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To: Members of the Committee of the Whole
for the Development Committee

From: The Acting Secretary

Subject: Private Sector Development

There is attached for the information of the Committee of the Whole a paper prepared by the staff of the World Bank on "Private Sector Development."

This paper provides background material for the October 14, 1991 Development Committee meeting, and for the discussion by the Committee of the Whole scheduled for Monday, September 9, 1991.

Att: (1)

Other Distribution:
Department Heads
Development Committee Secretariat

PRIVATE SECTOR DEVELOPMENT

Progress Report

I. INTRODUCTION: ROLE OF THE BANK GROUP IN PRIVATE SECTOR DEVELOPMENT

1. In response to the Spring 1991 request by the Development Committee, this paper reviews progress of the World Bank Group in implementing the PSD Action Program and reports recent management initiatives designed to strengthen the Group's efforts in this area.[1] The Bank Group's support for the private sector complements and reinforces its other special operational emphases which, together, form important instruments in the fight against poverty.

2. During the 1960s and 1970s, public policy was characterized by a confidence in the capacity of government to act as the main spur to development. In this context, and despite the Bank Group's concern with private sector development from its inception, it often accepted a large role for government and public sector entities in mobilizing and directing investment. In contrast, the 1980s witnessed a reexamination of the appropriate balance between the state and the private sector in promoting economic development.

3. As noted in the 1991 World Development Report, developing countries increasingly have come to rely more heavily on market signals and the actions of private entrepreneurs to help promote more efficient resource allocation and greater dynamism. The World Bank Group has played an active role in the reassessment of the relative role of the private sector (including NGOs), and is now acting as a catalyst in helping its borrowers to achieve a more appropriate balance between their private and public sectors and to promote greater efficiency in both government and business.

II. PROGRESS IN BANK GROUP ACTIVITIES SUPPORTING PRIVATE SECTOR DEVELOPMENT

4. This review of progress briefly covers first the activities of IFC and MIGA, and focuses then on Bank efforts to support private sector development. While considerable progress has been achieved, much remains to be done and Bank Group management will continue to seek ways of ensuring effective implementation of the 1989 PSD Action Program.

(a) IFC and MIGA Activities in Support of Private Sector Development[2]

5. As the environment for private initiative improves, it is vital that the private sector be helped in responding to emerging opportunities. IFC is responsible for providing direct finance to the private

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[1] See Private Sector Development Action Program (Sec.R89-9), January 11, 1989. This report is based on two recent Board papers: Private Sector Development: Strengthening the Bank Group Effort (Sec.R91-79) and Strengthening the World bank group Effort on Private Sector Development – A Supplemental Paper (Sec.R91-139).

[2] ICSID's activities are also of relevance, since it offers a forum for conciliation and arbitration of investment disputes between states and foreign investors.

sector in developing countries, without government guarantees. As a risk-taking minority partner, IFC's role can be crucial in encouraging and assisting entrepreneurs and companies, both domestic and foreign, to undertake sound investments which will benefit the local economy. IFC recently completed another strong year of operations, with the approval, in FY91, of 132 projects involving investments of $1.5 billion for its own account. The total capital cost of the projects it approved in FY91 is estimated to be nearly $10.7 billion; thus, for every dollar IFC invested, others invested $5.9 in non-recourse loans or equity participation. During FY91, direct mobilization, through loan participation and the underwriting and distribution of securities, reached $1.3 billion, as compared to approximately $700 million in FY90 and $400 million in FY89. IFC's portfolio also grew substantially in FY91 its committed portfolio consisted of loan and equity investments in 547 companies totalling $5.5 billion.

6. With the recent recommendation by IFC's Board of Directors to increase the Corporation's authorized capital by $1 billion, the Corporation expects its investments to grow at a rate of 11-12% per annum reaching $4 billion per year by the end of the 1990s. This increase in approvals is likely to mobilize additional private investment of approximately $29 billion per annum by the end of the decade. The Corporation expects its activities to grow in all major areas of the developing world, including Eastern Europe and the Middle East. In addition to expanding its own investment and advisory activities, IFC will work in close collaboration with the World Bank as described in section III below. The principal areas where IFC expects to make a meaningful contribution are:

Mobilization. IFC will seek to maximize its mobilization from private sources, with priority given to increasing direct mobilization through loan syndications, the underwriting and placement of securities, and possible new techniques such as securitized loan sales.

Privatization. Drawing on its knowledge of local business conditions and its financial skills, IFC will expand its privatization and restructuring services, particularly in Eastern Europe and Latin America. As part of this initiative, field offices have been opened in Warsaw, Prague, and Budapest, significantly expanding IFC's presence in that region.

Equity Investments. Given its financial structure and mandate, IFC is able to make equity investments in developing countries where alternatives to debt financing may be especially important. IFC management intends to raise the level of disbursed equity and quasi-equity investments from about $900 million in FY91 to $3.5 billion by the end of the decade.

Development of Domestic Capital Markets. IFC will continue to expand its activity in this area by helping to establish and strengthen local financial institutions and by providing technical advice to governments, in cooperation with the World Bank.

Private Sector Infrastructure Projects. In the 1990s, private investment in developing countries is expected to take place increasingly in areas, including infrastructure, that were previously dominated by the public sector. This will generate increased demand for IFC assistance in the private financing of telecommunications, power and port projects, without recourse to government guarantees.

Assisting Small- and Medium-Sized Enterprises. The Corporation will help meet the needs of these enterprises by extending market-based financing through local financial intermediaries. In addition, it will continue to support and expand programs targeted to assist new small and

medium enterprises (such as the Africa Project Development Facility and the recently created Polish Business Advisory Service).

7. MIGA is gaining ground in carrying out its mandate to encourage foreign private investment in developing countries. It helps by reducing or eliminating political risks through guarantee, consultative, advisory and promotional activities. In addition, FIAS (MIGA's joint facility with IFC) provides member countries with analysis and advice on their investment climate. These serve as the basis for reforms designed to eliminate obstacles to foreign investment. The activities of these member agencies of the World Bank Group provide valued services to member countries as they establish growing links with international private investors and capital markets.

(b) Bank Activities to Support Private Sector Development

8. Both Bank adjustment operations and a rapidly growing proportion of investment operations now emphasize private sector development as an objective. This trend holds true for all regions, with Africa and Latin America showing the fastest growth. Overall, two-thirds of Bank operations (150 out of a total of 228) in calendar year 1990 included identifiable PSD components. This represents considerable progress and compares with two-fifths (90 out of 220) in 1988. In addition, many Bank operations which do not explicitly involve the private sector nonetheless finance public investment complementary to (and often critical for) private sector development -- for example, transport infrastructure and agricultural research.

9. Bank adjustment loans all emphasize private sector development as an objective. These loans are mostly aimed at supporting fundamental reforms of the business environment, such as the elimination of entry barriers, the liberalization of trade, the reform of taxation systems, financial sector development and the streamlining of legal/regulatory frameworks.

10. The share of project investment loans that include direct or indirect private sector development components has risen from less than ten percent 1988 to almost half in 1990. Investment lending can provide support to private sector development both directly through resource transfers, and indirectly, through the backing given to policy, legal and regulatory reforms that strengthen the private sector. In addition, many Bank operations which do not explicitly involve the private sector nonetheless finance public investment complementary to (and often critical for) private sector development -- for example, transport infrastructure and agricultural research.

11. The 1989 Action Program provided a starting point for stimulating and disaggregating Bank Group efforts at private sector development. It distinguished among three key tasks to help promote PSD: (i) creating business environments conducive to maximizing the private sector's contribution to development; (ii) restructuring public sectors to improve efficiency and to tap private skills and resources; (iii) improving resource mobilization and allocation through financial sector development; and (iv) entrepreneurial support -- including resources transfers to the private sector. Considerable progress has been achieved in each of these areas.

12. Business Environment. For the World Bank Group, creating a supportive business environment means not just more private activity, but also expanded competition. Thus, the Bank Group helps governments to be supportive of business and also encourages government to phase out controls over prices and investment decisions, and to reduce subsidies, special tax incentives and import

protection, preferred access to government procurement and finance, and similar privileges which prevent competition from spurring efficiency and innovation.

13. Creating a supportive business environment is a primary objective of three-quarters of adjustment operations and an important component of many investment operations. Consistent with the goal of fostering competition, components designed to dismantle barriers to market entry and exit were included in 1990 in adjustment operations for 19 countries. During 1989 and 1990 operations also supported the reduction of trade restrictions in 23 countries; and pursued reform of the legal/regulatory framework in 32 countries and of the tax system in 20. Numerous efforts to deregulate all aspects of the economy, ranging from shipping to labor relations, also reflect this concern with enhancing competition.

14. During 1990 there was also a large increase in the proportion of investment operations which work to enlarge the range of economic activities open to private (for-profit as well as non-profit) agents. Reforms supported by Bank projects range from land zoning (Lesotho Industrial and Agroindustries), to training schemes (India Technical Education), housing (Fiji), and health programs (Haiti and Morocco). The lack of transparent land markets and security of tenure, for example, is a significant constraint to private sector development -- and Bank projects are helping to alleviate this constraint in a number of countries. In education, private alternatives to public schools are being encouraged and financed by Bank projects when that increases efficiency and expands access to the services. Similarly, Bank-supported regulatory reforms facilitate private provision of health services. In promoting private delivery of social services in Bank projects due consideration must be given to both the efficiency and equity effects of alternative delivery mechanisms -- an area on which a major research effort is planned in FY92-93.

15. Country Economic and Sector Work programs increasingly give priority to identifying deficiencies in business environments and to developing programs for overcoming them. These efforts are critical for private sector development and bring Country Department staff into contact with a wider range of economic agents, and provide them with a broader perspective on country-specific problems and options. The experience to date (including significant contributions from FIAS concerning the environment for foreign investment) is promising; it also indicates that a sustained, high level of analytical work on constraints to private sector development will be required to support effectively the market-friendly strategies being adopted by developing countries (see para. 31 below).

16. Public Sector Restructuring. Public sector restructuring components have become increasingly important in Bank adjustment operations, as countries move from basic ("stroke of the pen") policy reforms to lengthier, institutional reforms. Public sector restructuring involves both improving efficiency in critical functions of the state, such as the provision of social and physical infrastructure, and creating space for private initiative through shifts in the boundary between the public and private sectors.

17. Privatization is a major means for shifting the boundary between the public and private sectors in order to increase cost-effectiveness and better use of resources in both government and business. Privatization not only can open new opportunities for private investors, it can also free government resources and administrative skills for high priority activities. There has been a rapid increase in the demand from borrowing countries for Bank Group support in this area. During 1989 and 1990 Bank operations have supported divestitures in 41 countries, with 70% of all adjustment operations in 1990 including divestiture components. Divestiture programs are maturing and growing more complex. While early divestiture operations helped establish the policy dialogue and began preparatory work for divestiture, more in-depth support is now provided which focuses on the design of a strategy for reform,

measures to strengthen the institutional and decision-making framework, mobilization of funds to finance short-term costs, and development of the regulatory framework in which divested enterprises will operate.

18. Over and beyond divestiture, the Bank supports a host of government efforts to increase the role of the private sector in the production, delivery, and financing of public goods and services where that can be expected to foster efficiency and expand the reach of services. One-half of all social services projects in 1990 (compared to one-third in 1989) included PSD components. The mechanisms employed to expand private participation range from deregulation to more flexible procurement procedures, and include a variety of contractual arrangements:

- As a result of **deregulation**, sectors that were previously controlled or dominated by public enterprises have witnessed a dramatic expansion of private activity. The transport sector is a notable example. The deregulation of: urban bus service in Jamaica, Morocco, and Sri Lanka; trucking in Mexico; freight transport in Chile, Colombia and Guinea; and inter-island shipping in Indonesia have all increased efficiency by fostering competitive private participation in these activities. Deregulation has also resulted in higher levels of private activity in such diverse areas as: housing in Chile, financial services in Indonesia; telecommunications services in Argentina and Guyana; agricultural marketing in Honduras and Malawi; food retailing in Niger; and pharmaceutical manufacturing in Mauritania.

- In **service contracts**, public authorities pay private companies a fee for specified services, such as technical assistance, metering, billing, collection, or the operation and maintenance of the production or distribution system. For example, the private Electricidad de Caracas collects tariffs for the public water utility (which the Bank is now helping to restructure and privatize), and Jamaican public hospitals were encouraged, in the context of a Bank project, to contract out laundry and other services.

- In **leasing** arrangements, publicly owned systems are leased to private companies for operation and maintenance, with the company bearing financial risk for the functions it assumes. For instance, with support from Bank projects: the government of Guinea, weighed down by inefficient public management of its water supply system, has contracted a private firm for its operation; and four publicly-owned firms in Togo, including a steel mill, have been leased to private operators.

- **Concessions** turn over to the private sector not only the operation and maintenance functions, but also responsibility and risk relating to investing in and operating the system. Examples range from privatization of existing services (such as food services in Indian Railways or the water supply of the city of Abidjan, Côte d'Ivoire), to new investments (such as toll roads in Malaysia and Thailand, and power generation plants planned, with Bank support, in Pakistan) undertaken under concession arrangements.

- Public sector **procurement** is another area in which the private sector role can be enhanced. New opportunities for private enterprises can be generated by opening public procurement processes -- such as where public enterprises formerly produced their own inputs. Examples include: education ministries that have begun to procure textbooks from private publishers rather than from their own subsidiaries; the reduction of vertical integration in the Sri Lankan leather parastatal; and the Zambian government's decision to purchase its furniture from the

private sector, rather than producing it itself. The degree to which procurement procedures encourage efficient growth of the private sector depends on: using transparent, competitive processes in awarding contracts; preventing the operation of cartels among private providers; and, where scale economies permit, breaking up contracts into pieces accessible to small and medium enterprises.

- Finally, the Bank is increasingly promoting private **infrastructure** development and maintenance where that will enhance efficiency or augment resources for investment. Bank projects are helping expand the use of private contractors in the construction or rehabilitation of infrastructure (for instance, in Argentina, Colombia, Poland, Rwanda and Tanzania). In water supply and sanitation, Bank projects involve the private sector in countries as diverse as Madagascar and Mexico. In the power sector, a major effort is underway to help governments to tap private financing and management for capacity increases and better operation (for instance, in Chad, Pakistan, Turkey and Uruguay). And in agriculture, farmers are being given more choice and responsibility for irrigation investment and operations (such as in Bangladesh, Nepal and Pakistan).

19. Financial Sector Development and Entrepreneurial Support. An efficient and dynamic financial sector is crucial to a growing market-oriented economy. In the context of Bank operations, financial sector restructuring and policy reform are often necessary to raise the efficiency and effectiveness of resource mobilization from and allocation to the private sector. Bank adjustment operations have addressed these needs in a growing number of countries.

20. In growing recognition of the central importance of financial sector development, the Bank established a Task Force on Financial Sector Operations to assess its assistance activities in the sector. The task force report was issued in 1989. Subsequently, a review of all financial sector operations then in preparation was initiated to begin implementation of the report's recommendations and to identify issues and areas where additional clarification was needed pursuant to the preparation of detailed guidelines to staff. This process culminated in a policy paper[3] approved by the Bank's Board on July 11, 1991.

21. Following adoption of the recommendations of the task force, various forms of financial sector reform have been promoted: improvement in financial institutions was sustained in 21 countries; interest rate liberalization was pursued in 21; and resource mobilization for private investment and/or competition in financial intermediation were supported in various ways in 51 countries. The heightened emphasis on systemic concerns came at some short-term cost in the volume of Bank support to financial sector activities. In 1990, there were 10 adjustment operations with financial sector reform components, including financial sector adjustment loans (FSALs) for Bangladesh and Venezuela. This compares to a total of 33 such operations in the two-year period 1988-1989, of which eight had been FSALs. Renewed efforts on financial sector reform (including a considerable analytical effort reflected in country economic and sector work programs) are beginning to bear fruit and there are currently many FSALs in the pipeline (including Algeria, Brazil, Czechoslovakia, Ghana, Indonesia, Nigeria, Paraguay, Poland, Tanzania, Uganda and Yugoslavia).

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[3] "World Bank Policies Guiding Financial Sector Operations" (R91-80) distributed on April 26, 1991.

22. While continuing to play a major PSD role, financial intermediary loans (FILs) also were affected by the reorientation of the financial sector activities of the Bank group. There was a temporary decline in the volume of Bank financial intermediary lending to $3.2 billion (45 operations) in 1990 from $4.5 billion (49 operations) in 1989 and $4.0 billion (47 operations) in 1988, with most of the decline coming from reductions in lending through financial intermediaries to large industrial enterprises.

23. Nevertheless, an effort to enhance entrepreneurial support through Bank operations resulted in greater market-oriented financing and technical assistance for private small and medium enterprises, with the number of Bank microenterprise and SME lending operations rising from 5 in 1988 to 11 in 1991 An emerging trend is the use of financial intermediary loans to promote financial sector policy reforms and the strengthening of the overall legal, regulatory, and supervisory framework for capital markets. Support is also increasingly being given to existing informal savings and credit institutions, often through NGOs, instead of establishing specialized state institutions to reach low-income households.

III. STRENGTHENING THE BANK GROUP EFFORT FOR PRIVATE SECTOR DEVELOPMENT

24. The World Bank Group management is committed to reinforce the implementation of the 1989 PSD Action Program. With support from the Board it recently adopted a number of measures to strengthen the Group's effort in the area of private sector development. Four of these are highlighted here.

(a) Private Sector Assessments and Bank Group Projects

25. Private sector development cannot be pursued piecemeal, but requires an integrated approach which addresses systematically the full range of constraints inhibiting private firms in a given country. To this end, the Bank and IFC will collaborate in carrying out Private Sector Assessments (PSAs) -- with inputs from FIAS and with the benefit of lessons learned from similar exercises carried out by the Bank (such as in Ghana and Uganda). PSAs will contribute to the formulation of Bank Group country assistance strategies addressing PSD priorities (alongside similar work on other priority areas, such as environment and poverty alleviation), and will provide a basis for the Bank's country policy dialogue. PSAs will also serve as an input into the formulation of IFC's country operational priorities and plans. Consistent with these objectives, PSAs will identify priority policy reforms and actions critical for PSD. This will be accomplished through a two-pronged analysis of:

(i) *the importance of the private sector in the economy, at both the aggregate and* sectoral levels; the role of microenterprises/informal sector, small and medium enterprises, large firms, and non-profit private organizations; the relationships between public and private sectors; and the areas which can be more efficiently served by the private than by the public sector, with special attention given to privatization; and

(ii) the constraints to private sector activity (notably, to private investment), identified at a level of detail adequate for the development of remedial actions, including distorted incentive policies, inadequate legal frameworks, inappropriate controls and regulation, crowding out by public action, inadequate physical and social service infrastructure, limitations in the development of private technical, managerial and marketing skills and resources, and--

very critically--distorted and weak financial systems. PSAs will be done in collaboration with governments and will seek the views of a wide range of knowledgeable persons, including notably private entrepreneurs and managers.

26. The Bank Group, in consultation with the respective Governments, has identified the countries where the first 20 PSAs will be completed by the end of FY93, as part of a continuing effort. These countries have been selected, jointly by Bank and IFC staff, on the basis of the urgency of addressing PSD issues and of the potential of their private sectors, taking into account as well the role of the Bank and IFC in the country, and the government's commitment to pursue PSD-oriented reforms.

27. PSAs and country assistance strategies provide the framework within which Bank adjustment and investment operations will be designed to support in a variety of ways the pursuit of PSD by member countries. Bank management has, thus, identified key approaches and criteria to be considered in the design of relevant operations. Similarly, IFC's selection of priorities for financing in any country will seek to support the Bank Group's overall strategy for promoting private sector development.

(b) Enhanced Cooperation among the Bank, IFC and MIGA

28. If the Bank Group is to fulfil its potential in supporting private sector development, it is crucial that its component parts -- the Bank, IFC, and MIGA, as well as their joint facility FIAS -- work effectively with one another in pursuing their complementary goals. Recent management actions to enhance cooperation and strengthen the overall private sector development effort of the Bank Group include the following:

29. To enhance senior management oversight the existing Private Sector Development Committee of the Bank Group -- whose task is to assist the President in providing policy guidance and coordinating the work of the Bank, IFC and MIGA -- has been reconstituted and strengthened. The President has assumed the chairmanship of the committee which includes as regular members the Executive Vice Presidents of IFC and MIGA, and the Bank's Senior Vice Presidents of Operations and PRE.

30. To improve coordination in formulating strategies, Bank operational staff and IFC staff will work together (with assistance from FIAS and MIGA) in the preparation of private sector assessments. Both the Bank and the IFC will strengthen their staffs to ensure their capacity to formulate and implement individual country strategies for private sector development, with the IFC planning to establish a Private Sector Strategies Unit to effectively implement its enhanced role.

31. To coordinate advice on privatization, the Bank, IFC and MIGA will work to pool their complementary resources in a way that provides maximum benefits to member countries. Policy advice on the enabling environment, the related laws and regulations, or the broad classification of enterprises in line with objectives is clearly an area of the Bank's relative strength and is normally provided free by the Bank, although governments may also wish to tap the business perspective of the Corporation.

32. IFC primarily assists the privatization process by providing advice to governments on the structuring and implementation of specific transactions, and by providing similar technical and financial support to private parties interested in acquiring enterprises to be privatized. In all these types of advice the Bank and IFC will enhance their assistance by drawing on each other's expertise, informing each other of their plans at an early stage and providing an opportunity for a full exchange of views and

comments. A paper reviewing the lessons of experience in privatization and the progress in improving cooperation within the Bank Group in this area will be submitted to the Executive Directors by the end of FY92.

33. Similarly, to coordinate activities on financial sector reform, the Bank and IFC each focus on complementary tasks. In operations emphasizing financial sector reform, the Bank generally takes the lead, drawing also on IFC's expertise to analyze obstacles to greater private sector participation in the financial sector, needed reforms in the regulatory environment and measures to introduce new financial instruments and develop securities markets. IFC's main purpose is to provide and/or mobilize the necessary resources for private projects that can appropriately be financed on market terms, or joint-ventures that meet IFC's ownership guidelines, and which can appropriately be financed without government guarantees.

34. In countries and operations where the institutional advice of the Bank Group can appropriately be provided without significant governmental involvement or any governmental guarantee of repayment, IFC would normally be expected to play the lead in financing intermediary lending. In countries and operations having important sector and policy reform objectives, which thus enter into the Bank's country policy dialogue, the Bank would normally take the lead. In countries where both the Bank and IFC are active in the financial sector, the nature and design of their respective activities will be closely coordinated. A primary objective of both institutions is for intermediaries and final borrowers to be able eventually to raise funds from market sources rather than from official lenders such as the Bank or IFC.

(c) Research

35. The Bank's research program (mostly located in PRE but with significant tasks also managed by the Regions) will intensively address PSD issues. These range from the informal sector (microenterprises), sectoral regulatory environments and land tenure to competition, the impact of divestiture on efficiency and the determinants of private investment. IFC is also expanding its hitherto limited research activities with the aim to complement its financing and advisory activities. IFC's research activities will focus on areas benefiting from the Corporation's expertise as an investor in the private sector. They will also be targeted on topics likely to strengthen its operational work. For example, IFC research will examine: (i) corporate finance structures; (ii) stock markets and economic performance; (iii) intellectual property rights and technology transfer. MIGA's research and policy conference activities will focus on areas related to foreign investment policies and regulations, and will create an opportunity for policy-makers to exchange views on their experiences with foreign investment-related issues.

36. The recently created PSD research coordination committee, chaired by the Bank's Chief Economist and including key staff from PRE, OPN, IFC, and FIAS, will ensure close Bank Group coordination in PSD research. The committee will evaluate the goals and strategies of Bank Group research to ensure that private sector development issues receive adequate attention, and identify research priorities and steer new research initiatives in this area. The chairman is also planning to establish and convene an external advisory group of prominent private sector individuals.

(d) Staffing

37. Enhancing the Bank Group's capability to support the PSD efforts of borrowing countries will require expanding skills relevant to this area. This is being done through recruitment, training and staff redeployment by incorporating PSD considerations into the human resource development strategies of the different parts of the Bank Group.