poverty is multidimensional with a material dimension (income, assets); a physical dimension (hunger, poor health, poor education); and a psychological dimension (voice, freedom, power).

The World Bank's study *The Voices of the Poor*, based on interviews with more than 60,000 poor men and women in a number of developing countries and emerging economies, provides an in-depth view of the various dimensions of poverty, and also the critical roles markets and the private sector tend to play in their lives (World Bank 2000a). It shows, *inter alia*, that various dimensions and manifestations of poverty are generally interrelated at the individual level. For example, low income leads to vulnerability and often to poor health and the inability to educate children. Lack of education and poor health reduce the ability of poor people to improve their living conditions, i.e. it is a vicious circle.

4.1.2 Diverse manifestations of poverty

While material and physical dimensions of poverty tend to be correlated, they are poorly correlated in many countries to those dimensions that are related to the psychological dimension, especially freedom. The dramatic reduction in poverty, which has taken place in a number of socialist or communist countries in terms of income and/or health/education, has not been accompanied at all by any similar improvements in freedom, democracy or voice in those countries. The two leading "growth and poverty-reducing nations" over the last decade, China and Vietnam (World Bank 2004a), both openly maintain a communist system of governance, without democracy, and with severely restrained human freedoms and frequent human right abuses, as reported by human rights watch organisations and the media.

The donor community has not yet agreed on a joint measure of these different manifestations of poverty, and the lack of freedom objectives and targets in the Millennium Development Goals (see further section 4.2 below) is perhaps no coincidence. An important issue and possibly an ideological dilemma for donors is how the different dimensions of poverty are to be dealt with, and what weight they are to be given in the choice of support provided. Successful eradication of material poverty, but under conditions of highly restricted freedom and no democratic choice, would be a very partial success.

4.1.3 Poverty reduction through economic growth

The relationship between economic growth and poverty has been extensively discussed over the last decade. Today there is a consensus among development experts and donor agencies that sustained growth is a necessary condition for sustained poverty reduction. (See, for example: Sida 2002; UN 2004; Bourguignon 2001). The dramatic change through history in the Western world – from a situation two hundred years ago when almost the whole population of Europe could be considered poor and had been so in stagnant economies for hundreds of years - to today's affluence which includes basically everyone, is a result of economic growth over the same period (Rosenberg and Birdzell 1986). The same process is taking place in many developing countries.

The determinants of the success of the industrialised countries of today in escaping poverty and creating wealth have been intensively researched, leading to considerable consensus among donor agencies. The role of the market and the private sector as the engine for growth is also well documented (World Bank 2000b; 2004c). The conditions under which these institutions thrive and stimulate productivity, innovation and economic transformation are also quite well known. These determinants are spelled out in more detail below in this report, as well as ways in which donors can support such processes in developing countries.

Economic growth can, nevertheless, provide quite different dividends in terms of poverty reduction. The concepts of 'ruthless growth', a term coined by the UNDP, versus 'poverty-reducing growth' or 'pro-poor growth' indicate that economic growth can take many forms in respect of its impact on the poor and its ability to lift the poor out poverty. Thus, there is a strong current trend amongst donor agencies and multinational organisations to identify qualitative growth patterns (World Bank 2000b, Sida 2003b; UNDP 2003), as is further discussed in section 4.3 below.

4.2 Donor Visions: The Millennium Development Goals

4.2.1 Bold visions of the donor community

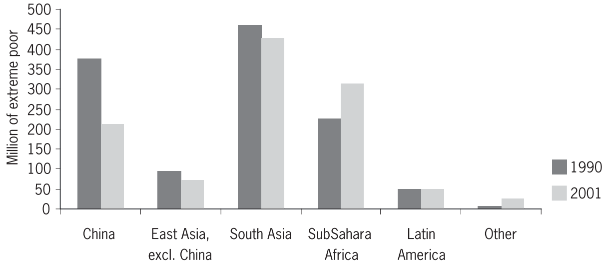
In 2000, the international community established the far-reaching and specific development objectives expressed in the Millennium Development Goals, with the overriding objective of eventually eradicating poverty and hunger in the world. Specific targets were established for the year 2015 concerning income, poverty, hunger, health, education, gender equality, a sustainable environment and global partnership (for details of the MDGs see Annex 2). The MDGs are the first bold joint effort by the international community to be specific about targets. Developing agencies, especially the World Bank and UNDP, are increasingly tailoring their annual 'state of the world' reports (such as UNDP's Human Development Report and the World Bank's World Development Indicators) to monitor development progress against these objectives.

4.2.2 MDGs and market development

There are strong linkages between market and private sector development and the MDGs. First, the attainment of the goal of reducing the number of people living in extreme poverty, by halving income poverty (measured in an income below USD 1 per day in Purchasing Power Parity terms) by 2015 requires robust economic growth, and a change from the current growth patterns in many countries and regions of the world. With current patterns, only East Asia is likely to achieve the poverty reduction goal. This is due to the fact that China, the world's most populous state, has had a record of high growth rates for a long period of time (World Bank 2004b).

In figure 2 below, the trend in reduction of extreme poverty is noticeable only in Asia, while for the rest of the developing world the number of people living in extreme poverty is either static or increasing in absolute terms. In particular, sub-Saharan Africa requires drastic changes in its growth patterns to achieve the MDG objective of reducing extreme (income) poverty. Sub-Saharan Africa is the most critical region since it is not only the poorest in the world, but also the one with the least promising

Figure 2. Number of People Living in Absolute Poverty 1990 and 2001
(No. of people living on less than USD 1 per day measured in Purchasing Power Parity)



Source: World Bank website March 2005 (www.worldbank.org).

growth. The challenge of breaking the trend of the 1990s of stagnant or declining economies in this region is formidable.

Second, achieving the MDGs depends on major investments in the social sectors. This includes: primary education; child and maternal health; efforts to halt and reverse the prevalence of major diseases such as HIV/AIDS and malaria; safe water, and improved conditions for urban slum dwellers (see further Annex 2). In many countries robust economic growth is essential for generating financial resources for tackling such issues, and the markets and the private sector are the engines for this. However, in many countries market reforms have had a clearly negative impact on the provision of basic social services, either through 'rolling back the state', and/or through efforts to apply pricing and market mechanisms to the provision of health and education. Hence, a qualitative and pro-poor market and private sector approach is also required in this context.

Third, while the public sector should and must play a pivotal role in the social and infrastructure programmes and investments mentioned above, the private sector can, besides enhancing the resource base for this through generation of taxes, also contribute directly in several ways. Given the right policy frameworks, the market and the private sector can do much to enhance the effectiveness of social, human and infrastructure programmes as investors, operators and service providers. Infrastructure in particular has been subject to flagrant government failures in many parts of the world. Market-based private sector solutions, or private-public partnership solutions, can make a difference. Especially reforms of telecommunication through opening up the sector for private competition has dramatically increased access to and reduced costs of telecommunication services in poor countries in just a few years, as is further discussed in section 10.2. Donors can play a role in: a) promoting such solutions; and b) assisting in establishing the necessary framework, such as regulations, financial models etc. Also, donors can play a role in disseminating 'best practices'. However, it must be stressed that privatisation of programmes in health and education is far from a panacea and that private solutions for infrastructure also have their problems, as is further discussed in section 10.3.

Fourth, the last MDG includes several dimensions of private sector development, for example changes in the global trade and finance systems, work standards, and transfer of technologies in certain key sectors such as communications. This indicates the role of the private sector in global public goods which is further discussed in section 8.5.

4.3 Pro-poor Growth

4.3.1 Determinants of pro-poor growth

What determines pro-poor growth or non-poor growth[3]? Both historically and more recently, different development patterns have resulted in different poverty reduction outcomes whether measured in the form of income, health standards, education or levels or freedom. The poverty levels in countries such as Vietnam and Sri Lanka in comparison to Brazil, El Salvador and Honduras indicate that some countries have been much more effective in reducing poverty (measured in income, health and education standards) than others at a similar stage of economic development. There are clearly pro-poor and non-poor growth trajectories in this respect (Kraay 2003; Bourguignon 2004). Considerable efforts have been made in recent years in the donor community to define pro-poor, and the conditions which trigger pro-poor growth (see Box 6.)

Box 6. In Search of the Holy Grail

A good summary of the state of the literature in terms of pro-poor growth is Klasen, 2003: *In Search of the Holy Grail. How to Achieve Pro-poor Growth?* A conclusion from this review is that, while there is no commonly agreed stringent definition of the term, a consensus is emerging on policy implications, for example that commonly accepted 'good macro economic policies and good governance' are especially critical for the poor; that reforms have to be phased carefully not to create volatility; and that human resource development is critical. Furthermore, a focus on economic activities in which the poor are directly engaged is critical, especially on effective agricultural policies and development, and rural non-farm employment. Equity in distribution of assets (such as land) and in income, and gender equality contribute considerably to pro-poor growth both from the point of view of triggering higher sustainable growth, and a more effective distribution of the gains of growth. (Klasen, 2003).

[3] This discussion concerns absolute poverty only, not relative. Absolute poverty is defined as the share of the population below a certain threshold in income, for example USD 1 per day measured in Purchasing Power Parity (PPP).

In general terms, it can be concluded that the extent to which growth is pro-poor or not is determined by a combination of the pattern of growth, the initial degree of equality (or inequality) in a country, and what happens to the distribution of income and wealth in the process of growth, i.e. the key parameters are:

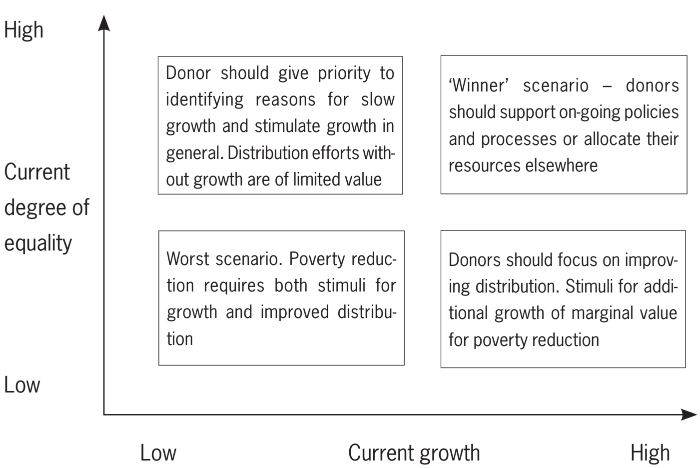
- The initial degree of equality in society – the better equality is at the outset, the better poverty reduction from growth will be.

- The distribution dimension during the growth process – improved equality during growth will impact positively on poverty reduction, while a deterioration in distribution will reduce such impact.
- The rate of growth – the higher the growth, the better the reduction of poverty, everything else being equal.

4.3.2 Balancing growth and equity for poverty eradication

The analysis above, i.e. that pro-poor growth is determined by the combination of growth and distribution, leads to the conclusion that, in order to be effective in poverty reduction, donors should focus on both growth and improved income distribution. The relative weight which should be given to these two dimensions depends on the basic conditions in a society, as exemplified in figure 3 below:

Figure 3. Strategies for Poverty Reduction



4.3.3 Distribution of income and wealth

Not only is effective poverty eradication dependent on fair income distribution. There is also increasing evidence that a fair distribution of income and wealth in society tends to be positive for growth (see, for example Bardhan et al 1999; Rodrik 2000; Easterly 2002; and Stewart 2003). However, there is one important condition for this. Countries which pursued equality, but chose a state planned model for their economies generally performed poorly, as history has shown. Given these conditions, the importance of distribution aspects in society is increasingly being highlighted in the pro-poor debate, as well as in 'economic growth-oriented' organisations such as the World Bank (see, for example Ravallion 2004). From a donor policy point of view, the next questions are: What are the determinants of equality? Why are some countries so much better at achieving an egalitarian society than others? Some critical factors are discussed below.

4.4 Factors Determining Equality and Distribution

4.4.1 Natural endowment

Countries which have abundant natural resources that are attractive on global markets, such as oil and minerals, are likely to include the poor to a much lesser extent in their growth (Auty 1993; Sachs and Warner, 1995). There are several reasons for this: Extraction technologies tend to be highly capital-intensive, hence, in relative terms, creating few jobs and limited spin-off activities. A contributory counterproductive factor to poverty reduction is also that wealth creation often takes place in a few business ventures in countries rich in natural resources, leading to higher risks of rent-seeking and other forms of corrupt practices by governments and/or politicians.

The extremely 'natural rich' countries of Central Africa, today among the poorest in the world, are classic examples. Also a country such as Botswana, which is often used as case of economic success in Africa, has had growth which is not particularly pro-poor as measured in Botswana's achievements in reducing absolute poverty[4]. Nevertheless, there are examples of how countries with "natural rich economies" have succeeded in created equality through a strong political will for re-distribution (see Box 7.)

[4] This view is based on an assessment of Botswana's development indicators (World Bank 2004a).

Box 7. Can "Natural Rich Countries" have Pro-poor Growth?

The poverty elimination which, over time, actually takes place in the 'natural rich countries' is strongly influenced by the mechanisms to distribute wealth. The successful economic transformation of Sweden, from one of the poorest countries in Europe in the mid 19th century to one of the richest in the mid 20th century, took place initially largely through natural resource exploitation of forests and iron (with FDI as a key input for modernisation). However, the wealth created was to a large extent ploughed back (through taxation, political action and labour union activities) into development of human resources by (free) education and health, which allowed a gradual transformation of the raw material extraction into increasingly higher degrees of processing and absorption of people into jobs.
(de Vylder 1996).

Countries lacking major natural resources, on the other hand, depend on people as the key means for their production, which leads more easily to the inclusion of the poor in growth through jobs. It is a historical irony that some of the most economically successful countries in the world are almost totally void of exploitable natural resources, for example Japan, Hong Kong and Singapore. Thus, these countries, which in retrospect must be considered to have had pro-poor growth, did not explicitly pursue pro-poor policies as such. The 'poor people inclusive growth' which has taken place in these economies was rather a by-product of a vigorous and successful economic growth strategy using the resources available, i.e. people.

4.4.2 Politics and culture

Distribution aspects of income and wealth in society are determined, to a very great extent, by politics. Societies differ considerably in the extent to which the leading political forces are committed to fair distribution. This is generally reflected in traditional right-left politics. Countries which have been dominated by communist or socialist ideologies, either as a result of democratic processes or through totalitarian regimes, have – in line with the basic social justice credo of the Marxist ideology – more strongly pursued egalitarian principles manifested in free and universal basic services such as health and education, subsidised food, housing, energy etc. It is often socialist countries that embraced market economies which have been the best pro-poor performers both historically and contemporarily[5]. It should be stressed that this concerns the material dimension of poverty, not freedom and human rights.

While modern politics and prevailing ideologies are essential to deter-

[5] Assessment based on data from World Bank World Development Indicators, selected years.

mine degrees of equality in societies, there are much deeper historical and cultural reasons with roots that go back many centuries. Feudal traditions; religious beliefs which justified social injustice, such as the Indian cast-system; land distribution based on conquests and the subjugation of indigenous populations such as in Latin America, are all examples of historical processes which created patterns of a high degree of inequality in society, difficult to change for a variety of reasons as societies modernised.

4.4.3 Investments in human resources

One major reason for pro-poor successes tends to be consistent investments in human resources through the provision of free and universal education and health care. Such investments are important as poverty-reducing strategies since they:

- address directly some of the most important manifestations of poverty: illiteracy, infant mortality and poor health;

- upgrade the productivity of people, facilitating the inclusion of poor people in production when the countries undergo market reforms;

- facilitate the continuous transformation of the economies by a more adaptable workforce, and also stimulate the creative forces of people for innovation and entrepreneurship.

The extent to which countries have invested in human resources is largely a result of political ideologies, but there are also considerable cultural differences between regions and nations, which explain to some extent the long-term tendency in many (non-socialist) East Asian nations for both governments and families to make major investments in education.

4.4.4 The importance of small-holder agriculture

Agriculture is the main part of the economy in the poorest nations in the world, and the main source of livelihood for the great majority of the poor even in less poor nations. The performance of agriculture (including other forms of primary production such as fisheries) is therefore naturally critical for poverty reduction in the short-term or medium-term perspective. Studies have concluded that a growth strategy focusing on agriculture tends to be effective for poverty reduction, and is thus an important pro-poor strategy (Mellor 1999; Majid 2004). Not only is agriculture the main source of income for the poor, the poor also spend a large proportion of their available income on foodstuffs. Neglect of the agricultural sector, without a dramatic improvement in other sectors, has strong bearing on poverty, as has been the case in much of Africa during the last three decades.

The degree to which agriculture is a pro-poor development strategy or not, is highly dependent on land holdings. In countries with a highly uneven distribution of land, such as hacienda-style Latin American economies, most of the people involved in agriculture are labourers. Ownership of land, or other forms of rights to land, is critical for pro-poor growth. Even in countries where the division of land has gone very far, to the extent that the size of average land holdings are minuscule, for example in Indonesia, growth was also successful in reducing poverty in rural areas on a considerable scale, at least until the Asian financial crisis at the end of 1990s. The small farm is an economic base, and a form of security to which other complementary sources of income can be added when the overall economy expands.

The distribution of assets such as land is a political issue and existing structures tend to be products of history and culture in which colonialism often played a critical role. Changes in such structures tend to be very difficult, requiring considerable political determination, and they can also be hijacked for political smoke screen purposes, as in the case of Zimbabwe today. Nevertheless, donors can play a role both by applying pressure for land reforms, and by providing technical assistance for ways to do it. In addition, technical aspects of property rights to land, such as provision of titles to land, can be a powerful pro-poor strategy. The importance of agriculture, and its opportunities and constraints as a poverty-alleviating strategy, is further discussed in chapter 6.

4.4.5 Implications for Market and PSD

Markets and the private sector cannot be considered systems which drive a fair distribution of income and wealth in society as such. A laissez-faire economy is not likely to be one of egalitarianism, especially not if the natural endowments lean towards exploitation of raw materials. One reason is that markets in themselves tend to under-invest in human resources. Distribution must therefore largely be seen as a political responsibility, to be manifested in institutions of society which promote fair distribution.

As mentioned above, there is no inherent conflict between growth and equality, but rather a positive correlation. Hence, unless the distributive efforts are counter-productive, for example by undermining the incentives for entrepreneurship and business, political action to increase equality in society could be considered part and parcel of Market and Private Sector Development, especially if such efforts focus on:

- Investments in human resources through universal and free basic social services, and in higher education

- Smallholder agriculture

- Physical infrastructure which is accessible to a wide section of society

- Land reform

- Institutions protecting the property rights of the poor.

4.5 Human Rights and Democracy

4.5.1 Human rights, democracy and markets

Human rights and justice are equally important as foundations for poverty eradication and global development as the material and physical aspects discussed earlier in this chapter. The human rights perspective places particular emphasis on democratic governance, freedom of expression, equal rights between men and women, and on the rights of children and disadvantaged groups in society.

The relationship between market and private sector on the one hand, and human rights, democracy and freedom on the other, is complex. There is no case in which freedom and democracy have flourished in non-market economies. On the other hand, there are plenty of countries under dictatorships with severe repression which have successfully applied market economies. Judging from history, the most successful economies over the last three – four decades in terms of growth have been, with few exceptions, in non-democratic countries, some of which with a very poor human rights record. China and Vietnam – the two fastest growing economies since the 1980s – are the main examples.[6] Superficially, 'enlightened dictators', such as General Park in South Korea in the 1960s and Lee Kuan Yew in Singapore, seem to have played a critical role in steering these economies towards high growth and industrialisation. However, as the economist Amartya Sen has argued, there are no convincing studies that show that authoritarian rule is better for growth in a statistical sense. He argues that freedom and democracy tend to correlate positively with some key underlying factors for growth (Sen 1999). Moreover, growth in the very long run (for example, the rise of Western economic superiority

[6] See for example the reporting of Human Rights Watch (www.hrw.org/countries.html) or Amnesty International (www.amnesty.org).

since the industrial revolution) seems to be linked to non-authoritarian societies, pluralism, and eventually democracy (Landes 1999). An important reason for this might be that authoritarian rule and suppression of individual freedom can be combined with high growth in early stages of economic development when the development process is more dependent on mobilisation of resources, than on innovation and change. Authoritarian rule, on the other hand, is non-conducive to growth in more advanced stages of development, since growth is then increasingly depending on the creative forces of individuals in terms of innovation and entrepreneurship.

In conclusion, respect for human rights, freedom and democracy are ultimate objectives of development assistance, and are pursued by donors in their own right. However, these dimensions of poverty reduction can interact positively with market and private sector development.

4.5.2 The role of donors

Donors can strengthen human rights and democracy in respect of market and private sector development by:

- Supporting national and international NGOs, civil society groups, and media with a focus on human rights, in order to make abuse more visible and to put pressure on governments and the private sector to eradicate such abuse;

- Supporting the development and diffusion of codes of conduct for business;

- Supporting national legislation and the potential for active enforcement of legislation and international conventions on child labour, workers' rights, women's rights, etc.

4.6 Strategies to Address Gender Structures

4.6.1 Addressing forces that create gender inequality

One element of human rights and freedom is gender equality. In most traditional societies women are discriminated against in the economic sphere due to cultural, religious and other institutions and power structures. Some of the inequality-creating factors are:

- division of roles in the market economy versus the household economy. As a rule, men dominate the market place and therefore control economic resources, while women are engaged in unpaid household work;

- different traditional or legal rules concerning property rights and the right of using property; in many societies women cannot own property;

- intra-household power structures, which give men power over financial issues in almost all societies even when women might play a very significant role in the household economy (see Box 8);

- the time-poverty of women, i.e. time and physical limitations for women to seek outside employment due to customs and their main responsibility for children and household activities;

- customs preventing women being involved in certain economic functions;

- the informal economy is often dominated by women, since they are excluded otherwise from the economic sphere.

Box 8. Tribal Vietnamese Women with Important Economic Roles but without Power

A poverty assessment in Vietnam described the economic activities of the Hmong women, living in the mountains in northern Vietnam. They spent most of the day and a large part of the night undertaking household tasks in combination with market-based activities such as feeding the animals, tending the fields, marketing products and making crafts such as basket weaving for sale. However, their decision-making power over the economy of the household and its investment decisions was almost nil.
(World Bank 1999).

The impact of market and private sector development on gender structures is largely a result of the interplay between politics, civil society and the market. There are dimensions of market economies which drive change: a rapidly expanding economy will absorb increasingly larger shares of the labour force, thereby generally impacting positively on women who are drawn into the market. First stage industrialisation based on labour-intensive manufacturing tends to bring in women into the (industrial) labour force in sectors such as garments, footwear and electronics. While foreign (and local) investors in such sectors often prefer female labour since they are perceived as being less prone to industrial action, easier to manage, 'more diligent' and often cheaper, their mobilisation into the workforce nevertheless often means a certain degree of empowerment of women in relation to their previous status as unpaid household workers or persons involved in low returning informal sector activities.

4.6.2 The role of donors

Policies and strategies for private sector development can be more or less aware of gender perspectives, and be more or less directed towards addressing inequalities. Changing the gender balance through donor assistance in market and private sector development is complicated. However, donors can make market and private sector development more effective in terms of gender by:

- Providing support for general growth which brings economic activities in the subsistence sector into the market place, something which is likely to have a positive impact on women.
- Support the spread, implementation and enforcement of the UN Convention on the Elimination of All Forms of Discrimination against Women (CEDAW), see Box 9.
- Assisting countries to develop and implement legislation which prevents discrimination against women in respect of wages, etc.
- Assisting in amending, and ensuring the enforcement of, laws on property rights, and the right of women to register and own enterprises.
- Focusing on increasing productivity in smallholder agriculture and in the informal economy, which engages a disproportionate number of women.
- Inducing a long-term process of change by promoting the universal education of girls and educating girls in higher education also.
- Making explicit gender analyses that can identify who gains and who loses in different scenarios.
- Assisting NGOs, civil society groups and other action groups with gender on their agenda to be more effective in their advocacy roles.

Box 9. The Convention on the Elimination of All Forms of Discrimination against Women, (CEDAW).

CEDAW, adopted in 1979 by the UN General Assembly, is often described as an international bill of rights for women. The Convention defines discrimination against women as "...any distinction, exclusion or restriction made on the basis of sex which has the effect or purpose of impairing or nullifying the recognition, enjoyment or exercise by women, irrespective of their marital status, on a basis of equality of men and women, of human rights and fundamental freedoms in the political, economic, social, cultural, civil or any other field."

Source: www.un.org/womanwatch.

4.7 Environment and the Issue of Sustainability

4.7.1 Dealing with negative externalities

Development which takes place at the expense of the environment is not a sustainable form of development. A comparison between the environmental degradation, which took place in the planned economies of the Soviet Union and Eastern Europe, and Western market economies gives an indication that market economies were effective in reducing the negative effects on the environment from economic development. However, market and private sector development is no panacea for a sustainable environment. Markets in themselves do not take 'negative externalities' (see section 5.2) such as pollution into account, whether it is local pollution such as polluted rivers, or global such as emission of ozone-depleting gases. In a globalised economy, international business can use developing countries with lax environmental standards or corrupt practices as dumping grounds for environmentally harmful waste, or for production systems with environmental effects that are unacceptable at home. Nor do markets pay attention to equity aspects of access to limited, non-renewable natural resources. On the other hand, well functioning markets tend to have in-built mechanisms to deal with certain environmental issues, such as the use of scarce natural resources (scarcity triggers price escalation, which triggers the search for substitution and more efficient use).

Many of the negative effects on the environment require harnessing of the market forces in an environment-friendly manner through legislation, price incentives or taxes, etc., which in turn require effective and non-corrupt governments. As many of the negative effects on the environment go beyond borders, these control mechanisms increasingly require international agreements (see further the discussion on global public goods below).

Poor people tend to be directly dependent on renewable natural resources for their livelihoods to a greater extent than the well-to-do. For example, small-scale farmers often use common forest resources, such as fuel wood, meat and nuts, to supplement the incomes they derive from agricultural activities. Many resources of great importance for the poor, for example fisheries and non-timber forest resources, are characterised by ill defined and absent property rights. To make private sector development and markets work for the poor, close attention has to be paid to the institutional framework and particularly its ability to secure informal property rights and good management of common resources.

4.7.2 Local versus global environmental effects

Stages of economic development determine to a large extent the type and scope of environmental degradation. Rich countries tend to be effective in controlling local negative environmental effects (both as a result of effective government regulations and due to the fact that such effects are increasingly subject to market forces). On the other hand, they are the main culprits in respect of global negative environmental effects such as greenhouse effects, depletion of the ozone layer, pollution and overfishing of the seas. Poor countries tend to have less impact on the global environment due to their much lower degree of industrialisation and use of non-renewable natural resources, but are usually destructive in respect of the local environment through non-sustainable use of agricultural or forest land, over-fishing of coastal waters, rivers and lakes, lack of regulation of emissions and other negative externalities from extractive industries. Much of the local degradation is a direct consequence of poverty at the household level: for example, pressure on land makes people cultivate increasingly fragile environments. Poor people cannot often afford to be concerned with long-term consequences on the environment as they have to survive in the short-term.

Donor countries concerned with environmental issues risk being hypocritical. If developing countries were to use the same per capita amount of non-renewable resources as rich countries, including fresh water, and allow the same emission of pollution per capita, it is unlikely that the world would be ecologically sustainable. Hence, the greatest challenge to economic development is how everyone on earth can have decent standard of living without jeopardising the environment and leave the same opportunities for future generations. The only hope for this seems to be a combination of a constant thrust for more efficient technologies – allowing the same output with much less use of resources and much less negative environmental impact – in combination with increasingly effective international agreements. The private sector, whether in the form of a small-scale farmer or a multinational company, is a critical instrument in this matter. However, it is an instrument which must be given the right incentives and the right directions through the institutions of society (Segnestam and Sterner 2001; Sterner 2000).

4.7.3 The role of donors

Donors can make market and private sector development more effective in terms of reducing negative environmental effects by:

- Assisting partner countries to establish effective environmental standards in respect of business practices and systems for supervision of these standards. This might include laws, regulations, establishing environmental authorities, etc.

- Assisting NGOs and other civil society groups with the environment on their agenda to strengthen their capacity to monitor environmental impact, and their capacity for advocacy, locally or in the international arena.

- Working for international norms for environmental standards.

- Supporting national and international research into environmental effects of production processes, use of chemicals, etc., common in developing countries.

- Assist developing countries to avoid being dumping grounds for hazardous waste by improving legislation and monitoring such trade flows.

4.8 'Good and Bad' Markets

4.8.1 Shifting values

Markets in themselves lack morals. They come into being for anything for which there is a demand, and for which someone is prepared to supply, as long as a price can be agreed between buyer and seller. Markets that are 'good' or 'bad' for society are determined by social values, which might shift over time, and which might differ from society to society. Governments can consider that certain markets are so negative for society that they are made illegal. These views might be commonly shared and result in international agreements to ban some markets globally. These markets do not often disappear despite such bans, but go 'underground' instead and by definition become arenas for criminals. There are numerous examples of such markets, some extremely extensive and with very high turnover in spite of high penalties. Narcotics and other drugs, prostitution, trafficking in women and children, trade in endangered species or trophies, and illegal arms trading are just a few examples. Poor people are often victims of, or involved in, such markets. For example, poor farmers are producers of cocaine in Colombia and heroin in Afghanistan, as these crops tend to be very profitable and thus difficult to replace by legal alternatives. Child labour is extensive all over the world in poor countries, often with the acceptance of poor families that feel that they have no alternatives for their survival. Prostitution and trafficking in women are major problems in Asia, the former Soviet Union and many other parts of the world, often with consent of the women or their families who want to escape poverty. The trade in endangered animals and banned trophies such as elephant tusks and rhino horns is based to a large extent on the involvement of poor people who derive a livelihood from catching and hunting animals which at any rate are often perceived as a menace to them as farmers and herdsmen.

These perverted markets can be very significant globally, turning over billions of dollars. Their profits generally play a very active role in financing Mafia organisations and other criminal gangs, separatist movements, terrorists, etc., which in turn create economic and political environments which are negative for economic activities, creating a vicious circle that harms both societies and the poor.

What constitutes a 'bad' and eventually banned market is subject to changes in social values. Slavery and the slave trade was an important, and accepted, market in the 17th and 18th century, involving the most 'advanced' countries at that time. Due to changes in human values in key countries, and a long process of political debate, this trade was first criticised and eventually banned, a ban that received international recognition over time. While there still are remnants of slavery and the slave trade in some minor corners of the world, the illegal elements of the slave market have basically been eliminated, indicating that radical changes are possible over long periods of time.

4.8.2 The role of donors

Donors can have a role in moving the frontier forward in effective outlawing of 'bad' markets through different means:

- by their involvement in the international debate, and by providing information to this debate on the prevalence, functioning and consequences of these markets;

- by participating in the process of establishing ethical standards for international businesses;

- by focusing on alternatives for poor people to products or services for 'bad' markets, such as alternatives to drug-related cash crops;

- and most essentially, by assisting robust growth, providing alternative sources of living for the poor to reduce child labour, prostitution, cultivation of banned crops, etc.

One lesson learned from economic reform processes is that competitive markets do not always emerge, in spite of reforms and liberalisation. This has, for example, often been the case in agricultural markets in Africa. Contrary to expectations, liberalisation has led to a poor supply of agricultural inputs such as fertilisers, seeds, implements, etc., and limited demand for and/or monopolised procurement of commodities. In other cases, markets do emerge, but they are plagued by various dysfunctional aspects such as corruption, monopolies, cartels, etc. In both cases, the poor tend to be particularly victimised. In this chapter, five fundaments for effective markets are discussed. These are:

- Creation of a "level playing field" at the market place

- Addressing market failures and equity

- Stimulating entrepreneurship and innovation

- Securing fair and effective property rights

- Ensuring decent work conditions and a sustainable environment

Fundaments of Market and Private Sector Development

CHAPTER 5

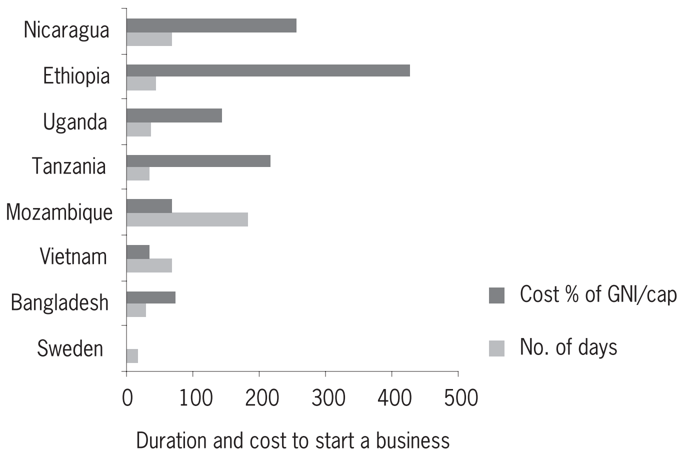
5.1 Creation of "Level Playing Fields" at the Market Place

Poorly performing markets can be the result of many factors related to undue regulations, such as excessive barriers to entry and/or exit for enterprises, discriminatory distortions where certain types of enterprises are given favours over others, high transaction costs due to information barriers, etc. Effective market development requires the establishment a "level playing field" at the market place, first by identifying factors which prevent markets from functioning properly or even emerging; and secondly by systematically reducing such constraints. Some of the key dimensions of a level playing field are discussed in the following sections.

5.1.1 Barriers to entry

Overly cumbersome government regulations, for example, for the registration of new enterprises, are a serious problem in many developing countries and transitional economies. A new enterprise might need hundreds of permits, something which is a strong disincentive to 'entry'. Such forms of bureaucracy are often part of a political economy in which powerful groups in society gain. Barriers to entry not only thwart enterprises from emerging, they also force entrepreneurs to operate in the informal economy. The World Bank's *Doing Business* reports are pioneering examples of identifying and quantifying various dimensions of the costs of doing business across the world, and also of monitoring changes in such costs over time (World Bank 2004c). This database has found that richer countries generally have much lower barriers than poorer, and the poorest often have the most cumbersome and costly procedures. Box 10 gives an illustration of such 'costs of doing business' in selected countries. These assessments are essential since they clearly identify barriers and set them in relation to other countries, hence allowing 'bench-marking', which can put pressure on poor performers to improve.

Box 10. The Cost of Doing Business



Based on data from the World Bank *Doing Business* Database – data from mid 2003. http://rru.worldbank.org/doingbusiness.

5.1.2 Barriers to 'exit'

Just as entry to a market by commercial players is essential for competition, so too are effective means of 'exit'. This means that non-competitive and failing enterprises that should be closed down can do so, for instance, through an efficient bankruptcy procedure. Such procedures also tend to be much better developed in rich than in poor countries, indicating needs for improvement (World Bank 2004c).

5.1.3 Distorted markets

Some market players, such as public sector owned enterprises or enterprises belonging to the ruling elite or its cronies, might be provided with subsidies or other privileges, creating an inefficient allocation of resources in society, stimulating 'rent-seeking', and reducing the incentives for other enterprises to enter, i.e. barriers to competition. Such enterprises tend to belong to the privileged, and are thus also a form of discrimination against the poor. Monopolies in utilities such as power generation and transmission and telecommunications are often good examples of such discriminatory distortions, which particularly affect the poor. Weak legal frameworks or poorly enforced frameworks allowing various types of dysfunctional behaviour at the market place such as asset-stripping, monopolies and oligopolies is a phenomenon that already Adam Smith was well aware of. Poorly defined property rights, especially for assets belonging to and used by the poor, are a serious constraint to poor producers to fully participate in markets, and act as a strong discriminatory force against women.

5.1.4 High transaction costs

There are other reasons for poorly functioning markets when none of the dysfunctional aspects above are in place. High transaction costs are due, for example, to a lack of information which creates higher risks, and infrastructure deficiencies that make transports exceedingly expensive hamper market development. The poor are especially affected by such constraints as they usually also have little information and do not possess the ability to collect and analyse market and other types of economic information. They tend to be discriminated against in respect of access to infrastructure and services, which also reduces their market activities, and adds to their transaction costs. (For a definition of transaction costs, see Box 11).

Box 11. Transaction Costs

Transaction costs are defined by economists as costs associated with uncertainty and imperfection in information in commercial operations taking place between producers and consumers. Transaction costs increase in situations of uncertainty, when rules and regulations are ineffective and arbitrary. Breach of contract is common and there are no effective institutions to make parties adhere to 'rules of the game' or to trust such rules. One explanation of the success of multinational enterprises is that such systems internally reduce transaction costs.

The creation of well-performing markets in general, and for the poor in particular, is largely a matter of reducing or eliminating 'government failures', i.e. government policies which for one reason or another impose distortions that have little or no functional value of the kind indicated above, which are unable to create and/or enforce the required legal framework, which apply discriminatory practices and frameworks, and/or allow non-productive 'rent-seeking' by officials and their cronies.

5.1.5 How are markets born?

One interesting question is how markets actually emerge and if public interventions and donor assistance can trigger markets to emerge or develop faster than through their 'natural evolution'. Such 'market triggering' is a common justification of some donor support for private sector development. Thus, donors provide assistance to set up new structures, such as business development services that provide various forms of consultancy services to enterprises. The objective of this assistance is to provide demonstrations to the private sector, both as clients – demonstrating that services are useful, and as potential suppliers – showing new market opportunities. The reason for 'market triggering arrangements' of this type is to find a method of true demonstration, and to avoid the risks of preventing markets from emerging and developing since the assistance can distort the incentives for the private sector. Furthermore, a major challenge is to find ways to phase out the assistance as 'true' markets evolve. An interesting case study in this respect is the emergence of micro-finance, which is further discussed in section 10.1.4.

5.1.6 The role of donors

Donors can assist partner countries in making markets more effective as a means of poverty reduction in different ways. For instance, by:

- Stimulating systematic analysis of constraints to market development in general, and to the poor and women in particular. A number of instruments have been developed for the purpose of assessing investment and business climates in developing countries, such as the World Bank's *Doing Business.* The World Economic Forum, Frazer Institute and others make regular business environment assessments for developing countries. These tools, however, are general and not geared to a poverty-focused business environment. Donors such as GTZ and DFID are now making efforts to identify business and market constraints of particular relevance for the poor.

- Highlighting constraints to competition embedded in poor government policies, undue regulations, inept bureaucracies, red tape, and rent-seeking, through a variety of means such as disclosing 'bad practices' and transferring 'good practices', especially those with a particular impact on the poor.

- Contributing to the high risk 'research and development phase' of market development in cases where there are potentially strong welfare gains to be made in terms of poverty reduction and/or gender equality This means bearing a higher risk than private operators are willing to do. Sometimes donor-supported NGO-led innovations, such as micro finance, can open up markets for the poor, which have previously been shunned by the private sector due to risk and transaction cost issues.

- Supporting the setting up of institutions in the public or the private sector which counter tendencies toward monopolies, imperfect information, imbalance between producers and consumers, etc.

5.2 Addressing Market Failures and Equity

5.2.1 Defining market failures

While the principle of the market is paramount, it is also important to identify when markets and the private sector are not performing from the point of view of society, i.e. when there is a major difference between private costs and benefits, versus costs and benefits for society. 'Market failures', as the term is used here, refer to situations in which the market is inherently not the optimal way of organising production from the point of view of society. There are several kinds of market failures:

- Public goods and natural monopolies refer to goods for which it is difficult or impossible to charge individual consumers, or for which it is difficult to create competition between suppliers. National defence and law and order are common examples of public goods. Also certain kinds of infrastructure, such as rural roads, are public goods. Market failures in respect of these goods are generally corrected by public sector production or publicly regulated supply by private companies. Global public goods are a special case and discussed further below.

- Positive externalities are benefits yielded to society which a private operator cannot capture to the full extent. Basic education, research, primary health care (especially in preventing communicable diseases) are examples of functions which are subject to sub-optimal production by the market from the point of view of society. Such market failures might be corrected by subsidies from private producers and/or consumers and/or public production.

- Negative externalities are the costs to society which a private producer does not pay for, such as pollution and public health hazards. Markets tend to over-produce such negative externalities, which require corrective action. Such actions might be bans, restrictive regulations, special taxes, etc.

- Imperfect or asymmetric information refers to markets in which the supplier or the consumer has inferior information vis-à-vis the other party. Health care is an example: often a patient cannot properly assess his/her needs, and thus depends on a health care provider who might have an incentive to supply more than is required.

Market failures are neither constant, nor always requiring public intervention for correction. Technological developments might allow competition in respect of natural monopolies, and market mechanisms can be used to correct externalities. Overall, market failures probably affect the poor more than the rich as they rarely have options themselves to compensate for such failures through parallel market mechanisms.

Another reason why the market does not create optimal social returns has to do with equity or social considerations. There are types of goods and services, often called 'merit goods', which can be considered to be human rights, such as primary health care, primary education and clean water. Markets generally provide sub-optimal allocations for these in terms of addressing the needs of people with poor purchasing power. Such areas might be the subject of various government interventions, from banning private operators and market principles for public production (such as primary health care in many countries), to subsidies. A hybrid form of private sector development in such areas is to allow private entrepreneurs to compete for the provision of government-subsidised or free services. There might also be regional considerations in the sense that market forces tend to have a centralising effect, leaving peripheral areas behind and outside development.

5.2.2 The risk of government failures

Successful market and private sector development is not a policy of laissez-faire, rather the reverse. However, just as there are market failures, there are also 'government failures', and it is rather the latter than the former which are the main cause of the disappointing performance of many developing countries. Governments have not been able to deliver public goods and services in a satisfactory way. They have often taken on tasks which they have then failed to perform as intended, due to lack of skills, shortages of funds, and other reasons. The political economy of development should also not be dismissed. Development is about resources. Pervasive 'rent-seeking' in poorly functioning bureaucracies is as much an issue in development as is the lack of skills or funds. Development cooperation agencies face a particular challenge since they provide resources mainly to governments, often far beyond what such governments can afford. Doing so they inadvertently create an open invitation to rent-seeking.

Box 12. Institutions of the Market

Besides the market-creating institutions of property rights and enforcement of contracts, which are essential for markets to emerge at all, two economists, Rodrik and Subramanian, have defined three other forms of institutions relevant for healthy long-term market development, namely:

- Market regulating: institutions dealing with externalities and imperfect information;
- Market stabilising: institutions ensuring low inflation, averting financial crises and macro economic instability; and
- Market legitimising: institutions providing social protection and insurance, redistribution and managing conflict.

(Rodrik and Subramanian 2003).

5.2.3 The role of donors

Donors can assist developing countries in dealing with market failures in different ways. Correcting such failures is a government responsibility. Donors can assist governments in partner countries

- to establish, implement and enforce legislation which deals with negative externalities such as environmental pollution, for example in agriculture, mining and other raw material exploitation ventures, industry and urban development.

- to establish effective authorities for regulation and supervision in areas where natural monopolies exist, but where governments prefer to let the private sector provide services, such as in power supply, roads, railways, etc.

- to provide essential services where there are strong positive externalities, such as preventive health care, either by supporting public services, or by developing payments schemes which counter the market's tendency to under-invest.

- to participate effectively and on fair terms in the emerging global trading of emission rights, etc.

5.3 Stimulating Entrepreneurship and Innovation

5.3.1 Creating dynamic markets

One common problem in developing countries is that markets are competitive, yet they do not lead to growth and development. Many markets are characterised by an over-supply of similar traditional products or services, leading to cut-throat competition, low profit margins, and sometimes prices that are pressed below production costs. This is often the situation in markets in which poor producers engage, such as peasant agricultural production for local markets, petty trading, and other aspects of the informal economy. In general, these markets are characterised by low levels of technology, a low degree of diversification, a lack of innovation and easy replication. Generally, the markets are local. Women, who are often over-represented in agriculture, small-scale production and local trading, tend to be particular victims of such cut-throat competition.

The markets described above fit the concept of efficiency: fierce competition, easy entry with no barriers, easily distinguished products and services, no opportunities for monopolies, and localised markets with direct interaction between buyers and sellers who often know one another and thereby personally reduce transaction costs. Only the most efficient producers will survive on these markets and, given the ease of entry, their return is likely to be low. However, an effective market economy is not associated with this description: it has to do with dynamic, creative change, constant re-invention of new products and services, new production methods which reduce costs, and new ways of approaching the customers to satisfy their needs, i.e. effective markets are in a process of constant change towards higher productivity, client satisfaction and economic growth. This is associated with what Douglass North defines as adaptive efficiency:

> "the willingness of society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of the society over time." (North 1997).

Two key factors are necessary for such dynamics: 1) entrepreneurs and business operators that are willing to take risks, and to innovate and create change at the market place through their economic behaviour; and 2) incentives in their environment that permit and reward such behaviour. The latter is concerned to a large extent with institutions in the sense of rules of the game, such as policy, regulations, etc.

5.3.2 Entrepreneurship – the illusive engine of innovation

Economic growth has been characterised 'as a process in which humans experiment by constantly recombining existing building blocks in innovative ways (Klein and Hadjimichael 2003). What drives this process is the subject of much theorising. Joseph Schumpeter has given rise to a school of thought which argues that human creativity is the most important production factor (Schumpeter 1911; 1943). According to this school, the market is characterised by a process of 'creative destruction' in which new enterprises and innovations make the old ones obsolete through constant structural change, creating evolution and development. It is a chaotic system, very different from a 'planned model', and the outcome is difficult or impossible to predict over time. The 'Swedish growth school', based on the theories of the Swedish economist Erik Dahmén, is a modern exponent of the same thinking (Johansson and Karlsson 2002).

The entrepreneur is an agent of change and modernisation. Many theories exist as to what creates such entrepreneurial spirit. One school of thought is that the culture and institutions of a society determine entrepreneurial activities. This is based on the classic Weber theory on the role of Protestant ethics in Western societies (later renewed to explain the rise of East Asia with the spirit of Confucianism). Other explanations are offered by the modern school of institutional economics. Yet another strand focuses more on individual or ethnic traits – entrepreneurs often tend to see themselves, and to be seen or treated by others, as 'outsiders' in society, due to personal traits, ethnic origin, etc.

Entrepreneurship is not only about breaking new ground. It is also a matter of copying and adapting. While ground-breaking entrepreneurs tend to receive the greatest attention, research shows that those who copy and adapt tend to be more important for growth and employment (Schmitz 2001). Nor is entrepreneurship confined to new and small enterprises. The spirit of entrepreneurship is essential in all types of enterprises, not least amongst the largest, in order to create change, to break new ground, to innovate and to be vital. The concept of intrapreneurship has been coined to indicate the importance of such agents of change within large enterprises.

5.3.3 The business environment and the entrepreneur

Societal conditions determine whether entrepreneurs emerge, the role that they play in society, and whether this results in poverty-reducing economic growth. The following are some key factors:

- Education is critical. In more advanced economies, entrepreneurial forces, innovations and new enterprises emerge around universities, especially natural science and management-based faculties. 'Silicon Valley' and the IT industry in the USA is a modern classic example, repeated and copied in developing countries. In some developing countries, such as India, the level and spread of higher education forms the basis of business development. Many entrepreneurs emerge from the cadres of the educated. The same dynamics can be observed at a basic level in many poorer developing countries: for example, the spread and adoption of new technologies in agriculture takes place where farmers are literate. Education provides the entrepreneur with the ability to absorb technology and information, to widen horizons and to see new opportunities, and also with the freedom to break social traditions and taboos.

- Openness in society determines the extent to which people are exposed to new ideas, markets, opportunities and new ways of doing things. Many successful enterprises in developing countries are started by citizens returning from abroad. Enterprises set up by foreign investments are copied by local entrepreneurs, often exploiting new market niches. These sometimes trigger large-scale clusters of enterprises, which in turn act as a breeding ground for new ideas and entrepreneurship.

- Freedom of expression and freedom of economic pursuit are critical factors. It is in such environments that people are stimulated to experiment, pursue creative ideas and take economic risks. A free press and freedom of information contribute to an environment of this type.

- Physical structures in society matter. These can facilitate or hinder exposure to ideas and opportunities to experiment. Infrastructure such as roads, and the supply of utilities, such as power, are critical for local entrepreneurship, creating the basic conditions for enterprises to emerge, develop and survive. Exposure and ideas are stimulated by proximity and spontaneous interaction. Urbanisation is in many ways a manifestation of these processes: interaction between people stimulates ideas; openness is greater, local markets are larger and more diverse, infrastructure is better developed, and transaction costs are lower. Thus, urbanisation is not only a result of economic development, it is also a triggering factor.

- Clusters play an important role in modern theories of entrepreneurship (see for example Snodgrass and Winkler 2003). Clusters consist of many enterprises, often of a similar kind in a limited regional area, which tend to have a high degree of spillover effects, synergies and cross-fertilisation, or, in economic terms, positive externalities. Some countries with more aggressive policies for economic growth and private sector development, such as China, Vietnam, and Malaysia, try to stimulate such cluster formation by creating tailor-made infrastructure.

- Government policies can do much to stimulate or thwart entrepreneurship. It is not only a matter of attitude, but also of readiness for change. This includes the ability of institutions governing markets to adapt to changed conditions, of using rather than refusing change, and providing the incentives for innovation and for upgrading technology.

5.3.4 The virtue of smallness

Entrepreneurship is generally associated with small enterprises. Behind almost every successful very large industry there is an entrepreneur, an innovation tried out in small enterprises. The language used in the policies of governments in many countries often pays tribute to entrepreneurship and small enterprises, but policy action tends to be the reverse: the large enterprises are favoured since they are more visible, have stronger bargaining power vis-à-vis the state. Their leadership is often part of the same social elite. The birth of small enterprises and their survival often takes place in spite of a hostile environment and policy frameworks. On the other hand, large enterprises tend to be protected and often rescued by the state if their survival is at stake.

5.3.5 The role of donors

Donors can assist countries to stimulate the development of entrepreneurship by focusing on creating conducive environments for entrepreneurs. Creative business development benefits the poor, directly or indirectly. In view of what has been argued above, critical inputs are support for:

- education, from basic to advanced levels. In the latter case, there should be a focus on subject areas which tend to spin off entrepreneurs such as natural science, engineering, agriculture and management.

- openness in societies, reflected in the free exchange of information, trade, and foreign investments.

- institutional structures which allow experiments, for example company laws which simplify entry and exit for small enterprises.

- non-discrimination against smaller enterprises and female entrepreneurs.

- regulations which provide incentives for innovation, such as effective patent laws.

- infrastructure which stimulates physical and mental interaction, for example access to the Internet.

- support for the development and diffusion of technologies with a high degree of relevance for the poor, in agriculture, small-scale power systems, transports, etc.

- basic research. It could be argued that it is research driven by human curiosity rather than in response to certain commercial needs, which tends to trigger the break-through innovations.

There are many schemes in advanced economies set up specifically to foster entrepreneurship and innovations, for example 'business incubators' and government-run venture capital funds. Overall, donor agencies should be sceptical of trying such special arrangements in developing countries until basic structures and institutions are in place. Donors should also avoid the temptation of using an individualistic approach, i.e. trying 'to pick winners' through direct financing of 'promising entrepreneurs'.

5.4 Securing Fair and Effective Property Rights

5.4.1 The evolution of property rights

The fourth fundament of market and private sector development is the institution of property rights. Such rights tend to develop in response to scarce resources. This is an evolutionary process over time where properties tend to move from free resources, commonly held resources based on traditions, to private holdings, with an increasing degree of legal protection. It is also a process of evolution from a limited number of properties (such as land and, at one point in time, people) to knowledge-based and immaterial assets such as patents, copyrights, brand names and other forms of intellectual property rights. Property rights are seen as a basis for the willingness of entrepreneurs to take risks and invest, making assets increasingly productive. The 'tragedy of the common' is a term that describes the depletion of physical assets that are used by many without clear rights. As noted above, Douglass North, in his pioneering work on the historical growth of the Western world, defined property rights as the most essential factor which created current wealth.

Non-existent, unclear and poorly formulated or implemented property and tenure rights are also claimed by some researchers, such as Hernando de Soto, to be the most significant factor explaining 'under-development' in general and for the poor in particular (see Box 13).

Box 13. The Assets of the Poor

"Developing and former communist countries' principal problem is clearly not the lack of entrepreneurship: the poor have accumulated trillions of dollars of real estate during the past forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market…"
(de Soto 2000).

A lack of clear property rights acts as a strong disincentive to private investments and makes it impossible to use assets as a basis for interaction with formal business systems (e.g. as security for loans), which, in turn, reduces the ability to trade assets, or make assets provide economic returns. Africa is a continent plagued with property rights problems due to traditional systems of rights to land complicated by superimposed colonial institutions and, after independence, various forms of Marxist-inspired reforms. Privatisation processes and so-called land reforms can easily be hijacked by the more influential in society, sometimes under the pretence of providing land for the poor. Zimbabwe is a current example. Unclear property rights are also regarded as a reason for the dominance and growth of the informal sector in many developing countries. While the capitalist system increasingly dominates the economy of the world, the most fundamental principle of this system, private ownership and the right to the fruits of private ownership, is only partially implemented in developing countries and emerging markets.

Well-developed institutions for property rights are not the same as a fair distribution of assets in society. Such rights can be extremely unfair from a moral or human rights point of view, and changes in property rights are often justified for distribution reasons. In situations of transition from one economic system to another, or from a traditional system to a modern system, abuses of property rights are common, often creating highly skewed holdings. The break-up of the Soviet Union and the creation of great private wealth over a short period of time among the oligarchs of the new Russia are illustrative cases in modern economic history.

5.4.2 The role of donors

Donors can support the development of the institution of property rights by:

- assisting countries in technical matters such as surveying, registration, titling, and the creation of land markets;

- assisting countries in reviewing specific constraints related to assets of particular relevance for the poor, such as land, and housing in urban areas;

- assisting countries in reviewing and changing property rights that discriminate against women, for example the right to land titles, and use of assets as security for loans;

- facilitating major reforms of property rights. There are specialised organisations such as Hernando de Soto's Instituto Libertad y Democracia which undertake work in this field. (For more details, see www.ild.org.pe).

The distribution aspects tend to be highly political and there are limited opportunities to exert an influence on the fundamental principles in a country from the outside. Nevertheless, donors can argue the merit of proper land reforms, and the importance of transparent and enforced rights concerning land for smallholders, for example in large reform packages.

5.5 Ensuring Decent Work Conditions and a Sustainable Environment

5.5.1 Decent work, sustainable environment and the market

A private sector which delivers growth and jobs at the expense of human health and dignity, at earnings and wages below levels that people can survive on, and which exploits the environment to the extent that the quality of life is jeopardised for current and future generations, is clearly poor quality Market and PSD in general, and bad pro-poor development in particular. The development of competitive markets must go hand in hand with decent working conditions and fair remuneration, whether they refer to the self-employed in agriculture and the informal economy, or to employees of transnational enterprises. The private sector must also take ecological dimensions into account to promote sustainable use of natural resources and the environment. Furthermore, a private sector which is discriminatory in terms of different working conditions for men and women, or for different ethnic or religious groups, is not high quality Market and PSD.

The quality of working conditions, levels of earnings and the environmental impact in and by the private sector are determined by a number of factors: national policy frameworks and legislation, the collective action of unions and co-operatives, lobbying and surveillance by civil society, the values and actions of the owners and managers of private (and public) enterprises, as well as global norms and standards. Working conditions and the return to labour cannot be treated in isolation. The private sector in richer countries can afford, and is obliged, both by norms and by labour market supply, to provide better pay and better working conditions than the private sector in a poor economy. Enforcing norms and standards through political means far above what an economy can afford usually results in non-competitive enterprises. Private sector development is a balancing and negotiating act between returns to capital and labour, and between exploitation of natural resources and ensuring sustainable use of the environment, in which private enterprises, governments, labour unions and civil society groups take part. Such standards change over time, including universal norms. Working conditions, which were general at the beginning of industrialisation, are clearly unacceptable today, even in countries which are in early stages of industrialisation.

5.5.2 The role of donors

Donors can assist countries in pursuing 'high quality' Market and PSD through a variety of means. These include: assistance in establishing effective and appropriate labour and environmental policies and related legislation; and support in forming organisations (such as technical assistance to unions, co-operatives and civil society groups), which act as a balance to the market forces, on behalf of the self-employed, employees and the environment. Donor countries can work on adopting universal norms and values manifested in international agreements, and on pursuing ethical standards in terms of working conditions and environmental standards in dialogue with transnational enterprises.

Traditional Markets of the Poor

CHAPTER 6

Two markets of particular importance to the poor are agriculture and the informal economy. Agriculture is the predominant source of livelihoods in many developing countries especially for the poorest, and also the supplier of food, the most important product for the poor as consumers. The informal economy – defined as unregulated small-scale business in trade and manufacturing outside agriculture – is the second most important source of livelihood after agriculture in most poor countries, and is also critical as a supplier of goods and services to the poor. Market and Private Sector Development that aims at reducing poverty cannot avoid paying strong attention to these two key markets.

6.1 Agriculture

6.1.1 The most common 'business' of the poor

Agriculture, including fisheries, livestock and forestry, employs over half of the total labour force in developing countries, mostly as smallholders, tenants and agricultural labourers. In low-income countries about 70% of the work force is engaged in agriculture, and in some of the poorest nations in sub-Saharan Africa, the ratio is over 90% (UN 2004a). Women are over-represented: in the low-income countries four of five women are primarily engaged in agriculture. Poverty in the world is to a large extent still a rural phenomenon. Over 75% of the people living in extreme poverty live in rural areas, and most of them have agriculture as their main source of employment (IFAD 2001). Besides income poverty, poor people in rural areas also perceive themselves as poorer than, for example, slum dwellers in urban areas, due to lack of services such as closeness to health clinics, schools etc (World Bank 2000a).

Thus, poverty-reducing private sector development cannot avoid paying close attention to smallholder agriculture, both in the sense of making the sector more effective as a means of making a livelihood, and as a means of taking the poor out of low-return agriculture. It is important to see smallholders, whether owners of land or tenants, as businesses and entrepreneurs. They are continuously forced to take commercial risks, to assess markets and production costs, to try new technologies. Sometimes they are able to expand, and sometimes they lose their businesses. While entrepreneurship in its conventional sense might not be associated with smallholder agriculture, it is still there that farmers apply new technologies, explore new market opportunities, and learn which production strategies provide the best returns from their own experience.

Smallholders tend to have other business and other economic activities in parallel with agriculture as a means of making a living. These might be small-scale agro-processing, trading, craft production, or temporary employment away from home (Havnevik et al. 2003). Thus, it is essential to have a view of the farmer household as an integrated 'business venture', where decisions are based on all these economic activities, rather than on one single activity.

6.1.2 Past discrimination of agriculture

One explanation of Africa's plight where poverty is concerned is that many countries pursued the transformation of their economies towards industrialisation at the expense of smallholder agriculture. This was reflected, for example, in:

- price controls which kept agricultural prices low for the benefit of urban consumers;
- a low degree of investments in agriculture (as the sector was seen as the backward part of the economy);
- taxing agriculture through export taxes;
- artificially high exchange rates, allowing 'cheap' imports of machinery and other industrial inputs, but having a negative effect on traditional export commodities;
- government monopolies in both domestic and export marketing of agriculture, leading to very low returns to the farmers as a result of inefficiencies in marketing boards

and rent-seeking by those controlling them; or perceived needs to transfer resources to the 'modern sectors'. (See for example Collier and Gunning 1999).

As the transformation failed, and the industries created turned out to be heavily dependent on government subsidies, agriculture was further exploited, leading in some countries to a return to subsistence farming. As a result of ill-fated policies, many African countries that, by tradition, had a strong position on global export markets lost these markets over a short period of time. Ironically, Africa, with most of its population in rural areas and with abundant land in most countries, also became a net-importer of food.

6.1.3 New potentials in agriculture

The role of agriculture for poverty reduction is complex, for example in the sense that most products produced have low income elasticity, i.e. increases in output tend to lead to declining prices. In view of this complexity, improvements in agricultural productivity might need to go in parallel with the transformation of the economy towards a relative decline of the role of agriculture in the economy.

Nevertheless, the potential of agriculture should not be under-estimated.

- The current agricultural market distortions in OECD markets, in the order of USD 300 billion (see further section 8.3.2), are likely to decline eventually with the expansion of the EU and its shift from production support to land subsidies. This would mean new market opportunities for developing countries.

- Market shifts and consumer preferences in industrialised countries for natural fibres and ecological products mean opportunities, and the current trend towards fresh products throughout the year and a wider variety of products in richer countries opens up new market niches.

- Biological energy resources might also grow in importance for long-distance markets as fossil energy sources decline and prices increase, and nuclear energy continues to be controversial.

- Farming of seafood is a rapidly expanding market which developing country producers are already capturing. Over time such farming can be expected to expand to new varieties due to the decline of wild populations.

- An expanded definition of agriculture to include natural resource management opens up new markets for the 'experience industries' such as wild-life and eco-tourism. Such new markets and ventures can be of relevance for the poor as sources of employment and sources of revenues, provided that they incorporate local populations as stakeholders.

6.1.4 The options to enhance agriculture

The proportion of the labour force engaged in agriculture is generally a good proxy of the stage of economic development. Development over the last century has meant a dramatic shift of people from initially very low-productive agriculture to manufacturing and services. In parallel with this, productivity per person engaged in agriculture has increased dramatically to the extent that the 5% of the population engaged in agriculture in the OECD area produce far beyond what the large majority of the population in those countries produced a century ago. The same process is taking place in many developing countries. For example, in countries such as South Korea, Malaysia, Mauritius and Botswana, the share of the labour force engaged in agriculture has dropped by half or more in the last 20 years, while the output from the sector has increased (UN 2004a). The difference in productivity between a poor farmer in an LDC and his/her counterpart in an OECD country is partly due to a difference in yields per hectare, but more importantly due to the farmed land utilised per farmer, which in turn is a factor of land available and of the degree of mechanisation.

At the national level, the last twenty years have witnessed major economic reforms in agriculture which have been beneficial, for example by reducing urban biases, and reducing 'rent-seeking' and other inefficiencies in state monopolies. Agriculture has grown more in output than the economy as a whole in many poor countries, notably also in sub-Saharan Africa (World Bank 2002c). However, the reforms have had winners and losers. While market-driven reforms have released productive forces and the creativity of masses of smallholders, they have also reinforced the process of marginalisation due to physical remoteness from urban areas or major roads, high costs due to transports, and other structural obstacles such as lack of market information. Ethnic minorities are particularly marginalised. Such groups, which tend to suffer a higher degree of poverty, are often subject to discrimination in terms of the right to land, access to credit, and so forth. They are frequently relegated to the most remote areas.

While much can be done to enhance the agricultural sector in developing countries and thereby reduce poverty, there are also clear structural limitations. Firstly, for many commodities such as cereals, coffee and rubber, income elasticity is low. Enhanced production of such commodities runs the risk of leading to depressed world market prices, occasionally to a level below production costs. This requires diversification of agriculture towards high-value products, itself often a high-risk venture due to volatile demand and quality issues. Secondly, poverty in rural areas is to a large extent due to 'functional landlessness', i.e. a large share of the rural population has no land or such small parcels of land, that land itself, however productive, cannot help people to escape poverty. A dual strategy is required: a) getting higher returns for the enterprises and people in the sector; and b) reducing the pressure on the sector as a means of making a livelihood. A strategy focusing on agriculture is thus essential, but focusing on agriculture alone will not work.

6.1.5 The area-based approach

Donor support for agriculture is often not sector-based, but area-based, with a history of poverty-focused integrated rural development from the 1950s and 1960s. The justification for the donors is: a) a desire to address particular pockets of poverty; and b) the perception that constraints to poverty reduction are many and need to be addressed simultaneously. Such area-based projects often had a combined thrust in enhancing agricultural production and providing various forms of social services. The results of these generally complex projects were often mixed, especially their efforts to improve income in a sustainable fashion. The approach has nevertheless survived, perhaps as these projects lend themselves particularly well to distinct poverty-focused donor support.

One strength of the area-based approach is that it allows experiments and as such can act as a model for broader, national programmes. Some countries have put such experimentation into practice. Vietnam is a case in point, where national poverty-focused programmes have often been piloted in small areas and, when proven successful, scaled up to the regional or national level. In many instances donor assistance has been used for pilot purposes. Such piloting is essential, and the often considerable resources put to use can be justified from a research and development (R&D) point of view. However, too often the R&D aspect was not at hand, and the intensive use of both financial and administrative resources by the donors and governments did not justify the meagre results, especially as governments had no plans, nor programmes or internal resources to replicate such projects on a larger scale. These integrated rural development projects became too often just showcases and development laboratories for donors.

In their efforts to address poverty, donors have tended to focus increasingly on areas of 'hard core poverty', which is often the result of a natural resource base with very limited capacity for farm production. Efforts to provide production development in such contexts, coupled with investments in infrastructure, can sometimes be counterproductive: farms are just too marginal to allow a decent living. The focus in such areas must be on people rather than on natural resources, i.e. on building human capacities which facilitate moving out and changing livelihoods, including migration to higher potential areas. Donors can face a moral dilemma in such cases: the donor interest in addressing 'hard-core' poverty in, for them, visible area-based rural development projects might divert scarce national manpower to these management intensive projects from the less visible but potentially much more important national programmes, for example in extension. This risk is that the net result is negative for overall poverty reduction.

6.1.6 The role of donors

In spite of the fact that poverty is largely a rural phenomenon and that the poor derive their livelihoods to a large extent from agriculture, donor assistance for such endeavours tends to be limited in relative terms, and furthermore has shown a declining trend. The strong efforts to enhance agricultural productivity in the 1960s and 1970s, e.g. through High Yielding Varities (HYV), extension systems, rural credit, investments in irrigation schemes and the integrated area approaches, have declined, and been replaced by structural reforms and liberalisation of agricultural markets in the 1990s.

The constraints in agricultural development which directly affect the poor are found at different levels, and should be addressed at these levels, as outlined below:

At the international level, one major constraint to developing country agriculture is that rich countries heavily distort global agricultural markets in their own favour. During the last decade, OECD countries have provided subsidies to their agriculture in the order of USD 300–400 billion per annum. (www.worldwatch.org.) Total ODA provided by the same countries, on the other hand, has varied between USD 50–60 billion per annum over the same period (www.worldbank.org). This has had the result that:

- Many OECD markets are de facto closed to agricultural exports from developing countries as these countries themselves produce more than there is a demand for. As these countries tend to be the most important markets for exports, such distortions are serious for developing countries.

- Over-production in OECD countries leads to the dumping of agricultural surplus in developing countries, thus undermining local producers and creating distortions.

This incoherence in policies is of a political nature and is nothing that donor agencies can do much about. However, as the beneficiaries of the distortions are few in relative terms (a limited number of farmers in the OECD), and the losers not only millions of agricultural producers in developing countries, but also most consumers in the OECD, making the effects of these policies explicit can have an impact on public opinion. This might, in turn, eventually impact on OECD policy makers. International civil society groups are often effective instruments for such lobbying efforts. Thus, donors can participate in the political debate by providing support for NGOs and opinion builders that lobby against the unfair practices.

Agriculture is one area where technical development and innovation can be diffused with dramatic changes in productivity, as reflected in the HYV revolution in the 1960s and 1970s. Although any such technological change has side effects, the potential to enhance productivity in traditional agriculture is still considerable in basically all sectors, including fisheries and animal husbandry. This is an area where donors have a comparative advantage in that they can underwrite the financial costs, which are often considerable, of the research and development phase. The new technologies in agriculture, such as gene modification and tissue culture, open up both opportunities and threats to agriculture in developing countries. Donors can support the capacity of developing countries to deal with such technologies.

At national level, agriculture has been the victim of efforts to industrialise rapidly in many developing countries, especially in Africa. *Policies* have been systematically skewed against agriculture to favour a few, over-protected manufacturing enterprises. Rural areas have been discriminated against in favour of urban areas through a variety of policy instruments such as price controls, monopolised marketing, over-valued exchange rates, and an urban bias in public investments. Such policies have been weeded out to a large extent, but there are still remnants of these policies in many countries. Donors can help countries in systematically analysing the policy framework to reveal such biases, and provide technical assistance for correcting them.

Property rights and the *distribution of land* are of critical importance. Land and the right to land are primary concerns for the poor who depend on land to such a great extent as the key resource for making a living. As land is scarce, and land values tend to increase, these rights are increasing in importance. Feudal, or quasi-feudal systems in many developing countries, resulting in extremely concentrated land ownership, are a major impediment to poverty-reducing agricultural development. Donors cannot directly interfere in such political issues but, at the international level, the argument for land reform and land distribution can stimulate political change, as can support for civil groups in countries involved in such issues. Also in countries with less of a feudal history, the institution of absentee landlords, often belonging to a political elite, who have gained access to land with more or less legal means, reduces effective poverty Market and PSD. Donors can act more strongly on such issues, and be less lenient with governments which systematically undermine fair land rights. The models of the NICs should provide an important message: their industrialisation often went hand-in-hand with land reforms.

Smallholder agriculture is heavily dependent on *supportive infrastructure* such as irrigation, roads, energy and telecommunications. Such infrastructure often determines production costs and productivity, access to markets and the transaction costs in commercial exchanges. Many of these are public investments, some of which are provided through donor funding and loans of varying degrees of softness from multinationals. The direction of such investments is frequently influenced by vested interests, where the poor generally have the least say. When involved in such financing, donors should assess in whose interests the investments are being made, and determine, with the aid of a poverty analysis, the most effective allocation of such funds from a poverty perspective. Poverty assessment should be as essential as environmental assessment in infrastructure.

The agriculture sector needs constant *diversification* towards new products, different quality products and expanded geographical markets to allow high growth in demand without pressure on prices. Both government and donors have often failed to pay attention to the demand side, and have assisted smallholders to build up over-supply, resulting in depressed prices. Donors can improve on this by: a) being more aware of the demand side in agricultural support and tailor production support to this; and b) assisting countries in building up more effective marketing and information systems. The latter does not mean supporting governments to take over marketing as in the past by ill-fated marketing boards, but providing support to develop facilitating marketing infrastructure for the private sector. The latter includes effective telecommunication systems for the purpose of transferring market information; effective harbours and airports for the handling of goods for export; systems for quality control and grading in order to enhance quality and reduce waste; infrastructure that supports the growth of local agro-processing (e.g. power), and a policy and regulatory framework for this which provides incentives for trade. There are also examples where donors have been highly effective in supporting countries through technical assistance in defining new markets.

Smallholder agriculture is a highly complex economic system, and the smallholder, often living on the threshold of survival, needs to be a very astute businessman (or businesswoman) to be able to make a living out of their smallholdings of land, and to balance risks and opportunities. It is essential that donors (and governments) when trying to support agriculture of this type, are fully aware of the complexities at the micro-level before introducing changes. Otherwise reforms might risk being ineffective or, worse, undermine the operations of the smallholders and their livelihood. Rapid Rural Appraisal, RRA and other similar participative techniques, involving the smallholders themselves in defining the problems and working out the solutions, offer excellent methods for governments and donors to learn.

In summary, donors can:

- Act at the international level to reduce trade barriers and to establish fairer markets for agricultural products relevant for developing countries.

- Support international research within CGIAR and similar organisations into improved varieties relevant for poor producers.

- Work with partner countries to strengthen property rights, especially for smallholders, including technical matters such as surveying and land registration.

- Improve market access for poor producers by investing in physical access, notably secondary and tertiary rural roads. Improve the system of maintenance of such infrastructure through decentralisation and through the involvement of service users.

- Address structural issues in factor markets relevant for rural producers, such as in financial services, input supply, water and energy.

- Learn about problems and solutions from the smallholders, through RRA and other participative techniques.

6.2 The Informal Economy

6.2.1 The importance in poorer countries

The concept of a dual economy, in the sense of a modern and a traditional sector existing side by side, has been used as long as development has been a discipline. The perception was initially that this dualism reflected a transitional stage: with development the modern sector would absorb the traditional, and the latter would wither away. Hence, there was not much need to pay attention to this temporary residual of development. The dichotomy was the subject of renewed interest in pioneering research work undertaken by the ILO in the 1970s, when the informal sector was 'discovered', and found to be both more significant as a source of non-agricultural employment and more resilient, than previously believed (ILO 1972). Furthermore, the sector was found to be of particular relevance as a source of livelihood for the poor.

The informal economy still tends to be the clearly most important source of livelihood for people in general and the poor in particular, in parallel with agriculture. The informal economy is estimated to employ about 60% of the non-agricultural labour force in developing countries, ranging from 50% in Latin America to 80% in Africa (DAC2004; Caar 2002; UN 2004). There are also indications that the informal economy is increasing in importance in many countries (World Bank 2004a). Nevertheless, there is evidence that the share of the informal economy of the total economy decreases as countries move up the economic ladder (Ayyagari et al 2003).

6.2.2 Informality – a sign of underdevelopment

Informality of the economy can be seen as a manifestation of under-development from several perspectives:

1) in poorer countries the institutional framework for business tends to be complex, cumbersome and expensive both in absolute terms and even more so in relative terms, compared to better-off countries. Hence, the incentive not to enter the formal sector is greater in low-income countries;

2) the cost-benefit ratio of being in the informal sector versus the formal sector is more positive in poorer countries in the sense that costs, such as taxation can be avoided. The

informal enterprises can also more easily avoid labour market rules, often rigid, in developing countries.

3) in some developing countries staying small and informal is a effective strategy to avoid predatory rent-seeking government bureaucrats or politicians (see Box 14).

Box 14. Avoiding Predatory Governments by Being Small

A Kenyan entrepreneur has developed a number of small enterprises over time. None of them took off to become a medium size or larger business. When asked the reason for this, he responded:

> "In Kenya during the Moi era you could be pretty sure that any owner of a business over a certain size would be called up by a top politician, often related to the President, wanting to be given a share of the business, free of charge. If you didn't comply, all kinds of hassle began, such as bank loans were recalled. So, you paid bribes or gave them shares. Keeping below the horizon by being small was the way I avoided this…"

(From a personal interview with a Kenyan businessman.)

In many countries, the informal economy has a high share of female operators, sometimes as a result of a cultural-historic pattern (such as domestic trade in West Africa). Informal economy operations, for example run from the home and/or part-time, lend themselves to the traditional role of women as caretakers of young children and being responsible for the home. Discriminatory property rights and formal regulations might also be reasons for a strong prevalence of women in the informal economy.

6.2.3 Characteristics of the informal economy

The informal economy is entirely private. The 'enterprises' operate, as per definition, largely or totally outside their countries' formal regulations and legal frameworks for business registration, licensing, taxation and labour legislation. The informality is either a result of the operators being too small to be covered by the formal system, or that they purposely avoid the system in order to reduce the costs of doing business, to avoid taxation, and occasionally also legality. The informal economy comprises everything from the self-employed to micro enterprises with sometimes 5–10 employees. The term tends to be used for non-agricultural production, but otherwise covers basically all economic sectors, both urban and rural. In most countries the informal economy tends to be dominated by services, especially in trade, and also to be a predominantly urban phenomenon.

Informal economy operators are typically labour-intensive with no, or very little, capital invested. They often cater to the poor in terms of products and services with very local markets. Returns can be substantial but, as copying by other operators is easy and prevalent, profit margins and return to labour tend to be low. The informal economy might include criminal activities such as smuggling, prostitution, and drug-peddling, but the vast majority of informal enterprises are honest from the moral, albeit not the taxation, point of view.

6.2.4 Reduce barriers for entry into the formal sector

There is a notion that the informal economy is a major potential recruitment ground for fast-growing small-medium enterprises, which is probably incorrect. The transition from informal to a more substantial formal enterprise is rare. Informal businesses tend to be sources of livelihoods catering for highly local markets, rather than an expression of entrepreneurship exploiting new ideas or innovations. Most informal operators have neither the capacity to expand into larger enterprises, nor often the willingness to do so. The importance of the informal economy is rather its ability to provide a degree of income through a vast number of 'enterprises', its adaptability, easy entry and exit, and low transaction costs, and its status as an important source of livelihood for women. However, as governments reduce the barriers to entry into the formal sector, graduating enterprises increase their ability to expand and to become small-medium enterprises as they can more easily gain access to production inputs such as credit and land. Reducing such barriers (expressed in cumbersome, time-consuming and expensive procedures to register a firm) is an essential element to promote markets and private sector development and, in general, to improve the investment climate in a country. Donors can play a significant role in this, not least by providing international comparisons of the level of barriers.

6.2.5 Ambivalent views on the informal economy

Governments in developing countries tend to have an ambivalent view of the informal economy, because recognising this part of the economy would undermine the regulatory or legal frameworks for business. Often these operators are ignored, discriminated against or actively harassed in order to close them down, for example in slum clearance programmes. Nevertheless, since the 1970s, donors and NGOs have showed interest in the informal economy, devising various contributions to support it. These include training programmes for entrepreneurs, technical assistance for informal enterprises, and credit schemes. Increasingly such programmes are also accepted by governments. Perhaps the most significant and wide-spread scheme of this type is micro finance, which today has over 50 million clients, of which the vast majority are in the informal economy (see further below). Another significant programme spread to many countries is the ILO operated *'Start and Improve Your Business'* programme (SIYB), which provides business training for informal sector entrepreneurs and would-be entrepreneurs in some 60 countries. See further section 11.3.3.

Recently, donor agencies have given greater attention to the informal economy, triggered by the fact that the informal economy is not only resilient but, in fact, is increasing in importance in many parts of the developing world. With the downsizing of governments and the public sector in many developing countries during the 1990s, the informal economy has become a survival strategy for many laid-off formal sector workers.

The most effective support for the informal economy is indirect. If donors can assist countries to accelerate growth provided by the formal sector, the informal economy would benefit. The informal economy, apart from businesses such as illegal border trading, is domestic and local. It is dependent on the local purchasing power of both the rich and the poor as it supplies goods and services to both groups.

6.2.6 The role of donors

To support the informal economy as an element of pro-poor Market and PSD, donors can:

- Promote enhanced growth in general in the economy. As discussed above, such growth will also spill over into the informal economy by creating market opportunities, and sometimes trigger an interest in informal entrepreneurs to join the formal sector in order to expand their businesses.

- Assist, or more likely put pressure on, governments to streamline the regulatory framework for business in order to reduce the costs incurred by small enterprises in becoming formal. As discussed above, the regulatory burden is a major reason for informal enterprises to remain informal. The reason why donors might need to use pressure is that there is often a reason for entry barriers from a political economy point of view. The more cumbersome the entry regulations are, the greater the opportunities for rent-seeking by those enforcing the regulations, whether at high or low levels of government.

- Address property rights of assets essential to the informal sector, such as urban housing.

- Assist governments in eliminating all kinds of gender discrimination in (formal) business.

- Support efforts to spread sustainable micro-credit programmes, the only successful major model for non-collateral small-scale credits to informal economy operators.

- Support selected programmes for training and capacity building of entrepreneurs. Gender-specific training might be a strategy to tailor-make support to address gender inequalities.

6.3 Modernisation as the Long-term Solution

It is important to note that neither of the markets discussed above will solve the poverty problem in the long term. First, development is a question of modernisation, transforming societies from primary production into manufacturing and services. All historical evidence of development shows that agriculture has a diminishing relative share of an economy, both in terms of its share of GDP and of employment While some countries like Denmark or New Zealand may specialise in and prosper from agriculture for export as a successful development strategy, if all the countries dominated today by agriculture did so, it would not work.

Second, the informal economy is to some extent a reflection of failed development. It is to a large extent a depository of people who are not absorbed in gainful, productive formal sector employment, whether public or private. Due to its informality, and as so many are dependent on it, it is highly dynamic, adaptable and resilient. However, it is an economy generally characterised by low returns, low ability to enhance productivity, and poor, sometimes appalling, working conditions. It is outside the taxation system and does not contribute to government budgets. In many cases the informal economy actually undermines such budgets, for example by diverting border trade to smuggling. It is also not always easy to draw a line between what is an ‘acceptable’ informal economy, and what is morally despicable. However, the dichotomy formal-informal also has a lot to do with rules that apply to the formal sector. In many countries overly cumbersome regulations and laws, corrupt and/or inefficient regulators, and protective instruments have created the division. Thus, the problem is as much related to the formal system as to the informal.

Introducing a Systems Approach to Market and Private Sector Development

CHAPTER 7

7.1 Meta, Macro, Meso and Micro Level Dimensions

The discussion so far has made it obvious that the functioning of markets and the private sector depends on a number of broad conditions in society, which establish an 'enabling environment' in general, and provide the incentives – or disincentives – for economic activities. It is also the character of the environment which determines how effective markets and the private sector are in their contribution to a poverty-free world. For the purpose of analysing this environment, and the potential role of a donor, the following structure is applied[7]:

- The meta-system, or the international environment: global markets in trade and finance, international technology and innovations crossing borders, and related international agreements. This is the setting in which countries and their commercial players operate. Donors are a part of this meta-system.

- The macro-system: 'institutions' in the meaning of 'rules of the game' in a specific country. It includes everything from overriding conditions in a society such as peace and stability, the rule of law, and governance, to more specific institutions governing the economy, such as macro economic policies, property rights, and the many laws and regulations specific to the private sector.

[7] This structure is applied, in a slightly different form, in an evaluation report to Sida, which triggered the development of a Private Sector Development Policy for the organisation. See further Sinha, S. et al (2001).

- The meso-system: resources, or 'capital' required for business operations in such financial systems, physical capital in the form of infrastructure and human resources.

These systems will impact on the micro level in a specific country, i.e. the market players in the form of commercial enterprises in the formal and informal economy, whether micro, small or large. Some of these conditions can only be changed over a long period of time, while others are more short-term, an important aspect in the actions of governments and in the sequencing of support by donors.

7.2 Interacting Systems

These systems interact. Conditions at the higher level of these systems tend to set the parameters at the lower level. Efforts to solve problems at a lower level might be fruitless if the higher system levels create hindrances. Higher system opportunities might trigger development at a lower level.

However, the reverse also applies: by their actions, the operators at the micro level determine and shape the resources of a society, influence the macro policies, and also the international meta system.

In a donor perspective, the analysis of the functioning of the different systems in respect of the market and the private sector is critical for the design of effective and meaningful interventions. Too often in the past, donors have been active in providing all kinds of support to the private sector at the micro level, in situations where market and private sector development had little chance to take place as the incentive structure in the society was all wrong due to prevailing policies. (See Box 15).

Box 15. Interacting Systems – a Case from Tanzania

In the 1970s and early 1980s donors provided considerable levels of technical assistance to Tanzanian enterprises to make them succeed on export markets. The results were very meagre. At the time, the Tanzanian shilling was over-valued by a factor of 20 or more. Exports were basically doomed due to the exchange rate policy.
(Lindahl and Ulfsax 1985).

Similarly, donor assistance focusing entirely on creating the 'right' policy environment for economic growth has sometimes been quite disappointing in terms of private sector response, as too many other obstacles limited the incentives for economic activities. Thus, a holistic approach is required which makes it possible to identify where scarce donor funds can be most effective, and in which order.

In chapters 8–10 these systems will be further discussed, and options for donor support proposed.

The Meta System: the International Environment

CHAPTER 8

8.1 Global Technology and Innovations

8.1.1 New technologies as an engine for modernisation

It could be argued that it was the scientific and industrial revolution in the 18th century which made the dramatic shift in development in Europe and North America possible, and which has paved the way for unprecedented wealth and reduction of poverty in a large part of the world today[8]. The catching-up by many poor countries in recent decades at a faster speed than ever before is based on the fact that these countries have leapfrogged development through the application of largely imported technologies in agriculture, manufacturing, infrastructure and services, and participated in a global division of labour and production. Today poor countries have access to the most recent technologies of the most advanced economies in the world. The ability to emulate, copy and utilise these technologies is the basis of growth and the creation of wealth at national and individual level. It is also the underlying reason why key human quality-of-life indicators such as longevity and child mortality rates have improved so much more dramatically in developing countries than they did at the time when the industrialised countries developed. The opportunities available for latecomers are shown in data: the best performing of the Western nations doubled their GDP per capita (in real terms) in about 50 years when they began industrialising in the 19th century. Japan did it in little more than 30 years in the beginning of the 20th century. The NICs such as South Korea, Singapore and Taiwan proved that a very rapid pace was possible by doubling their GDP per capita in just over 10 years in the 1960s and

8 While this is a common view, modern institutional economists, such as Douglass North, rather focus on the underlying conditions which created the industrial revolution, i.e. conducive institutional arrangements.

1970s, a pace that also applies to countries such as China and Vietnam in the 1980s and 1990s (Myers 1996).

8.1.2 Pro-poor technologies

Global technologies not only allow rapid economic growth through copying mechanisms. Many of these technologies can also be considered pro-poor in the sense they have particular direct relevance for the poor. The development and spread of High Yielding Varieties for grains dramatically changed the conditions of the poor in countries such as India, both as consumers and producers (see, for example Fan 2002). A continent which was used to regular famines became self-sufficient and a major exporter of grain in less than a decade. Some argue that the current developments in bio-technology in the laboratories of the Western world, including the controversial gene-modification, can be a new spur for a new major push in poverty reduction, a 'Gene Revolution'. The development of low cost pharmaceuticals such as antibiotics, available to large proportion of people living in developing countries, including the poor, either through public health systems or over the counter, has meant a dramatic change in life-quality in the sense of reducing ill health or death from common diseases. Over time, it is likely that it will be possible to prevent today's plague, HIV/AIDS, with a vaccine at a reasonable cost, which will benefit millions of poor people all over the world. Dramatic reductions in transport and communication costs through technological development have meant that manufacturing and services can be located almost anywhere in the world, and that firms search for low-wage locations. A process of this type benefits the poor by providing new sources of employment. Micro finance is an innovation that is tailor-made for poor people, and especially women – an innovation which has spread from its origin in Bangladesh to the whole world (see further section 10.1).

8.1.3 Appropriate technologies

Catching-up, however, is often not a simple process of copying. The ability of countries, enterprises and individuals to apply modern technologies depends on a number of pre-conditions: skills embedded in education, an appropriate infrastructure, the organisation of society, policies and attitudes, and not least that the technologies make sense in a local environment. For example, industrial technologies are often driven by a concern for factor costs, such as reducing costly labour, making them of little relevance to low-income countries. Transfers of technologies from rich to poor countries contribute to the extreme dualism visible in all poor countries: a modern, urban-based sector for the well-to-do with all the technologies of the industrialised countries, side by side with people using technologies not much different from those available a thousand years ago. Some countries have been able to absorb a rapidly increasing share of the population into the modern sector by using up-to-date technologies. However, in too many countries the dualism is becoming greater, with the majority largely left outside, frequently living on the scraps of the modern sector.

As the technological sophistication of the industrialised countries increases, the market reasons for them to address technology issues of the poor diminish. The gap in the use of modern technology between rich and poor nations is much wider than income differences would indicate (see Box 16).

Box 16. Difference in Technology Use

In many industrialised countries the rate of use of personal computers per 1000 inhabitants is 300 or above, while in many of the least developed countries it is less than 1. The number of mobile telephones per 1000 inhabitants is over 700 in many of the rich, and almost zero in most of the poorest. Electricity consumption (Kwh) per capita is over 20,000 in some industrialised countries while it is below 100 in most poor nations.
(UNDP 2003, World Guide 2002).

'Second-hand' technologies can sometimes be a solution and are often applied. But there is stigma attached to this, and there are no well-developed market mechanisms for broad-based second-hand technologies. A further issue is that research and development is increasingly being privatised and carried out in large enterprises. The companies have an interest in monopolising new technologies to capture the benefits of innovation, such as bio-technology, with the consequence that the technologies, at least in the short-term, will not be affordable by the poor.

8.1.4 The role of donors

Donors can assist partner countries and the ability of their private sectors to exploit international technologies and innovations, and to stimulate technologies directly beneficial to the poor, in different ways:

- In the long-term, the foundation of the capacity to participate in the global technology exchange is through education. Basic education is essential for broad-based assimilation, as is higher education, especially in subjects such as agriculture, engineering, natural science and technology; and management-related sciences are important for more advanced local entrepreneurship and business development.

- Openness in societies in respect of trade, foreign investments, information and exchange of ideas is the means by which technologies spread. To a large extent, they are embedded in government policies, as well as in infrastructure.

- Support and promote the exchange of new technologies that particularly benefit the poor. For example, donor support for the NGO-led development of micro finance since the 1970s has meant a dramatic change in access to finance by the poor, and by poor women in particular, all over the world.

- Support research and development of technologies of particular importance for the poor. R&D efforts can be applied to numerous fields of private sector development of direct relevance for the poor. This, however, would require joint efforts by donors in order to muster all the financial resources required.

- Stimulate global industries to develop and disseminate relevant technologies for the poor, for example in preventive and curative health (such as malaria control, HIV-treatment), in Private-Public Partnerships.

8.2 Information Technologies

8.2.1 The promise of a revolutionary technology

The information age revolution, manifested in the mass use of personal computers, mobile telephones and the Internet, is dramatically changing the economies of the industrialised countries. It also promises dramatic changes in developing countries. Already mobile telephone systems are circumventing poorly functioning fixed-line telephone systems, since the technology requires far fewer investments in infrastructure, and the systems are supplied outside the traditional public sector monopolies. There are numerous examples of ways in which mobile telephone systems in rural areas in poor countries in Africa and Asia are creating dramatic changes in the information available, for example to small producers, making them much better linked to relevant commodity markets. The mobile phone system is also the form of infrastructure which is best suited for private sector supply among infrastructure services, which has triggered more rapid development at lower costs, due to competing private multinational suppliers, than if the same services had been provided by governments. The Internet is completely revamping access to information, reducing the cost of information, and also creating the means of supplying information to poor producers. These forms of evolution are based on existing technologies, designed mainly for advanced economies, but a process of adapting the new technologies to developing countries, and to the needs of the poor, is taking place, using methods such as Intranet kiosks, etc (World Bank 2002).

The potential benefits to the poor of the new information technology include the following:

1) IT reaches poor people as consumers, providing new services to them such as cheap telephone services;

2) IT helps poor producers by bridging information gaps, providing up-to-date market information; etc.;

3) IT assists and creates various markets through which developing countries can speed up their economic growth, and thus indirectly provide benefits to the poor. Service industries using information technology are being outsourced from industrialised countries to developing countries, for example call-services, software production, etc., creating new export-oriented markets in many poorer countries;

4) IT creates in itself new 'information markets' for e.g. advocacy, political action by NGOs, civil society groups, political parties, etc., which can benefit poor people.

8.2.2 The role of donors

Donors can support the process of enabling the poor to benefit from the information technology revolution by:

- providing assistance for the adaptation of IT to the needs of the poor. There are numerous efforts of this type currently being made by local NGOs;

- supporting efforts to create awareness and to train people in developing countries to use the new technologies;

- supporting government institutions which enable information technologies and technology providers to operate and spread. Examples of this are regulations for mobile phone systems operators, Internet servers, etc.

The modern technologies of information, such as the Internet and mobile telephone systems, are revolutionising access to information, including access for the poorest nations. Reforms of monopoly systems for such communications can dramatically reduce costs and increase access, which can be used by the poor in their day-to-day life and their business activities (see Box 17 for an example).

Box 17. Breaking Inefficient Telecom Monopolies through New Technology and Market Liberalisation

In 1997, Bangladesh had one of the lowest telephone densities in the world with only 0.26 lines per 100 people. The waiting time for a fixed connection was more than 10 years, and the installation charge of US$450 for a new fixed line was one of the highest in the world. The technological developments in the telecom sector combined with liberalisation have made it possible for Grameen Telecom and other newcomers using new technology to introduce mobile services in rural areas. A potential user can now simply walk into a Grameen Phone office and walk out in half an hour with a phone that works. Grameen is also involved in making the technology available to the poor through collective use. Similar dramatic changes are taking place in other liberalised telecom markets such as in Uganda and in Nicaragua.
(Lindahl, 2005).

8.3 International Trade

8.3.1 The importance of trade

International trade flows have increased dramatically in the last three decades. Developing countries have increased their share of exports, accompanied by a change in the composition in their exports from primary commodities to manufactured products. However, many countries have not taken part in this integration process and have experienced a decline in their share of world trade. Indeed, the export share of the 50 least-developed countries dropped from 3% in the 1950s to less than 1% in the early 2000s (www.un.org.int, March 2005).

There is a broad consensus among economists that those countries that have integrated into the world economy through trade have enjoyed higher economic growth. The successful NICs all applied aggressive export development as a cornerstone of their development strategies in the 1960s and 1970s, first in labour-intensive manufacturing and later in increasingly sophisticated exports. On the other hand, countries such as Tanzania, which applied a strong import-substitution and self-reliance strategy in the 1970s and 1980s, slid during this time to become one of the poorest in the world. The theoretical explanation for this is clear: a country's trade policy is an important instrument for channelling price signals from the world market to the national economy, thereby allowing resource allocations consistent with comparative advantage and increasing productivity.

Recent research is also shedding light on the importance of imports versus the past focus on exports. Imports put pressure on the domestic sector to increase its efficiency, and to weed out poorly performing operators. Imports provide an inflow of technologies as discussed above, besides providing welfare gains as price levels are reduced relative to protected domestic production (Stiglitz and Yusuf 2001). However, dogmatic approaches to trade might not be the most effective approach. Countries successful in achieving growth, such as the NICs, have often applied asymmetric policies in terms of protection of certain parts of their economies. Also, today's industrialised countries had much more protectionism at critical stages in their development than is commonly assumed (Chang 2002). Certain vulnerable segments of society, such as smallholder producers for the domestic market, or operators in the informal economy, can be affected particularly negatively by rapid liberalisation.

Many developing countries have been impeded in their efforts to take advantage of the global economy by inadequate policies, institutions, and infrastructure. Their efforts have also been frustrated by the protectionist measures of developed countries, including:

- high tariffs on products of special interest to developing countries (agriculture, textiles and clothing);

- a tariff system in which the rate increases with the degree of processing (so-called tariff escalation), hindering the development of industries in developing countries;

- import quotas applying to textiles and clothing (up to year 2005 when such quotas were ended);

- large amounts of subsidies (mainly agricultural) in industrialised countries;

- stringent technical, sanitary and phyto-sanitary measures which can hinder the export potential of poor countries.

8.3.2 Industrial country double standards

While developing countries have liberalised and opened their economies, the rich countries have maintained protection of important domestic markets, especially those where poor developing countries tend to have their strongest comparative advantage, such as in agriculture and textiles. Agriculture in the OECD is subsidised by over USD 300 billion, or more than six times the total level of ODA (Hoekman et al 2002). As a result, rich markets are closed to developing countries, and farmers in the wealthy nations can sell their produce at highly subsidised prices in the poor countries, thus undermining local markets and producers. Donor countries are faced with the critical issue of double standards in terms of economic reforms and private sector development.

8.3.3 Pro-poor trade

The poor are often directly involved in certain segments of international trade as producers, and most of them are affected as consumers. Many export-oriented commodities such as coffee, cotton, spices, as well as exported food crops such as rice, are predominantly smallholder crops, involving millions of tenants and agricultural labourers. The policy framework for such trade is critical. In too many countries, such trade has been discriminated against through export taxes, overvalued exchange rates, and monopolistic trading arrangements that have undermined whole sectors. Women dominate certain agro-based exports in many countries, both as farmers and farm workers. They therefore depend on conducive environments for such trade. Reforms of export-oriented agriculture, for example by eliminating export taxes, facilitating the physical transport of these commodities, and liberalising of export marketing (such as abolishing monopoly marketing boards) are often clearly and sometimes dramatically pro-poor as was shown, for example, in the reform of Uganda's coffee sector in the 1980s and 1990s. Opening up international trade in non-traditional agricultural products in which the poor can be producers, as has taken place in respect of flowers, fresh fruits and vegetables, etc., tends to have a clear pro-poor dimension.

In countries pursuing openness to trade, labour-intensive, export-oriented manufacturing dominates in the first stages of industrialisation. This provides formal sector employment, primarily for women, often triggering empowerment in oppressive family structures.

Trade is an important means of livelihood for people in border regions, who often belong to the poorest strata. Excessive tariffs, bureaucratic and corrupt customs officials, non-supportive infrastructure, and cumbersome procedures and exchange mechanisms either thwart such trade or send it underground. Liberalising border trade has a clear pro-poor dimension.

8.3.4 The role of donors

Donor countries should support partner countries to become more competitive in international trade which directly and indirectly benefits the poor by:

- improving market access through the multilateral trade talks taking place within the framework of the WTO (World Trade Organisation), ensuring that the new round of trade negotiations achieves a pro-development outcome;

- promoting the importance of trade as reflected in government policies and regulations, including analysing the constraints in the trade sector in specific countries;

- strengthening trade policy expertise and analytical capability in the partner countries, with a focus on the WTO rules;

- reinforcing partner countries' trade-related infrastructure to enable countries to live up to the requirements of export markets in respect of standards and quality (with links to the WTO agreements on technical barriers to trade, and sanitary and phyto-sanitary measures);

- supporting countries to develop skills and resources in trade promotion both in public sector and private sector organisations; and

- assisting countries in reviewing the effects of changes in trade regimes on different poor groups.

The specialised agencies in the donor community in terms of trade development are the WTO, UNCTAD, ITC, and the World Bank group. Bilateral donors, such as Sweden, have, nevertheless, certain comparative advantages in supporting partner countries in trade development.

8.4 Foreign Investments

8.4.1 The most important source of external capital

Foreign Direct Investments (FDI) in developing countries, in the order of USD 150–200 billion per annum, outstrip current official development assistance by a factor of 3–4 (Mistry and Oelsen 2002). Not only is FDI a significant source of capital, it also tends to come with essential development inputs such as technology transfer, modern management and organisational techniques, productivity, market know-how, and access to developed economies. As a result, the earlier scepticism towards FDI in many developing countries has changed and today most of these countries compete with various benefit packages to attract FDI. However, FDI is selective. It flows to countries perceived to offer the best business opportunities, with low political risks. Hitherto, a handful of countries have received the bulk of FDI, of which China is the clearly the most important since the 1990s. Yet, LDCs get more or less a commensurate share of FDI, and some of them such as Cambodia, Vietnam and Tanzania have ranked high on FDI per GNP. However, many poor countries, especially in Africa, tend to attract FDI for the extraction of minerals, oil, etc., in what has been described as 'low development, low-quality FDI, i.e. investments in enclaves with few links and little impact on the rest of the economy. (Mistry and Oelsen 2002).

FDI is not only a flow from rich 'North' countries to the poor 'South', but increasingly a South-South pattern. In Asia in particular, the major source of FDI is regional. The concept of the 'flying geese' has been used to describe how a more advanced economy out-sources production to one nearby with lower production costs which, in turn, after growth and increasing production costs, outsources to the next one nearby with lower costs.

8.4.2 Pro-poor FDI

The relationship between FDI and poverty elimination has been studied by, amongst others, the World Bank (Klein 2001). A review of the issue concluded that FDI is beneficial as a means for poverty reduction under conditions of fair competition and a transparent and fair regulatory framework. FDI opens up sources of employment, often of a higher quality than in the domestic sector. FDI in agro-processing can have direct effects on the rural poor through systems of out-growers or by increasing the demand for agricultural labourers. In some countries export-oriented FDI in garments, electronics, and shoes has had a significant effect in providing mass employment, mainly for poor women.

The ability of a country to attract FDI is a good indicator of its competitiveness in a global context. The direction of such FDI is also an indication of the sectors in which countries have comparative and competitive advantages: whether FDI dominates in export-oriented labour-intensive manufacturing or services due to low labour costs and good labour productivity; or whether it is prevalent in natural resource exploitation in the form of mineral extraction, agriculture or tourism. The latter form of FDI is linked to a perception of 'ugly foreign businesses', and there has been, and still is, a great deal of abuse. It should be stressed, however, that such investments are not per se of 'low quality' or 'inferior quality', with less potential to trigger development, or even less poverty-reducing. It is rather the policy framework under which such investment takes place which matters: whether these frameworks provide incentives for the ruthless exploitation of humans, resources and the environment; or whether the frameworks are such that the economic benefits are ploughed back into the economy in a way which benefits development in general and the poor in particular, without detrimental consequences to the environment.

8.4.3 The role of donors

Donors can assist developing countries in attracting FDI which is beneficial for poverty reduction through different means:

- As a long-term measure, attractiveness to FDI parallels the overall business and investment environment in a country. It depends on a host of development efforts such as regulatory frameworks, governance, political stability, productivity of labour, educational standards and infrastructure. As FDI is more sensitive to such factors, gauging attractiveness, or lack of attractiveness, to foreign investors is a good proxy of key constraints in these environments, which can influence the sequencing in the development agenda for PSD.

- Assist countries in reducing and eliminating constraints to FDI, for example embedded in policies concerning 'sensitive sectors' such as finance.

- Assist countries in strengthening their voice and role in the development of the WTO rules concerning FDI, the so-called Trade-related Investment Measures (TRIM), so that legitimate developing country concerns are placed high on the agenda.

- Help countries in formulating effective policies, regulatory frameworks and the execution of such frameworks concerning FDI, especially in natural resource exploitation, including tourism, so that a) benefits accrue to the poor; and b) the environment is protected.

Donors have various instruments to assist developing countries in the promotion of foreign investments, for example through multilateral organisations such as the International Finance Corporation (IFC) and technical assistance provided through the World Bank-related Foreign Investment Advisory Service (FIAS), and risk insurance companies such as the Multilateral Investment Guarantee Agency (MIGA). In Sweden, Swedfund plays a similar role to the IFC, and the Swedish Export Credits Guarantee Board (EKN) provides export credit and investment insurance.

The open or hidden subsidy element in direct investments in commercial enterprises is a subject of controversy. There are clearly risks for 'sub-standard' investments, and distortions by a public sector subsidy element in commercial FDI in developing countries. Thus, public sector organisations involved in direct investments or credits to foreign investors should apply market rates of return, so that clear externalities through such investments can be demonstrated.

8.5 Emerging Universal Institutions and Public Goods

8.5.1 Towards global governance

In a globalising world a number of values, norms, rules and policies accepted by all or almost all nations are emerging. These might be called 'universal institutions'. Many of these are expressed in international conventions and declarations ratified by a large number of countries usually under the umbrella of the United Nations. These universal institutions are of relevance for market and private sector development as they form value systems under which the private sector operates, for example against child labour, discrimination based on race and gender, and for sustainable use of the environment. Of special relevance for the private sector are various conventions on labour rights (see Box 18).

Box 18. Labour Rights Conventions

(In brackets number of countries which had ratified the convention by 2003.)

- Freedom of association and protection of the right to organise (141)
- Rights to organise and collective bargaining (152)
- Abolition of forced labour (157)
- Equal remuneration (160)
- Discrimination in employment and occupation (157)
- Minimum age (121)
- Worst forms of child labour (131)

(UNDP 2003).

In recent times, there has been a tendency to seek a stronger partnership between the public sector and, in particular, the multinational enterprises in order to apply and enforce these universal institutions. The Global Compact is a UN initiative in which the Secretary General has challenged companies to embrace and enact nine principles relating to human rights, labour and the environment (www.unglobalcompact.org). A similar initiative was taken in 2002 by the Swedish government, called the Swedish Partnership for Global Responsibility, with the objectives of making Swedish enterprises ambassadors of human rights, and of promoting decent economic and social conditions and a good environment at home and abroad (www.utrikes.regeringen.se/ga).

8.5.2 Corporate Social Responsibility

One element of the emerging universal institutions is what is generally referred to as Corporate Social Responsibility (CSR), a term used to define extended behavioural norms or codes of conduct for business in terms of social responsibility for the workers, the community or the environment, in addition to what is required by law. While morals or philanthropic motives among business leaders should not be dismissed as a driving force, corporate social responsibility is increasingly essential for business as it adds to image building, reduces the risk of consumer action in the market place, the risk of strikes, and the risk of punitive actions by civil society groups. It may also create added value amongst investors. International NGO activists have been in the forefront in putting pressure on transnational corporations to accept their social responsibilities in a number of fields such as labour rights, child labour, human rights, environmental standards, and fair trade. Civil rights group activists have also put pressure on these enterprises to check conditions for local suppliers and sub-contractors, hence triggering improved conditions in local industry.

While the enforcement of these institutions tends to be weak, as the world community has no system for effective enforcement, their effectiveness depends on the adherence to them by individual countries, governments and private operators. An important function of such institutions is that they promote values, i.e. over time countries and enterprises are likely to be less inclined to break such conventions in order to avoid being ostracised in the international community (see Box 19).

Box 19. Corporate Social Responsibility

A system of CSR is embedded in the OECD Guidelines for Multinational Enterprises, see www.oecd.org. An interesting international initiative in this context is the Global Corporate Governance Forum (see www.gcgf.org).

8.5.3 Global public goods

An increasingly important 'meta system' for the private sector is what is commonly labelled global public goods (GPG). Global Public Goods are defined as goods whose benefits reach across borders, impact on a large number of people, and have an impact over several generations. Examples of global public goods are:

- environmental protection, such as minimising climate change, reducing pollution, protecting biodiversity and defending global commons (such as the seas);
- prevention of communicable diseases which easily cross borders such as HIV/AIDS, malaria and tuberculosis;
- knowledge, for example scientific results which the global community benefit from, as well as basic skills which tend to become global goods due to increased migration;
- peace and security, as wars and conflicts have implications far beyond the borders of the combatants; and
- global governance, for example financial and overall international economic stability.

Markets tend to under-finance these public goods, and therefore they require public interventions which go beyond borders. Such international public interventions require binding international agreements on institutions and/or funding. From a private sector perspective, GPG both implies an emerging international regulatory framework and new incentive/disincentive systems. A source of information for the development of global public goods is the Global Network on Global Public Goods: www.gpgnet.net.

8.5.4 The role of donors

Donors can support the universal institutions and global public goods relevant for business by various means:

- Applying them in action, for example ensuring that enterprises participating in donor-funded activities aimed at PSD fulfil the conventions. These should also include local or international contractors that undertake investments funded by donors.

- Supporting international efforts to develop such universal institutions (see Box 20).

- Assisting countries to develop systems to monitor and enforce adherence to conventions relevant to business.

Box 20. An Initiative on Global Public Goods

Sweden, France and the UNDP have established an international task force with a mandate to foster an enhanced provision of international public goods, which are of critical importance to achieving the Millennium Development Goals (MDGs), notably the objective of reducing poverty.
See further www.gpgtaskforce.org.

Macro Level: Institutions of Society

CHAPTER 9

9.1 Institutions as an Overriding Determinant of Growth

Under the influence of economists such as Douglass North, institutions defined as norms, rules and other structures of social behaviour have emerged in development economics over the last decades as the overriding factor that explain long-term development processes, especially economic development (see Box 21).

Box 21. The Role of Institutions

"Efficient economic organisation is the key to growth. The development of an efficient economic organisation in Western Europe accounts for the rise of the West. Efficient organisation entails the establishment of institutional arrangements and property rights that create an incentive to channel individual economic effort into activities that bring the private rate of return close to the social rate of return…If a society does not grow it is because no incentives are provided for economic activities"…
(North and Thomas 1973).

Institutions of relevance for private sector development encompass many things, from the overall conditions of peace and stability, national policies, and norms and laws promoting and regulating the market, down to specific institutions such as auditing and accounting principles. Institutions are generally developed over the long-term and are a result of historical processes. In many developing countries, colonialism strongly influenced the emergence of institutions, especially as 'modern' institutions were introduced to replace the 'traditional'. An important element of this is to determine what are 'good' institutions and what are 'bad'. Historical evidence seems to indicate that there are no strong reasons to believe that societies automatically gravitate toward 'good' institutions (Acemoglu 2003). The vested interests of power groups benefiting from a set of 'bad' institutions can prevent change and perpetuate the existence of such institutions.

9.2 Peace and Political Stability

9.2.1 A vicious circle of poverty and war

It is no coincidence that the majority of the poorest nations of the world either are involved in a conflict or have recently emerged from a conflict. From an economic point of view, conflicts increase costs and uncertainty, thus discouraging investments by both nationals and foreigners. Wars, conflicts and civil strife also steer business activities to criminal and socially non-desirable areas such as the arms trade, drugs, and the criminal exploitation of natural resources such as oil and precious minerals. In many countries civil wars might be fuelled and maintained in order to continue such criminal business ventures. There are strong economic reasons possessed by certain groups, sometimes including governments, for avoiding peace. The pattern of development in large parts of west and central Africa is a case in point. Recent research indicates that conflict tends to emerge in countries with weak governments, unable to control interest groups which gain from turmoil and conflict.

Conflicts and stagnating or perverted economic activities tend to form vicious circles, whereas a state of peace, stability and order tends to lead to substantial dividends in terms of economic growth through reconstruction and private sector development. Growth also improves conditions for peace and stability. The risk of the resumption of conflicts is clearly higher in stagnant or declining economies, than in dynamic economies. Getting the economy through reconstruction and effective PSD post-conflict are thus critical for peace-building. Business development might also be a way of building bridges to former enemies. There is less likelihood that countries which are engaged in mutual business and trade start violent conflicts. This was an underlying hypothesis for the formation of the EU, and is applicable elsewhere.

9.2.2 Pro-poor conflict resolution

Today, conflicts tend to be a domestic problem rather than a cross-border problem. Not only are conflicts predominant in the poorest nations: within countries, the poor also tend to be the prime victims of wars, conflicts and civil strife, not only from the human perspective, but also economically. Smallholder agriculture and livestock farming are major economic victims of war due to mine infestation, destruction of land, killing of animals, destruction of access to markets and supply chains of inputs, and the confiscation of productive resources by warring factions. Women and children tend to be the most vulnerable. Children are sometimes abducted and used as soldiers; and women in war zones are subject to rape and abuse. The poor have the fewest opportunities to escape conflicts and often become internally displaced persons, receiving least attention by refugee organisations. Conflict resolution is almost by definition a pro-poor strategy. Restoring peace, which allows local markets to return, local production to be resumed, and reconstruction to take place, benefits the poor.

9.2.3 The role of donors

Donors can do a number of things to promote a virtuous circle of peace, stability and business development, and to break the vicious circle, thereby also paving the way for market and private sector development. For example:

- donors should be aware of the fact that poor or negative growth can be an early warning signal of civil strife and conflict in society; it is easier to prevent conflicts from breaking out than ending conflicts;

- conflicts might be initiated or fuelled by disputed or non-enforced property rights and economic discrimination, hence requiring institutional development and policy changes as a preventive measure;

- ending conflicts might require cutting off the revenues from illegal business activities, or the business of warring factions, which might require tracing the trading routes, and working for political action to close such trade;

- humanitarian assistance is easily siphoned off for illegal business purposes in conflict scenarios, hence often requiring protection by force;

- in the reconstruction phase, donors should rely on local entrepreneurship and businesses, rather than on imported materials, housing and food (see Box 22);

- donors should sequence their support in such a way that in a post-conflict scenario kick-starting local business and economic activities is given high priority in order to create employment and to channel energies into productive use.

Box 22: Humanitarian Assistance and PSD

Reflected in the concept of *Do no harm,* there is a growing practice in donor humanitarian assistance that activities in the field during an emergency should not undermine local efforts and their coping capabilities, for example the local market, by importing grain or using foreign transporting companies. Instead local service providers and institutions should be used. An added value is that purchasing locally produced food staples does not distort the market. The point is that a) local initiatives are generally quite capable of effectively responding to emergencies; and b) a long-term local coping capacity should not be destroyed through massive support from the outside, but should be maintained and enhanced.

Donors are increasingly working in countries which lack functional government due to a conflict or a post-conflict situation. Working with the existing or emerging business community might be an effective method for peace-building or reconstruction in such cases, requiring the development of new, unorthodox methods of development assistance.

9.3 Macro Economic Policies

9.3.1 Sound macro-economic policies as a fundament

Sound macro economic policies, manifested in the form of low levels of inflation, a realistic exchange rate, and low budget deficits are today well-established principles for both developed and developing market economies and a basis for an 'enabling environment', critical for growth, market development and effective PSD.

Since the 1980s, donor countries have been active in macro economic reforms led by the World Bank and the IMF. Much has been achieved in weeding out serious mismanagement. However, the structural adjustment reforms have also had shortcomings. One explanation is that the reforms underplayed the importance of basic institutions. Today there is evidence that reform processes require a much longer time for basic institutions to change than what is usually implied in, for example, donor-supported IMF/World Bank loan conditions (Rodrik and Subramaniam 2003).

Most donor countries have supported macro economic reform processes since the mid-1980s, in the form of both balance of payments support and general budget support. Such financial support tends to be co-ordinated with the efforts of the World Bank and the IMF, and is aimed at the poorest and most heavily indebted countries, as under the Heavily Indebted Poor Countries (HIPC) initiative.

9.3.2 Macro economic policies for pro-poor growth

Sound macro-economic policies are not only a determinant of economic growth, they can also be considered to be a precondition of pro-poor growth. The major victims of poor macro economic policies (e.g. high inflation, unrealistic exchange rates) tend not to be the rich, but the poor. Serious macro economic mismanagement in the past, especially in Africa, had a negative effect, particularly on peasants and farmers, by distorting both domestic and export-oriented agriculture in a negative way. Price controls on domestic markets, such as on food, generally benefited a limited number of urban dwellers and punished large numbers of rural producers. Considerable government subsidies of loss-making parastatal industries benefited some formal (not so poor) workers, but the subsidies came at the expense of reductions in public services such as health and education, and had a severe effect on a large number of poor people.

9.3.3 The role of donors

The role of donors in terms of getting the policy framework right is often critical as a precondition for all other types of market and private sector development and should be undertaken prior to interventions with a micro focus. However, as discussed above, a focus that is too dogmatic and too narrow, based on a set of blue-print policy recommendations, can be counterproductive. Policy reforms need to be country-specific, sensitive to political processes, and also to the likelihood that the private sector is ready and able to respond to changed policies. If not, there is a need for strong simultaneous efforts to reduce the constraints of the private sector. The latter must be able to deliver the benefits assumed from reforms within a limited time frame in order to avoid the policies being reverted for political reasons. Policy reforms also need to be sensitive in their effects on the poor, and the businesses of the poor, carefully balancing ‘short-term pain for long-term gain’, with the risk of political backlashes. Reform processes which are based on broad-based consultation in society seem to have better chances than those imposed on countries from the outside.

9.4 Laws and the Regulatory Framework

9.4.1 The dual importance of laws and regulations for business

The legal and regulatory framework of a nation is critical for economic growth, a healthy market and private sector development, from two basic points of view.

1) The conditions of 'rule of law' set the parameters for players in the economy, the willingness of local and foreign investors to invest and their investment choices, and their behaviour in general.

2) There are specific regulations governing the market and the private sector. The most important are commercial laws, property laws and contract laws, essential to the 'cost of doing business', and for the interplay between business, government and civil society. As economies develop, specialised laws for the market tend to increase in number (see Box 23).

Box 23. Examples of Laws Directly Relevant to the Private Sector and the Functioning of Markets

- Property laws
- Contractual laws
- Commercial law
- Company law
- Accountancy law
- Banking law and financial market laws
- Stock exchange law
- Laws concerning property rights
- Intellectual property rights law
- Laws of association
- Credit legislation
- Insurance laws
- Bankruptcy law
- Laws concerning competition, including anti-trust laws
- Laws concerning compensation for damage
- Rental laws
- Laws concerning consumer safeguards
- Labour laws, minimum wage laws, working safety laws
- Laws concerning environmental protection
- Taxation laws.

Lawlessness in society is bad for business. Businesses in lawlessness environments tend often to be bad for society. A vicious circle is created. While establishing rule of law is a task with broader objectives than the economy, such as establishing conditions for human rights, good governance, and a democratic society, it also contributes to a conducive environment for economic activities and for growth.

One prerequisite of a dynamic economy is a system of rules, which reduces transaction costs in the economy by making economic transactions predictable and allowing the enforcement of contracts. Many countries are in the process of shifting from traditional economic systems, including customary rules of ownership, often intermingled with systems imposed during the colonial era, to modern systems in a short period of time. One common problem is that the new and old systems operate simultaneously, and the penetration of the modern systems is often shallow. Often the legal issues relating to the poor are dealt with through customary law and/ or informal systems, for example concerning property rights. In most developing countries traditional laws are highly discriminatory against women, for instance preventing women from owning productive assets.

Lessons learned by donors in supporting developing countries to build appropriate and effective regulatory frameworks for the private sector and markets include the following:

- Genuine ownership of and a local interest in the reform of the judiciary system is more critical than in most other forms of development assistance due to the proximity of politics and law.

- Better analysis is required of the specific circumstances in which development takes place, including customary systems and existing institutions which might facilitate or hinder a development process. 'Holistic analyses and approaches' are needed.

- Donor support for building legal frameworks in general, and for economic transactions in particular, has tended to be socio-culturally biased, as expressed in a belief in transplanting systems from developed countries to developing countries, and in a disregard for the existing customary systems.

- A long-term support process is necessary in order to build institutional and human capacity. 'Legal transplants' do not work.

- A legitimacy-building process for the framework, requiring the involvement of the economic players, civil society, and others, is necessary.

9.4.2 Improved regulations as a pro-poor approach

The poor, and their economic activities, tend to be the first victims of lawlessness, while they are often the major beneficiaries when rule of law is established. As discussed above, in many countries the regulations for business operations tend to be expensive, cumbersome and time-consuming. They are also often open to unproductive rent-seeking by officials, thereby adding to cost. As such they constitute effective barriers to small enterprises, diverting many entrepreneurs to the informal economy. Workers in the latter enterprises tend to have less favourable and more exploitive working conditions, and tend to be less protected and more vulnerable to abuse. Effective business legislation with 'easy to enter' conditions is both a growth and a pro-poor approach.

9.4.3 The role of donors

Donors can play an essential role in assisting countries in making the legal and regulatory framework more enabling for business development, and for pro-poor PSD. This might include assistance in:

- Modernising appropriate commercial laws, contract laws and property laws. Such support should be based on a systems approach, in which the 'sector' is first reviewed, rather than on ad hoc measures and 'legal transplants'. Note should also be made of the fact that commercial law often is a good entry point for politically sensitive judiciary reforms.

- Facilitating the harmonisation of the commercial regulatory system with international practices and legal frameworks. This primarily concerns foreign investments and trade. One special case is assistance for reforming the legal framework for economic activities for countries applying for EU membership.

- Paying proper attention to customary law and informal rules and laws governing economic activities involving the poor, for example in terms of property rights, land use, and the relationship between tenants and owners.

- Adjusting/reforming formal commercial regulatory frameworks to eliminate legal biases against economic activities that are essential for the poor. This includes, inter alia, legal frameworks for the informal economy; financial regulations preventing non-collateral based micro finance, and other regulations.

9.5 Governance

9.5.1 Implementing regulations and enforcing laws

As the regulatory framework establishes the 'rules of the game' for the market and its operators, implementation determines transaction costs. One common experience in many countries is that the formal law and regulations are often appropriate, but their implementation leaves much to be desired. Bureaucratic red tape, corrupt practices and the slow performance of essential public institutions add costs, slow down business and lead to various distortions. These factors might cause export-oriented enterprises to become non-competitive, stop others from growing, or make them prefer to operate in the less tightly controlled, but also less growth-oriented, informal economy. They constitute an obstacle to foreign investors and to trade.

Recent research by the World Bank indicates that disappointingly little has been achieved in terms of 'good governance' during the last decade in most developing countries. It often requires changes in administrative cultures, major reforms of the public sector, simplification of procedures (often resisted by the bureaucrats as it reduces their power, employment and 'rent-seeking' opportunities), and it requires a process of responsible corporate culture in the private sector. Many of the efforts to replicate models from developed countries have failed, and the donor community is currently searching for new models. The focus is on the role of civil society, on the media, and on other groups that can act as correctives. It is to a large extent a matter of political will, of the quality of leadership - aspects that donors can rarely influence but, on the other hand, can support when the political willingness already exists.

In terms of private sector development, good governance is critical both as an element of the general environment for business, and for business specifically. The latter aspect includes the accountability, fairness, honesty and effectiveness of government functions, for example taxation, customs, business licensing authorities, bank inspections, as well as the authorities that supervise infrastructure such as harbours; the determination of transaction costs; predictability; and the overall business culture. Corruption results in a major distortion of markets, leading generally to sub-optimal resource allocation based on cronyism and political connections, rather than efficiency of operation.

9.5.2 Good governance for pro-poor market and PSD

Poor governance in the sense of corrupt and inefficient implementation is particularly a problem for small enterprises, including small-scale agriculture, since the means available to them to pay their way to bypass all the obstacles are fewer, and their political clout is small. Good governance is often more important for the poor than for the rich, as the former are more negatively affected by bad governance than the better-off.

9.5.3 The role of donors

Donors can support countries in improving governance in general, and governance of specific relevance for business development, with many instruments. Capacity building in public organisations has a long tradition in bilateral assistance. It was initially believed that such capacity building was a mere transfer of know-how, and that the organisations would 'take off' after an initial dose of technical assistance. However, the political economy of governance is coming to the forefront, and issues of corruption and 'rent-seeking', words never used before, are now common language in ODA. Donors need to be less lenient with 'rent-seeking' and inefficiencies than is often the case, and should also be aware of the fact that poor pay in government in the aftermath of donor-driven public sector reforms promotes neither honesty nor efficiency. An effective taxation system is also often a prerequisite for the emergence of an effective bureaucracy. The success story of the Asian NICs is partly explained by the fact these countries traditionally had reasonably efficient and non-corrupt public sector organisations.

9.6 Developmental Economic Management

9.6.1 The case for the developmental state

While the concept of market development and establishing enabling environments for the private sector are non-controversial, development economists and practitioners debate whether governments can, or should, try to steer markets and the private sector in order to 'speed up' the economic development process. The developmental state, it is argued by those in favour, is rather the norm than the exception for 'success stories' in economic development since the Second World War (see for example, Chang 2002; Stiglitz and Yusuf 2001, Kotler et al 1997). Most of the successful economies in South East Asia, including Japan, are examples of developmental states with a pro-active government that established the direction of the economies and manipulated the market forces, particularly in order to gain foothold on global export markets. Also an African success story such as Mauritius is an example of the strategic re-orientation made by a government at a crucial state of development in the 1970s, from a troubled mono-crop dependent economy to one pursuing labour-intensive manufacturing and services for exports. It has been argued that these economies largely broke the doctrine of the typical liberal economy with the aid of an asymmetric policy of aggressive export-orientation by certain industries, and the protection of domestic markets from external competition. Also the two economic success stories of the 1990s, China and Vietnam, must be considered to be examples of highly developmental states, only partially applying orthodox market economies.

9.6.2 Private-public partnerships

South Korea, Taiwan, Singapore, Mauritius etc., are examples of success stories of interventionist governments. There are many other cases with a lesser degree of success or that have failed. Tanzania, which in the 1970s applied strong government interventions in the economy with disastrous economic results, can be given as an example of failure (see Box 24).

Box 24. Why did President Nyerere's Tanzania not Change Direction?

Tanzania in the 1960s and 1970s was driven by a strong vision of economic development, largely non-corrupt leadership, and massive support from the donor community on Tanzania's terms, i.e. with strong national ownership under a charismatic leader. A key element was self-reliance: the Basic Industry policy. The failure of the approach was clear in the 1980s when Tanzania had fallen to the bottom of the list of poor countries, and the economy was almost at a standstill. It took a long, traumatic process to change direction. Why did Tanzania not change earlier? Reasons might include the strong commitment by President Nyerere to the selected policy linked to international prestige; excessively strong vested interests among the powerful minority who benefited from the policies; or excessively strong willingness of the donors to keep the Basic Industry strategy afloat. Donors must take part of the blame: there was considerable vested interest among many donors to maintain past policies.
(Lindahl and Catterson 1999).

What are the differences? One common denominator is that the successful interventionists did not do away with the market or the private sector, but manipulated these systems selectively for clear purposes, hence reinforcing market outcome rather than preventing it. They all also used integration with the global economy in exports as a lead theme, hence exposing the domestic sector to intense competition, learning and technological development. Using the donor jargon of today, the success-stories were examples of good public-private partnerships. Another common denominator was strong economic leadership by governments based on a vision – in some cases very different from the prevailing situation. The strategies pursued were different, and were not based on a globally applicable 'blue-print'. However, one common factor was that these governments were ready to copy and learn from others and, most important of all, were not afraid of changing policies and strategies from learning. Trial and error was an essential element in the strategy. To use another term in the developmental jargon – the ownership of the economic strategies and management was total.

Donor behaviour in these processes is critical. Donor assistance that is excessively on the terms of the recipient can maintain poor domestic management by bailing out countries and keeping failing systems going, and create aid dependency, at least in smaller countries (see Box 24). Excessively strong pressure by donors for change might, on the other hand, take away initiative, ownership and the ability to manage, and create a different form of aid dependency.

9.6.3 The role of donors

The role of donors as supporters of developmentalism is controversial. Most donors would refrain from such support. However, a question must be raised in a competitive globalised world: are 'conducive environments' enough, or must countries seek and develop niches and competitive advantages more aggressively? If so, should donors try to assist in such processes? Besides the modern cases of economic success, economic historians have indicated that the industrialised countries of today were far from models of liberal economies at their crucial stage of development, but rather applied selective policies (Chang 2000).

The Meso Level: Resources

CHAPTER 10

The 'meso level' is defined as the 'resources' or various forms of capital which are important for market and private sector development in general and for pro-poor market and PSD. These resources are essential both as determinants for the private sector, and increasingly as major markets for private operators. The following such resources or types of capital are discussed below:

- financial,
- physical (infrastructure, including transports, energy and telecommunications),
- human.

10.1 Financial Capital

10.1.1 Financial markets

There is a close relationship between economic growth and the development of financial markets. Financial market development triggers economic development and vice versa. Financial actors, such as banks, stock exchanges, risk-capital companies, credit institutes and insurance companies, are also a part of markets and the private sector and, as such, essential service providers to businesses and markets. Financial services are not just demanded by formal businesses, they are also demanded by the poor, both for personal use and in their economic activities. The formal financial markets have been notoriously bad in serving these markets, which have relied on informal suppliers. However, the worldwide growth of micro finance has paved the way for formal financial services to the poor and those without assets (see below).

Banking was a prime sector for nationalisation in the 1960s and 1970s. In many countries it became a mistreated sector, utilised to underwrite unprofitable government enterprises. Also, in economically successful countries, the (largely private) financial systems have been misused by cronyism. The lack of soundness of the banking system in many of the 'miracle economies' in South East Asia was revealed in the financial crisis in 1997, triggering major banking reforms in countries such as South Korea and Indonesia. However, this crisis and other financial crises in the 1980s and 1990s resulting overnight in massive poverty in countries such as Thailand and Indonesia were not all the wrongdoings of individual countries. These crises have partly been faults in the global financial system in the wake of the liberalisation of financial markets during the 1980s. As such, they are now the subject of efforts to regulate the global financial system.

One distinguishing feature between a poor country and an industrialised country is the extent to which people and businesses use credit. In poor countries, (formal) private credit accounts for about 10% of GDP, while in industrialised countries the ratio is 80–90%. (World Bank 2004c). Credit leverages development in the sense that it speeds up productive activities. Pursuing a business idea, the entrepreneur in a poor country typically has to find finance from his/her own sources and relatives, and expansion is largely self-financed. With a developed financial system, own capital can be leveraged with credit, facilitating not only the start-up, but more important, the expansion of business. See box 25.

Box 25. Financing Housing

The housing market in developing countries is a good illustration of the effect of poorly developed financial markets. Building one's own home in many developing countries is a step-by-step process, determined by when the owner has cash in hand. Building even a simple home is a long-term process, a room at a time, a storey at a time, procuring necessary building materials as money is being made and saved over extended periods of time. Buildings are thus often entirely self-financed, leading to low and erratic activities in the construction sector. This slows economic activity, hampers the development of a local construction industry and delays the point in time when the owner can complete his house. It contributes to slow growth.

10.1.2 Venture capital

In the 1990s venture capital was seen by the donor community as a potentially effective way of addressing investment needs in emerging economies, replacing largely unsuccessful development bank initiatives. Venture capital is a specialised financial service which emerged in industrialised countries on a large scale in the 1980s and 1990s and which was linked to a large extent to the 'new economy'. Venture capitalists provide long-term high-risk capital to emerging enterprises, and their business idea is to be prepared for many failures, but a few very high returns, allowing the venture capitalists to receive a good net return on their investments. The model was emulated in developing countries by specialist organisations such as IFC in the 1980s. In spite of high expectations, experience gained from this type of support has generally been disappointing, as the opportunities for high returns are usually low due to few investment opportunities, a higher degree of uncertainty, and higher costs for management in most developing countries (Lindahl 2002, IFC 1996). While venture capital is likely to expand through commercial initiatives at least in some developing countries, the justification for donor support for such private sector initiatives, if pursued at all, must be clearly spelled out. It should be linked to the fact that there are clear positive externalities at hand, for example that a pioneering venture capital fund is likely to 1) trigger broad changes in the financial market; and/or 2) lead to improvements in government policies and regulations concerning financial markets; or 3) act as a powerful demonstration to other local or foreign venture capitalists to enter the market.

10.1.3 Risk mitigation

The private, commercial banking sector in developing countries tends to be involved to a very limited extent, or not at all in medium or long-term financial ventures, such as investments in infrastructure. This is especially true in developing countries rated as "high risk" politically or commercially. The latter include almost all LDCs and all the poorest nations.

Government or quasi-governmental Development Finance Institutions (DFIs) such as the multilateral IFC and the European Investment Bank, or the bilateral DFIs such as OPIC (USA), Proparco (France), FMO (Holland), Norfund (Norway) and Swedfund (Sweden), provide much of the needed investments through equity or loans. However, involving private commercial capital markets is essential from several development perspectives, in order to:

- add private capital flows for such investments, especially in the poorest countries;

- add what often is perceived as a stronger commercial and market-based element to the financing of these investments; and

- not least important, develop and deepen the local capital markets in these countries and create opportunities for long-term investments for institutional investors.

Innovative approaches to mobilise commercial players by mitigating the perceived risks in such investments have been developed by some donor initiatives. One such approach is 'guarantee schemes', in which a donor share the political and commercial risks with a local capital market institution, such as a bank, for a loan to a major private or public investment. The guarantee by the donor is provided against a risk-reflecting fee to be paid by the recipient of the loan. Thus, the donor provides a fee-based insurance which does not exist on the commercial market. Sida has operated such a guarantee scheme since 1999 on a pilot base (Lindahl 2005). GuarantCo, based in Stockholm, is a special company for such fee-based insurances, established in 2004 by the multi-donor Private Infrastructure Development Group (PIDG). If the guarantee schemes are implemented effectively, they can have a considerable development impact both by adding investments in infrastructure and by development of the local capital markets at potentially low or no cost to the donors.

Another initiative for risk mitigation, which also can provide this impact at low or no donor cost is the PIDG sponsored Emerging Africa Infrastructure Fund (EAIF), see Box 26.

Box 26. A Successful Public-Private-Partnership in Long-term Finance of Infrastructure

The Emerging Africa Infrastructure Fund, EAIF, is a public-private partnership project initiated by DFID. It has successfully mobilised private capital for long-term lending to private sector infrastructure investments in sub-Saharan Africa, with the aid of donor capital that has mitigated the perceived high risk for such lending. EAIF has successfully impacted on a market dominated by quasi-public funds, such as those provided by the International Finance Corporation, IFC, by providing innovative financial solutions, hence expanding the flow of private capital for these types of investments.
(Lindahl and Rudo 2004).

10.1.4 Pro-poor financial markets: Micro finance

Micro finance is of particular interest to donors with a pro-poor and gender equality perspective. It has become a global industry, today encompassing some 7,000 Micro Finance Institutions (MFIs) servicing some 40 million clients, mostly poor people, worldwide[9]. Micro finance, including savings and credit, and to a smaller extent insurance, has proven to be

[9] Data from CGAP and UN 2004.

a powerful instrument for addressing financial needs and reducing the financial vulnerability of the poor, and of poor women in particular. The innovation of 'social collateral', i.e. guarantees by groups of people for the credits, combined with 'social mobilisation' (sensitising poor people through training and awareness-raising), has allowed a very high repayment ratio. It is a sector which has grown with the active support of donors that have underwritten most of the MFIs, and actively promoted micro finance in new country settings. Today the micro finance industry is well established and moving increasingly towards commercial viability. However, only an estimated 3% of the MFIs are self-sustaining, the remainder are subsidised to a greater or lesser extent by donors. The low degree of MFI sustainability is often more a problem of donors providing soft loans or grants, thus undermining the process of sustainability, than a lack of inherent sustainability in the industry. Thus, donors have to some extent undermined their own success story by not being able to withdraw subsidies from an emerging, potentially commercially viable market. As some of the schemes have proven: poor people often are prepared to pay the fairly high commercial rates for credit which are needed to cover the costs of their administration, and thus sustain the schemes.

10.1.5 The role of donors

Donors can assist in the development of effective financial markets at different levels. Thus, at the international level, donors can support the development of International Financial Standards and Codes (IFSC) in order to reduce the risk and costs of global financial instability. These codes and standards include transparency of economic and financial policies, sound institutional and market infrastructure, and effective financial regulation and supervision. This framework is essential both from the point of view of establishing a more predictable and stable international financial environment and for providing standards for individual countries. One important initiative is the development of the IFSC and the Financial Sector Reform and Strengthening Initiative (FIRST). For more information, see www.firstinitiative.org.

Donor agencies can provide assistance at the macro level for shaping financial policy; setting up legal frameworks for central banks, the banking sector and capital markets, and the insurance sector; and establishing and strengthening banking supervisory authorities, inspection units, national debt offices and other authorities governing the financial markets. Preferably, such support should take a holistic sector-wide approach (see Box 27).

Box 27. A Sector Approach to Financial Markets

Uganda has launched a Financial Systems Development Programme co-ordinated by the Bank of Uganda. The Programme is supported by Sida and the German GTZ and marks the start of long-term co-operation in the financial sector with elements of the "sector wide approach". The Programme views the financial sector as a system of independent but interrelated segments and actors. It includes not only support to financial institutions but also to the institutional and structural framework, e.g. financial sector policy, prudential regulation and supervision.
(Second Programme Progress Review, Dr Detlef Radke, Dr Ludger Buescher, Stig Jonsson, Henry C. Knight and Dr Marguerite S. Robinson, August 2004).

At the micro level, donors have been active in promoting various financial services, either those emerging from developing countries, such as micro finance, or models and systems from developed economies, such as stock exchanges, venture capital funds and leasing companies.

The role of donors in the further development of a successful and sustainable micro finance sector worldwide should have several thrusts:

- It should reduce and eliminate subsidies to MFIs which distort the sector in countries where micro finance is well-established. It is important that coherent donor policies are applied, otherwise highly subsidised and ineffective MFIs can undermine non-subsidised and effective MFIs, causing a long-term detrimental impact on the industry.

- It should make efforts to mobilise commercial capital or semi-commercial capital such as philanthropic funds to replace donor funding based on grants.

- It should focus on capacity building of MFIs in countries and markets where such services are not yet established.

- It should have a focus on the 'social mobilisation' elements of micro finance, which was the hallmark of the earlier efforts in Bangladesh, which Sida has made significant contributions to in many countries, and which is labour-intensive and demanding. These efforts are particularly important for the empowerment of poor women.

- It should work towards a better balance between supply and demand of donor funds to MFIs. Today, there is an over-supply in many countries, driving distorting practices.

- It should widen the financial instruments from credit, towards savings, insurance, and others.

10.2 Physical Capital: Infrastructure

10.2.1 Physical capital as a determinant of growth

Physical infrastructure, such as roads, bridges, railways, harbours, lighthouses, airports, as well as systems for power transmission, water, telecommunications and other electronic media, is critical for business development, whether in basic agriculture or sophisticated manufacturing. Efficient and accessible infrastructure reduces production and transaction costs, enhances productivity and competitiveness internationally, nationally and regionally, and is often a pre-condition for business in the first place.

Infrastructure does not only refer to physical facilities. It is also a matter of the efficient operation and maintenance of such facilities. In many countries in Africa especially, donors built roads and other forms of infrastructure only to find that these deteriorated almost as fast as they were built. Such support had often an in-built perverse incentive: from the government's budget point of view it was better to wait for a 'free' rehabilitation project once the infrastructure had collapsed, than spend scarce domestic government resources on maintenance.

Roads that make transport slow or which are seasonally impassable increase transport costs and time, and may prevent market access. Harbours with very low turnover rates make shipping expensive and non-competitive. Frequent power cuts hamper most types of industrial production and agro-processing, resulting in higher costs and lower productivity.

Poorly managed infrastructure, in combination with unjustified under-pricing of utilities, might 'cost' developing countries in the order of USD 200 billion per annum, or four times the total value of ODA (Kessides 2004). Reforms of infrastructure are critical, and various types of privatisation were introduced during the 1990s. A considerable amount of experience of infrastructure reforms in developing countries has been gained during the last two decades, resulting in emerging 'best practices' for infrastructure reforms. (World Bank 2003).

10.2.2 Infrastructure as pro-poor market and PSD approach

The poor themselves often define their poverty as lack of infrastructure (World Bank 2000a). It affects their access to clean water, health care and education for their children. It determines access to markets and the cost in money and time to reach markets where products can be sold and necessary commodities can be bought. Lack of irrigation can make the difference between a prosperous farm, and one which a family cannot make a living from, and so on.

Infrastructure development, which supports market activities, can be one of the most effective pro-poor development strategies: rural roads or rural electrification tend to spur considerable local economic activities (see box 28).

Box 28. The Impact of Rural Electrification in Mozambique

A recent impact study of the electrification in the Nampula province shows that benefits are reaped by all strata of the population: the local cotton industry is expanding, providing new job opportunities, directly and in the form of contract farming; small businesses are flourishing; security in electrified villages has been improved thanks to street lights; electrified hospitals and health posts can operate around the clock, and medicines and vaccines can be kept refrigerated and instruments sterilised; schools are starting two-shift operations, and female enrolment and examination in both primary and secondary education has been dramatically enhanced.
(Åkesson et al.: 2002).

Agriculture, fisheries and livestock are particularly dependent on physical infrastructure such as extensive road networks from highways to rural roads, harbours and other marine infrastructure, warehouses, public markets, refrigeration facilities and irrigation systems. Physical access to markets is one of the greatest determining factors for the economic welfare of smallholders, and also of the poor as consumers of goods and services. Rural electrification can spur local agro-processing and small-scale rural industries. Telecommunications, which increase access in rural areas, contribute to reducing transaction costs in rural private sector endeavours by improving market information and reducing the asymmetric relationship between poor producers and buyers that have more resources.

10.2.3 Reforms of infrastructure operations

Private sector development is not only dependent on infrastructure. Infrastructure is also an important and increasing sphere for private sector operations. This involvement can take many forms, from a management contract of a publicly owned and operated facility, to fully fledged private ownership and operation of an infrastructure facility. The options depend on the type of infrastructure. Some types of infrastructure lend themselves poorly to private ownership or private operation due to their character as public goods or natural monopolies. Rural roads are an example. However, seaports as well as electricity and water networks which also constitute natural monopolies can be privately operated through leasing or concession arrangements reached through competitive bidding processes. Efficiency improvements have been reported (Harris, 2003). Also the privatisation of the operation of railways, a notoriously poorly managed facility by the public sector in many countries, has proven to be successful in terms of efficiency in operations and may even generate revenues for the government (see Box 29).

Box 29. Sida and the Privatisation of Zambia Railways

No reform blueprint was in place in 1997 when Sida - after several years of discussions with the Zambian Government - decided to support the restructuring and reformation of the ailing parastatal Zambia Railways Ltd (ZRL). Sida assistance was provided to finance a management contract, to support the work of the ZRL Board and to support policy work by the Government in respect of the privatisation of the company. The project was regarded by Sida as a high-risk venture. In March 2000, the Government of Zambia decided to privatise the railway through a concession. The World Bank agreed to provide a loan to facilitate the privatisation process. In February 2003, the Government of Zambia signed a 20-year-concession agreement with a private consortium. The concession is expected to yield some USD 253 million in revenues to the Zambian Government over the 20-year-period. Significant improvements in the financial and operational performance of the company have been achieved during the course of Sida's programme of support. (Contribution by Mikael Söderbäck, Dep. for Infrastructure and Economic Cooperation, Sida, 2003).

In some types of infrastructure, such as telecommunications, technological innovations have allowed the successful introduction of competition in areas previously subject to monopolies. Competition is also possible in electricity generation although such reforms are complex and may involve considerable risks to society.

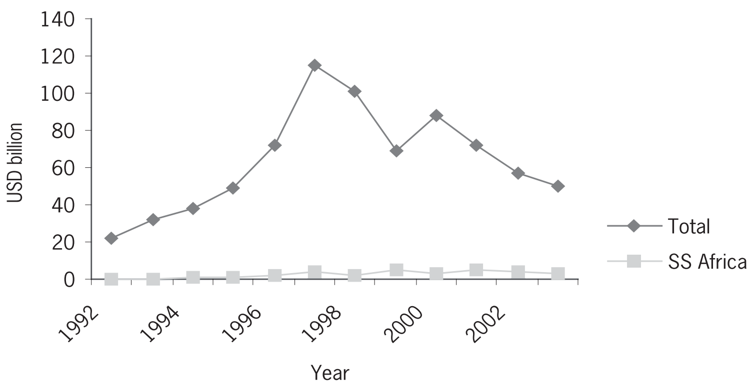
Experience of telecommunication reforms shows that competition - even with only a few market actors - is a powerful tool for bringing about increased efficiency and dynamism in a market. In a country like Uganda, which started its telecommunications reform by allowing the entry of new actors, consumers saw rapid improvements. In countries which, on the other hand, have chosen to maintain the previous monopoly while privatising the public telephone company, the outcomes have been much more problematic. Although the revenues from sales of protected monopolies may be larger, the losses to consumers and society are usually much greater (World Bank 2002).

The investment needs in infrastructure in developing countries are enormous. Public funding and local capital markets are clearly not capable of raising all the necessary capital. International flows of capital in the form of lending for build-operate-transfer (BOT), FDI or portfolio equity investments increased rapidly during the 1990s. The Asian crisis, as well as the economic downturn in Latin America, halted this development and, from 1999 onwards, capital flows to infrastructure have contracted.

10.2.4 Chequered experience

Infrastructure privatisation has become increasingly controversial in many countries, especially in Latin America. Some water and energy privatisation schemes have failed due to strong opposition from groups affected by the abolition of subsidies in connection with privatisation. Corruption, poor delivery of services and financial scandals have accompanied privatisation to the extent that the privatisation of infrastructure delivery is viewed very sceptically by governments and the public in many places (Kessides 2004). Also investors have been disappointed, leading to a situation in which private sector investments in infrastructure in developing countries, which peaked in the late 1990s with investments in the order of USD 120 billion, have declined steeply since then, as indicated in Figure 4.

Figure 4. Private Infrastructure Investments in Developing Countries and Emerging Economies 1992–2003[10] (Investments per year in USD billion)



Source: World Bank Private Participation in Infrastructure Database, (PPI), October 2004.

The decline has particularly affected sectors such as water and sanitation, and the only sector which has performed well is (mobile) telephone systems and, to a lesser extent, power. Furthermore, many private investments are performing poorly. For example, currently 50% of the private power investments are under stress in Africa alone (Lindahl and Rudo 2004).

[10] The PPI data includes also government contributions. The World Bank estimates that 85–90% of the investments are private, including equity and debt.

Experience gained over the last few years has led to a rethinking of private sector participation in infrastructure. The development of an effective government regulating mechanism is critical. There is no guarantee, however, that a government will be more efficient in regulation than it was in supply. Therefore, considerable work is required in order to establish non-corrupt, transparent and efficient regulatory systems. Such regulatory systems, requiring laws and supervisory public bodies, are complex and take considerable time to build.

In some cases reforms are not, and should not be, a matter of transferring ownership, for example in natural monopolies, but an issue of enhancing the efficiency of a public enterprise. The insight that privatisation does not offer simple solutions to problems generic to infrastructure has led to a renewed interest in public ownership and public operation options for organising infrastructure. The previously common negative view of management contracts may have to be reconsidered in the light of recent positive experience of such contracts[11]. The crucial factor is the quality of ownership and regulation exercised by government in its relations with publicly-owned companies. Experience shows that the developing countries which have demonstrated that they can be "good owners" are rewarded by financial markets which may accept lending to publicly-owned companies without sovereign guarantees.

10.2.5 The role of donors

Donors have a key role to play in infrastructure reforms and private participation in order to assist both governments and the market to find effective formulas, which make investments in infrastructure interesting to the private sector and regulate the market so that the benefits to society are optimised and, in particular, that the poor gain access. Donors can:

- Review the experience gained hitherto in developing countries of privatisation and private operations of different types of infrastructure. Identify in which sectors, and under which conditions services function well. Telecom is a sector which has been near universally successful.

- Assist countries in making price reforms which both allow sufficient return to the operator and make infrastructure services affordable, especially to the poor.

- Adopt the regulatory systems to better match needs in developing countries.

[11] Zambia Railways (see box 29) and the Tanzanian Power Company, TANESCO, offer examples of apparently successful management contracts.

- Assist countries build and strengthen the public regulatory and supervisory institutions.

10.3 Human Resources

10.3.1 Education as an investment for effective PSD

Human resource development (HRD), in the sense of providing people with better education, better health, more freedom and choice, and so on, can be considered the ultimate objective of development assistance, and thus its overriding objective. However, HRD is also essential for Market and PSD. The private sector depends on educated people, from people with the most basic forms of education such as the ability to read and write, to people with advanced scientific education. One of the most important single factors behind the countries with the most rapid growth in the world over the period 1870–1970, Japan and Sweden, quite poor countries in the mid 19th century, was the reform for universal education for children. This reform achieved 100% literacy for both men and women quite early in the development process. The full capacity of people could be used in modernisation of these economies. The most recent success stories in economic development, such as China and Vietnam, are to no small extent due to the initial high literacy rates in these countries, allowing the rapid mobilisation of their human resources for economic development.

10.3.2 Health as an investment for effective PSD

Human capacity is more than skills formation. Health standards are essential. People that are malnourished, anaemic, or sick from tuberculosis, malaria or AIDS, have considerably lower capacity, or no capacity at all, to participate in productive processes in society. HIV/AIDS is expected to retard Africa's development and growth significantly, possibly in a similar fashion to the plague that affected Europe in the 14th century. Investing in preventive and curative health, which improves the health conditions of large numbers of people (rather than the few which benefit from, say, advanced coronary medical support), is essential, not only for public health and human welfare but also for market and private sector development. Health care aimed at poor women generally has a strong pro-poor PSD as poor women in many cultures have a disproportionate role as earners of the family livelihood, from agriculture, livestock, petty trading and crafts.

10.3.3 Balancing demand and supply

While basic education is an important determinant of growth, and a critical element of effective PSD, the balance between the supply of human skills and demand in the labour market is critical. The history of development has proven that the higher level educational system has often been out of tune with labour market needs. School-leavers aspire to white-collar jobs in the public administration, shunning the labour markets in agriculture and the private sector. This has not only created a shortage of skilled workers in the latter sectors, it has also tempted many governments to bloat the public sector to absorb such potentially politically verbal groups into unproductive public sector jobs created for no other reason than to pacify them. In many countries, the tendency to favour social science in preference to natural science and engineering, often based in colonial traditions, is likely to have hampered the ability of such economies to absorb new technologies and innovations into productive development. Korea, a success story, invested considerably in technical education; and one of the driving forces in the current modernisation process in India and China is the very large number of persons with a higher technical education.

10.3.4 The private sector as a supplier in HRD

The private sector, as the engine of the economy in market economies, is the prime generator of financial resources for public HRD investments, mainly in the form of the taxes it pays. Government failures to deliver universal basic social services such as education and health at an acceptable standard are due to a large extent to financial constraints, turning the best intentions and bold policies for universal services into statements without content. Donor assistance can never replace domestic resources, and the fact that in some countries donors pay a substantial share of the recurrent costs of public health and educational budgets is more a sign of unsustainable systems than of sound development practices or donor generosity. Many developing countries ‘under-invest’ in human resource development from an economic growth point of view, and also from the point of view of the ultimate objective of development: human welfare.

Human resource development is increasingly a market supplied by the private sector. In many developing countries the private sector has taken over a large share of the health care and education services that governments were supposed to deliver. For example, in the health care system in many developing countries private practitioners, private hospitals and private supplies of pharmaceuticals make up as much as 60–75% of the total health care expenditures, provided on free market terms (WHO 2005). This is mainly due by default to ‘government failures’, but sometimes also by design in planned privatisation schemes. ‘Private for profit’-schemes[12]

[12] Private health services for profit means that the providers undertake such services as a commercial venture aiming at making a profit as in any business venture – without subsidies for (poor) consumers from government and without the altruistic reasons of some NGOs that provide health care.

tend to have various negative effects on public health. For example, they tend to lead to: 'supply induced demand' (i.e. an over-consumption of health services); and the diversion of health workers from sectors of importance for public health, such as primary care, to highly specialised care for the well-to-do. Furthermore, they tend to lead to declining standards in basic health care.

To enable the private sector to play a socially useful role as a provider, governments must put in place a clear policy, a regulatory framework, and mechanisms to counter 'market failures', especially in terms of distribution and equity aspects. All too often governments fail to do so, sometimes ignoring the fact that the non-public sector runs a large share of the health and educational systems.

Steering and co-ordinating the private sector in the provision of health care and education jointly with public sector efforts, utilising the private sector and civil society on a sub-contractual basis, and devising systems for the financing of basic services and making them available to all, require new skills and systems in governments. It is questionable if governments are likely to achieve this in more than a few cases. The current trends of fee-based public basic education and health care, or the deliberate privatisation of such basic services in poor countries and emerging economies, are likely to pay negative dividends for economic growth and poverty reduction in the short and long term. It is unfortunate if, for ideological reasons, donor agencies propagate such solutions, even if they are seemingly justified by failures of governments to deliver the services. There are, on the other hand, services related to health and education where private providers easily can provide much better services than public monopolies (see Box 30.)

Box 30. Schoolbooks in Tanzania: from a State Monopoly to a Market System

During the 1980s it became increasingly evident that the monopoly system of textbook provision was not working properly. In 1991, the Government issued a new Textbook Policy, stating that the monopoly system was to be phased out. In the future textbooks would be published by commercial publishers and distributed through commercial channels. Over a period of eight years, Sida supported human resource development in local publishing and book-selling companies and the establishment of Government institutions for regulating the textbook market. These institutions included a national Education Materials Approval Committee and district Book Selection Committees. The new system was introduced gradually. The local publishers responded positively by investing in textbook development. A dynamic local textbook market emerged and today most textbooks are published by 7–8 competing publishing companies. The new system not only improved the provision of textbooks in Tanzania, it also had positive side effects for example on other publishing.
(Contribution by B. Lindahl, ÅF International, 2003).

10.3.5 Human resource development as a pro-poor PSD approach

In the view of the poor people interviewed in the World Bank's study *The Voices of the Poor* (World Bank 2000a), their most important capital is themselves: i.e. their ability to work the land, to seek employment, and to undertake small-scale business activities such as trading. If the bread-winner in the family falls sick, or abandons the family, this often means the difference between poverty or not, and the prospect of escaping poverty or not. Good health is thus more than physical well-being. It might be the difference between a decent life and destitution. Likewise, the lack of basic education and illiteracy do not only deprive a person of dignity, they also dramatically reduce his/her opportunities of getting a job, of succeeding on the market, and of avoiding poverty. The ability to provide one's children with decent education is a determinant of their chances of moving out of the poverty trap as adults.

Hardly any government investment is more effective as a long-term pro-poor PSD approach than basic education and health.

10.3.6 The role of donors

Donors can play an essential role in making the linkage between HRD and market/private sector development effective in the following ways:

- Making the linkage between HRD investments and overall economic development clear in the dialogue with partner countries. In this context it should be stressed that there is no inherent conflict between a human rights perspective in health and education and a pro-growth and pro-PSD perspective, as discussed, for example, in section 4.5. Rather, a pro-poor growth perspective largely coincides with a human rights and basic needs approach.

- Supporting countries to use the private sector more effectively in HRD by providing assistance for the creation of appropriate policies, regulatory frameworks, subsidy schemes and financial systems designed to utilise all types of providers and to provide services to all. The concept of output-based aid is an innovation in this context, see Box 31.

- Working towards more effective HRD in countries which have liberalised their markets for health and education towards fairer systems in the sense of universal coverage of these basic services. Donors should counteract the dismantling of efficient public systems.

- Supporting countries to develop higher educational systems which are more in line with the demand of local labour markets. Moreover, donors should support the reform of higher education in order to make such education more private sector and growth oriented, for example, by promoting a shift from social science to natural science, agriculture and engineering.

Box 31. Output-based Aid for the Poor

Output-based aid is a concept launched by the World Bank in the context of private sector supplied social services or utilities. Private for-profit or non-profit providers are contracted to deliver such services, and their payment is based on the output delivered. Such output is measured in, for example, the number of children immunised, or children reaching a certain standard in terms of literacy. The concept can also apply to utilities, such as providing poor communities with water or electricity, etc.
See http://rru.worldbank.org/obabook.asp

10.4 Labour

10.4.1 Labour markets

Labour markets are defined as the supply and demand for labour. They are essential for private sector development from two perspectives: firstly, labour is a key resource, if not the most important resource, for business. The availability, cost, productivity and creativity of labour determine the outcome of commercial operations. Secondly, the labour market determines economic returns to labour, working conditions, rights, and other outcomes.

Poverty eradication takes place when labour markets develop and absorb more of the poor into employment with decent wages. Such changes take place when an economy is expanding. Then the supply and demand equation for labour changes, putting upward pressure on the price of labour, especially for labour in under-supply such as skilled workers. It is when labour is scarce that collective action by labour unions can be powerful and labour legislation effective. Thus, the political and economic dimensions of labour markets tend to go hand-in-hand. The dilemma in most, if not all, poor countries is that the demand for (unskilled) labour is less than the supply, putting strong downward pressure on wages and forcing the majority of the people to seek self-employment or temporary low paid jobs in the informal economy. In contrast to industrialised countries, in developing countries unemployment is not a way of countering imbalances in supply and demand, as the poor cannot afford to be unemployed and must seek a livelihood at almost any level of pay. Labour legislation, collective action through unions, and other measures can be important for the improvement of conditions for employees, but these actions cannot replace market forces. With demographic conditions characterised by 40–50% of the population below the age of 15, and population growth rates of 2–3%, the ability of a developing country economy to generate gainful employment, and to absorb the new entrants into the work force, is often very limited.

10.4.2 Dualism in labour markets

The labour markets in developing countries tend to be dualistic: on the one hand, there is a formal sector with certain regulations, basic workers' rights, minimum wage legislation, a labour union presence; and, on the other hand, there is an informal labour market, characterised by the absence of formal regulations, whether minimum wages or any other rights for workers, and no labour union action. Working conditions and wages tend to be considerably better in the former than in the latter. It is also noteworthy that the regulations for the protection of formal sector workers tend to be stricter in poorer countries than in industrialised countries (UN 2004a). Such regulations might, for example, concern hiring and firing procedures, leading to rigidity in the labour market, but most important, increased dualism between the informal and formal sectors. In poor countries, the informal economy is by far the most important source of employment, if self-employment is included. This is not due to the choice of the poor, but a result of the inability of the formal sector to generate employment to absorb more than a small share of the job-seekers and new entrants into the labour market. Contrary to the expectations of the 1970s and 1980s, when the informal economy was 'discovered' by the donor community, it has not diminished in scale, but has expanded in most developing countries. In Africa, the informal economy accounts for 60–80% of all non-agriculture jobs, and for over 90% of the new jobs created during the last decade (Xaba 2001). In addition, there is a process of change in formal sector employment towards sub-contractual arrangements with non-formal work units and temporary jobs. The changing importance of the informal economy tends to be inversely related to the performance of the economy as a whole. The most rapid expansion is taking place in poorly performing economies.

10.4.3 Globalisation of labour

Labour is increasingly subject to globalisation trends. Multinational enterprises are outsourcing production and services to low-income countries, restructuring the division of labour between nations. This form of job creation is essential for changing local labour markets in some developing countries, not only for the direct employment created, but also indirectly for sub-contracting arrangements and services. Outsourcing is often a force for modernising labour markets, providing working conditions more similar to developed economies than developing economies in terms of working conditions, not in terms of wages, but in skills-upgrading, rights and services. The downside is that only few developing countries are attractive in this outsourcing process.

Furthermore, poor people in developing countries are a strong force for generating income outside their home countries through the process of temporary or permanent migration. In some countries such as the Philippines and Sri Lanka, remittances from workers abroad constitute one of the most significant inflows of capital, equalling the major exports of these countries. On a global scale, remittances represent a larger flow of capital to developing countries than ODA. However, this process is not evenly spread. In particular, legal job-migration is attractive to limited countries, a process determined by the attractiveness of the labour market from the point of view of language. From one perspective, this globalisation of labour markets is one of the strongest and most dynamic forces for poverty reduction on a global scale. However, it is a force largely resisted by governments, enterprises and labour markets in the well-to-do countries due to the fear of losing jobs and privileges.

10.4.4 The role of donors

Donors can improve the function of labour markets by:

- supporting efforts which aim at reducing the dualism between formal and informal labour markets, for example by providing support for better working conditions in the informal economy along the lines of ILO's *Decent Work Programmes* (see further www.ilo.org).

- supporting NGO initiatives which focus on conditions in the labour markets, such as treatment of workers, child labour, fair trade, etc.

- supporting labour union efforts to benefit workers in developing contries. An example is the efforts of the International Confederation of Free Trade Unions (ICFTU) to meet the challenges of the globalised markets.

- supporting efforts to allow the formation of free unions in the labour market in partner countries.

Micro Level – Business Infrastructure and Direct Intervention at the Market Place

CHAPTER 11

11.1 The Quest for Public Support to Market Players

In industrialised countries, many public or semi-public organisations have emerged for the purpose of nurturing the private sector, especially smaller enterprises. Many of these have been copied by developing countries, often through assistance from the donor community. Examples of such organisations are exports and trade promotion; promotion of foreign investments and tourism; agencies for standardisation, quality control and certification; agencies for the development of small and medium-size industries; and organisations for research and technology development. In agriculture almost every country has or has had public organisations for agricultural research, sometimes linked to a public seed-multiplication company and then linked to a government-financed extension service system. Public organisations for the promotion of business in particular regions are common, such as various promotion agencies in municipalities and cities. Such regional or local business promotion and support systems have been copied in developing countries, often with the support of ODA. Export development has been promoted by setting up special zones for export-oriented enterprises, often based on foreign investments, which, in addition, are provided with various incentives such as tax holidays.

The justification for these types of business support structures is related to a large extent to market imperfections. Thus, some of these support organisations deal with positive externalities in the sense that the market tends to under-invest. This applies to R&D, agricultural research, and standardisation. Others are justified due to assumed information imperfections. For example, agencies to promote trade or FDI, agricultural extension, etc., are established on the assumption that the private sector at home and/or abroad does not have full access to information on markets, customers, etc., i.e. a public organisation can fill such gaps.

The effectiveness of these types of organisations as a means to stimulate business development varies. Firstly, one key issue in development is to determine which organisations are critical in emerging markets. This means determining their importance at different stages of economic development, and sequencing the development of such support systems. One lesson learned from development is that many such business support organisations were set up at the wrong time, leading to governments overextending themselves, both technically and financially, with services that were, at best, marginally useful. There has been a tendency in donor support to replicate the systems of advanced economies in emerging ones, leading to the establishment of irrelevant organisations, given the state of the emerging economy. These become a strain on financial and managerial resources, and finally become unsustainable organisations, dependent on continuous financial aid in order to survive.

Secondly, many highly relevant support organisations were so poorly managed by the public sector that their assumed clients lost faith in them, making these organisations irrelevant. The most prominent example is agricultural extension. In many such cases the private sector has stepped in, such as in extension services, but potential welfare gains have been lost in terms of reaching and assisting marginalised farmers.

Thirdly, some of the public support is discriminatory, providing favours to some companies and not to others, or, as is the case with the Export Processing Zones, providing enterprises with subsidies which are in conflict with the spirit of the emerging global framework embedded in WTO rules.

In addition to providing assistance to business support organisations, donors have also attempted to intervene directly in the business community, providing direct technical and/or financial support to specific enterprises. An example of this is so-called matching-grant funds. Below, some major types of business support systems for market and private sector development are discussed, as well as examples of direct enterprise assistance.

11.2 Business Support Systems

11.2.1 Export Processing Zones

The concept of Export Processing Zones (EPZ) as a means to foster industrialisation and export-orientation was born in Ireland in the late 1950s. It spread to East Asia, the Caribbean and Central America in the 1960s and 1970s, and EPZs were instrumental in the rapid industrialisation of countries such as Hong Kong and Singapore. Today about 120 countries have established EPZs, and globally some 3,000 EPZs employ over 40 million people. China is by far the most significant source, employing 30 million in over 2,000 special economic zones (Boyenge 2003).

Export Processing Zones are enclaves established to provide conducive environments for export-oriented enterprises[13]. They are usually combined with various incentive systems for foreign investments in export-oriented enterprises such as tax holidays, free repatriation of profits and capital, rapid customs clearance, duty-free imports of materials, etc. A contested form of incentive for EPZs is also that they are sometimes excluded from national labour legislation. Many donors have been active in promoting EPZs, from funding the infrastructure to providing assistance for policy frameworks and regulations.

In the past the EPZs have been effective instruments in many developing countries, especially in Asia and the Caribbean, for industrialisation and diversification from traditional commodity exports. The successful transformation of Mauritius in the 1970s from an economy dependent on sugar into Africa's most successful industrialising economy is a case in point. Mauritius has also been described as a case of successful 'two-track' trade development during the 1970s, in which EPZs were a major part of Mauritius' aggressive export development based on FDI, while the country protected its domestic industries (Rodrik 1999).

For some countries, such as the Dominican Republic, exports from EPZs account for as much as 80 per cent of merchandise exports (Madani 1998). EPZs are also particularly effective in creating employment for women. The labour force in EPZs tends to be dominated by women – in some countries up to 90% – by virtue of the fact that the most common types of enterprises (garments, footwear, assembly of electronics) typically employ women. Today, the trend in EPZs is not manufacturing, but service industries outsourced from industrialised countries, such as call-centres.

The more successful EPZs were largely pro-poor strategies in the sense that they were important instruments in industrialisation based on export-oriented labour-intensive manufacturing and thereby created new job opportunities, often for (poor) women who lacked economically meaningful job alternatives. The earlier EPZs provided a modern business environment, generally with better pay and conditions than were otherwise available in the host-country (see Box 32).

[13] There are a number of similar concepts to EPZs used by different countries, such as Free Trade Zones, Industrial Free Zones, Export Free Zones, Special Economic Zones, Free Economic Zones, Bonded warehouses, etc. EPZ is used here as a collective name for these forms.

Box 32. The Benefits of EPZs

New growth theory researchers have argued that the neo-classical theory of technology transfer in EPZs in a conventional sense is probably exaggerated; there are other externalities which often have been neglected in the literature. First, domestic firms lack the technical, marketing and managerial know- how, and FDI in EPZs fills this gap. Second, domestic firms seldom have access to international distribution channels and they need support from international or joint-venture companies. Finally, entry into international markets would be difficult without access to established foreign firms with wide international business dealings. The EPZs, which incorporate the above factors, may be beneficial to a country because of their spillover effects and their catalytic impact.
(Johanson 1994).

EPZs can still be a pro-poor strategy as they might circumvent an otherwise complex business environment. However, like most competitive means, when many use the same approach, there is a risk of a 'race to the bottom' as, in their efforts to attract FDI in global competition, countries undercut one another in terms of salaries and abuse of workers' rights, etc. Providing special incentives and conditions for EPZ enterprises also means a distortion of the market, favouring some enterprises over others.[14] One problem likely to emerge in the next few years is the fall-out at the end of the Multi-Fibre Agreement in 2005, as many EPZs attracted garments industries for no other reason than utilising free quotas.

11.2.2. Trade promotion organisations

Trade Promotion Organisations, (TPOs) were a main feature in the pioneering, aggressive, export-oriented approaches in countries such as Japan, Ireland, South Korea and Singapore. Since then TPOs have been established in almost every country as the organisational focal point for government support to businesses in trade. Donor support has contributed to this, not least through the International Trade Centre (ITC), since the 1960s. The performance of the TPOs has varied. Some have been integral parts of successful export development such as JETRO of Japan and KOTRA of South Korea. Also the TPOs of Singapore, Taiwan, Hong Kong, Thailand and Malaysia have been effective instruments for export development in these countries. However, the critics of TPOs tend to claim that exceptionally strong export environments and a dynamic private sec-

[14] EPZs risk distortion of fair and free trade principles. For example, under the Agreement on Subsidies and Countervailing Measures (SCM Agreement), many WTO developing country members have been prohibited since 2003 from providing certain export subsidies, calling – in some cases – for adaptation of their current incentive schemes, including export subsidies provided. Exemptions may, however, be granted until 2007 and least developed countries automatically qualify for exemption from the obligation to reduce subsidies laid down in the agreement.

tor helped these agencies, and therefore the contribution of state support is difficult to assess (Donald and Keesing 1988). On the other hand, it is clear that a number of TPOs established throughout the world in developing countries have displayed a bleak performance.

Successful TPOs are almost without exception to be found in countries which have generally performed well in labour-intensive export-oriented growth, characterised by (skilful) governments with a strong commitment to growth based on competition on global markets. On the other hand, in too many countries TPOs were set up as an alibi by governments with a lukewarm interest in market development, staffed by people with no business know-how, and in the form of servicing enterprises with only a marginal interest in export markets. Furthermore, such TPOs tended to focus on industrial exports (which were marginal in the economy) and to neglect commodity-based exports (which were often considerable). In many of these cases, the TPOs did more harm than good.

Nevertheless, a TPO with a well paid, professional staff, with a committed government behind it that refrains from direct intervention in the affairs of the TPO and the direct involvement of the private sector in its management, focusing on a limited number of services to the business community, not least channelling interest from the outside, can make a difference for agricultural exporters and other enterprises with direct links to poor producers or workers. It can also be an active voice vis-à-vis government for the business community, defining bottlenecks or problems in the market environment that require action. TPOs can be considered essential private-public partnership organisations in an emerging economy. The current lukewarm attitude of the donor community reflects disappointment in past support rather than the potential usefulness of these organisations.

11.2.3 Quality infrastructure

The importance of quality control, standards and certification is increasing in the global trade environment. Standards are used both as a means of voluntary quality assurance in the commercial sphere, and as official regulatory mechanisms applied by governments, generally justified as a means to assure safety and health. The ability of developing country enterprises to comply with such standards is critical for their participation in global markets. As a result, most developing countries are establishing 'quality infrastructures' to support their export sector (as well as a means to guarantee the quality of their imports).

A difference should be made between *mandatory standards*, as reflected for example in the rules concerning food safety under WTO's SPS, and *voluntary* *standards*, such as ISO standards, the Codex Alimentarius Commission (CAC), SA 8000, etc. Labelling of products, especially related to eco-friendliness and organic production, is a form of voluntary standard, which creates fast growing market segmentation in agriculture, forestry, etc. (See Box 33.)

Box 33. The Importance of Standards

Standards enable companies to communicate with their suppliers and customers precisely, consistently and efficiently. A formal standard is a document, established by consensus and approved by a recognised body that provides, for common and repeated use, rules, guidelines or characteristics for activities or their results, aimed at the achievement of the optimum degree of order in a given context. This definition is the one used by the International Organization for Standardization (ISO), which is one of the three apex international standardizing bodies. The other bodies are the International Electro-technical Commission (IEC) and the International Telecommunication Union (ITU).

While tariff structures have generally declined after the multilateral trade agreements in the Uruguay round and the creation of the WTO, the non-tariff barriers have increased, especially in respect of food products. Many developing countries are finding it difficult to meet the SPS measures of the developed countries, and are concerned that, in practice, their access to export markets for some food and agricultural products is being hindered, rather than encouraged, in the wake of the agreements. Various studies have found that the SPS measures have created losses in exports from developing countries in a variety of products such as marine products, meat, vegetables, groundnuts etc. (Boutrif and Pineiro 2002).

In recent years, there has been a marked evolution in private sector approaches to managing product quality. Industries have been moving away from the traditional, largely reactive approach that focused on end-product testing and "fire-fighting" to deal with quality problems, to a total quality approach emphasising prevention and involvement of all personnel in providing customer satisfaction. For example, in the food industry a set of tools for establishing food safety management systems include the *"Good Practices"* guidelines, *"Hazard Analysis and Critical Control Point" (HACCP)* principles, and various guidelines for total quality management, such as the *International Standards Organisation (ISO)* 9000-2000 set of standards. Increasingly, these principles – and particularly *the HACCP* approach – are being taken into account by regulatory agencies, and incorporated into food safety legislation. This trend is relevant for developing country suppliers, as they aim to satisfy customer requirements for export markets (Nicolaides 2002).

In this context, quality infrastructure means the institution encompassing the policy framework; organisations specialising in providing recognised services in terms of product or production quality testing; and standards, certification and accreditation, generally linked to international systems. The institution is a service provided to the business community, for example in their export efforts. Most of the organisations involved tend to be public sector undertakings, but there might also be elements of private initiatives.

As producers of products which are eventually sold on global markets, the poor are increasingly dependent on quality, certification etc, to enter markets: types of services which small-scale producers are unable to provide themselves. In the past donor support has often been insensitive to the structure of the economies where these types of services were needed. However, as developing countries emerge as more diversified producers on global markets, and as the mandatory quality standards expand, the need for domestic quality structures increases. A lack of such structures can be devastating for poor producers as and when the OECD markets suddenly ban imports of, for example, certain food products from countries with poor quality standards. Furthermore, a shift by small agricultural producers from conventional commodities, in which competition makes the returns to the producer very marginal, to more diversified products attractive to niche markets (such as up-market organic coffee), requires an infrastructure for certification, labelling, etc.

11.2.4 Business development services

Government and/or donor sponsored projects and programmes providing (small) business development services (BDS) in auditing, accounting, marketing and management through training, advisory services and information are common. In the past donors/governments tended to provide such services directly, often free of charge or at highly subsidised prices. These efforts were not only poor in achieving effective support services, but also undermined the emergence of commercial markets for such services. Donors have changed their approach in terms of BDS towards facilitating markets rather than replacing markets. Such facilitation should be based on how the BDS markets function in a specific country, and on an understanding of a possible lack of demand or poor supply. This new style of approach has been called a change in paradigm in the donor community (ILO 2001). The Committee of Donor Agencies for Small Enterprise Development has issued guidelines for donors in BDS support.[15] Commonly agreed principles for BDS are given in Box 34.

[15] Business Development Services for Small Enterprises. Guiding principles for donor intervention, 2001.

Box 34. Principles of 'Good' BDS Market Development

- Focus on markets
- View clients as customers
- Market transaction relationship
- Greater potential for sustainability – more limited use of subsidies
- Work towards goal of sustainable markets
- Work with many – preferably private – providers
- Roles: distinction between market facilitator and BDS providers
- Clear exit strategy
- Intervention focus on addressing market constraints.

(Committee of Donor Agencies for Small Enterprise Development, 2001).

11.2.5 Chambers of Commerce

In more developed economies, the private sector has developed their own organisations for common functions, lobbying, etc., for example Chambers of Commerce, Industrial Associations or Exporters' Associations. Similar organisations exist and are also increasingly being created in developing countries, sometimes with the active support of donors. In many former socialist countries, Chambers of Commerce existed as a part of the public sector system, but they have now been transformed to private sector organisations. The private sector organisations have become popular vehicles for donors as part of their private sector development efforts. Chambers and other organisations have often taken on, or been persuaded to take on, various service functions to the private sector such as consulting and other services. "Twinning programmes" between private sector organisations in a developed and a developing country is a popular form of assistance with the purpose of developing the organisations.

The experience gained from such support varies: there are examples where the organisations have been too weak, both financially and in terms of staff, to play a meaningful role and to absorb the support. The financial bases of the emerging chambers and associations are too meagre for anything but to achieve skeleton staff as they depend on voluntary fees from the private sector. Furthermore, in many countries the ambition to have regional chambers contributes to shortage of resources. There is a risk that donors spend too much on adding services to be carried out by these organisations, which cannot be sustained when the support is withdrawn. While the long-term capacity building of private sector organisational systems to act on behalf of private enterprises is an essential task, it is often felt that these organisational are regarded rather sceptically by the private sector and often considered as arenas for vested interests (Lindahl et al 1999). Lessons learned from such support are that donors need to carefully assess the degree to which a chamber or other private sector organisation is representative of the business community before providing support and, when such support is provided, to focus on building its internal capacity to manage its core functions.

11.3 Direct Interventions at the Market Place

Donors have sometimes tried to provide assistance to market-players directly without channelling such assistance through any local system or organisation. Such support can be in the form of subsidised services provided by outside consultants, or such services provided free of charge. Three examples of support of this type are discussed below.

11.3.1 Matching grant funds

So-called Matching Grants is an increasingly popular form of support among donor agencies for business development, for example to promote exports. Selected companies are provided with a donor grant on a matching fund principle for undertaking specific activities, such as market research and export marketing and promotion. The justification of such grants is that imperfections in information and/or high initial costs to establish a new country/product on external markets make potential domestic exporters unwilling to invest in export facilitating activities as pioneers. The subsidy is expected to pay off in welfare returns as other companies benefit from 'spillover' (market information and/or generic market investment, etc.) resulting in increased foreign exchange earnings, employment and economic growth. In addition, matching grants are expected to create domestic markets for consultancy services.

Studies of matching grant schemes have shown that the benefits of such schemes can be considerable: the exports of the subsidised firm can have a value that is many times more than that of the investment, and also more than that of other firms (Phillips 2001). However, the evidence is not conclusive. Other studies indicate that the donor grants only subsidise developments which would have taken place anyway on the initiatives of the firms. For example, a study by the World Bank of a 'successful' matching grant scheme supported by the World Bank in Mauritius, concluded that the scheme had resulted in high private returns to participating enterprises, but low public benefits. The grants largely financed technology acquisition that would have taken place anyway through the companies' own efforts. The study also concluded that the argument that the Mauritanian consultancy sector had expanded as a result of the grants was weak (Biggs 1999).

11.3.2 Direct enterprise support

The International Trade Centre (ITC), a UNCTAD/WTO organisation that has specialised in technical assistance in trade development since the 1960s, embarked on what was called the *direct enterprise approach* in the 1980s, due to disappointing results in working through public sector entities such as TPOs. Selected enterprises in developing countries in specific sectors, such as garments, furniture, etc., which were considered to have export potential, were provided with technical assistance in design, product development, marketing, packing, participation in trade fairs, etc., on the basis of a company needs assessment. This assistance was supplied by international consultants, generally free of charge to the enterprises. The justification of such intensive assistance to individual enterprises was that these enterprises would act as models to other enterprises in the same sector, both as successful examples and through organised workshops and seminars for dissemination of their learning and experience. The direct enterprise approach became a popular model, applied also by some (bilateral) donor agencies wanting to provide assistance in trade development.

The experience gained was that some enterprises in receipt of support indeed began exporting or expanding existing exports. However, the ITC and other agencies eventually gave up much of the direct enterprise approach. The overall impact on the export sector was limited compared to the considerable resources invested. The demonstration effect was often limited as the successful companies tended to avoid 'disseminating' their learning for reasons of competition. Furthermore, there was a tendency that some enterprises specialised in attracting (free) donor support, thus receiving similar types of support from different donors who did not coordinate their efforts.

11.3.3 Training of informal entrepreneurs

Provision of training programmes for entrepreneurs in different subjects is a common form of public sector support in both developed and developing countries, in the latter generally through donor assistance. One example of a programme of this kind, aimed at the smallest type of enterprises, is the *Start and Improve Your Business, (SIYB),* operated by the International Labour Organisation (ILO). The programme, which is aimed mainly at small business operators, emerged from a training programme called *Look after your firm*, which was produced by the Swedish Employers' Association for small enterprises in Sweden. Sida funded an adaptation of this programme for developing countries in the 1970s through the ILO. The programme, then called *Improve Your Business*, was first held in Africa, but expanded in the 1990s under the name *Start and Improve*

Your Business to other regions as well. It has hitherto been spread to over 60 countries, and over 100,000 entrepreneurs have undergone training through various SIYB projects. A large share of these entrepreneurs are female entrepreneurs in Africa (Samuelsen 2000). While a massive and diverse programme of this nature is difficult to assess in its totality, there is evidence that the programme has met with some success in terms of changing attitudes and improving basic know-how in business operations (Lindahl and Dainow 1988; Fish 1991; Samuelsen 2000).

11.4 Direct Business Support

11.4.1 The pros and cons of market support systems

Direct interventions in markets and in the private sector by donors tend to be justified as efforts to overcome various structural constraints, such as undeveloped financial markets, financial gaps, lack of knowledge of entrepreneurs, undeveloped markets for business services, and lack of business organisations. Such interventions tend to be heavily subsidised or provided free of charge. The direct enterprise support is often modelled on that provided in industrialised countries, where subsidised interventions by governments to 'nurture' the private sector have been common. While there are many examples of meaningless and unjustified interventions both in developed and developing countries, there are also good arguments for some types of interventions:

- Externalities: If a government/donor intervention in a 'pioneering activity' can demonstrate the viability of a concept, and spur copying by other enterprises, thereby generating employment and spreading new technologies, the benefits to society are greater than to the individual enterprise. The government/donor accepts the higher risk associated with the demonstration and the pioneering effort. The risk, of course, is that the pioneering effort is premature and ill-adapted to the particular environment, leading to no spin-offs.

- Information asymmetries: Small enterprises and the informal economy in particular are confronted with clear obstacles to obtaining market information and information about recent technologies.

- Equity and distribution: Government/donor support to market players for the purpose of developing depressed regions is a case in point. Support of business development for groups discriminated against in society, e.g. ethnic minorities, is another example. Such equity considerations tend to be a trade-off with the most efficient use of resources. Regional development in particular might be a costly affair with limited long-term benefits.

While there are arguments for certain types of direct market interventions by donors, there are also inherent risks with such support. These can be expressed as market distortions, and are of the following types:

- Distortion of competition: This is almost inherent in direct support to individual enterprises, be it financial or technical support. The assistance, if provided below cost, provides – at least in theory – an advantage to the recipient enterprise over other enterprises in the sector. Such distortions are negative in terms of efficiency – less efficient enterprises might be given an advantage, and there are also arguments of fairness and 'level playing fields'.

- Sub-standard investments: Assistance provided below market prices, especially loans, risk promoting sub-standard investments and enterprises, leading to an inappropriate allocation of resources in the economy. Similar arguments can be made for equity financing, when the expected return on such investments is below the market rate.

- Preventing markets from emerging: Subsidised or free business support prevents the development of a commercial market for such services, both by making enterprises expect subsidised services, and by crowding out commercial players.

11.4.2 Principles for business support and direct interventions in markets

Direct private sector support is often hands-on and provides visible benefits to participants. It has a strong goodwill value. Direct support to the private sector is also essential as a means of 'reality testing' of achieving direct feed-back, and of maintaining a dialogue with the prime movers in PSD. From this point of view, donors can use opportunities in PSD to feed back information on structural constraints to PSD, which, in turn, can be used in other forms of development assistance.

Certain key principles which should govern direct support are:

- Assess each potential PSD intervention in respect of its leverage effect on the business environment. In general, to justify development assistance, the impact of the support must go beyond the enterprises targeted. Administratively costly support with a marginal impact in a broader PSD perspective is poor resource utilisation.

- Avoid obvious market distortions in direct PSD support by focusing on industrial or business sectors, including regional clusters, rather than on individual enterprises. PSD support should, in principle, be open to any company in a sector. However, a system of selection might be required. Selection of this type might use the price mechanism as a means of making allocations or could draw on quality assessment by professional bodies.

- Avoid capital subsidies to commercial operators, unless there are very clear cases of externalities and, in such cases, only for high-risk, pioneering efforts. Donors should particularly avoid distorting capital markets by providing subsidies to specific financial intermediaries.

- Carefully review the risk of direct PSD support for retarding and preventing development of markets, for example in business services or micro finance. In such cases, donors should promote the development of such markets, rather than compete with them.

- Be restrictive in direct forms of PSD support that bypass domestic organisational structures. In funding such structures, preference should be given to private sector organisations, especially in fields where there are no compelling arguments for a government intervention.

- Support PSD advocacy groups, especially for small enterprises, with the purpose of changing government policy, institutions and governance, as a means of creating change towards enabling environments.

Integrating Market and Private Sector Development into the Development Agenda

CHAPTER 12

12.1 A Cross-sector Approach

Market and PSD should be at the heart of a donor agency's work and objectives. As discussed throughout the text, effective market and private sector development is dependent on peace and stability, and human resource development, including health and education. A functional infrastructure and utility services are critical, as is good governance, democratic development and a vibrant civil society, i.e. broadly the focus of most donors. However, it is not a one-way flow: private sector development can also contribute to all these aspects of development. Thus, Market and PSD is not about a sector, but is at the centre of development assistance. In donor agencies which organisationally tend to be departmentalised, for example into subject areas, a cross-sector approach of this type tends to be difficult to implement, and there is a tendency to create yet another department or section to deal with markets and/or private sector development. While such an organisational focal point might be unavoidable, the effectiveness of pro-poor market and private sector development will depend on the extent to which such units can mobilise the actions of other units for coherent approaches.

Donors can reinforce a cross-sector approach through:

- an on-going dialogue between the different sector departments on the role of the private sector;

- on-going programmes of human resource development in order to create an enabling environment for effective private sector development and pro-poor growth; and

- the development of instruments for analysis and diagnosis of the market and the private sector. Such instruments aim to determine areas to be given priority by development assistance and would assist in assessing various projects and programmes from a Market and PSD perspective. This is further elaborated in Annex 1.

12.2 The Poverty Reduction Strategy Papers

The Poverty Reduction Strategy Paper (PRSP) initiative is a World Bank initiative which today underlies much of the support provided by the World Bank and IMF to specific countries, as well as the assistance provided by many other donors. A PRSP describes a country's macro economic, structural and social policies and programmes to promote growth and reduce poverty, as well as associated external financing needs. PRSPs should be prepared by governments through a participatory process involving civil society and development partners, including the World Bank and the IMF (see Box 35.)

Box 35. PRSP

According the World Bank, five core principles should be the basis for the development and implementation of poverty reduction strategies. The strategies should be:

1) country-driven — involving broad-based participation by civil society and the private sector in all operational steps; 2) results-oriented — focusing on outcomes that would benefit the poor; 3) comprehensive in recognising the multidimensional nature of poverty; 4) partnership-oriented — involving co-ordinated participation of development partners (bilateral, multilateral, and non-governmental); 5) based on a long-term perspective for poverty reduction. See further www.worldbank.org/poverty/strategies.

While growth is an essential element of PRSPs, one common experience is that hitherto many PRSPs have been weak in outlining ways in which growth can be achieved. Also, PRSPs largely focus on the role of government and sectors in which governments are key players, while the private sector dimension is less prominent. However, the donor community is active in improving the quality of the PRSPs as a general tool and in specific countries and over time the private sector dimension is likely to be given a more explicit role. If fully 'owned' by the government and other stakeholders a PRSP is an excellent instrument to create the cross-sector and coherent approach which is required for pro-poor market and private sector development. The importance of bringing in a broad spectrum of players in society, from those setting the rules of the markets to those acting within such frameworks, must be stressed.

12.3 Dialogue with the Market Players

Donors need to interact with and take into consideration the market players and the private sector much more than in the past, both domestically in recipient countries, and internationally on a global scale. Such a dialogue should not be considered a "sell-out to the market", but a means to make commercial forces working for the poor most effective. Donors, who generally themselves have little experience of business, should not second-guess what business thrives on, but need to maintain a dialogue with the market players, for example in their formulation of donor strategies and programmes.

The interaction with the market players should ideally cover the whole spectrum –the poor in the informal sector, smallholders, domestic small and medium-size enterprises, and representatives of multilateral companies investing in or trading with the developing countries. If private sector organisations exist, such as Chambers of Commerce, or Industrial Associations, these can be appropriate partners in the dialogue. Interviews with global traders and investors can quickly provide an insight into the reasons why certain countries are marginal in the global business environment, and what the key constraints are in their business environment.

Particular attention needs to be given to the constraints and opportunities in respect of the poor and women. Participatory methods, such as those developed in Rapid Rural Appraisal, RRA, (see section 1.6.6) can be applied and are critical for canvassing the views of smallholders and operators in the informal economy.[16]

12.4 Diagnostic Instrument for PSD

In Annex 1 of this report a diagnostic instrument is presented, based on the concepts of this report. The purpose of this instrument is to assist a donor to make an overall assessment of the market and private sector environment from a pro-poor perspective. The assessment can be used as a background to define interventions, for the dialogue with governments, etc. The diagnostic instrument uses to a large extent public sources of information offered by, for example, the World Bank and the United Nations Development Indicators. The instrument is based on a principle of relative performance of various parameters in comparison with other countries at a similar stage of development, or in the same geographical region. It should be stressed that it is an instrument that is still under development.

[16] Rapid Rural Appraisal (RRA) is a technique which was developed in rural development in the 1980s with the purpose of involving local stakeholders in the definition of the development problems facing their villages and also involving their problem-solving.

Annex 1:

A Diagnostic Tool for Country Level Assessment of Conditions for – and Performance of – the Market and Private Sector

The following is an outline of a diagnostic tool where different indicators are assembled for a specific country in order to guide an assessment of conditions for, and performance of, the market and the private sector. It was originally outlined for Sida's purposes and should still be considered work in progress. The purpose of the tool is to assist donors in their development of approaches to assistance, and to provide an instrument in the dialogue with partner countries. It can also easily be used by governments or other parties in their work.

The diagnostic tool is based on a process of gathering data from public sources, some of which are available on-line, as indicated below. The data are linked to, and analysed against:

- *a set of eight different key indicators,* essential for poverty-focused market and private sector development, either as an outcome or as a condition. The set of key indicators is based on the determinants for market and private sector development discussed throughout this report: Economic Performance Growth, International Competitiveness, Broad Macro Conditions, Private Sector Policy and Institutional Environment, Property Rights, Human Resource Base, Financial Systems and Infrastructure.

- *trends over time of the key indicators,* indicating the direction of the Market and PSD in the specific country.

The benchmarks against which these key indicators and trends can be judged should be the averages and trends of key indicators from relevant 'peer' countries, such as countries at a similar stage of (economic) development or countries in the same geographical region, etc. It should be noted that the benchmarks need to be established before the tool can be used.

An analysis of these data gives a first cut diagnosis which should be supplemented by qualitative assessments of the market and the private sector and the role for poverty reduction from formal sources such as the PRSPs, the IMF, the EIU and the World Bank country reports, etc., as well as from available informal sources. (It should be noted that, in respect of the model's efforts to quantify performance for a number of key indicators and to compare these to 'peer' countries as benchmarks, the process suggested here is a more ambitious undertaking in assessing markets and PSD than what is undertaken today, for example in the PRSP.)

For the diagnostic tool to be comprehensive, the assessment should ideally cover, for each key indicator: 1) Market and PSD in general; 2) the degree of inclusion of the poor, and 3) inclusion of women.

The Key Indicators: 1. *Economic Performance/Growth*

Relating *Economic Performance/Growth* to Market and PSD in general

The main objective of an efficient, private, market-based economy is to generate sustained economic growth. Thus, the level of economic growth over an extended period of time can be considered the most important indicator of how effective PSD is. Long-term growth in GNP per capita is also a critical indicator of a country's ability to combat poverty. Economic growth data (real GDP or GNP growth per annum) are readily available for almost all developing countries over extended periods of time from a variety of sources, notably the World Bank's *World Development Indicators*, also available on-line; www.worldbank.org; IMF's *World Economic and Financial Surveys* and *World Economic Outlook* database, www.imf.org; and UNDP's *Human Development Report*, all published annually. The World Economic Forum's *Global Competitiveness Report* provides longer-term series (30 years) on an annual basis for those countries included (currently about 80 countries). However, WEF's reports are not on-line.

As no countries are independent of the world economy, short and long-term economic growth data should be benchmarked against parallel time series for a set of countries, preferably presented as a graph for easy consultation. A donor may use average economic growth for one or several of the following benchmarks:

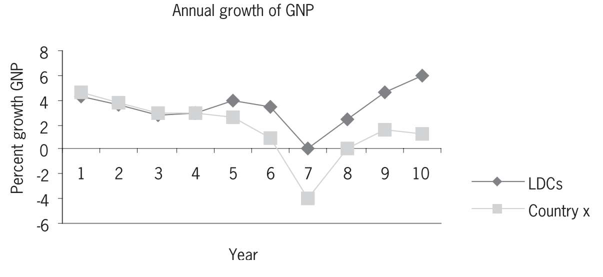
a) developing countries in total

b) developing countries at a similar level of income (e.g. LDCs, low income, etc.)

c) the relevant geographical region (such as sub-Saharan Africa)

For an example of how such a graph could look, see the figure below.

Example of growth pattern in a chosen country



Qualitative assessments from formal and/or informal sources should be consulted to obtain an in-depth assessment of underlying reasons for good or bad performance relative to benchmarks. Such assessments might show extraneous factors such as major changes in world market prices for dominating commodities, 'transitional costs' from induced policy reforms, etc.

Relating *Economic Performance/Growth* to the inclusion of the poor

Effective Market and PSD for poverty elimination requires growth strategies which either directly include the poor (pro-poor growth) and/or effective redistribution mechanisms. A combination of the following indicators might be used:

- *Income equality*, for example measured by the Gini index (for a definition of Gini, see below[17]). An alternative to Gini is the percentage distribution of total income on different strata, e.g. the percentage of total GNP by the bottom and top 10 or 20% of the population. Data are available for most developing countries, for example in the World Bank's World Development Indicators. However, data are often 5–10 years old. A 'low' Gini indicates either effective direct inclusion of the poor, or effective redistribution, or a combination of these.

- *The overall quality of human development*, expressed in rates of literacy, enrolment of children in primary school, life expectancy, infant mortality rate, nutritional status, etc. Such data, adjusted for income levels as these parameters are strongly correlated with the per capita income level of countries, can be used as proxies of socio-economic distribution in society. Data are readily available from the World Bank, UNDP, etc.

- *The number of absolute poor*, i.e. people living on less than USD 1 per day. As this is a key objective and indicator for the Millennium Development Goals, such data should become increasingly available. Both the World Bank's World Development Indicators and UNDP's Human Development Report make assessments. Data must be benchmarked, for example against the average for countries at a similar level of income.

[17] The Gini index measures whether the distribution of income in a country deviates from a perfect equal distribution. Zero represents perfect equality, 100 (%), total inequality. Countries with a good degree of equality in income distribution tend to be in the range of 20–30, while unequal societies are in the range of 50–60.

- *Growth of agriculture*, since agriculture is often the main livelihood of the poor. Such growth might be compared to the overall growth of the economy, and to countries at similar level of income. Data are available from annual reports of the World Bank and UNDP. Such data can shed light on the direct involvement of the poor.

- *Government expenditures on health and (primary) education* might be used as a proxy of the redistribution mechanisms in society. Data readily available from the annual development reports of the World Bank or UNDP. They can be benchmarked against developing countries as a whole.

The UNDP's *Human Development and Human Poverty Indices,* which are calculated and published each year, use some of these indicators and others. Such indices might also be used, adjusted for economic levels, to determine the inclusion of the poor in the economy, directly or indirectly. Another source is the UNU/WIDER *World Inequality* database, see www.wider.unu.edu/. The Social Watch Institute, an NGO based in Uruguay, provides information on an annual basis on trends in poverty reduction and gender development, especially against the Millennium Development Goals and other international commitments, see www.socwatch.org

In addition to these indicators, qualitative assessments by formal and informal sources of the inclusion of the poor in the economy and in the private sector should be consulted to provide a more comprehensive picture.

Relating Economic Performance/Growth to the inclusion of women

The inclusion of women in the economy and Market and PSD is both an essential aspect of poverty elimination, as women tend to be over-represented in poverty categories, and an objective in its own right. In many countries women are highly over-represented in non-market and lowly remunerated economic activities. Discriminatory practices affecting the economic position of women and their ability to participate in productive private sector activities exist in many countries and are, for example, manifested in legislation, regulations, property rights, etc., as well as in more general cultural norms.

Gender-related international data are collected by various UN organisations (ILO, UNESCO etc.), which can provide a proxy. UNDP assesses gender equality in its *Gender-related Development Index*, based on gender gaps in parameters such as life expectancy, literacy, school enrolment and income. UNDP also compiles a *Gender Empowerment Index*, based on parameters such as representation in politics, professions, management systems, etc. See UNDP *Human Development Report*. A broad database for gender is the WISTAT produced by the UN, www.un.org/Depts/unsd/gender, which also includes various data on economic activities, wage levels, etc. ILO produces a *Female Economic Activity Rate*, as part of its efforts to assess the work burden and time allocation on market and non-market activities for selected countries.

An indication of gender participation is also female representation in parliaments, reported annually by the Inter-Parliamentary Union, www.ipu.org.

These data, however, provide a poor reflection of activities in the informal economy, and need to be supplemented by qualitative assessments, country by country, in a thorough PSD diagnosis.

Strategic choices in relation to indicators of Economic Performance/Growth

Economic performance and the degree of inclusion of the poor and women should give a broad, first-cut proxy of the quality of a country's poverty-oriented market and PSD. Countries which show positive genuine trends in economic growth, with a high degree of inclusion of the poor/women, and clearly perform above the benchmarks, appear to be 'doing things right'.

On the other hand, countries which 1) show declining growth trends, and/or 2) consistently deviate negatively from benchmarks, probably have problems in PSD. In particular, poor nations with such poor growth are almost prevented by definition from addressing poverty. If such countries also have a low degree of inclusion of the poor/women, a 'worst' scenario is at hand. Such cases should be taken as a strong signal to a donor to probe more deeply into the constraints in PSD and the options available to the donor to address such constraints. Below there are some possible hypotheses for further analysis:

		Rate of economic growth	
		Low	**High**
Degree of inclusion of the poor	**Low**	Most serious scenario; situation possibly due to conflicts and societies in stage of collapse; or seriously misconstrued policies; might require basic governance; conflict resolution and/or fundamental policy reform as preconditions for PSD	Requiring redistribution policies; focus on human resource development for empowerment, etc. In PSD focus on pro-poor growth approaches, e.g. in agriculture; informal economy, etc; review of discriminatory policies of the poor in economic activities
	High	Focus on obstacles to PSD for overall growth; e.g. required policy reforms; institutional reforms; less focus on pro-poor growth strategies	Best scenario: Lower priority for PSD; focus on long-term capacity and transformation to higher economic levels, e.g. diversification of exports, value added production, etc.

The Key Indicators: 2. *International Competitiveness*

Relating International competitiveness to PSD in general

In a globalised world, a country's ability to achieve sustained economic growth is closely linked to its international competitiveness, which is reflected in its export performance and in its ability to attract investments. To assess international competitiveness, the following indicators might be used:

- *Degree of openness of the economy* – measured as exports of goods and services as a percentage of GDP data readily available from the annual reports of the World Bank, IMF and UNDP. Benchmarks should be based on the size of the economy. The smaller the country, the greater the need for exchange with surrounding countries. Standards, based on size and economic performance, need to be established.

- *Tariff structures* – high protection of the domestic economy through tariffs or other barriers tends to indicate a low degree of competitiveness. Tariff structures and trends in tariffs are provided by IMF and World Bank databases, which show mean tariffs for different categories of products. Data to be benchmarked against developing countries in general.

- *Export growth* – both current and long-term trends. Export growth, preferably shown as long-term trends in a graph, should be benchmarked both against GNP growth for the country, and the average of countries at similar level of income. Such data are readily available from the sources mentioned above.

- *Diversity of exports* – the share of the most important export products compared with total exports. High reliance on one or a few products or services reflects a narrow production base, and a higher degree of economic vulnerability.

- *Terms of trade*. The extent to which the price relationships between exports and imports are favourable or not. Improving terms of trade indicates that the country is specialising in exports with more favourable conditions on global markets.

- *FDI as a share of GDP*, indicating attractiveness to foreign investments – data are available from UNCTAD's World Investment Report, and also reproduced in World Bank and UNDP reports. Such data should be benchmarked against countries at a similar level of income and/or geographical region. UNCTAD's FDI in LDCs provides an in-depth picture each year of the FDI environment.

- *Diversity of FDI* – single sector FDI, for example in mining or oil exploration, reflects higher vulnerability and possibly also a much less positive impact on the overall economy. Data available from UNCTAD, www.unctad.org.

- *Technology transfers* through FDI and technology licensing. WEF includes indicators of this type in its competitiveness report.

As international competitiveness tends, in general, to be a good proxy for the business climate in a country, broad-based indices of competitiveness might be used. Several organisations make such assessments, weighing together a large number of criteria. Since 1979, World Economic Forum, WEF, has published *the Global Competitiveness Report*, which currently includes 80 countries, and also Competitiveness Reports for Africa (24 countries), Arab countries, Latin America and Asia. Summary data are available on the web, www.weforum.org. The Heritage Foundation and the Wall Street Journal have published *the Index of Economic Freedom* annually since 1995, also available on the web, www.heritage.org. The Canadian Fraser Institute has issued *the Economic Freedom of the World Report* annually since the 1970s.Today it covers 124 countries and is available on the web, www.fraserinstitute.ca. The International Institute for Management Development, IMD, has published the *World Competitiveness Yearbook* since 1989, which covers some 60 countries. However, only a few are developing countries, mostly in Latin America, www.imd.ch. A limited amount of information is available on the Internet.

Relating *International competitiveness* to the inclusion of the poor

None of the data sources mentioned above attempts to single out inclusion of the poor, or to make gender assessments in terms of competitiveness. Parameters essential for the assessment of the role of the poor in a country's international exchange may provide an indication of their economic inclusion. Examples of such parameters might be:

- The role of the poor in exports of goods and services. This is reflected in the structure of exports of goods and services (e.g. in employment in export commodities)

- The importance of (smallholder) agriculture in the country's exports of goods and services

- Tariff structures for products and services of particular importance to the poor

- Disincentives for poor producers, such as export taxes of smallholder export-oriented agriculture.

The Key Indicators: 3. *The Macro Conditions*

A number of broad factors of a political nature have been defined as critical determinants of effective private sector development in general, and of Market and PSD, which is effective in reducing poverty and creating gender equality, in particular.

- *Peace and stability.* Usually conditions of political instability, civil war etc., are well-known, requiring no assessment from specialised databases. It is, nevertheless, a critical determinant of the environment for business, and should thus feature clearly in a PSD diagnosis. Recently, the risk of terrorism has also emerged as a critical condition in the business environment, and is now included in WEF's competitiveness report. For more detailed information on conflicts, armaments, military spending, etc. Useful sources are the International Institute of Strategic Studies, SIPRI, etc. and UN and World Bank databases, which also have certain data.

- *Rule of law,* for example reflected in an independent judiciary, impartial courts, integrity of the legal system and efficiency in the legal system. A rating of this has been undertaken for a large number of countries by the Fraser Institute as an element in its Economic Freedom Index. Also WEF has a series of indicators in its Competitiveness Reports, for example of the prevalence of organised crime and the cost to business due to crime and violence.

- *Democratic rule* and respect for human rights might be considered a determinant of PSD, especially in the longer-term. The depth of democracy and respect for human rights is assessed by a large number of organisations, allowing international comparisons to be made to a certain extent. Qualitative assessments for selected countries are made by organisations such as Amnesty International; the Freedom House; the US Bureau of Democracy, Human Rights and Labour, www.state.gov/wwwglobal/humanrights; and the Human Rights Watch Institute, www.hrw.org.

- *Good governance,* for example reflected in honesty, competence, transparency, impartiality, reliability and efficiency in government and government services. WEF includes a series of assessments in its Global Competitiveness Report. One often used rating of the degree of corruption is the index in the Global Corruption Report, produced annually by Transparency International for a large number of countries, www.transparency.org.

These broad aspects of the political environment tend to be reflected from a business point of view in political risk (of doing business or investing in a particular country). Such political risk analyses are carried out by a large number of commercial and semi-commercial organisations, such as the EIU *(EIU Country Risk Guide* published regularly for some 180 countries, www.eiu.com) ; and PRS, which issues *the International Country Risk Guide* for some 130 countries, (www.prsgroup.com) etc. They might be used as a first-cut proxy in a PSD diagnosis, supplemented by in-depth analysis of the factors that contribute to a high (or low) risk rating. Export Credit Agencies also make political (and economic) risk analyses for a large number of countries.

The Key Indicators: 4. *Private Sector Policy and Institutional Environment*

Relating *Private sector policy and institutional environment* to PSD in general

There is a broad consensus in the donor community and among economists today that an enabling private sector policy environment comprises the following key elements:

- Macro economic stability and sound monetary policies, reflected in low inflation rates, controlled budget deficits, and realistic exchange rates. Data available in World Bank and IMF databases. Benchmarks should be developing countries in general.

- An open trade regime, reflected in low tariff rates, few non-tariff barriers and limited other forms of protectionism, no taxes on exports, allowing a high degree of competition in the economy, and free flows of goods and services. (Data as above).

- Reasonable levels of taxation for both enterprises and individuals, and transparent and predictable methods for the collection of taxes. Taxes are disincentives to business activities, and high levels and arbitrary implementation promote tax evasion, corruption, capital flight, etc. IMF is the key source, also reproduced in World Bank database, focusing on levels of taxation, while WEF assesses efficiency of tax systems.

- Low level of government intervention in the economy, reflected in reasonable government consumption and a limited level of state ownership of productive assets.

- Low level of regulatory burden on markets in the form of licensing, permits to start new businesses, etc., reflected in ease in starting and operating businesses, and a small amount of time for dealing with regulatory matters. Government regulations limited to corrections of market failures.

- Low degree of price controls.

- Liberal capital and foreign investment policies, reflected in openness to foreign investments, limited restrictions and regulations on foreign investments, freedom to own foreign currencies, etc.

Assessments of the private sector policy environment are critical in a PSD diagnosis, as policies are often the key cause of a poorly functioning economy. There are many existing systems that try to assess the policy environment for the formal business sector on the basis of these and similar indicators. The World Economic Forum, the Canadian Fraser Institute and the Heritage Foundation/Wall Street Journal, include such assessments in their annual publications. The World Bank has published annually (from 2003) a *Doing Business* Report, based on assessments, initially for 110 countries, of parameters that will eventually include: business entry regulations; licensing; enforcement of contracts; predictability of changes in government regulations governing business activity; bankruptcy procedures; taxes and taxation administration, labour market regulations; credit markets, international trade transactions; access to external finance; and property rights. Each of these parameters uses a series of criteria, all shown in the database. The database is freely available on the web, allowing detailed assessment of the countries included in respect of the parameters listed above. See rru.worldbank.org/DoingBusiness. Currently it includes the indicators in italics above.

Relating *Private sector policy and institutional environment* to the inclusion of the poor, and specifically of women

The sources mentioned above concern primarily, or entirely, the formal business environment. The business environment as it impinges on the poor (or women specifically) might differ considerably, especially if the poor derive their main livelihood from the informal economy. There is a need to establish key indicators and to build databases in this respect. Parameters that might give an indication of the policy environment for poor producers might include:

- *The size of the informal sector* in terms of GDP and/or employment (a large sector, relative to the stage of economic development of the country, probably indications of discriminatory policies against small, poor producers, barring them from the formal sector);

- *The regulatory burden* in sectors of specific importance for the poor, especially smallholder agriculture, using similar criteria to the World Bank's *Doing Business* database.

The Key Indicators: 5. *Property Rights*

Relating Property Rights to PSD in general

A short cut to the assessment of formal property rights is provided by the Heritage Foundation's Economic Freedom Index. It assesses on an annual basis aspects such as the legal foundations of property, commercial codes, degree of government influence over the judiciary system, and corruption within the judiciary. The World Bank's *Doing Business Report* also includes property rights assessments, and includes indicators such as the process of land registration, security market regulations, intellectual property rights, etc.

Relating Property Rights to the inclusion of the poor

Ways in which property rights affect the poor cannot be assessed from available data sources. The Instituto Libertad y Democracia, ILD, of Hermann de Soto, has undertaken a few such assessments, available on the Internet. ILD claims a year's work for a thorough country diagnosis, but short cuts can obviously be made. There is a need to develop a rapid diagnosis instrument in this field as a guide.

The Key Indicators: 6. *The Human Resource Base*

Relating the Human Resource Base to PSD in general

The human resource base is a critical determinant of long-term growth and effective PSD. The key elements of human resource development are universal and gender-neutral educational and health standards. As proxies to judge the human resource base, the following indicators might be used:

- *School-enrolment* – using for example UNDP's combined primary, secondary and tertiary gross enrolment ratio (see UNDP Human Development Report). This data should be benchmarked against countries at a similar stage of economic development.

- *Government spending* on health and education as a share of GDP using countries at similar level of income as the benchmark;

- *Health indicators*, for example infant mortality rates and expected longevity, percentage of malnourished children, benchmarked against countries at similar stage of economic development.

Data on human resource development are available from the World Bank's World Development Indicators and UNDP's Human Development Report, both issued on an annual basis, but with varying years of time-lag.

Relating the Human Resource Base to the inclusion of the poor

The basic indicators of human resource development are in themselves a sign of the degree of inclusion of the poor in the economy. Thus, good standards in literacy, school enrolment, and health – relative to the degree of economic development of the country – is sign of inclusion of the poor.

Relating the Human Resource Base to the inclusion of women

Where gender is concerned, the UN publishes gender gaps in terms of life expectancy, literacy, school enrolment and also income, for example in the UNDP Human Development Report. In particular, data on gender gaps in school enrolment in primary, secondary and tertiary education provide good proxies of the extent to which countries include women in building human resources for the future.

Human resource development as a key determinant of the ability of an economy and the private sector to transform, enhance productivity and innovate is closely related to investments in higher education. Indicators of this, adjusted to income level, are:

- *Government expenditure* on higher education as a share of GDP
- *Tertiary students* in science, mathematics and engineering, provided for most countries by UNESCO, reported also by UNDP.

The Key Indicators: 7. *Financial Systems*

Relating *Financial systems* to PSD in general

The WEF Competitiveness Report includes a series of parameters in the assessment of the financial systems in the countries included. Most of these are based on the executive poll carried out by WEF, and hence are qualitative judgements by informed persons in business. Examples of such parameters are: financial market sophistication; soundness of the banking system; ease of access to loans and access to credit; venture capital availability, and local equity market access. The IMF database *International Financial Statistics* provides information on 'hard' aspects of the financial system which can contribute to an assessment of its depth and effectiveness as a determinant of the PS environment. Such data are, for example, credit to the private sector (as a share of GDP); interest rate spreads; bank liquid reserves (as a share of bank assets), etc. In terms of the function of stock markets, a number of indicators are available through the IMF and the World Bank for countries which have such equity markets, for example market capitalisation (as a share of GDP), value traded (as a share of GDP), and turnover ratios (value of shares traded as a percentage of capitalisation). See further the World Bank's World Development Indicators. Country investment risk analysis is provided by a variety of commercial organisations such as PRS, Moody and Standards and Poor, some of which are available through the World Bank database. At a more detailed level, BankWatch provides analyses of banking systems in about 100 countries.

Relating *Financial systems* to the inclusion of the poor

None of the major organisations providing international data on financial systems has a breakdown by poverty groups or gender. Such indicators need to be constructed in order to assess the effectiveness of the financial systems directly for these groups. Examples of such parameters might be:

- *The depth of micro finance*, expressed as number of clients (of total population), value of portfolio, share of women among clients

- *Agricultural credit systems.*

The Key Indicators: 8. *Infrastructure*

Relating *Infrastructure* to PSD in general

Transport. The quality of the transport system in a country, given its stage of economic development, can be assessed to a certain extent for different types of transport systems using a variety of data sources. However, the quality of data is often poorer than desired, and the data are not always subject to the same standards, making international comparisons difficult. A reasonable proxy for the road infrastructure system is the World Bank's *Normalised Road Index*, provided in the World Development Indicators, which uses the length of paved roads in a country, compared to its 'expected' length (the latter determined by population density, per capita income, degree of urbanisation, etc.).

Information technologies: reflected in access to telephones, television and the Internet. Data per 1,000 inhabitants are provided in, for example, the annual reports of the UNDP and the World Bank. Also aspects such as waiting time, costs per local and international call, etc., are available, which taken together can provide an indication of the quality of the IT infrastructure. The WEF's *Competitiveness Report* undertakes ratings of countries in terms of various IT aspects such as availability of PCs, mobile phones, Internet users, Internet access in schools, etc. The original source of data for IT is largely ITU, www.itu.int. Any quantitative assessment of IT infrastructure must be related to the country's stage of economic development, expressed for example at the income per capita level.

Energy tends to be a key factor and input to private sector development. Important dimensions are accessibility (for example access in rural areas), diversity (availability of different sources of energy), reliability and price. The functioning of the energy market(s) is an important issue. Energy use, in terms of electric power per capita, or expressed as per capita kg of oil equivalent, is recorded in international statistics by IEA, and also published in the World Bank's *World Development Indicators*. Also trends in energy use are given. Such data might be used to indicate trends over time, and deviations from other countries. If such benchmarking is considered, it must be adjusted for income level. (For example, low-income countries use about 10% on average per capita compared to industrialised countries.)

Relating *Infrastructure* to the inclusion of the poor

Indicators needs to be established which make it possible to determine the extent to which the infrastructure in a country is adapted to, and available for the poor as producers (and consumers). No such databases are available today, as far as is known. Proxies which might be used as a starting point are:

- *Share of the population* with direct access to electric power through connection to the national or regional grid (benchmarked against countries at a similar overall level of economic development (income/capita); if possible broken down by rural-urban areas

- *Availability of power systems in rural areas*

- *Cost per KWh* expressed as a share of GNP/capita (urban-rural)

- *Share of rural population with direct access to all-weather roads* (benchmarked as above)

- *Share of population with access to a telephone*

- *Cost of connection to telephone system* as a share of GNP/capita; cost per minute in mobile phones.

Annex 2:
The Millennium Development Goals and Targets

The Millennium Development Goals are an ambitious agenda for reducing poverty and improving lives that world leaders agreed on at the *Millennium Summit* in September 2000. For each goal one or more targets have been set, most for 2015, using 1990 as a benchmark:

The goals and the targets are:

1. Eradicate extreme poverty and hunger

Target for 2015: Halve the proportion of people living on less than a dollar a day and those who suffer from hunger.

2. Achieve universal primary education

Target for 2015: Ensure that all boys and girls complete primary school.

3. Promote gender equality and empower women

Targets for 2005 and 2015: Eliminate gender disparities in primary and secondary education preferably by 2005, and at all levels by 2015.

4. Reduce child mortality

Target for 2015: Reduce the mortality rate among children under five by two-thirds

5. Improve maternal health

Target for 2015: Reduce the ratio of women dying in childbirth by three-quarters.

6. Combat HIV/AIDS, malaria and other diseases

Target for 2015: Halt and begin to reverse the spread of HIV/AIDS and the incidence of malaria and other major diseases.

7. Ensure environmental sustainability

Targets:

- Integrate the principles of sustainable development into country policies and programmes and reverse the loss of environmental resources.

- By 2015, reduce by half the proportion of people without access to safe drinking water.

- By 2020 achieve significant improvement in the lives of at least 100 million slum dwellers.

8. Develop a global partnership for development

Targets:

- Develop further an open trading and financial system that includes a commitment to good governance, development and poverty reduction – nationally and internationally

- Address the least developed countries' special needs, and the special needs of landlocked and small island developing states

- Deal comprehensively with developing countries' debt problems

- Develop decent and productive work for youth

- In co-operation with pharmaceutical companies, provide access to affordable essential drugs in developing countries

- In co-operation with the private sector, make available the benefits of new technologies – especially information and communications technologies.

For details and most recent updates on performance, see www.undp.org/mdg or www.developmentgoals.org.

Source: UNDP and World Bank 2005.

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Glossary

BDS	Business development services
BOT	Build-operate-transfer
BOO	Build-operate-own
BRAC	Bangladesh Rural Advancement Committee
CGAP	Consultative Group to Assist the Poorest
CGIAR	Consultative Group on International Agricultural Research
CRS	Corporate social responsibility
DAC	Development Assistance Committee
DFI	Development financial institution
EKN	Exportkreditnämnden (Swedish Export Credits Guarantee Board)
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign direct investments
FIAS	Foreign Investment Advisory Service
FIRST	Financial Sector Reform and Strengthening Initiative
GDP	Gross domestic product
GNP	Gross national product
GPG	Global public goods
GTZ	Deutsche Gesellschaft fur Technische Zusammenarbeit
HIPC	Heavily indebted poor countries
HRD	Human resource development
HYV	High yielding varieties
ICFTU	International Confederation of Free Trade Unions
IFC	International Finance Corporation
IFSC	International Financial Standards and Codes

ILO	International Labour Organisation
IMF	International Monetary Fund
KWh	Kilowatt hours
LDC	Least developed country
LFA	Logical framework approach
LMD	Labour Market Dialogue
LO	Swedish Trade Union Confederation
LRF	Federation of Swedish Farmers
MDG	Millennium Development Goals
MFI	Micro finance institution
MIGA	Multilateral Investment Guarantee Agency
MSEK	Million Sweden Kronor
NICs	Newly industrialised countries
NIR	International Council of Swedish Industry
NGO	Non-governmental organisation
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PIDG	Private Infrastructure Development Group
PPI	Private participation in infrastructure
PPP	Public private partnership
PPP	Purchasing power parity
PRA	Participatory rapid appraisal
PRSP	Poverty reduction strategy papers
PSD	Private sector development
R&D	Research and development
RIPE	Reforming Infrastructure and Public Enterprises
SIYB	Start and Improve Your Business
SME	Small and medium-sized enterprises
TCO	Swedish Confederation of Professional Employees

UNDP	United Nations Development Programme
ZRL	Zambia Railways
WTO	World Trade Organisation

Notes on the Author

Claes Lindahl, a graduate in Business Administration from the University of Lund, Sweden, has thirty years of experience working in development assistance around the world. He was employed by the World Bank 1974–1978 in Washington DC in the fields of small-scale industry, development finance and rural development. Between 1978–1980 he was seconded by the World Bank to UNDP for a regional development project in Malaysia, functioning as an advisor on monitoring and evaluation to the government. Since 1981 he has managed his own consultancy company, Management Perspectives International, MPI, based in Stockholm, and undertaken numerous assignments on policy, strategy formulation and evaluation for bilateral organisations such as Sida, NORAD and Seco, and multilateral organisations such as the World Bank and the United Nations.

He has worked in some thirty developing countries and transitional economies, with extensive involvement in India, Indonesia, Kenya, Mauritius, Palestine, Sri Lanka, Tanzania and Vietnam. In terms of market and private sector development, he has worked extensively with development of trade and exports, finance, small-enterprise and rural industry, and industrial and private sector strategy formulation. He recently assisted Sida in its development of a Private Sector Development Policy. He is also a writer of fiction, with several novels published in Swedish.

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