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DEVELOPING THE PRIVATE SECTOR

A Challenge for the World Bank Group

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Washington, D.C.

This volume reports the findings of the Private Sector Development Review Group, which was chaired by J. Burke Knapp. Members drawn from the private sector were Abdlatif Al-Hamad, Richard Debs, Jaime Garcia-Parra, Jean-Yves Haberer, and Yoshio Terasawa. Members drawn from the staff of the World Bank Group were Richard Frank, Gautam Kaji, Ian Newport, Judhvir Parmar, Robert Picciotto, and Wilfried Thalwitz. The final version was written by Douglas Gustafson, Emmanuel Jimenez, and Johannes Linn, who drew on extensive background work prepared by the staff of the World Bank Group.

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Foreword

The balance of economic activity in most industrial and developing countries has shifted dramatically over the past three decades toward greater reliance on government to provide goods and services and to regulate the private sector. In recent years, however, there has been growing recognition that the distortions caused by government regulations, taxes, subsidies, and budget deficits and the poor performance of public enterprises place limits on the legitimate role that governments can play in supporting development. In fact, private sector initiative and competitive markets have reemerged as dominant themes in development thinking today. The public policy debate now focuses on how governments can improve incentives and business conditions to help stimulate domestic entrepreneurs, attract foreign investment and technology, and ensure that resources are used efficiently, while making progress in the critical areas of poverty reduction and environmental protection.

The World Bank Group has long emphasized the advantages of market discipline and private initiative in promoting efficient development. Over the past five years it has intensified its work in this regard through a number of new departures: the International Finance Corporation (IFC) has grown rapidly; the Foreign Investment Advisory Service was created by IFC in 1986; the Multilateral Investment Guarantee Agency was established in 1988; and the World Bank itself has increasingly emphasized the business environment in its adjustment lending. Development strategies have been changing during the 1980s, and the World Bank Group's approach has changed with them, as staff in all sectors and regions are increasingly working with member countries to seek in the private sector solutions to development problems. But this approach has evolved unsystematically over time, and there are gaps that must be filled and areas in which the Bank's efforts need to be intensified and better coordinated.

For this reason I set up the Private Sector Development Review Group in February 1988 to propose ways in which the World Bank Group can do more to help its member countries strengthen the private sector's contribution to development, particularly in nonagricultural activities. The Review Group brought together five distinguished members of the international business community and six senior managers of the World Bank Group under the leadership of J. Burke Knapp, a former senior vice president of the World Bank.

The Review Group's report, which is published in this volume, considers how the private sector can contribute to economic growth in developing countries and how governments can reform their policies and interventions to give the private sector greater scope. The report also provides an overview of the World Bank Group's experience with private sector development, formulates a strategy for the future, and recommends ways to expand and improve the efforts of each member of the World Bank Group. The recommendations of the report formed the basis for an action program, which the Bank Group's management has adopted to expand and focus its support of private sector development in the following priority areas:

- improving the business environment for the private sector
- restructuring or privatizing public enterprises and other public efforts to provide infrastructure and services
- developing the financial sector, particularly to improve the operation of financial intermediaries and the transfer of resources

- undertaking research and policy analysis to lay the basis for future operations.

Three considerations are at the core of the Review Group's report and have shaped our thinking about how to implement the recommendations. First, the Bank Group's membership includes countries with different economic, political, and social objectives, and their private sectors are at different stages of development. This necessitates an approach tailored to the circumstances of each country. Second, the World Bank Group will continue to focus on efficiency, not ownership alone. Efficiency requires competition. Competition, in turn, requires an appropriate legal and regulatory framework designed to ensure the validity of contracts and ownership rights, to facilitate the entry and exit of firms, and to limit the scope of monopolies. Third, private sector development cuts across virtually all aspects of the Bank Group's work, and there are ways to pursue it in every sector and subsector. The Review Group's report has provided a broad overview of the many areas in which the Bank Group can and should be active; implementation is now proceeding in those areas in which the Bank Group can make the greatest difference in the short and medium term.

Although the Review Group also considered organizational and staffing issues, this report focuses on the substantive issues that the World Bank Group faces in intensifying its support for private sector development. I believe these issues will interest many readers concerned about the way the Bank Group conducts its business in support of development in its member countries. The report provides the framework and sets the agenda for the World Bank Group in private sector development.

Barber B. Conable
President
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Introduction

In the past few decades public sector activity has expanded greatly in many developing countries—as it has in the industrial world. Although this expansion has often supported development efforts, it has also frequently and unnecessarily stifled private initiative and market forces and has reduced the flexibility with which economies can respond to the rapid changes in the international environment. Increasingly, developing countries have recognized the need to expand the role of the private sector and market forces. This presents an opportunity and a challenge for the World Bank Group to intensify its efforts and find new ways to support private sector development in the developing world.[1]

Private sector development (PSD) requires three main elements:

- a supportive (or "enabling") business environment consisting of a stable macroeconomic setting, economic incentives that promote efficient resource allocation by the private sector, and laws and regulations that protect the public interest but do not unnecessarily interfere with private initiative
- the services in infrastructure and human resource development necessary to permit private enterprises to function effectively
- a financial system that provides the incentives and institutions needed to mobilize and allocate financial resources efficiently.

In all three areas government has a critical supporting role to play, while minimizing the distortions caused by regulations, taxes, subsidies, and budget deficits. In fact, the reform of government policy and institutions is a critical component of better performance in the private sector. Private sector development cuts across all major components of the Bank Group's support for its client countries and therefore must be an integral part of its strategy for country assistance. PSD is not a separate topic or discipline requiring isolated treatment, either in the instruments to be used (policy and project lending, technical assistance, research, and policy dialogue) or in organizational responsibilities. Moreover, given the wide variety of socioeconomic systems and stages of development of the countries belonging to the Bank Group, there is no universal approach to private sector development. Analysis and prescriptions need to be country-specific and closely tied to the development aims of each member country.

The Bank Group has traditionally carried out a significant amount of activity and financing that supports PSD. This has included policy analysis and advice on a wide range of macroeconomic and sectoral issues, as well as direct or indirect financial support for private sector enterprises. A number of recent initiatives have further strengthened the Bank Group's role and responsibilities in support of PSD, including the initiation of MIGA, the expansion and diversification of IFC activities (including new initiatives in Africa), and the reorganization of the Bank.

But gaps remain in some areas of the Bank Group's PSD work; in other areas its efforts need to be expanded, intensified, and better coordinated. For example, there is a need for greater involvement by private providers of goods and services traditionally produced by public agencies; for more attention to

1. The World Bank comprises the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). In this report they are referred to together as the Bank. These two institutions and their affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA), constitute the World Bank Group and are referred to here as the Bank Group. The fiscal year of the Bank Group ends on June 30.

legal and regulatory reform; for more innovative, effective, and expanded support for financial sector development and the financing of private sector activity; and for more support for privatization efforts. In addition to these particular issues, there is a pressing need for the development of explicit country-specific PSD strategies for the entire Bank Group.

Filling these gaps and expanding and intensifying efforts presents a great challenge. It requires more active and explicit pursuit of priorities in PSD throughout the Bank Group. It requires more effective use of existing managerial and procedural tools to ensure a consistent and sustained focus on PSD issues. And it requires the strengthening of analytical work and staff resources. PSD is of central importance to the prospects of the Bank Group's client countries, and the Bank Group is uniquely placed to facilitate PSD by drawing on the different but complementary roles of its member institutions. At the risk of oversimplification, these roles can briefly be summarized as follows.

The strengths of the Bank (IBRD and IDA) lie in its ability to (a) help develop the macroeconomic and structural (sectoral) policy climate conducive to PSD, (b) finance the social and physical infrastructure needed to support the development of productive enterprise, (c) assist in identifying and setting the framework for transferring public sector activities that are more efficiently operated by the private sector, and (d) organize major lending operations designed to provide substantial foreign exchange resources or other benefits to the private sector.

IFC's strengths lie in its ability to (a) do the hands-on job of helping specific companies structure and finance new investments, restructure existing operations, or assist with privatization, (b) use its skill base for developing a wide variety of new institutions or investment vehicles to improve capital markets in member countries, and (c) facilitate foreign investment by brokering the needs of foreign and domestic investors, as well as advising governments at their request on ways to improve the setting for foreign investment.

The Bank Group's newest member, MIGA, will offer a product heretofore not available from the Bank or IFC: it will provide insurance to foreign investors covering noncommercial risk, including breach of contract by the host government. Coverage is available for equity investments in MIGA member countries, as well as equity-like forms of production agreements, management contracts, franchises, licenses, leases, and turnkey agreements. MIGA will support the development of bilateral investment protection agreements; it will advise governments on the protection and promotion of foreign investments; and it will sponsor dialogues on investment policies between governments and investors.

The three institutions thus have distinct capabilities and will play different roles in supporting private sector development. In some areas there is a potential for overlap, but this report finds that no rigid boundary lines can or should be drawn between the functions of the Bank, IFC, and MIGA. In many cases what is needed is a flexible response by the three institutions to the specific requirements of a particular country. Collaboration rather than separation is frequently in the country's best interest.

This report explores how private sector development can contribute to overall development and what in turn is needed by the private sector to make this contribution possible: an effective enabling environment, the required physical and human infrastructure, and a supportive financial system. The report also recommends a variety of ways to harness the energies of the institutions in the Bank Group, first, to identify appropriate PSD initiatives; second, to take the necessary actions; and, third, to ensure that Bank Group institutions collaborate in a consistent and productive manner. The appendix contains a summary of the report's recommendations for the Bank Group.

1 Designing a Strategy to Support Private Sector Development

The purpose of private sector development is to encourage the growth of an efficient private sector capable of contributing to economic development. The private sector is usually defined as the collection of enterprises that are owned by individuals or groups not representing the state, whereas the public sector comprises government agencies and state-owned enterprises. In practice, however, the dividing line between the public and the private sector is often blurred, especially since ownership and control by the state may vary in degree and over time. Furthermore, countries differ in their legal or customary definitions of what is private and what is public. Ultimately, this report, like the Bank Group generally, has to work within the conventions of each country in drawing the dividing line between the public and the private sector.

Private sector development pertains not only to the realm of organized industry, finance, and commerce, but also to all areas of activity in which private initiative can have a useful role. Private enterprise activities in education, health, infrastructure, and other services are therefore included in the definition of private sector in this report. (Private activities in agriculture are also covered by this definition, but they have been excluded from consideration here.) Also included here are informal, unorganized, or underground activities, which in many developing countries form a sizable and dynamic sector of the economy, outside of the statutory framework of laws, regulations, and taxation.

The characteristics of the private sector vary widely among developing countries. At one extreme are the dynamic, well-established private sectors of the newly industrialized economies, such as the Republic of Korea or Singapore, which have a diversified structure of enterprises of all sizes and well-developed capital markets. At the other extreme are the nascent private sectors in, for example, much of Sub-Saharan Africa. Here private activity consists mainly of very small-scale businesses concentrated in the informal sector and agriculture, and a few, often monopolistic or principally foreign-owned enterprises. In between these two extremes are the private sectors of countries such as Côte d'Ivoire, Peru, or Tunisia, which are moving tentatively into large-scale modern activities but are still dominated by small-scale enterprises in traditional agriculture, trading, and services. Because of these and other important differences among countries (in their political systems and social goals), efforts to support PSD need to be tailored to the specific characteristics of each country.

A private sector can operate efficiently only if it works within the environment of a well-functioning market system, which provides price signals that accurately reflect the social costs and benefits of production. If the market environment is highly distorted—in the sense that there are great discrepancies between social and financial costs or benefits due to monopolies, externalities, or government intervention—the private sector is likely to act in an inefficient way, wasting the economy's resources on unsustainable activities. The existence of a sizable and strong private sector is therefore not sufficient to ensure efficient development. PSD also requires that the market environment in which the private sector works be improved, so that those activities already carried out in the private sector may be done more efficiently.

Evolving Views of the Private Sector

From the 1940s into the 1970s public policy in much of the developing world, as in the industrial coun-

tries, was characterized by a confidence in the capacity of government to act as the main spur to development and to correct market failures. This confidence was based on many factors: the underdeveloped state of private sectors and capital markets in many countries; the mistrust of the private sector stemming in part from the experience of the Great Depression and the Keynesian faith in expanded government spending as an antidote to unemployment; a fear of multinational corporations and expatriate domination of major sectors in the economy; and the trust placed by many development theorists and practitioners in central planning as a tool for accelerated development and greater equality of income distribution. All these factors combined to convince many governments that only they could mobilize and effectively deploy the financial and managerial resources required to promote development.

In many countries, this confidence in the public sector as the principal agent of development began to erode during the late 1970s and eroded even more during the 1980s. Many developing countries launched special initiatives to limit the growth or even to reduce the size of the public sector. Brazil, for example, introduced a National Debureaucratization Program in 1979, and Senegal set up in the early 1980s a Special Commission on the Disengagement of the State. What accounts for this change in direction of development strategy?

Public spending and other forms of government intervention have rapidly grown in developing countries since 1940: central government spending typically accounted for only 5 to 10 percent of gross national product before 1940; now it accounts for 20 to 30 percent, even without making allowance for the rapidly rising role of state-owned enterprises. This much-enlarged role of the public sector has brought into stark relief the evidence of bureaucratic shortcomings associated with the shortage of well-trained and organized civil servants. It has also showed many examples of public agencies that lack market tests and competitive pressures. As a result, many of them also lack financial discipline and efficient management.

The growth in government has also brought to the fore the issue of rising costs. The unintended distortions that accompany interventionist incentive policies have raised the economic and social costs of government. And tax burdens have increased to finance higher expenditures. Casual observation of these costs has been increasingly confirmed by specific research in areas such as trade policy, agricultural pricing, and tax policy.

As development proceeded rapidly during the 1950s, 1960s, and 1970s, private sectors matured significantly in many developing countries. Research and experience began to demonstrate that private entrepreneurs, whether in agriculture, industry, or services, are in fact very responsive to economic incentives. Previously many development economists and planners had believed that the private sector in the developing world was inflexible and unresponsive to market signals. Therefore, they had reasoned, explicit government intervention, planning, and control was needed to achieve the levels and distribution of investment and economic activity necessary to support higher economic growth and development. Increasingly it was also recognized that competitive market pressures on private firms tend to improve their internal efficiency, particularly when compared with quasi-monopolistic public sector counterparts.

The rapid changes in the international economic environment that occurred in the 1970s and 1980s also shifted perceptions about the respective roles of the private and public sector. These changes included greater international competition, higher mobility of factors of production, more efficient flows of information, and faster technological change. Financial imbalances among the industrial countries, the resulting exchange and interest rate fluctuations, and gyrations in major commodity prices (especially for oil) also added a large element of uncertainty. Countries that adjusted rapidly to these changes were able to keep growing (Indonesia, Korea, and Thailand, for example). In contrast, countries that pursued inward-oriented trade strategies, that borrowed heavily to finance ambitious and often misguided development programs, and that did not adequately mobilize domestic savings in response to the apparent need for structural adjustment, encountered severe balance of payments and debt servicing problems. These in turn translated into a serious loss of growth momentum. Flexibility of the economic structure in the face of a highly uncertain international environment therefore came to be seen as a necessity.

Flexibility requires the capability and willingness to respond quickly to changing opportunities and international price signals. This response involves changing levels of production and factor use, the entry of new profitable enterprises, or the exit (through merger, liquidation, or bankruptcy) of unprofitable ones. Experience shows that governments are generally not very responsive to economic signals. The Korean government is an exception to

this rule; it has successfully orchestrated strong economic growth over the past three decades by showing considerable foresight and flexibility.

It is doubtful, however, that the Korean approach is transferable to countries with weaker public administrations and less cohesive central economic management. For most developing countries less, rather than more, public intervention in markets would be appropriate. The reduction in the share of public spending in the economy, which occurred in a number of developing countries during the 1980s following severe fiscal distress, was probably a step in the right direction. Economies based more on market-oriented, private activities tend to be more responsive to the signals of international markets and changing domestic opportunities.

To achieve greater economic efficiency and growth, governments in the developing world have shifted their development strategy from one based on a growing government role to one that seeks to support the development of the private sector and the improved functioning of markets. Indeed, many socialist economies have moved to reduce the scope of central planning in favor of an increased role of the market and have sought to increase the scope for private initiative.

The Bank Group's Approach

One of the principal objectives of the Bank, as set out in its Articles of Agreement, is the promotion and encouragement of private investments for productive purposes. Accordingly, it has always been the Bank Group's policy to help countries obtain the advantages of private initiative and market discipline in promoting efficient development.

Bank Group support for private sector development has been concentrated in three areas: developing a supportive environment of stable macroeconomic conditions and appropriate overall incentives; strengthening the support services for private sector productive activities by improving the physical and human infrastructure of a country; and providing financial resources for the private sector through direct lending (albeit with government guarantees, in the case of the Bank) or through lending to financial intermediaries.[1] IFC was set up specifically as the Bank Group's arm for lending to the private sector without guarantees and has done so ever since its creation in 1956. Of the total $140 billion of IBRD and IDA funds lent from the Bank's creation through fiscal 1987, $14 billion (10 percent) has gone to nonproject (program, sector, or policy) lending, $76 billion (54 percent) to infrastructure and human resource development loans, and $37 billion (26 percent) to finance predominantly private agricultural and industrial activities. IFC investment activity since its creation has totaled $10 billion.

Despite the Bank Group's concern with private sector development from its inception, it, like its client governments, took part in the shift in development strategy. Into the 1970s the Bank tended to favor an expanded role for government and public sector entities in seeking to increase the mobilization of resources and the rate of investment, while also working to improve the efficiency of public and private resource allocation. During the late 1970s and even more so during the 1980s, the direction of the Bank Group's analytical work, as well as its lending, increasingly shifted to improving the functioning of markets, reducing the distortions created by government intervention, limiting or reversing the growth of public spending, and exploring more actively the role that private enterprises could play in traditional public sector responsibilities. Although this shift is not readily quantifiable, important examples are cited in the next few paragraphs.

Since their inception in 1978, the Bank's annual *World Development Reports* have placed increasing emphasis on delineating the appropriate roles for the public and the private sector and on limiting public sector involvement to those areas where it is best equipped to foster development. The government's role is seen primarily in the provision of public goods (including defense, diplomacy, macroeconomic management, and a legal and institutional system that defines and enforces the rules of justice, property, and commerce) and in the provision of social, physical, and information infrastructure, where market failures are common and basic needs have to be met. Other areas, especially agriculture, industry, energy, and mining, are better left to the private sector, although some public support and regulation may be needed.

Increasing attention has been given in the Bank's policy analysis, dialogue, and lending to improving the functioning of markets, especially through macroeconomic management and incentive policies in trade, agricultural pricing, and finance. The initiation of adjustment lending in fiscal 1980 and the

1. IDA's Articles of Agreement permit it to lend directly to the private sector without government guarantee. In practice this has never been done, because of the view that the sizable subsidy implicit in IDA terms should not go directly to individual public or private actors, but rather accrue to the country as a whole. Accordingly, IDA credits are lent to governments, which may onlend them to private entities at market or near-market terms.

expanded use of this instrument subsequently provided a vehicle for translating concern for markets into an active policy dialogue with governments (see chapter 2). The Bank Group has also given active support during the 1980s for the increased reliance on market forces in centrally planned economies, particularly in China, but also in Eastern Europe and other socialist developing economies (see box 1-1).

During the 1970s and into the 1980s the Bank Group significantly expanded its support for financial market and industrial sector development. The Bank boosted its lending through financial intermediaries, with most of the benefit of the on-lent funds going to private enterprises. It developed new lending instruments (apex loans, financial and industrial sector loans) to assist financial and industrial sector development, and it carried out extensive research and sector work. For example, in the East Asia Region at least fourteen major economic and sector reports were prepared during fiscal 1979–87 on the

Box 1-1. Centrally Planned Economies

What role does private sector development have to play in the Bank Group's member countries where central planning has, at least in the past, dominated?

Yugoslavia, many years ago, and more recently China, Hungary, and Poland all joined the Bank to secure resources and assistance in moving their economies toward market-based, outward-oriented systems. All four countries also joined IFC, a further signal of their desire to look for opportunities to begin to reduce the role of state intervention.

Yugoslavia adopted early on a quite radical decentralized structure in which the state did not own enterprises and production plans were not handed down from on high. Foreign investors were invited to set up joint ventures, and trade was redirected toward the West. It was a bold experiment that brought considerable dynamism to economic activity. However, decentralization was not followed by adequate discipline. Yugoslavia's unique, consensus-building political and managerial system began to bog down. Loss-makers were excessively protected; the banking system, which ultimately is the allocator of resources for investment, was increasingly controlled by the enterprises it was financing; and growing inefficiencies in the system were covered by foreign borrowings.

Yet there are many examples of well-managed dynamic enterprises in Yugoslavia. Efficiency *can* be improved, and Yugoslavia is on the verge of further, deep reforms to reset its course more vigorously toward a market economy. Provided policy reform proceeds apace, the Bank Group through structural adjustment lending, financial market interventions, and joint ventures can be of significant assistance at this critical juncture.

Hungary and Poland have also started introducing market forces and supporting private initiatives. In Hungary, the Bank has supported these efforts through its lending program and economic sector work. Actual encouragement of private activity has come in three ways: (a) loosening some restrictions on small, private business endeavors, (b) encouraging the cooperative movement, which for some time has been more arms-length from the state than the formal state sector, and (c) encouraging joint ventures whereby enterprises that would have been in the state are, de facto, privatized by the entry of foreign investors. IFC has been centrally involved in all the major joint ventures actually agreed to since these policy changes were put in place and is financing the cooperative sector in agribusiness and industry. Bank operations in Poland have not yet commenced, although IFC has begun to finance nonstate ventures. Based on the considerable exploratory work by the Bank and IFC, the potential for private initiative appears to be considerable.

Realism is required as to the pace and result of moving toward a more open and thus disciplined economic system, given the economic history of these countries. But the start made is both courageous and impressive.

In China, the transition to an economy where market forces are being increasingly brought into play began with the opening up of the economy and reforms of agriculture in 1979. During the 1980s these reforms were gradually extended to industry and the towns. Price reform is a key element. Macroeconomic management—including fiscal, credit, and pricing policies—are playing a greater role. After a reform and decentralization of the banking system, interest rates are beginning to reflect the scarcity of capital. Foreign investment through joint ventures has been stimulated. Individual initiative and competitive pressures are being encouraged in many areas of the economy. Even bankruptcy rules have been established on an experimental basis. The World Bank Group has supported this reform drive from early on. Through economic and sector work, lending operations, and research, the Bank has provided assistance in a broad range of sectors and issues; IFC has provided substantial advice on the foreign investment framework and assisted in structuring specific joint ventures.

topics of trade and industrial and financial development.[2] Similar work was undertaken in other regions.

During the same period, IFC expanded its capabilities in direct investment and lending to private sector enterprises, capital market development, and support for foreign direct investment. More recently, MIGA was created as a new arm of the Bank Group to facilitate direct foreign investment (see chapter 4 for a more extensive discussion).

In regard to infrastructure and human resource development, the Bank has also been increasingly concerned with identifying and supporting the appropriate division of public and private responsibilities. In the urban sector, for example, the Bank has actively promoted, beginning in the early 1970s, a policy shift in developing countries away from the construction of public housing to the provision of infrastructure services (see chapter 3 for more about this and other examples).

Although in the past the Bank Group concentrated on strengthening state-owned enterprises—and in a number of cases supported the creation of new ones—during the 1980s it has increasingly turned to encouraging government efforts to privatize such enterprises. As of fiscal 1988 there were some forty-one projects approved and thirty-one projects under preparation by the Bank that included a component supporting the divestiture of state-owned enterprises through liquidation, sale, contracting out, or leasing. Bank support has taken the form of conditions in structural or sector adjustment loans, studies to help identify divestiture candidates and design sales programs, and financing for legal, accounting, or investment banking advice (see chapter 2 , box 2-1).

The Bank's reorganization in 1987 led to the creation of a new division with the explicit mandate to examine and support the Bank's private sector development efforts. Since its creation, this division has actively developed a work program in the area of PSD.

The Bank Group has been involved in assisting legal and regulatory reform to reduce red tape, promote investment, increase competition and eliminate public monopolies; in strengthening the public institutions that encourage entrepreneurial development and promoting a better dialogue between public and private sectors through workshops, seminars, and similar forums; and in assisting microenterprises, peasant agriculture, and the informal sector by increasing access to credit, securing property rights, and addressing legal, regulatory, and other factors that drive business underground.

However, the Bank Group's coverage of these issues has been unsystematic, sometimes even neglected, compared with its more traditional concern with broad incentive systems, infrastructure development, development finance, and public sector management. Even in these more traditional areas the Bank Group's renewed emphasis on the private sector and market orientation has been reflected in an ad hoc way. The Bank's knowledge of enterprise and financial market development in many member countries remains fragmentary. New instruments (financial sector loans, public sector restructuring loans) have been developed only slowly.

A Strategy for Bank Group Support

As a first step in responding to these concerns, it is necessary to develop a strategic framework for the involvement of the Bank Group in private sector development. The six elements of such a framework are laid out as follows:

First, private sector development is an integral part of the Bank Group's work. It is not a separate topic or discipline requiring isolated treatment, either in the instruments to be used (policy and project lending, technical assistance, research, and policy dialogue) or in organizational responsibilities. Nevertheless, a sharper focus on PSD is necessary to ensure that the contributions it can make to development are fully utilized.

Second, growth and economic efficiency, complemented by the need to alleviate poverty, should be the main criteria for judging the right boundaries to the private and public sectors. In this respect, the expansion of competitive markets and deregulation may be as important as transfer of ownership. If there is a transfer of ownership to the private sector, positive steps should be taken to protect the public interest by ensuring that a new private enterprise does not exploit a monopolistic position. Public interventions in the name of poverty alleviation have often failed to achieve that goal while imposing considerable loss of efficiency. An increased role for private initiative, in contrast, may improve access by the poor to essential goods and services at lower cost (see chapter 3 for examples).

Third, the Bank Group's approach to PSD must be

2. This work was reviewed and summarized in a regional report by Amar Bhattacharya and Johannes F. Linn, *Trade and Industrial Policies in the Developing Countries of East Asia,* Discussion Paper 27 (Washington, D.C.: World Bank, 1988).

pragmatically tailored to different country circumstances. Countries have different political, social, and economic systems and objectives. Moreover, their private sectors vary widely in structure, characteristics, and capacities. Thus a variety of strategies are required for private sector development, depending on a particular country's circumstances.

Fourth, in developing its country-specific strategy for PSD, the Bank Group will have to consider the appropriate mix of five possible approaches:

- the *incentives approach*, stressing the reduction of distortions in country or sectorwide incentive structures through appropriate reform of macroeconomic, trade, tax, and financial market policies
- the *deregulation approach*, emphasizing the reduction of unnecessary regulations, restrictions, and other public interventions in the private sector
- the *promotion approach*, designed to encourage PSD through provision of credit, information, and advisory services
- the *development approach*, focusing on the creation of physical and human infrastructure required by private entrepreneurs
- the *privatization approach*, transferring functions and enterprises from the public to the private sector through divestiture of state-owned enterprises, contracting out or leasing of activities or functions, and reducing public involvement in particular areas while permitting greater private initiative.

Fifth, country-oriented strategies could broadly involve the following priorities for the Bank Group:

- in the *highly indebted, middle-income countries*, the Bank Group should work to develop a supportive policy and regulatory environment that promotes domestic competition
- in *Sub-Saharan Africa* the stress should be on creating the institutional and policy framework to stimulate entrepreneurship and ensure the development of the minimum physical and human infrastructure required for long-term PSD
- in much of *South Asia* the primary focus should be on the promotion of deregulation and liberalization of overly bureaucratized administrative and incentive systems
- the *East Asian* market economies provide an opportunity to strengthen PSD in a number of areas (for example, regulatory reforms), but mostly they provide a wide range of experiences of broadly successful PSD, which should inform Bank work in other regions
- in the *centrally planned economies* the Bank Group's role should be to encourage and support government efforts to expand the role of markets and of private initiative.

Sixth, country-specific PSD strategies will have to be supported by analytical work that explores the various experiences with PSD and focuses particularly on areas that have previously been neglected. This work should be carried out both at the country level through appropriate country economic and sector work, and at an intercountry level through research and policy studies.

2 Improving the Enabling Environment

The private sector responds to signals from the overall economic, legal, and regulatory environment in which it operates, and it depends on the supporting inputs, especially infrastructure services and human resources. If the signals are distorted, the private sector will reflect these distortions. If infrastructure and human resource inputs are limited in accessibility, low in quality, and high in cost, the growth of the private sector, and thus the growth of the entire economy, will be stunted. Many of the private sector's problems lie in the various factors that distort the environment for private agents. Improvements in this "enabling" environment are almost always necessary to enable the private sector to function efficiently. Thus they are an essential component of any strategy for private sector development.

Seven main factors contribute to the enabling environment:

- the state of the international economy
- the domestic macroeconomic conditions and policies
- the domestic incentives for private producers and consumers
- the legal and regulatory framework within which the private sector operates
- the efficacy of public sector institutions
- the physical and social infrastructure
- the efficiency with which the country's financial sector mobilizes and intermediates financial resources.

The first of these factors, the international economy, is obviously important to developing economies, especially those that are small and open to international trade and capital flows. The external shocks of the 1970s and 1980s have brought home the need for a flexible domestic economic system, which can respond quickly to changes in the international environment. Nonetheless, international economic conditions—commodity prices, interest rates, growth in developing countries' export markets, access to international capital flows, and aid—are, to a considerable extent, the outcome of policy decisions by the governments of the industrial countries. These policies and their potential impact on the world economic outlook have been discussed in successive *World Development Reports* and will not be considered further in this report.

The last two factors—infrastructure and financial sector policies—are discussed in chapters 3 and 4. The current chapter concentrates on the remaining factors in the enabling environment for PSD: macroeconomic conditions and policies, incentives, the legal and statutory framework, and public sector institutions. For each of these four factors an overview of how it affects PSD in developing countries is followed by an assessment of what the Bank Group has done and could do better to assist its members in strengthening the enabling environment.[1]

The Bank has traditionally emphasized the enabling environment for private sector development in its research and operations. Research staff have thoroughly analyzed virtually all the factors mentioned above in a country or cross-country context. In country economic and sector work, operational staff

1. The analytical presentation draws on much accumulated Bank work, especially as summarized over the years in *World Development Reports*, published annually by Oxford University Press. The information and conclusions on the Bank Group's operational experience summarized here draws on two recent reviews: World Bank Country Economics Department, *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series 1 (Washington, D.C.: World Bank, 1988) and an internal report on the Bank Group's experience with private sector development.

have assessed many aspects of the enabling environment and, based on this analysis, have carried on policy dialogue with member countries. In the preparation and supervision of investment projects, operational staff have also pursued individual aspects of the enabling environment for particular sectors or institutions. Finally, the introduction of structural and sectoral adjustment lending—and concomitant assessments of the policy framework jointly with the International Monetary Fund in the case of low-income countries—has provided the Bank Group with its most comprehensive and effective tool to assist member governments in improving the the enabling environment for PSD. (Box 2-1 gives an example of how structural adjustment lending has addressed specific aspects of the enabling environment in Thailand.)

Macroeconomic Conditions and Policies

How They Affect PSD

Macroeconomic conditions in a country influence the private sector through their effects on the production and investment climate in which private producers operate. Fiscal policy (especially the management of the public sector deficit), monetary policy, and the management of the nominal exchange rate shape the macroeconomic conditions faced by the private sector. Among these three, fiscal policy is most important for maintaining a stable macroeconomic environment in developing countries. Monetary policy, because of the limited development of domestic financial markets and institutions in most developing countries, has little scope for independence. Nominal exchange rate management, although important in the short term, is less significant in the longer run.

Imprudent fiscal management leads to an overvalued and unstable exchange rate, a high real interest rate, and high inflation. These in turn result in current account deficits and accumulation of foreign debt, crowding out of private investment, inefficiencies in domestic production, and the serious risk of capital flight. Ultimately, the country's creditworthiness may be impaired to the extent that it loses access to voluntary lending from commercial borrowers. This loss of creditworthiness, in turn, seri-

Box 2-1. Improving the Enabling Environment through Structural Adjustment Lending: The Case of Thailand

The Bank approved two structural adjustment loans for Thailand in 1982 and 1983. Both loans were in support of the structural reforms initiated by the Royal Thai government as part of its Fifth Development Plan (1982–86). Thailand's experience of adjustment has been one of success: it has avoided economic crisis and sustained strong economic and export growth. The responsiveness of Thailand's economy has been partly due to its traditional reliance on a dynamic private sector, but also to the government's willingness to reverse potentially damaging policy directions, some of which directly interfered with efficient private sector development.

The Bank's structural adjustment loans supported policy reform designed to improve the enabling environment for PSD in the following areas:

- *Macroeconomic management*: reduction in the budget deficit through reduced public spending and increased public revenue mobilization (both taxes and user charges)
- *Incentive reform*
  - reduction in industrial tariff protection
  - reduction in agricultural export taxation
  - improvements in central and local government tax structure and administration
  - reduction in subsidies on energy prices
  - reduction in subsidies for water, bus, and railway prices
  - elimination of price controls
  - streamlining of investment incentives
  - strengthening of export incentives (tax rebates and credit)
  - elimination of rice price support schemes
- *The legal and regulatory framework*
  - elimination of export restrictions
  - deregulation of livestock and meat marketing
  - improvements in rural land tenure system
  - reform of domestic content legislation (automobile industry)
- *Reform of public institutions*
  - liquidation of small commercial state-owned enterprises
  - diagnostic study of all state-owned enterprises
  - review of public expenditure priorities and selective cut-backs in low-priority areas
  - various efforts to improve performance of public institutions (planning, budgeting, accounting, civil service reforms).

Significant progress has been made in implementing these and complementary actions.

ously affects private producers and financial intermediaries in two ways: first, they lack direct access to foreign long-term finance; second, and more pervasively, the economic crisis forces drastic reductions in domestic aggregate spending and shifts in domestic production, much of which has to occur in the private sector. This, of course, is the problem today for most of the highly indebted countries.

In the absence of a stable macroeconomic environment, other efforts to support PSD—through incentives, the legal and regulatory framework, and financial sector management—will be severely limited in their effectiveness and may not be sustainable. In fact, it is often possible to trace the imposition of many inappropriate restrictions on private sector activity (higher import tariffs, price controls, and interest rate ceilings, to mention just a few) to a government's effort to redress the symptoms of macroeconomic instability rather than their underlying cause.

What the Bank Group Can Do

For each of its member countries the Bank reviews macroeconomic policies in close coordination with the International Monetary Fund (IMF). The principal vehicles for the Bank's operational work in this area are its country economic memoranda and reports and its adjustment lending operations. In connection with these activities, the Bank routinely assesses the macroeconomic conditions in the member countries and reviews the policies most likely to enhance the macroeconomic outlook of the country in the light of expected international economic developments. In addition, the Bank has for many years sponsored research and policy reviews that have led to a better understanding of the major factors that need to be addressed in the design of consistent and stable macroeconomic policies.

A recent review of adjustment lending has addressed the adequacy of the Bank's work in this area.[2] It suggests that the Bank's approach has generally been well designed and that macroeconomic issues have been given adequate consideration in country economic and sector work, policy dialogue, adjustment lending, and research. Nonetheless, some aspects of macroeconomic policy require more research and consideration in the design of country-specific policies. Questions that have recently come to the forefront of the Bank's concerns in this area are:

- What must be done to ensure consistency of macroeconomic policies with the main macroeconomic goals of the government?
- What are the appropriate balance and relationships between stabilization and structural reforms?
- What are the appropriate timing and sequencing of macroeconomic and other policies?
- How can stabilization be achieved in high-inflation countries?
- What are the lessons for macroeconomic policy in the low-income, Sub-Saharan countries?
- What is the role of the real exchange rate in determining economic performance and incentives?
- Can the analytical models used to evaluate adjustment programs within and across countries be improved?

Work on these questions is either under way or planned. This report recommends that this work be carried out expeditiously.

Domestic Incentives

How They Affect PSD

Achieving and maintaining stable and prudent macroeconomic policies are necessary but not sufficient conditions for effective PSD. Other elements of the enabling environment are essential ingredients. In particular, government policies affect the incentives faced by private producers and consumers. Trade policy, tax policy, pricing of publicly produced products, and special incentives for investment and exports are briefly reviewed here.

Trade Policy. Import substitution and inward-looking trade policies characterized the development strategies of many developing countries through the 1970s. Research and policy experience now demonstrate that an outward-oriented trade strategy is more likely to lead to a dynamic and efficient private sector. Outward orientation is defined here as a neutral trade regime, which does not favor import-substituting activities over export-oriented production. Private sector activity is directly affected by protectionist trade policies, which distort relative prices. It is also negatively affected by the frequent instability of such policies, and by the need to devote scarce financial and managerial resources to competing for the economic rents implicit in protectionist policies.

2. World Bank Country Economics Department, *Adjustment Lending*.

Trade policy reform requires a reduction in the level and dispersion of protection for domestic industries and a reduction in the taxation of exports. Moreover, whatever level of protection is in place, it is usually better achieved through tariffs than quantitative restrictions. Two caveats are in order, however. First, some private producers (and consumers) will be negatively affected by trade policy reform, although on balance the private sector will be better off over the long term. Second, full neutrality in the trade regime, especially the elimination of all import tariffs, cannot usually be a short-term goal for developing countries. Tariffs are an important source of tax revenues in many developing countries, especially the poorer ones, and some, albeit low, protection of domestic industries may be appropriate to deepen the domestic industrial structure.

Tax Policy. Most taxes affect private consumption, savings, investment, and production decisions. But views about the ability of tax policy to control such decisions have changed over the years, just as views about development itself have changed. The view that taxes can be effectively and widely used to steer private sector development (raise savings and investment, direct production into particular sectors and locations, redistribute income, and so forth) has now shifted to the view that taxes have a limited scope to achieve broader social goals. According to the new view, tax systems should be designed to raise the revenue necessary for public spending programs in the least costly manner, with the least distortion of private sector decisions. Tax reforms, therefore, should stress broadening the tax base rather than raising rates, eliminating unintended disincentives to investment and differentiation in tax burdens for the company income tax; replacing distortive turnover taxes by value added taxes; limiting the progression of personal income tax rates in higher tax brackets, while exempting low-income taxpayers altogether; and simplifiying tax structures, administration, and compliance at all levels of government. All these changes are specifically designed to lower the cost of taxation to the private sector.

Pricing. Setting efficient prices for publicly provided goods and services is important for private sector development. Although subsidized prices lower the private costs in the short term, they not only lead to inefficient consumption patterns, but also tend to erode the financial viability of the public agency providing the goods and services and thus undermine its ability to provide quality products. Furthermore, subsidies have to be financed from some source, either general taxes or higher prices for some consumers. This in turn results in higher private costs. For example, the common practice of subsidizing residential users of power and water by charging more to industrial and commercial users distorts private production decisions and can reduce the international competitiveness of domestic producers.

Incentives. Many governments have traditionally sought to foster investment and exports through special incentive schemes, which relied heavily on tax and subsidy instruments, in addition to regulatory interventions (see below). Although in principle designed to support the development of certain favored segments of the private sector, such incentive schemes have in practice suffered from serious shortcomings in design and implementation. Since such schemes often compensate for distortions introduced by other government policies (import restrictions and tax policies), it is generally better to reduce those distortions than to expand the special incentive schemes. In addition, streamlining existing special incentives systems, reducing their budgetary costs, and limiting the scope for bureaucratic discretion in their application can go a long way toward strengthening the country's incentive system.

What the Bank Group Can Do

Domestic incentive policies have been addressed extensively by the Bank in the context of its country economic and sector work, structural and sector adjustment lending, its policy work, and research. For example, four-fifths of all adjustment loans have had trade policy components; public revenue measures (including tax reform and public pricing measures) have been pursued in about one-quarter of all adjustment loans; reform of special investment and export regimes has been pursued intermittently. No systematic accounting of the extent of country economic and sector work in this area is readily available. Scattered evidence indicates that country economic and sector work has been extensive in the case of trade policy, but more selective in the areas of tax policy and special incentives. Bankwide and regional policy and research studies have been carried out in all these areas and have reviewed typical country approaches and drawn lessons for policy design and implementation.

From the information currently available, it is clear that the Bank's research and policy studies in this

area have made a significant contribution to the general understanding of how to design appropriate incentives systems. Similarly, the level of attention given to trade reform in adjustment operations is appropriate; however, more attention should perhaps be given to tax policy and special incentives reform. To the extent that reforms have not been implemented as expeditiously or extensively under these operations as had been expected (tariff reductions have been significant only in six out of forty countries recently examined by the Bank; significant tax reform has taken place in only four countries), more emphasis will have to be given to the details of reform implementation and constraints on implementation capacity, to government commitment and political opposition, and to policy conflicts. To do so effectively requires more intensive preparation and supervision of the relevant components of adjustment loans.

The Legal and Regulatory Framework

How It Affects PSD

The laws governing property rights—the rules of the game for ownership and exchange—also govern the working of markets and thus profoundly affect the efficiency of the private sector. Clear, simple laws, effectively applied, are essential for generating expectations of a stable and supportive business climate, both for domestic and foreign investors. Shortcomings are common, however. Surveys have shown that uncertainty about the rules of the game has been a major concern for foreign investors. Two particular areas have been of special importance in many developing countries: land tenure security and the rules governing the exit of firms. Research has shown that uncertain land tenure limits private incentive for improving the land, both in rural and in urban areas. Lack of clear laws governing commercial liability, bankruptcy, and liquidation may have been one of the factors limiting the responsiveness of many developing countries to changes in the international environment.

Government regulation of private sector activity has a legitimate role. Indeed, it is at times preferable to public ownership and management of firms. It is appropriate when markets fail, as in the case of natural monopolies (water resources) or externalities (congestion and pollution). In practice, however, governments have used regulatory intervention for many other purposes, frequently to counteract the undesired effects of other government interventions. For example, price controls have been introduced to limit inflation generated by poor macroeconomic policies; import quotas have often been imposed in reaction to current account deficits resulting from overvalued exchange rates; import and investment licensing has often been an effort to allocate the rents generated by import controls to preferred firms (this applies especially to restrictions placed on foreign investors); rent control has frequently been a response to rising urban property prices as a result of poor land use and infrastructure policies. The danger of such interventions is that they tend to reduce the flexibility of the private sector, raise its costs, and increase the uncertainty under which it operates. Often these interventions drive businesses "underground" or into the "informal" realm. Perhaps most important, regulations often limit the entry and exit of new firms, especially smaller firms, by giving existing, larger firms an advantage over the small newcomer. Even regulations ostensibly designed to deal with market failures are often more effective in limiting the entry of new firms than in limiting the detrimental aspects of the externality or monopoly that they are supposed to control.

Reforms of the legal and regulatory framework are thus an essential counterpart to macroeconomic and incentive reforms. The elimination of all regulations is obviously not desirable, but unnecessary or overly restrictive ones should be eliminated after careful review. At the same time every effort should be made to foster the local legal and accounting professions, on whom heavy reliance will have to be placed in carrying out the reforms described in the following paragraphs.

What the Bank Group Can Do

The regulatory framework has received erratic treatment in Bank operations, including structural and sectoral adjustment lending and investment projects. Some form of regulatory reform appears in 48 of 109 projects recently reviewed by the Bank, principally in the policy-based operations.

Streamlined Procedures. Twenty-nine projects involved the abolition or streamlining of controls, the most frequent form of regulatory reform. Examples are the elimination of most import licenses (in a structural adjustment loan to Burundi), automatic access to importer-exporter cards (a structural adjustment loan to Senegal), and an effort to minimize regulation of investment (a structural adjustment loan to Pakistan). Another eight projects tried to cut red tape

by proposing a "one-stop-shop" for such things as approval of investment applications (a structural adjustment loan to Dominica) or for providing clearances and permits to potential export industries (a loan to Mauritius).

Investment Code. Ten projects (nine of them in Africa) proposed to study and revise the private sector investment code to provide more effective incentives for private domestic investment. Ten projects supported changes in the legislation governing foreign direct investment. For example, foreign investors were granted more equal treatment with domestic investors (a sectoral adjustment loan to Indonesia); they were entitled to deduct part of their taxes paid at home from their tax liabilities (a loan to Bolivia); and mining, petroleum, and tourism laws were reviewed with an eye toward promoting foreign private investment (adjustment loans to Turkey). IFC has also been active in the area of foreign direct investment. Its activities and those of MIGA are explored in more detail in chapter 4.

Labor Laws and Regulations. Only nine projects proposed revisions to labor legislation and practices. Labor legislation was to be revised to encourage employment by reducing social charges (a structural adjustment loan to Senegal); a study of wage and employment issues in the private sector was commissioned as a step toward improving wage negotiation, simplifying labor legislation, and developing a legal framework for a coherent wage and incomes policy that encourages industrialization and growth (a loan to Mauritius).

Competition. Many of the regulatory reforms initiated in Bank projects helped increase competition. Besides reducing import protection and price controls, quite a few projects also eliminated public monopolies or monopsonies. But only six of the projects explicitly addressed barriers to entry and exit, such as giving private dealers the right to buy fertilizer stocks from both public and private wholesalers (a sectoral adjustment loan to Pakistan) or the revision of the industrial development act to encourage competition and restrict protectionist use of the licensing system (a structural adjustment loan to Malawi). Only four projects sought to strengthen the government's capacity to identify and curb private sector monopolistic or oligopolistic tendencies.

Informal Enterprises. There is also little apparent effort to regularize the legal status of the informal sector or to remove discriminatory regulations. None of the projects studied addressed the legal status of informal enterprises, although the structural adjustment loans to Jamaica supported the legalization of certain forms of foreign exchange trading. Nor were any projects found which changed the regulations dealing with informal or microenterprises. A few projects supported studies or technical assistance to government agencies to investigate how to assist the informal sector.

Property Rights. Despite the importance of ownership issues for access to credit and services, only one of the projects dealt with property rights, by accelerating distribution of land titles to employees laid off from privatized state enterprises (a structural adjustment loan to São Tomé and Principe). In addition to the projects studied a few other recent projects have dealt with land reform issues (for example, Thailand's structural adjustment loans). The Bank's urban projects often have also supported the regularization of urban land titles. Other property rights issues (for example, the right of women to own or inherit property) have apparently not been addressed in Bank projects.

Assessment and Recommendations. Although not entirely neglected, the legal and regulatory framework appears to be the weakest link in the Bank's support for PSD. Moreover, little systematic information appears to be available about the extent of implementation of the regulatory and legal measures agreed to, and about the impact of those measures that were actually taken. Among the reasons for this are principally:

- lack of government interest
- lack of prior research and country economic and sector work dealing with regulatory issues (exceptions are an internal 1986 study of industrial regulation in India, two similar studies in progress on Brazil and Indonesia, and a few research studies)
- limited staff resources and skills in dealing with regulatory and legal issues.

This report recommends that more research, country economic and sector work, and eventually lending resources be devoted to the legal and regulatory constraints to PSD. Future Bank operations in this area should also tap the technical expertise of IFC.

Public Institutions

How They Affect PSD

In many developing countries in recent years the public sector has assumed new functions and rapidly

expanded its domain of public agencies and state-owned enterprises. As indicated in chapter 1, this expansion is now viewed in many countries as having gone too far. Efforts are under way to limit and streamline the role and number of public agencies, especially through privatization of state-owned enterprises, and to improve the quality of institutions that remain in the public sector.

Privatization. Privatization encompasses not only the sale of public assets to the private sector but also the transfer of management of other services performed by the state to private entities. Not many years ago the concept of privatization was almost unheard of in developing countries. Now it has almost become a buzzword in development conversations, as countries have become disenchanted with the performance of state enterprises. Small and large countries in each region have indicated intentions in regard to privatization. Although hard data are not available on the subject, it appears that there has been more talk than action. A Bank survey of thirty-seven countries showing interest in privatization found that in all but two (Chile and Bangladesh) fewer than twenty enterprises, primarily small ones, had been privatized.

These results, on reflection, are not surprising. The impediments to privatization vary widely from country to country, but may include (a) opposition from entrenched state bureaucracies or labor interests, (b) unrealistic hopes to sell enterprises that should perhaps be liquidated,[3] (c) indecision about whether to sell "as is" at low prices or to attempt restructuring and then sell, (d) political concerns about concentration of control in the hands of local powerful groups or foreign investors, and (e) serious valuation gaps between buyers and the government. The two important elements to serious progress in the area of privatization are political will and a pragmatic, hand-tailored approach.

Of course, privatization is not an end in itself and certainly should not be promoted merely on ideological grounds. The acid test for any privatization proposal is whether, given all the circumstances in the country concerned, it can be relied upon to promote economic efficiency. For example, selling a firm that continues to operate in a highly protected environment cannot be expected to bring long-run benefits. Hence, if maximum benefits are to be achieved, positive steps should be taken (such as regulatory, tariff, or licensing reforms) to create a competitive environment. This may not be easy in small countries with limited economic development. Nevertheless, it is clear that in many cases privatization would make a valuable contribution to economic efficiency. Privatization can also provide new and attractive investment opportunities to foreign investors, including those interested in debt-equity swaps, as well as to holders of flight capital from the country concerned.

Other Reforms of Public Institutions. When privatization is not appropriate or possible, the efficacy of public institutions must be increased, both to lower budgetary costs and to ensure greater benefits from public intervention, be it through more effective public spending or better administration of government regulations. The quality of government is clearly crucial to the private sector. Effective public planning, budgeting, and administration are major areas for policy reform, but go beyond the scope of this report. (See *World Development Reports* for 1983 and 1988.)

What the Bank Group Can Do

Two issues are briefly addressed here: the treatment of privatization of state-owned enterprises in Bank operational work and the treatment of the private sector in the Bank's public expenditure and investment reviews and related adjustment lending conditionality.

Privatization. Privatization has been supported by the World Bank as part of its broad efforts to rationalize the performance of state-owned enterprises and by IFC as part of its support for the development of private sector activities. The Bank's work usually involves country economic and sector work, structural and sectoral adjustment lending, and public enterprise restructuring loans. Of the 109 projects in the previously mentioned survey, 33 provided for divestiture, 21 contained components involving other forms of privatization (leasing, management contracts, concessions, and so forth), and 30 provided for liquidation of state-owned enterprises. In a number of countries, adjustment loans also contained diagnostic studies which categorized state-owned enterprises according to their appropriate eventual disposition (public ownership and management, public ownership and private management

3. Liquidation is the appropriate response in cases where there is no economic and financial merit in continuing the business. Indeed the limited data available suggests that liquidation has outpaced actual privatization.

or leasing, divestiture, or liquidation). Interestingly, divestiture and liquidation were the two most common features of institutional reforms among the projects studied. IFC's efforts have been in both advisory and financing capacities. It has financed twelve restructuring operations that involved privatization largely in Africa and Latin America. It is currently involved in advisory work in a number of other cases.

Divestiture and liquidation, however, have proved difficult to carry out, even where governments are firmly committed. Thin local capital markets, resistance to purchases by foreign or minority investors, difficulties in determining an accurate sales price, political obstacles, and labor opposition were just some of the factors limiting the extent and speed of divestiture and liquidation. Other forms of privatization, although they are being explored, have so far found only limited application. In the Bank Group, the ability to assist governments has been hampered by limited in-house expertise in relation to the high intensity of staff input required.

This report recommends an expansion of the Bank's research and advisory capacity on privatization, especially as regards the institutional and incentive framework; an increase in the analysis of the legal and regulatory environment for privatization; an expansion of the technical operational support in the design of components for adjustment and restructuring loans dealing with privatization; and an expansion of IFC's capacity to provide technical assistance and advice to the Bank and to governments and to prepare for specific privatization undertakings. MIGA's start-up is also propitious, for it can provide incentives for foreign capital in relation to privatization. In any case, operations designed to support privatization should be realistic about the scope and speed of progress.

Public Expenditures. The Bank has carried out many reviews of public expenditure over the past decade. Many of these studies, and the adjustment operations drawing on their findings, have advocated cuts in public spending and changes in priorities, mainly to reduce the public sector deficit and eliminate low-priority projects. Reducing the deficit indirectly affects the private sector, as it reduces the crowding out of private by public activities. Moreover, to the extent that high-priority expenditures are frequently those most complementary to private sector activities (operation and maintenance spending for infrastructure, for example), cuts of low-priority expenditure are indirectly supportive of PSD. However, it does not appear that public expenditure reviews have explicitly considered ways to increase private sector participation in the provision of services. This report recommends that this question be more explicitly addressed in future public expenditure reviews. The sector policy studies on PSD proposed below will provide guidance and support for the country specific work in this area.

The Need for a Comprehensive Framework

The factors that contribute to the enabling environment for private sector development are highly interactive:

- A stable macroeconomic setting is essential for effective reform of incentives.
- Macroeconomic stabilization without structural reform may damage growth performance.
- Incentive reforms have fiscal implications that can threaten macroeconomic stability.
- Reform of incentives without reform in the legal and regulatory framework will limit the supply responses.
- Privatizing state-owned enterprises into a distorted market environment may make matters worse.
- "Getting the prices right" will not be of much use when much of the productive capacity of a country is owned and run by the government.
- Sustaining a supportive policy environment is impossible if the administrative capabilities of the government are weak.
- The quality of government may suffer where the incentive, legal, and regulatory framework provides ample opportunities for civil servants to abuse their discretionary powers.

For these reasons, reforms designed to strengthen the enabling environment for the private sector have to be based on an understanding, at the country level, of the binding constraints, the essential interactions among them, and the importance of timing and sequencing, so that reforms may be effective and sustainable.

The enabling environment is particularly important for two special areas of concern: entrepreneurial and technological development. Entrepreneurship is the ability to identify and exploit profitable business opportunities. Entrepreneurs are risk takers, innovators, people able to manage and market. They have a central role in PSD. Studies of entrepreneurs have found them generally concentrated in small firms, among members of minority groups, among the better educated, and located often in the central areas of

large cities, where they have ready access to labor markets and business services. Studies also indicate that in developing countries potential entrepreneurs are not in short supply, not even in the least developed countries in Sub-Saharan Africa.

Instead, the scope for entrepreneurial development in developing countries is often limited by policies that tend to be stacked against the typical entrepreneur. These policies are usually the ones reviewed here as determining factors of the enabling environment. Weakness in supporting services and in financial market policies further aggravates this bias. Governments can go a long way in fostering entrepreneurial growth by removing international trade and regulatory barriers against small firms, by reexamining their policies toward minority and foreign-owned firms and the domestic trading sector, by increasing access to basic education and infrastructure, and by ensuring that the financial system can respond flexibly and competitively to the special needs of the small firm.

Another critical element in PSD, also dependent in part on the enabling environment, is technological change. Many governments in developing countries want to move ahead in what they see as a rapidly changing race in the development and adaptation of technology. The temptation has been to get public agencies to take direct responsibility for the development and intermediation of technology, to the exclusion of other options. Studies of technological development have concluded that the demand side, in particular the competition and the incentives that domestic industry face, is as important as the supply side, if not more important. These studies have also found that controls on technology imports are generally not an effective means of developing an indigenous technological capacity; that on balance more resources should be devoted to technology adaptation than new technology development through basic research; that effective interaction between publicly supported technology development institutions and private industry is essential; and that fiscal and credit measures in support of technological development should be unambiguous and simple and should involve some cost-sharing by the benefiting industry. The elements that make up a good enabling environment in general therefore also apply to the specific case of technological development.[4]

In sum, efforts to improve the enabling environment are an essential part of any strategy to foster private sector development, entrepreneurship, and technological development. The factors that determine the enabling environment are interrelated and need to be treated in a comprehensive framework. Such a framework has to be country specific and strategic in nature. This report recommends that considerations of the enabling environment be made an integral part of the Bank Group's country strategies for PSD. Adjustment operations are the natural vehicle to translate analytical insights into explicit support through lending operations. Without overburdening existing adjustment programs, reforms in the enabling environment should feature prominently in future adjustment loans. The scope of such operations can be appropriately narrowed, as in the case of the recent restructuring or adjustment loans to the Philippines and Indonesia. In any case, it is essential that the narrower adjustment operations be firmly embedded in a clear macroeconomic strategy accepted by the government.

4. Other elements supportive of technological development include the establishment or strengthening of scientific research and teaching institutions—this is an area where the Bank has provided support—and assistance to governments in locating, evaluating, and acquiring technologies—this is an area in which IFC is considering the development of advisory capabilities. Both efforts by the Bank Group should be further strengthened.

3 Providing Infrastructure and Services

Creating and maintaining infrastructure and social services are preconditions for the development of the private sector, as well as general economic growth. They affect an enterprise's cost of doing business in a country and its competitiveness in international markets. Transport and communications systems are critical in linking production points with markets, whether foreign or domestic. Power and water are essential inputs in the production process. Education, health care, housing, and other services affect the productivity of laborers and managers.

Many infrastructure and social services are widely recognized to be primarily the responsibility of government, because an unregulated private market would or could not provide them well. The first part of this chapter discusses how publicly financed and administered infrastructure activities, to which a large part of the World Bank's resources has traditionally been channeled, can stimulate the enabling environment for PSD.

The private sector may also have a greater role to play as a provider of these services, because the effectiveness of government intervention is limited. The second part of this chapter is devoted to the private sector's role as a provider of some services that have traditionally been considered public. The Bank Group has played only a limited role in this area.

Private Sector Development through Public Services

Why is public involvement sometimes necessary? A conventional market sets prices where buyers' willingness to pay equals suppliers' cost of providing the last unit consumed. But private and social benefits and costs may significantly diverge for services that exhibit the characteristics of "public goods." For example, when an individual's consumption also affects the well-being of others, as it would for immunization, family planning, or basic education services, a private market would lead to underutilization of the service. Another example is basic research—because findings are easily disseminated and benefits widely shared in society, self-serving individuals need to be given an incentive to do more than they would normally do. Also, the government may simply have goals, such as the reduction of poverty, that are not adequately considered by individual consumers and entrepreneurs.

Another justification for public involvement in infrastructure is that private providers may find it difficult to obtain a fair return on their investment. For ports, telecommunications, and power systems, for example, expansion may require a few large investments rather than many small ones. Potential private providers would thus be deterred from entering without some assurance of a large market share. In other cases, such as urban road construction, the costs of identifying individual users and charging them may simply be too high.

The Impact of Publicly Provided Infrastructure

The impact of such public investments on private entrepreneurs, as well as on the general economy, is undeniable. Studies based on wage employment data show that the social rate of return to education, as calculated by comparing the higher lifetime productivity of educated workers employed in the private sector with the social cost of education, generally exceeds that of most alternative investments. This finding is corroborated by evidence that annual crop

Table 3-1. The Share of Infrastructure in Bank Lending, Fiscal 1960–87
(average annual share in percent)

Purpose	*1960–64*	*1965–69*	*1970–74*	*1975–79*	*1980–84*	*1985–87*
Education	0.5	3.4	5.1	4.4	4.4	4.7
Population, health, and nutrition	0.0	0.0	0.5	0.7	0.8	1.4
Irrigation and drainage	7.6	6.2	6.7	9.6	8.3	6.2
Research and extension	0.0	0.0	0.1	1.5	1.1	1.5
Power	32.1	25.8	17.8	12.7	15.5	16.6
Telecommunications	1.4	3.4	4.9	2.0	1.7	1.7
Urbanization	0.0	0.0	0.8	2.5	3.4	5.9
Water supply and sewerage	1.2	1.5	4.6	5.2	4.6	4.9
Transport	40.5	29.5	24.2	16.4	12.8	11.3
All infrastructure	83.3	69.8	64.8	55.0	52.5	54.2

Note: Infrastructure is broadly defined to include investments in human capital, as well as physical capital.
Source: World Bank data.

yields of farmers with four years of education are as much as 9 percent higher than those of farmers with no education. Research in Seoul and São Paulo has shown that crowded city centers, which have good transport, electricity, and communications services, are good at hatching new industries. The proof that they act as incubators is that they have a substantial share of the total number of new jobs and firms in the city and attract small firms.

If the public sector did not provide these services, or provided them unreliably, the private sector would have to compensate. Many of these private infrastructure investments are inefficient because they are too small. For example, Nigerian manufacturers face frequent interruptions of publicly provided water, electricity, telecommunications, and waste disposal. They have had to make substantial capital investments in these services themselves, which adds to their production costs and thus has hurt their international competitiveness. Private water vendors, who have an inefficiently small volume of business, operate in cities where the unit cost of piped water provided by a utility would probably be much lower (by a factor of four in Lagos, three in Nairobi, and two in Lomé). Long-term development of the economy in general and the private sector in particular must therefore be complemented by efficiently built and operated infrastructure services, many of which need public support.

What the World Bank Has Done

The Bank has long been a major source of financing for investment in public infrastructure and supporting services. In the early 1960s such lending accounted for three-fourths of the Bank's portfolio (see table 3-1). Since then, the share has been declining, particularly as agricultural area development schemes took off in the early 1970s and nonproject lending grew rapidly in the 1980s. Still, lending in these sectors totaled more than half of all IBRD and IDA lending in fiscal 1987.

Physical Infrastructure. The Bank's investment in physical infrastructure has significantly extended Africa's formerly skeletal road network, Asia's irrigation systems, and Latin America's power capacity. Many of these projects have eliminated bottlenecks to private sector growth. Although it is difficult to isolate the direct impact of these projects on PSD, they have generally been successful on the basis of broader economic criteria.[1]

The problems that infrastructure projects have faced reflect the general constraints on the public sector in developing countries (which are discussed more fully below). Inadequate tariff increases in the face of inflation and management problems have led to problems of sustainability in railways, water, and power projects.

Human Resources. In the mid to late 1960s the Bank started lending for human resource development. Investments in education and health raise the level of managerial and labor skills, which is critical for expanding the private sector. The magnitude of

1. A recent review of project performance results by the Bank's Operations Evaluation Department indicates that, for projects audited between 1976 and 1985, the average economic rates of return for transport and urban development projects ranged from 17 to 23 percent—higher than the returns for agriculture and industry in eight of the ten years in the study period. Rates of return for power, water, and telecommunications projects, although not strictly comparable for methodological reasons, were also "judged to be satisfactory." World Bank Operations Evaluation Department, *Twelfth Annual Review of Project Performance Results* (Washington, D.C.: World Bank, 1987), p. 10.

the Bank's involvement has been large—almost $8 billion since 1962 in education, for example. IDA alone contributed 14 percent of all external resource flows to African education and training in 1983–85. The Bank is now the largest international source of lending for health in developing countries.

All human resource investments, including basic education and primary health care, affect private sector development in the long run through their impact on labor force productivity. The Bank has also traditionally directed a large share of its human resource operations toward activities that have a more direct and immediate link with the private sector's labor market needs. Vocational education and training have taken up almost half of all Bank lending in education from the early 1960s to 1986. As indicated in box 3-1, the success of these projects in delivering the needed quality and quantity of trained labor to the private sector varies according to the type of training provided.

The Bank has also invested in more broadly based scientific and technical research. These investments have long-term payoffs to industry, particularly in rapidly modernizing economies. In Korea a sector loan in fiscal 1984 for science and technology provided loan assistance to strengthen the management of Korean grant-giving agencies for science, and it encouraged closer coordination between graduate schools and research institutes. In Brazil two years later, a project for science and technology financed a program of research in science, chemical engineering, and biotechnology and promoted the setting of industrial measurement standards. A follow-up loan is currently being considered. These investments are too recent to be evaluated.

Limits to Publicly Provided Infrastructure

Despite this record, much more needs to be done by countries and the Bank to maintain what has already been built, never mind adding to it. In meeting this challenge, the public sector confronts severe constraints:

- *Finance.* The fiscal crisis that began in the 1970s slowed the expansion of infrastructure, although the need for it continued to grow. In a sample of fifteen developing countries, central government spending fell by 18 percent in real terms from 1979 to 1985, while spending on infrastructure alone fell by 25 percent. Many of the poorest countries have made large cuts in spending per capita for social services. Between 1975 and 1983, for example, real expenditure for each pupil in primary education declined in seventeen out of

Box 3-1. Bank Lending to Train Workers and Entrepreneurs

Although the Bank has continued its strong support for vocational education and training in the past decade, there have been significant changes in emphasis and considerable variation in investment performance. For example, Bank lending for diversified secondary schools (which combine academic and vocational curriculums) was virtually discontinued after a rigorous evaluation revealed that it was not cost-effective. Graduates were not entering the labor force at a higher rate than their counterparts in academic streams, even though more money was spent to expose them to more practical courses. Increasing emphasis has instead been given to the development of national industry training systems, often built around informal training centers and involving work-study. Such systems have closer ties with employers and greater flexibility in responding to rapidly changing demands for skills. Bank research in Latin America found them to have high rates of return.

Another type of human resource investment closely linked to the labor market is project-related training—training components attached to traditional project investments. For example, the recently approved Pakistan highway project contained a component to train local contractors in maintenance. Although project-related training is used in many Bank-sponsored projects to fill gaps in skills needed for construction and operation, various reviews have shown that the design and implementation of these components are frequently in need of improvement. The Bank has had more success in implementing its free-standing training projects, particularly those providing agricultural extension, management, and accountancy training.

For all of these systems a fundamental difficulty is that the public sector has difficulties in matching graduates, skills, and job needs. Manpower projections are cumbersome and inaccurate tools to assist the government in planning training places for the private sector. The signals and incentives inherent in training that is privately provided may better serve the needs of the labor market. Thus, options in the private sector, such as private training centers or on-the-job training, need to be given increased attention.

twenty-five low-income countries. Trends such as these suggest that the large gap in human resources between developing and industrial countries will widen.

- *Inefficiency.* A fundamental problem is that limited public resources tend to be badly used. Not enough is channeled toward cost-effective services. For example, a general neglect of maintenance has led to accelerating deterioration in existing capital stock. As a result, about a quarter of the paved roads in eighty-five developing countries are in need of reconstruction—at a cost three to five times that of timely maintenance. In some countries, de facto policies to have the public sector act as an employer of last resort have led to a large inflexible wage bill and, often, a wage structure devoid of incentives.

Because of these problems, the success of further investment in infrastructure depends upon complementary policies regarding pricing and institutional reform. Establishing appropriate pricing policies would give the right signals to public sector providers regarding investment needs and to private sector firms regarding use of the service. These issues are reviewed in detail in *World Development Report 1988*. Developing countries, with Bank assistance, have begun to address these issues with broadly based sector adjustment programs, in social as well as physical infrastructure.

Another type of reform is institutional—public administrators need to be more efficient themselves if they are to provide efficient and effective infrastructure conducive to PSD. Proper budgeting and managerial reforms in the public sector are discussed in the 1983 and 1988 editions of the *World Development Report*.

In some cases, countries have recognized that the public sector's pervasive role in the provision of infrastructure cannot be sustained. Adequate infrastructure depends not only on more resources for investments, but also on improvements in the way that such infrastructure is operated and maintained. In the face of constrained public resources and skills, many countries are considering ways to use private initiatives—sometimes with Bank Group assistance. These issues are reviewed in the next section.

The Private Sector as a Provider of Infrastructure

In most developing countries, electric power, water supply, and telecommunications services are provided by publicly owned utilities; transport networks, schools, and health facilities are constructed, run, and maintained by government departments. However, tightening budgetary constraints and administrative failures have led many governments to reevaluate the appropriate role of the private sector as a provider of some physical infrastructure and social services. There are precedents for private involvement. In the early years of many industrial countries, basic infrastructure—such as roads, railways, and power—was financed and built by private entrepreneurs.

Striking a Balance between Public and Private

There is no single correct balance between public and private providers. In each case, it depends on the characteristics of the good or service and conditions of the country. However, some general principles can be applied, which may mobilize more resources from the private sector and may improve competition in the provision of public services.

Services Where Conventional Markets Work. For some infrastructure services, such as housing, urban bus transit, trucking, curative medical care, and job training, competitive markets are viable—there are no technological barriers to entry, and externalities can be handled by government regulation. In such situations, studies consistently show that private providers are more efficient than comparable public ones. Conventional markets work reasonably well in providing the appropriate service at least cost because the agents are accountable to users.

Data for urban transport illustrate this point. In cities where bus services are provided by both public and private operators, the cost per passenger is lower for private operators than public operators, who are invariably highly subsidized. The ratio of private to public costs per passenger in 1985 for comparable bus service in selected cities is as follows:

Ankara	0.48	Jakarta	0.50
Bangkok	0.63	Karachi	0.36
Calcutta	0.37	Khartoum	0.40
Istanbul	0.85		

For these same cities, the public operators have a lower fleet utilization rate, a higher staffing ratio, and a greater incidence of fare evasion than unsubsidized private operators.[2]

2. Data are calculated from table 6.3 of *World Development Report 1988* (New York: Oxford University Press, 1988).

Even when these services are provided privately, the government still has a role. In urban transport, it has a role in traffic regulation and management, vehicle licensing, safety and environmental standards, and where feasible, road pricing. Policy changes in these areas can be cheap, congestion-relieving alternatives to new transport investments. The government may also want to ensure access to transport facilities for the poor, through subsidized ridership and neighborhood road improvement.

However, when government intervention itself has stifled competition, there is little hope that the private sector can be an effective provider unless the restrictive aspects of public policy are changed. Private housing markets in many cities, for example, have been overly restricted by rent control, which has often produced results exactly opposite to those intended. Studies show that the benefits of such restrictions to present renters are low. Some restrictions are simply not effective because of side payments, such as key money paid directly to the landlord in lieu of market rents. Effective restrictions, however, inhibit maintenance and new construction—as in Kumasi, Ghana, where controls have virtually stopped new construction. Another constraint on the supply of private housing is overregulation of housing finance markets. Interest rate ceilings and portfolio restrictions on banking institutions have significantly limited the ability of savings to be channeled to the housing markets, as in Argentina and Malaysia, and, until recently, Chile and Korea. These restrictions can have debilitating economywide effects on PSD because housing supply constraints decrease labor mobility.

Thus, private providers, whether in transport, housing, or other services with strong competitive markets, work best with a minimum of control on price-setting. For the very poor, some form of assistance may be warranted. Such intervention can also be efficiently channeled through the private sector (as in box 3-2).

Services Where Competition Is Not Ensured. For some infrastructure and social services, the absence of economies of scale or the presence of externalities hinders competition. If so, it is difficult to argue that a regulated private monopoly would necessarily be more efficient than a well-run publicly owned utility. While managers of a private monopoly are ultimately answerable to shareholders and debt holders and may have an incentive to maximize returns, their monopoly position does not provide much incentive

Box 3-2. The Private Sector Can Be Used to Meet Social Goals

Public spending is often seen as an efficient way to redistribute resources to poor households. Many governments would like to have a social "safety net" to ensure the poor's access to basic physical infrastructure and social services.

This goal need not be inconsistent with the private provision of infrastructure and social services. In many cases, the poor may have limited access to the most highly subsidized, publicly provided services. Subsidies to higher education and expensive urban hospitals go primarily to upper-income groups. Costly subway systems, such as those being built in Caracas and São Paulo, will not directly serve the lowest groups, who demand few of the longer trips the subways provide. Subsidizing the unit cost of electricity does little good to the small consumer who has few appliances.

Thus, encouraging unsubsidized private provision in some services may not adversely affect the poor. It may even help, if public subsidies are then redirected toward services used by the poor, such as basic education and health care. Also, lower-cost, competitive providers may find it profitable to serve low-revenue areas that public providers could not financially sustain—this is the experience of private bus contractors in Bangkok, Istanbul, and Kingston.

Even where public subsidies are necessary, the private sector can have an important role. If subsidized consumers were given an incentive to choose the most efficient supplier of the service, there would be more resources to redistribute. Chile's restructuring of its housing finance system, funded partly by the World Bank, is a good example. Until the mid 1970s Chile used directed credit (at artificially low interest rates for everybody) and publicly built units to provide housing. This system was financially and economically unsustainable. Now an explicit housing subsidy system is targeted to families who may have some capacity for savings but lack sufficient income to buy housing. The subsidy is a direct, one-time grant given in the form of a certificate, which the beneficiary can use to purchase or build a new or previously occupied dwelling in the private market. This reform has significantly lowered the cost to the government and to the economy, while serving more poor people.

Box 3-3. Public-Private Partnership: Build-Own-Operate Power Schemes

Innovative techniques to overcome the classical problems of underdeveloped capital markets, high risks, and lack of private sector interest in financing large power projects are being tried in developing countries such as Pakistan. The so-called build-own-operate scheme is designed to increase the incentives for the private sector to construct and operate facilities to generate power. The scheme encourages contractors to own equity interests in the projects.

In Pakistan eight power generation projects are being considered. Together they would be worth about $2 billion and would have a production capacity of 2,000 megawatts. All of the projects are joint ventures by consortiums of domestic and foreign contractors. The private sponsors would mobilize the equity for each project. The World Bank and several development agencies—notably from the Federal Republic of Germany, France, Italy, Japan, the United Kingdom, and the United States—will provide as much as 30 percent of project costs through a recently created Private Sector Energy Development Fund. That fund is currently being administered by the National Development Finance Corporation. The rest of the money would be provided by export credit agencies and private lenders. IFC, which has worked with the Bank on this scheme, is poised to help raise private funding for these projects. Altogether about 7 percent of the financing would come from the Bank, 23 percent from bilateral agencies, 25 percent from private equity holders, and 45 percent from private lenders.

The government of Pakistan will institute measures that provide financial incentives and reduce risks to lenders and investors. Important elements of this package are an expected rate of return providing a reasonable yield to private owners, provisions for repatriation of profits, and guaranteed purchase and price agreements between the power generators and the national utilities. The initial reaction of interested parties indicates that the scheme will be a success.

to reduce costs. For example, prior to its break-up in 1983, the Bell telephone system in the United States provided excellent service (and returns to its investors), but it was needlessly expensive. The company was able to justify high local rates by adding to its cost base. Such a system puts a heavy burden on regulatory authorities to monitor the firm closely and to develop innovative incentive schemes—a difficult task, particularly in developing countries.

Nonetheless, the private sector can still play a role as a provider of infrastructure services in some stages of the production where competition can be introduced. U.S. telephone users now benefit from extensive competition in telephone equipment and long-distance service. In regard to electrical power, even though natural monopolies exist in transmission and distribution, generation can be done efficiently by small producers, who can sell it to consumers through public utilities. In the United States, because of the Public Utility Regulatory Policies Act implemented in 1982, most new planned power generation is anticipated from private generators (mostly cogeneration facilities). A similar proposal is being considered in the United Kingdom. In developing countries, Turkey and Pakistan have recently opened the door to the private sector, through foreign as well as domestic firms, to construct and operate power plants. These initiatives (yet to be implemented) are on a "build-operate-and-transfer" (BOT) or "build-own-and-operate" (BOO) basis, under which a private firm finances some or all of the initial investment and is remunerated directly from revenues earned by the project from selling output to a public utility. BOT schemes provide for the eventual transfer of ownership to the state or to private domestic investors (see box 3-3 for further description of the Pakistani initiative).

To increase competition in transport and water supply, some countries now allow free market entry and fair treatment to qualified private contractors for construction and, to a lesser extent, operation and maintenance. It is difficult to assess the cost-effectiveness of contracting compared with force account (that is, work done directly by a government line agency), because force account units undervalue the true economic costs of their operation. One example from Brazil indicated that force account costs 60 percent more than contracting. A recent review of experience found that roads under contract were well maintained in Argentina, Brazil, Central African Republic, Ghana, Kenya, and Yugoslavia. In addition, services such as stevedoring in Chile or the sale of railway tickets in Korea, which used to be done by public agencies, are now being contracted out. In Côte d'Ivoire, the public water supply authority is responsible for owning and financing the fixed assets, while a private company is responsible for operations and maintenance. Contracting out is

also being tried in education. Chile and the Philippines have implemented exploratory schemes to allow the surplus of students over the maximum public school enrollment to be educated in private schools for a fee charged to the government.

Initiatives such as these require improvements in regulatory frameworks and institutions to ensure efficiency. One major impediment to direct private sector investment is the risk that price controls or government interventions will reduce returns. Another barrier is governments' inability to design, award, and supervise contracts that ensure equitable risk sharing and good performance. Governments must shift from being doers to being regulators—which may require different skills and rewards. In some cases, government officials may see such moves as a loss of authority. A recent Bank-funded scheme in Bangladesh to privatize lift pumps failed because of bureaucratic hurdles. Two recent BOT initiatives for highway construction in Southeast Asian countries have been delayed because of political obstacles.

What the Bank Group Has Done

The Bank Group is only beginning to support greater private sector involvement in infrastructure and service provision. This section reviews a few significant initiatives, without attempting to compile an exhaustive list.

In lending operations, Bank Group support includes the following: sector work and policy-based lending to enhance the enabling environment for these initiatives; the promotion of private subcontractors to public agencies for construction, operation, and maintenance; and direct lending (or on-lending) to private firms in these sectors or assistance to divest state-owned enterprises. In some cases, nonprofit, nongovernmental organizations have been involved (box 3-4).

Changing Policies toward Private Providers. Recent Bank sector loans have stressed the need to provide an atmosphere conducive to PSD. Much can be done through deregulation. For infrastructure services that could feasibly have conventional markets, the private sector is being encouraged to participate.

Recent housing loans by the Bank in Korea and Chile (see box 3-2 for the latter), for example, have eased financial restrictions that make it unprofitable for commercial lenders to channel their resources to housing (see also IFC initiatives, discussed in chapter 4). At the same time, the governments have limited subsidized public construction in order not to crowd out more efficient private providers, while attempting to target housing subsidies to the lowest income segments of the population. The Bank supported a recent program by the government of Zimbabwe to involve private financial institutions in supplying mortgage loans at commercial rates to low-income households.

In urban transport, the emphasis has been on traffic management and safety standards. A loan to Jamaica focused on traffic management and road maintenance in direct support of the government's privatization plan (see below). The first Mexico urban project, launched in fiscal 1987, provides for the development of a maintenance facility to be operated and funded by a cooperative representing private bus owners and operators to make adequate maintenance available at reasonable cost.

The Bank has also made significant contributions in the policy dialogue to expand private participation, particularly in the social sectors. Recent papers in health and education have put topics like user charges, educational credit, and health insurance on

Box 3-4. The Role of Nongovernmental Organizations

Nongovernmental organizations (NGOs) often have a good understanding of the local environment, easy access to intended beneficiaries, and a willingness and ability to finance and use low-cost technologies. In recent years the Bank has tried to incorporate NGOs into projects, particularly those concerned with rural development, health and education, the environment, and poverty alleviation. NGO roles range from project implementation to consultant services to cofinancing. In some cases governments have made grant funding available to NGOs in the context of a Bank project. In Bangladesh, a population project allocates support for NGOs and emphasizes expanding their role in the delivery of services. Similar NGO support has been included in population projects in Guinea, India, Malawi, and Zimbabwe.

the international agenda—all topics that will facilitate an expansion of PSD in areas traditionally reserved for the public sector. These issues are starting to be included in some sector adjustment loans (in Morocco and Ghana education programs, for example).

Contracting Out. The Bank has been instrumental in strengthening the performance of state enterprises and government departments by advancing fair treatment for private contractors. Contracting out introduces private involvement in activities where competitive ownership is not economically or, in many instances, politically feasible. By the end of fiscal 1986, the Bank had financed 169 operations in 74 countries aimed at strengthening the construction industry through technical assistance, training, credit, and encouraging borrowers to change from force account to contracting. Although some of this went to state-owned construction corporations, much of it was devoted to contractors, particularly in highway projects.

In addition to construction, contracting out of operations and maintenance has also been encouraged. Guinea is only one of the more recent examples, where the loan covers repairs and maintenance of private contractors and, as important, strengthens the public management's capability to supervise such work. Another innovative project is in Nigeria, where the Bank loan establishes an infrastructure development fund to be used by selected merchant banks to identify, appraise, supervise, and cofinance urban infrastructure projects undertaken by state governments.

Direct Lending to Private Providers. The Bank Group has also increased its support of private financing of infrastructure and services, although this is still relatively rare. The Bank has provided technical assistance to develop a management contract for water supply in Senegal. It has also provided funds to be on-lent to private bus companies to buy equipment in Jamaica and Mexico. The only on-lending scheme in education has taken place in Korea, where loans for private technical institutes of higher education provided for equipment, construction, and staff upgrading. The BOO power plant in Pakistan was mentioned earlier (box 3-3).

Some Bank projects include the divestiture of public infrastructure agencies. In Jamaica the government returned Kingston's bus service to the private sector in 1984, seven years after the service had been nationalized. While it was publicly owned, the company's operations declined to the point where only 140 of the company's 575 buses were operational and deficits were enormous. The Bank provided loans for technical studies of privatization and for road maintenance. The recent Bank loan for rationalizing public enterprises in the Philippines also included the privatization of Metro Manila transit. In Guinea, Conakry's urban transport company, long plagued by administrative difficulties, is to be turned into a joint venture company with private participation; its port has agreed to privatize ship and cargo handling so that importers and exporters can now freely select freight forwarders and customs agents among private companies.

IFC has been involved in the development of infrastructure in a variety of ways. Examples of direct IFC investments in the development of infrastructural facilities are, however, few. Ventures in the 1960s and 1970s were mainly in electric transmission and long-distance telephone networks. The first and so far the only investment in a gas transmission pipeline was authorized in 1977 in northern Colombia. The 1980s saw a slight broadening of IFC involvement. In 1981 two bulk terminals—one in Korea and another in Somalia—were initiated with partial IFC financing. In 1982 IFC made its first investment in a health-related field by financing about 25 percent of a $64.3 million project in Yugoslavia. The project involved the expansion of a medical rehabilitation facility for the treatment of patients with arthritic, rheumatic, pulmonary, and cardiac ailments.

The limited number of IFC investments in infrastructure is not surprising. Most infrastructural facilities in developing countries are in government control and closed to the private sector. It is, therefore, hard to come across private initiatives that could have been supported by the IFC.

What Can Be Done in the Future

- Promote the expansion and efficient operation of public infrastructure services needed for private sector development.

Despite increased emphasis on institutional strengthening and financial efficiency, there is a need for further improvement in the public sector performance of many Bank borrowers. The Bank's infrastructure lending has increasingly focused on cost controls, appropriate pricing, commercial operating practices, careful targeting, and administration of programs to assist low-income groups. Recent sector adjustment loans have aimed at achieving policy reforms in energy, transport, telecommunications,

urban services, health, and education. The Bank needs to continue to support such reforms.

- Undertake more research and policy work on the appropriate role of the private sector for various infrastructure services.

A more thorough, sector-specific assessment is needed of the possibilities and limitations of private sector involvement in infrastructure. Although there are compelling theoretical reasons why private sector involvement will increase the efficiency of service provision in infrastructure, the empirical evidence for developing countries is relatively weak. The Bank has undertaken some case studies in bus transport and housing, although these evaluations can be improved in methodology and design; more rigorous analysis has been undertaken in education. Carefully designed studies can address questions like the following: Under what conditions and for what services will a private competitive market work better? Can public providers mimic the incentives inherent in private sector provision?

In addition, research should be undertaken on pricing and other aspects of regulatory policy for private natural monopolies. Questions that need answers include: Should prices be regulated on the basis of costs or on the basis of broader price indices? What incentives need to be given to the private sector to ensure efficient competition? Can regulatory schemes be effectively enforced?

This basic research should complement more operational studies on service contracting (such as the one done for highway maintenance) to form the basis for sector-specific policies on private sector development in infrastructure.

- Increase the private sector role in financing and operating infrastructure and basic services.

Even while the basic research and policy work is being undertaken, the Bank Group should continue to assist interested member countries in tapping private finance and managerial skills. Although some of these innovative schemes have been tried, the experience to date has been limited. In some cases, privatization is the path to follow (see chapter 2). In cases where complete privatization is neither economically nor politically desirable, there are other ways to introduce private interests to enhance efficiency. This activity would include: (a) seeking opportunities to fund all or part of government's share in joint ventures, on-lending, or BOT schemes; (b) identifying the scope for greater private participation through subcontracting some activities in project implementation and operation of the service; (c) where feasible, allowing the local and foreign capital markets to participate in infrastructure investments.

IFC can play an increasing role in these areas (see chapter 4). The enlargement of its capital base now allows it to make individual commitments of a size that, when combined with its syndicating capacity, will make it a major player in infrastructure projects, a role not financially feasible even five years ago. MIGA can also play an important role by according its guarantees to investors, and in particular by guaranteeing the stability of their agreements with the host government. Because of the experimental nature of many of these schemes, on-going evaluations of the lessons learned are essential.

Equally important is the policy dialogue with member governments. The Bank Group should continue its stress on subjecting public monopolies to competition. Research results on the efficiency gains from having some services provided privately should be used to quantify the opportunity costs of present systems. The Bank can work on liberalizing regulations that prohibit or restrict such competition. Where public and private sectors compete (as in housing and bus transit), Bank Group projects should not give an unfair advantage to enterprises that seek a monopoly position. Assistance should be given to strengthen the analytical capability of regulatory staff.

4 Financing the Private Sector

World Bank Group activity directly addresses the financial needs of the private sector in five ways: (a) by helping governments set policies that will send the right signals to the financial sector as a whole, (b) by promoting the development of the local capital market, (c) by establishing and financing intermediaries for domestic and foreign resource mobilization, (d) by directly financing private sector activities, and (e) by facilitating foreign investment in member countries. This chapter takes stock of the Bank Group's efforts in these areas.

Financial Issues

The financial system facilitates growth by increasing the volume and efficiency of domestic intermediation—that is, the ability of banks and other institutions to pass resources from investors to borrowers, so that rewards are maximized relative to the risks assumed. The starting point for financial reforms is the macroeconomic framework. Overvalued currencies, severe trade restrictions, and high inflation will impede reforms or reduce their benefits. Therefore, the opportunities for successful financial reform are greatest when the incentives and other macroeconomic conditions required to put an economy on a sustainable path of growth are already in place.

A 1985 internal policy paper on financial intermediation examined financial issues prevalent in developing countries, and it articulated an initial approach for the Bank Group.

The paper identified four concerns. First, the debt crisis had created unexpectedly adverse macroeconomic environments that had weakened many intermediaries in developing countries. Second, policy regimes of negative real interest rates had undermined domestic resource mobilization and the financial system. Third, governments' excessive reliance on directed credit programs and their usurping financial markets for their own use had led to inefficient resource allocation. Fourth, the task of building a sound institutional base required overall development of the financial system, as well as special attention to regulation and supervision and to the underlying legal framework. The Bank Group thus needed to assist countries on a broad range of sector and institutional issues in its future financial sector operations.

These concerns are as pressing today as they were in 1985. Indeed in many developing countries insolvent financial intermediaries, both commercial banks and specialized intermediaries, seem to be more widespread now. Only a few years ago general insolvency was thought to be largely a Latin American phenomenon, with origins in erratic or inconsistent macroeconomic policies. Insolvency is now widespread in most Latin American and African systems, and problems caused by public ownership and credit allocation may be even more serious in Africa than in Latin America. Severe portfolio and structural problems have emerged in Eastern Europe, as many systems there move toward financial reform. In Asia, financial distress is less prevalent, but does exist in a number of countries. If judged by a criterion that less than, say, 20 percent of system assets be in institutions with negative net worth, few developing countries would emerge with a clean bill of health. The extent of the problem, however, is not easy to gauge because few developing countries have adequate systems of financial reporting, loan classification, auditing, and regulation.

One cause of financial distress has been the implementation of stabilization and structural adjustment

programs. These have involved: (a) large real devaluations, which have increased the burden of dollar debt (for many countries, foreign debt far exceeds domestic financial claims—a reflection of the historic inefficiency of domestic intermediation), (b) trade liberalization, which has weakened the financial position of major borrowers, and (c) tight monetary policy, which has often been imposed to provide governments with the financial resources to service the predominantly public sector foreign debt. Furthermore, financial liberalization, undertaken as part of an adjustment program, can itself spur financial distress by raising interest costs. Conversely, general financial distress inhibits successful adjustment, as insolvent, but still-operating firms squeeze out potentially viable firms from the credit market. Thus fewer firms can respond to the changes in incentives that are usually part of a country's strategy for adjustment.

Because of the complex links between adjustment policies and financial distress, structural adjustment reform needs to anticipate the potential impact of losses on the financial sector. Structural adjustment programs should involve regular financial reporting and loan classification, for example, so that the process of sorting out losses and considering how the system should handle them is started early on.

The depth of institutional reforms needed to enable countries to successfully operate a market-based, competitive financial system has also become more apparent. It is not enough to liberalize interest rates, reduce government preemption of credit, and reduce the direction of credit to privileged borrowers, although these in themselves are difficult goals. Banking institutions are likely to require extensive technical assistance to enable them to function successfully in a competitive environment. Accounting and auditing procedures frequently must be revised, and regulatory and supervisory institutions must change their emphasis, away from ensuring compliance with rules for directing credit and toward assessing institutions for safety and soundness. A change of management is often a critical ingredient for successful reform. Although some countries have the skills needed to liberalize their financial systems, most do not, since such skills have not been required in the existing regulatory structure. The problems of low-income and socialist countries are particularly noteworthy in this respect.

It is too early to pass judgment on the success of adjustment lending to the financial sector. However, the consensus is that financial sector liberalization is best introduced at a time when macroeconomic and political conditions are reasonably under control and improving—the absence of such stability can frustrate the reform process. Financial sector adjustment loans have been made to countries where the macroeconomic situation was doubtful. It may not be realistic to expect major goals to be achieved if the macroeconomic situation is not under control.

This experience is not necessarily an argument for delaying financial sector reform until all other components of a package are in place. The longer reform is delayed, the more costly it is likely to be in fiscal terms. The lack of reform also inhibits recovery by diverting credit from viable borrowers. Comprehensive financial reform can itself have adverse side effects, such as the emergence of very high real interest rates following their liberalization. Consequently, the phasing of reform is a complex question. In view of the problems being encountered, it is timely that the *World Development Report 1989* (forthcoming) will have the development of financial market as its theme.

The Bank Group is now participating in financial reform packages that go far beyond the traditional scope of its financial operations, which have often focused on interest rates. About one-quarter of the operations that involved development finance intermediaries have included studies or actions related to overall financial policies, and conditions agreed to in the negotiation of adjustment loans increasingly touch on domestic intermediation. The Bank has also begun to approach the problems directly through financial sector adjustment loans. As of fiscal 1989, four such loans have been made (one each to Argentina and Ecuador, and two to Turkey), and additional ones are under consideration. An economic recovery loan to the Philippines also had a large component for the financial sector.

Three broad issues have typically been addressed in the Bank Group's financial operations. Specific measures have depended on the degree of distress in the financial system; severely distressed systems have required the most draconian measures to deal with the losses of the banking system, as was the case in Chile.

- *Frameworks for prudence and restructuring.* Bank Group lending has supported measures to strengthen accounting and auditing procedures and to determine the state of portfolios, provisions, and writeoffs; efforts to clean up loan portfolios, recapitalize banks, and merge or close banks; and improvements in the system of prudential regulation and supervision to ensure that the financial system will be sound in the future.

- *Freeing-up the financial system.* The Bank Group has also endorsed removing or relaxing interest rate controls and directed credit; moving to broad methods of monetary control and away from bank-by-bank credit limits; relaxing barriers to entry and exit and increasing competition in the financial sector; and reducing and rationalizing fiscal burdens on financial systems.
- *Capital market development.* Increasingly a component of Bank loans (and one where IFC is usually involved), efforts to develop capital markets have included formulation of suitable regulatory and tax provisions to encourage a range of instruments, including equity; technical assistance in setting up new institutions to facilitate capital markets, arrangements to improve market transparency and liquidity; and cooperation with international investors.

The remainder of this chapter reviews how the Bank can mobilize its skills to meet the complex challenge of financial system reform in three main areas: reform of development finance intermediaries, direct financing in productive sectors, and facilitating flows of foreign capital and know-how.

Development Finance Intermediaries

Historically development finance intermediaries (DFIS) have been the principal way the Bank Group financed industry. DFI lending by the Bank started in the early 1950s. Initially it was Bank policy to support only privately controlled institutions, and lending activity was modest.

The 1960s saw considerable Bank Group activity in creating new, predominantly private DFIS, as IFC put together the shareholding group and the Bank provided loan financing. The short-term objective was to develop institutions capable of competent project-based lending and equity investment; the longer-term objective was to develop institutions having the capacity to raise equity and debt resources independent of government financial support.

In the mid 1960s the Bank began to include both government-controlled and privately owned DFIS in its lending program, on the grounds that ownership did not, in itself, determine competence. IFC continued to monitor its own DFI portfolio but was involved in creating only five new "traditional" DFIS in the 1970s (three in Africa), and in the 1980s only three new DFIS (two in Africa) have been set up with IFC's assistance and equity participation. Because most of the DFIS in which IFC held shares were recipients of Bank loans, there was a tendency for the Bank to take on a larger role in the ongoing dialogue with a number of those institutions.

There were several reasons why IFC's DFI activity declined while Bank activity increased. First, IFC had helped to create DFIS in most markets where it was possible to assemble private sector backing for such institutions. Second, it had discovered how difficult it was to establish DFIS that would meet a reasonable test of return on equity, which, given IFC's own investment criteria, led to declining interest by IFC in specialized, term-lending DFIS. Third, in line with its divestment policy IFC had rolled over its DFI investments where it could do so, some at a good profit, while others not. The critical ingredients in the financially successful DFIS seem to have been a reasonably stable macroeconomic environment and outstanding management capable of adapting and changing financial product lines and services to their changing environments.

For the Bank, the use of government-controlled intermediaries (usually existing entities—rarely has the Bank created new government DFIS) plus the use of commercial banks (government and private) under apex loans vastly extended the potential for DFI lending. Moreover, following an internal review of DFIS in 1973, which concluded that many of these institutions required more of a "development orientation," the Bank began to focus on the use of DFIS to achieve specific targets within sectors regarding the size and location of enterprises or the level of employment. Finally, the Bank's widening objectives and the growing number of DFIS it dealt with facilitated sizable resource transfers to the private sector and thus provided opportunities for policy dialogue on a range of issues.

Today IFC holds shares in twenty-four DFIS. All but three are recipients of Bank loans. The total cumulative amount of IFC financing to these twenty-four institutions is rather small: about $40 million in equity and $180 million in loans.[1] The Bank, in contrast, has in its DFI portfolio some 150 institutional borrowers. Its lending to them has covered small as well as large private sector investment projects (see box 4-1). The volume has averaged $1.3 billion a

1. IFC lends to creditworthy DFIS when no government guarantee is available and IFC financing is critical to the DFI's achieving its objectives or when IFC can help more mature DFIS tap international markets. In addition to these loans to what might be considered traditional DFIS, IFC has provided credits or agency loans totaling $62 million to other types of intermediaries, such as merchant banks.

Box 4-1. Small Business Development

Entrepreneurship—how to develop it—and small business—when and how to support it—are topics that have received considerable attention in both the industrial and developing countries. There is a visceral consensus that small business deserves support, but how and with what effect, still remain somewhat difficult questions. It is even elusive to define what is meant by small. The Bank has financed about six small-scale enterprise projects a year over the past five years, at an average yearly total of $0.5 billion. Included in the "small" classification are projects where subloan size is $60–$100 (Indonesia), up to $500,000 (Mexico), and up to $2.5 million (Turkey). Likewise, it is difficult to determine whether programs focusing on the $1,000 borrower are more or less important developmentally than the ones that are 5 or 100 times larger. Size, in itself, does not seem to be a reliable indicator of economic virtue.

What does seem generally clear, however, is that (a) small enterprises, quantitatively, make up a significant portion of the productive economy in many countries, (b) policies are often stacked against them, and (c) distortions in the financial sector often close off commercial sources of capital to them. Hence, the Bank and to a lesser extent IFC have assisted governments in a number of cases to redress the imbalance. The Bank has done this for the most part through specialized agencies mandated to assist entities of a certain size, often with a technical assistance component; the size range is wide, as noted earlier. On occasion, however, commercial banks have been included in the delivery process. IFC's leasing companies also tend to deal with the smaller enterprises (leases ranging between $30,000 and $300,000), as do agency equity-credit lines (average financing of $300,000), and venture capital companies (average financing of $130,000). In addition, IFC is experimenting in the Caribbean and Africa with hands-on project development facilities, whose job it is to assist entrepreneurs to develop their projects to a bankable stage.

Reaching down to the small entrepreneur is a labor-intensive operation. Although specific credit projects will still be desirable, the Bank Group can make more of an impact by focusing more explicitly on government policies that frustrate small enterprise development. Bureaucratic regulatory environments, cumbersome tax policies, difficult business entry requirements, credit policies that reduce risk capital for this sector, discrimination against certain minority groups that tend to produce entrepreneurs, and subsidies and advantages given large firms are a few of the policy factors that often disadvantage the small businessman.

In working on the enabling environment issues (discussed in chapter 2), the Bank could put more focus on making the playing field level for the small-scale sector vis-à-vis larger enterprise. This might include eliminating discriminatory tariff treatment (often large capital goods are duty-free, while small are not), tax concessions given to large but not to small investors, and unequal access to credit on foreign exchange. Policy dialogues between the Bank Group and member governments may yield large payoffs in these matters. As for direct action to promote grassroots business development, the Bank may not have a comparative advantage over bilateral and nongovernmental programs that have more intensive representation in the field. In this respect, the intensifying Bank dialogue with nongovernmental organizations that deal directly with the smallest economic units is to be encouraged. Finally, one area that has not been reviewed adequately is the potential for nonagricultural cooperatives in the service and productive sector. This may have particular relevance to countries such as China, Hungary, and possibly Poland, where IFC has begun working with some market-oriented cooperatives. More research and evaluation of small-scale projects financed by the Bank Group may produce some useful guidelines in this area.

year over the past five years, as shown in table 4-1. These amounts are net of adjustment lending (which has grown rapidly to $1.9 billion in fiscal 1988) and also net of rather small amounts for DFI lending for state enterprises in centrally planned economies (which now averages about $100 million a year). In recent years about 80 percent of DFI lending has been to government-controlled institutions.

Issues

The 1985 Bank study of financial intermediation concluded that, while there were notable exceptions, quite a number of DFIs faced serious problems. About one-third of the DFIs were significantly in arrears and had low or negative returns on assets. Very few DFIs had successfully mobilized domestic or

Table 4-1. Bank Lending to DFIs for Private Sector Investment Financing, Fiscal 1960–88

Year	*Billions of dollars*
1960s annual average	0.1
1970s annual average	0.5
1983	1.7
1984	1.5
1985	1.2
1986	1.0
1987	1.1
1988	1.1
1983–88 annual average	1.3

Source: World Bank data.

foreign resources without governmental support, perhaps as much because of their environment of directed credit and distorted interest rates as because of their own financial health. What remained unclear were the balance of factors that had brought this about (environmental, managerial, political, and so forth) and the key elements that distinguished the excellent from the poor performers. Although the debate may go on over how serious the situation was for these DFIs, it was clear that their problems deserved attention as a Bank Group response was articulated. That 1985 study argued that in lending to development finance intermediaries:

- A healthy financial system was essential to the long-term health of individual intermediaries. Hence efforts to "fix the system" were essential.
- More effort was needed to address particular DFIs' own financial strength and their managerial capacity to handle adversity and opportunity in changing environments, rather than regarding them as conduits for the transfer of resources.
- The objective should be to develop seasoned intermediaries, operating in market-based financial systems, that could move toward effectively mobilizing commercial funds on their own.

It was also clear in the 1985 study that, in the deteriorating economic environment in which many DFIs exist, no single transaction could address every problem. Transitional management required, in many cases, second-best solutions. The goal was to develop, over time, efficient, market-based financial systems. Finally, apex or multi-institution loans were seen as a way of reaching beyond a single DFI to achieve broad improvements in the financial sector.

Data on Bank-financed DFIs since the 1985 study suggest that problems still exist. An analysis of DFI operations originating in 1982–87 indicates that for government-controlled DFIs, which account for 80 percent of DFI lending, arrears continue to present significant problems. The Bank's 1986 annual review of project performance results points to similar conclusions.[2] Data on the privately controlled DFIs in IFC's portfolio indicate, on average, stronger performance, but quite a number of these institutions, particularly in Africa, face serious problems.

There has been no marked increase in the use of apex loans since 1985. Roughly half of DFI lending during 1982–87 has been in operations involving one or two intermediaries. About a quarter of such lending has involved six or more intermediaries. What is of concern is that in apex lending the financial health of participating banks (commercial or development) is often not dealt with in depth, because these operations focus on broader sectoral objectives. It appears, on average, that DFIs under apex loans have weaker portfolios than those with which the Bank has direct relations.

IFC also faces several issues in its support for DFIs. In some of its DFIs, IFC expects losses on its equity. Provisions in these cases run from 30 to 90 percent of original cost. A number of these institutions are reasonably competent as project lenders, and their shareholders, both governmental and private, support them for their indirect benefits rather than their direct earning capacity. Some are useful lending conduits for the Bank and bilateral lenders, and their mixed shareholding structure helps insulate them from political influence. IFC's posture in these cases is to stay involved, usually by taking a board seat, if it helps maintain the institution's integrity. But IFC is not setting up new institutions of this nature unless a good case can be made for sustainability, opportunities for resource mobilization, and adequate returns. At the other extreme a few DFIs have deteriorated beyond repair, given the environments in which they work.

Lending Standards. The first issue for the Bank Group is that it must increase the rigor of managerial and financial assessment in its DFI lending. Credit line lending by the Bank to DFIs, which does not include adjustment lending, is expected to remain substantial over the next three years. This implies a major operational challenge in light of the needed strengthening of standards for DFI lending.

The goal should be to assist and develop entities (irrespective of ownership) that are (a) well managed,

2. World Bank Operations Evaluation Department, *Twelfth Annual Review of Project Performance Results, 1986* (Washington, D.C.: World Bank, 1987).

(b) responsive to the demands of changing markets, (c) able to stand independent of pressures to finance activities likely to undermine their own financial position, and (d) able to operate without prolonged dependence on government for their domestic resource needs (or government's assistance in raising foreign exchange, in those cases where country conditions are reasonably conducive to foreign commercial financing). Noncompetitive institutions should not be supported indefinitely. Furthermore, other goals, however desirable—such as sector policy changes, acceptable economic and financial rates of return, or shifts in subproject lending patterns—should not be allowed to divert effort (as they have on occasion in the past) from the principal goal of institution building.

In order to ensure a consistent, rigorous, and strategic approach to DFI lending, an in-depth review of the Bank's experience to date is needed. In trying to explain the successes and failures of previous operations, that review should address four issues:

- the appropriate approach for institutional analysis, including the quality of financial analysis to be undertaken, the types of financial performance measures required, and the evaluation of management staff, decision processes, and independence
- domestic and foreign resource mobilization and their links with the development of the domestic capital market
- the method of pricing of resources from the DFI to achieve market-based levels
- the consistency of approach and standards across regions, to the extent that differences in experience cannot be explained by country-specific considerations.

Division of Responsibilities. The division of responsibilities between the Bank and IFC with respect to DFI has to be determined in the context of broad country strategies for private sector development by the Bank Group. Such strategies would define the objectives of DFI lending and propose how these objectives can be reached, which institutions in a given country are likely to achieve those ends, and how collaboration between the Bank and IFC can best be marshaled.

Although strategies will obviously vary from country to country, DFI lending by the Bank should typically aim to address systemic financial or institutional problems that impede the country's financial intermediaries—those directly supported by the Bank, as well as others—from playing a more effective and self-sustaining role in mobilizing and intermediating financial resources. The concept of graduation of mature institutions from Bank support also remains valid, particularly in countries where the financial sector is maturing. This growing independence is certainly desirable from the DFI's standpoint, and it is in this context that IFC can play a bridging role by introducing such institutions to commercial markets by lending or syndicating loans without government guarantees.

The reality is that country and institutional situations evolve and change, sometimes rapidly, and thus sometimes both the Bank and IFC may be involved in helping a particular institution. The test is whether the particular DFI's needs at a particular time, both for resources and for progress toward its maturation, are better served by the Bank, IFC, or both. Finally, for some established intermediaries both the Bank and IFC might find a particular institution a good partner for achieving different objectives—the Bank for addressing systemic reforms and IFC for gaining access to particular enterprises that need its funding.

Subloan Pricing. A frequent issue in DFI lending that bears on financial intermediation is the relending terms of Bank funds through DFIs. Existing Bank policy states that sub-borrowers should pay rates commensurate with the cost of capital, that normally sub-borrowers should take the foreign exchange risk and, if the government takes that risk fully or in part, a fee should be charged to bring the cost of funds to sub-borrowers to levels reflecting the opportunity cost of that resource. Targeting the cost of capital is complex in many cases. Given the Bank's present currency pooling and interest rate system, the Bank's own charges may not, in some countries, be a good proxy for a market rate for private borrowers.

To add to the complexity, it is not uncommon, as noted earlier, for many governments to back administered credit regimes that underprice capital. If pricing on certain credit streams is subsidized, intermediation will be distorted, and commercial lenders (including IFC) outside those credit streams can be crowded out by government-guaranteed credits. Currently, in about half of the Bank's DFI lending, governments have assumed the foreign exchange risk on behalf of borrowers for no charge; in another third some fee was levied; for the balance sub-borrowers took the full exchange risk on Bank funds. Greater rigor is needed to ensure that pricing issues, taking into account foreign exchange risk, are handled in a way that avoids significant distortions or subsidies.

With respect to the secondary question of the exchange risk itself, there are a range of options that may be justified. In some cases it may be appropriate to pass the risk on to sub-borrowers. In others an option might be for foreign resources, not necessarily just Bank loans, destined for domestic borrowers to be pooled centrally—by the central bank or some other mechanism—and the proceeds relent in local currency at a rate reflecting the cost of capital, with an appropriate fee to cover the risk assumed by the pooling agent. A variation is for the sub-borrower to take a single currency, or fixed mix of currencies, again with a pricing and fee arrangement reflecting the cost of capital and the risk assumed by the pooling agent. Ultimately (although this is not the case for many Bank borrowers) for economies with open currency and credit markets the market will establish relevant rates for whatever currency is borrowed, and this is the ultimate objective to which Bank Group assistance should be aimed. Whatever solution is adopted, care should be exercised that government-guaranteed foreign exchange loans not become part of a privileged credit stream that subsidizes private borrowers and crowds out commercial, market-based funds that would otherwise flow to the private sector without recourse to the government.

New Types of Institutions

Although recently its activity with respect to DFIs has been limited, IFC has been active, given the resources at its disposal, in other areas. In the past ten years or so IFC has been involved in the creation of forty-eight financial institutions outside the traditional DFI field. IFC has tried to identify new types of private sector institutions that could deepen the financial structure in a country, while concurrently dealing with specific policy issues that affect the depth of the institutional structure. The objective has not been to maximize investment levels (such IFC investments account for only about $100 million) but to create first-of-a-kind institutions that, in many cases, can then be replicated by others. The current portfolio includes nineteen leasing companies, eight housing finance institutions, two commercial banks, ten merchant banks or securities companies, nine venture capital companies, two insurance companies, and one mutual fund. The critical element in bringing new institutions and products into a financial market is experienced, vigorous management, and thus in almost all cases IFC helps to find, and conditions its investment on, an active partner-investor, often foreign, who will take on managerial responsibilities.

What are the lessons learned so far? By and large the leasing activity has gone well, as evidenced by good portfolios and earnings. Leases are often an attractive way to finance equipment for smaller firms for a combination of fiscal and financing reasons. In many cases IFC has had to work with governments to get appropriate regulations in place to allow lease financing to proceed. In most countries, after IFC has helped open the field, a number of additional leasing companies have started. Further scope exists for introducing leasing to smaller economies, and IFC intends to pursue this.

In housing, IFC has set up five finance companies, and all are doing reasonably well. The scope for this activity is limited by significant governmental interventions in housing finance and directed credit. To the extent that the Bank Group is successful in reforming the financial sector and freeing up financial markets, however, relatively more opportunities would develop for IFC to play a catalytic role in this sector.

The same holds true for the insurance sector, where IFC has done two projects. The merchant-investment banks have a generally good record. These banks provide a wide range of corporate finance activity, advisory services, underwriting, and the like. IFC has divested, profitably, from four of the fourteen that it has set up. The remainder are performing satisfactorily, except for two where a deterioration in general economic conditions has cut off business opportunities.

Perhaps the most adventuresome part of IFC's capital market institutional activity has been the establishment of venture capital companies. IFC has helped to establish nine such companies; the main mission of these companies has been to take substantial stakes of risk capital in relatively small companies, with close and continuous inputs by the venture capital company to the companies financed. Two have been unsuccessful in volume and earnings, five seem to be on their way to reasonable success, and two are brand new. The overriding determinant of success, once again, is management. In Spain, where a venture capital company might be expected to do well, the project failed. In Kenya, where a more difficult environment exists, the project succeeded because of outstanding management.

Direct Financing

What the Bank Is Doing

There was no expansion of Bank direct financing in productive sectors in fiscal 1983–87; indeed approv-

Table 4-2. Direct Bank Lending to Industry, Fiscal 1983–88

	Oil, gas, and coal		*Other industry*	
Year	*Number of projects*	*Billions of dollars*	*Number of projects*	*Billions of dollars*
1983	19	1.0	13	0.7
1984	16	0.9	12	0.5
1985	16	1.3	9	0.6
1986	6	0.2	9	0.8
1987	8	0.7	7	0.4
1988	2	0.4	11	0.9

Source: World Bank data.

als fell in 1986 and 1987 as indicated in table 4-2. Virtually all the oil, gas, and coal projects recently financed by the Bank were state enterprises; half of this program over the past five years has been absorbed by China and India. The same is true of "other industry," where the vast majority of funds have gone to state enterprises. About one half of that program has been in China, Hungary, and India. Only three of some sixty industrial operations involved a significant private sector component, and these were largely related to subsector restructuring operations. In many cases the public sector projects financed have not met with great success in reaching their objectives. The problems surrounding public management are often more intractable than had been anticipated.

This raises a legitimate question as to whether the Bank should simply withdraw from parastatal financing. This report argues that there certainly have been cases, and there will be cases in the future, where it makes sense for the Bank to finance such projects, provided the parastatal (a) is or is likely to become an efficient producer and (b) fosters or at least does not curtail competition, so that efficient private sector activity is not crowded out by a less efficient parastatal. There will also be cases where Bank help for restructuring a parastatal may be a desirable step toward privatization. Consequently, the established and logical pattern in recent years has been for IFC to handle larger private sector projects, while the Bank supported relatively smaller private sector projects through DFI lending and directly financed public sector projects that merit support.

The use of the government guarantee capacity should be minimized for private sector projects. For enterprises that can appropriately be financed privately without recourse to government guarantees and that meet IFC's ownership guidelines, IFC is the appropriate Bank Group financier. In this regard IFC's enlarged capital enables it to make commitments that, in terms of size, were beyond its earlier scope.

Nonetheless, there may still be large, important projects that could not be completed without Bank support in addition to that of IFC. In such cases, assuming government support in guaranteeing the Bank loan is forthcoming, the Bank and IFC would cooperate to finance the project jointly. The Dikheila Steel joint venture in Egypt is a historical example, and this type of joint Bank-IFC effort could well be replicated more frequently in the future in large infrastructure projects to be developed by private investors under build-operate-transfer principles (see chapter 3). If IFC were not in a position to finance a significant private sector project because of constraints related to exposure or risk, and a government considers it important enough to provide a guarantee, then the Bank could proceed without IFC.

What IFC Is Doing

IFC's mandate *is* the private sector; all its energies are directed to making a difference in the private sector in its member countries. IFC's principal goal is not to transfer resources but to catalyze private sector activity. In bare volume terms the recent history is shown in table 4-3.

IFC is normally exposed to full project risks, a useful but demanding discipline in allocating scarce resources in rather risky environments. The health of IFC's portfolio is discussed at length elsewhere; suffice it to say here that there has been a marked improvement in recent years, both in regard to equity returns and the loan portfolio. IFC's collection rate is now slightly above 90 percent, and the portfolio affected by nonaccruing loans has been reduced from 19 percent in fiscal 1986 to 12.5 percent in fiscal 1988, based on conservative accounting treatment. The expectation is that the improving trend will continue, despite rather difficult macroeconomic conditions in many of the markets in which IFC operates.

Actually IFC has a dual mandate: to do business that

Table 4-3. IFC Investment Activity, Fiscal 1983–88
(millions of dollars)

Year	*Total investment approved*	*Equity portion of total investment*
1983	426	55
1984	391	62
1985	609	61
1986	711	75
1987	790	80
1988[a]	1,050	197

a. Estimate.
Source: IFC data.

is both financially sound and of economic importance. Unfortunately, there is a significant amount of activity in developing countries that is financially attractive but is of questionable value economically or vice versa, given distorted pricing signals.

IFC's lending strategy is based on the fact that its more remunerative investments (because of their size and risk profiles) have to carry the costly efforts to meet private sector needs in its smaller and least developed member countries. About 28 percent of IFC's staff effort goes to benefit Africa (not including special African initiatives), although this region is likely to produce only 17 percent of short-term investment volume.

The availability of long-term loans for project finance is still a problem for the private sector in many developing countries. In many others, however, the issue is not how to load additional debt on to a country or enterprise but how to capitalize or restructure enterprises so that sound growth can take place. This suggests that IFC should place increasing emphasis on (a) providing equity or quasi-equity finance, (b) bringing critical technical, managerial, and marketing skills into enterprises, (c) advising and assisting on restructuring opportunities, (d) facilitating privatization where that is appropriate, and (e) supporting private sector involvement in infrastructure activities. In these areas it is know-how, ideas, and international contacts, as much as capital, that IFC can uniquely contribute.

IFC recently reviewed its equity policy, not primarily to assess its scope (although IFC's program calls for an increase in the relative share of equity instruments in the total), but to assess its quality and catalytic power. The framework has now been set for that effort.

In regard to its advisory services, IFC has begun systematically to break down its effort into normal project-related advice and advisory efforts that go beyond the norm in complex projects, or advisory services not related to project finance. The mix of IFC business is thought to be shifting to include more idea-brokering in areas where IFC's accumulated knowledge can benefit private sector investors. As this work develops, IFC needs to focus on how it can channel the special skill mix required to maximize its impact.

Chapter 3 discussed private delivery systems for "public" services. This is a developing market for IFC and an area for increasing collaboration between the Bank and IFC, as well as MIGA. Although IFC has always been ready to finance such projects, there have been few opportunities to do so, given the past state domination of these sectors. However, IFC is now finding that many governments are increasingly open to private investment in sectors long dominated by the state, if efficiencies can be achieved. At the moment private sector proposals are under discussion in IFC for power projects in Côte d'Ivoire, Mexico, Pakistan, Turkey, and Venezuela; telecommunication operations in Argentina and Sri Lanka; ports in Colombia and Turkey; and pipeline storage projects in Mexico. Expectations are that the list will continue to grow. MIGA can be directly supportive by insuring the foreign investment component of such projects against noncommercial risk. The Bank can also directly help IFC by making its technical skills available to IFC in examining such projects, and IFC can be helpful in lending its financial packaging skills to the Bank when a collaborative effort is required.

Facilitating Flows of Foreign Capital and Know-How

Foreign Direct Investment

A broad consensus is emerging that, to prosper in an increasingly competitive, fast-changing world market, developing countries can benefit from and may indeed require an increased flow of foreign direct investment. This attitude (new to many) rests on several tenets. First is the recognition that outward-looking enterprises need up-to-date technical, managerial, and marketing know-how, which often is not available locally. With strong local management, technical know-how can sometimes be purchased; managerial know-how, however, usually cannot be purchased. Moreover, in many countries it is the combination of technology and management that is critical.

Second, risk capital, rewarded by results, is seen as an attractive alternative to debt, particularly as foreign commercial bank lending, never available in many countries for long-term project finance, has dried up in others. Third, there is growing confidence in the ability of developing countries to avoid the abuses (most prevalent in highly protected sectors) and secure the advantages of foreign direct investment. Foreign investors increasingly recognize the need to be "good corporate citizens" within the host country. As a result, dozens of countries have made efforts in recent years to revise their investment codes and regulations to facilitate foreign direct investment.

Unfortunately, as the need and desire on the part of developing countries for foreign direct invest-

ment has increased, the flow has decreased—from $15 billion net in 1981 to about $10 billion a year in 1983–87. And even that amount has been concentrated in a rather narrow band of countries. The decline is due to foreign investors' perceptions of the opportunities and risks of investing in many countries, given such factors as political instability, debt overhang, macroeconomic policies, rigid trade problems, and foreign exchange allocation schemes. However, *the* critical issue for foreign investors in many countries is the macroeconomic environment.

Consequently, the Bank's greatest impact in facilitating foreign direct investment will come through supporting structural adjustments that deal with macroeconomic instruments and through encouraging countries to move from inward- to outward-oriented strategies. These efforts will also tend to reduce internal opposition to foreign direct investment. Increasingly, structural adjustment operations (about half of them at present) contain specific conditions related to foreign direct investment, such as improvements in investment codes. As part of its economic sector work, the Bank has also, on occasion, looked specifically at a country's foreign investment policies (Mexico is a case in point), where those policies loom as a development issue.

One of IFC's original and basic roles is to facilitate the flow of foreign direct investment. About 40 percent of IFC's operations are joint ventures between foreign and local sponsors; in many more there is foreign involvement in providing technological, managerial, or marketing know-how. Indeed IFC's role is truly catalytic in situations where the foreign investor simply would not invest unless IFC was an involved coinvestor. In recent years about half of the IFC-financed joint ventures fall into this category. This is particularly true in countries that have recently opened their doors to foreign investors (for example, Hungary) and in those that have always had a difficult time attracting them (for example, African countries).

Foreign Investment Advisory Services

Responding to increasing requests from member countries for advice on foreign direct investment, IFC launched the Foreign Investment Advisory Service (FIAS) in 1986. FIAS advice centers on the content and administration of investment policies and on the strategies for promoting investment. As of fiscal 1988, work has been done in seven countries, and projects are under way or planned in ten additional countries. Thus the demand is significant. In taking on assignments, FIAS coordinates with the Bank to ensure that its work does not duplicate other ongoing programs.

Settlement of Investment Disputes

In 1966 the International Centre for Investment Disputes (ICSID) was established under the auspices of the Bank. Administratively integrated into the Bank and fully funded by it, ICSID provides a forum for conciliation and arbitration of investment disputes between states and foreign investors. Eighty-nine countries have joined ICSID, and twenty-five cases have been submitted to it for arbitration; increasing use is being made of this facility. ICSID's activities include research and information on investment arbitration and law. It publishes materials and organizes symposiums on these topics.

Investment Guarantees

The newest member of the Bank Group, the Multilateral Investment Guarantee Agency (MIGA) has recently come into being. It too is a response to the need for a new mechanism to encourage foreign direct investment. MIGA will specialize in the reduction or elimination of noncommercial risks, especially political risk, and will carry out this mandate through guarantee, consultative, advisory, and promotional activities. Specifically, MIGA will provide guarantees against (a) restrictions on the repatriation of investment proceeds in convertible currency (transfer and inconvertibility risk), (b) expropriation and similar measures, (c) breach of contract by a host government in certain defined cases of denial of justice, and (d) war, revolution, or civil disturbance. (The breach of contract coverage, not normally provided as such by national investment guarantee agencies, can be important in encouraging build-operate-transfer contracts, which were discussed in chapter 3.) Coverage may be extended to other noncommercial risks, except currency devaluation.

In addition to equity investments (including equity-type loans), coverage will encompass production-sharing contracts, profit-sharing contracts, management contracts, franchising agreements, licensing agreements, leasing agreements, and turnkey contracts, if they have a term of at least three years and the contractor's payment is substantially linked to the operating results of the project.

MIGA is coming upon the scene with a strong mandate in its charter to provide a broad range of advisory services that will aid the protection and

promotion of foreign direct investment. Both IFC (including FIAS) and MIGA have unique contributions to make to member governments seeking foreign investment advice. IFC's capability in this respect flows principally from its activities as a direct investor and from its experience in forming joint ventures and promoting investment projects in developing countries. MIGA's capability will in time be built upon the business experience resulting from its investment guarantee operations and its particular focus on investment protection. In order to take advantage of these potential contributions, it is recommended that the managements of IFC and MIGA develop an advisory service jointly managed and supported by both institutions.

In the area of guarantees, there is a question of the division of labor between MIGA and IFC. MIGA envisages providing guarantees under carefully designed arrangements against noncommercial risks in investments for productive purposes. MIGA's program would initially focus on equity investments and other forms of foreign direct investment. In contrast, IFC has occasionally provided repayment guarantees for lending activities, and only in a few special situations has it guaranteed equity-type arrangements.

IFC's program for a guaranteed return of investment principal (GRIP) is in essence designed as an investment partnership, sharing risks and rewards, rather than as a protection scheme for political risk. Consequently, IFC's guarantee activities entail little, if any, overlap with MIGA's, and there is little need at this time to further delineate MIGA's and IFC's respective guarantee functions. If particular cases arise where an overlap is anticipated, the two institutions should consult to ensure the complementarity of the two programs.

Foreign Portfolio Investment

As more developing countries deepen their financial systems, the potential grows to build links between their markets and foreign portfolio investors. IFC's Emerging Market Data Base tracks securities markets in eighteen developing countries and covers about 8,500 stocks. Although only some 300 of these securities now meet the liquidity and "visibility" requirements of international portfolio managers, the market is growing. Capitalizations of each of the five largest developing markets are already comparable to those of a medium-size European country.

In 1984 IFC pioneered the listing of a country fund on the New York Stock Exchange. This fund—which was for Korea—has served as a model for other country funds that IFC or other institutions have promoted. As of fiscal 1988, IFC has managed or co-managed ten such funds with a total capitalization of about $1 billion.

Considerable effort goes into establishing the appropriate legal and regulatory framework for such investment funds, arranging independent management for them, and putting together the underwriting of each transaction. Although the capital flows represented by these funds are still limited and the short-term growth rates were no doubt reduced by the worldwide stock market decline in 1987, they are an important new capital-raising mechanism for some developing countries. IFC is expected to play a catalytic, market-leading role in more country funds; it is now examining proposals from Argentina, Brazil, Chile, Mexico, the Philippines, and Turkey. One impetus to this type of activity is the debt-equity conversion plans being developed in Chile and other countries, which specifically link the country fund to debt conversion. In many cases the country funds set up with the help of IFC have been established after the country has undertaken extensive adjustment programs with the help of the Bank. This sequence underscores the connections between macroeconomic policies and conditions conducive to deepening financial markets and increasing international capital flows.

Debt Flows

Commercial bank lending and export credits have undergone a major reversal. In 1981 commercial lending to developing countries totaled $52 billion; by 1986 it fell to $5 billion. Export credit finance declined from $18 billion to $2 billion in the same interval. The overwhelming amount of commercial long-term credit has gone to meet public sector needs, as has almost all export credit finance.

The picture varies somewhat from country to country. In those markets where the credit risk is perceived to be low, as it is in some Asian countries, loans from foreign commercial banks to strong private sector borrowers are common. For the bulk of the Bank Group's member countries, however, foreign commercial bank financing is hardly available to the private sector. When available, it is usually limited to short- or medium-term trade financing for the most solid exporters.

Against this backdrop, IFC's efforts to sell participations in IFC loans to commercial banks (averaging about $300 million a year) account for a sizable share of commercial bank finance for projects in the pri-

vate sector. Properly structured loans based on project cash flows avoid the dangers of the pre-1982 lending boom, which was based instead on easily available government guarantees. IFC should continue to emphasize this aspect of its activity.

Although commercial bank lending is currently depressed, in some countries the Bank Group can encourage, in conjunction with financial sector reform, the introduction of foreign banks into traditional, protected banking systems. Foreign banks can play a valuable role in financial sector reform by introducing modern techniques and standards and by increasing competition.

Both the Bank and IFC can also encourage the flow of export credit finance to the private sector. Except for the Export Credit Guarantee Department in the United Kingdom, which has initiated a limited project finance program, the large export credit agencies still insist on government guarantees; this tends to drive their financing toward the public sector. However, the Bank Group, through its involvement in build-operate-transfer schemes, for example, can raise the willingness of these agencies to finance private sector infrastructure projects.

Conclusion: The Need for Collaborative Effort

In many of the Bank's member countries deficiencies in financial institutions and policies limit the potential for private sector growth. The Bank Group, because it has so many ways to influence the means by which private sector firms secure the resources they need for their growth, is well placed to help its members develop their financial sectors, and a start has been made. Still, a more concerted effort is needed, based on country-specific long-term strategies for financial sector development.

Such strategies should balance macro (sector) and micro (institutional) issues. Financial sector adjustments will have to parallel adjustment policies in the economy as a whole and will depend on the degree of financial distress encountered in the particular country. Some systems will require massive restructuring and loss-taking, as well as changes in the ownership or management of major banks and firms. Others will need only the kind of policy reforms that affect all intermediaries (for example, banking regulation, audits, and accounting transparency; liberalized interest rates and the reduction of directed and subsidized credit; the removal of barriers to new financial instruments and institutions; and the exit of loss-makers).

The Bank, through its macroeconomic and financial sector work, has the capacity to take the lead in the overall assessment and programming of necessary reforms and systemic improvements. This will be reflected in increased lending to the financial sector in the coming years, as well as increased focus on financial sector issues in other adjustment lending operations.

As countries achieve success in implementing some of the basic reforms needed to improve intermediation, opportunities will emerge for deepening financial structures by further development of capital markets. It is in this area that the Bank and IFC should fully collaborate. IFC's work in developing securities markets, establishing and strengthening nonbank financial institutions, introducing new financial instruments, and developing links to international capital markets effectively allows the Bank Group to cover the full range of issues affecting the financial sector.

Private sector development requires a great variety of efforts and skills. Here are some of the most important that have been explored in this report: to establish an adequate regulatory framework for primary and secondary markets, so that a wider variety of debt and equity instruments can be sold, based on adequate disclosure and protection conditions for investors; to make tax policies more neutral to different types of securities, especially by removing tax deterrents to the use of long-term debt and equity instruments; and to promote institutional development, so as to provide liquidity in the financial system for new instruments.

The Bank Group encompasses many of the skills that can help member governments implement these reforms. With greater cooperation and commitment, the members of the Bank Group can create a synergism in support of private sector development.

Appendix: Summary of Recommendations

This report has made a number of recommendations for the Bank Group. These are summarized below.

The Enabling Environment

A major contribution of the Bank will continue to be the assistance it offers governments through policy analysis and advice and through adjustment lending to ensure that the enabling environment and business climate are supportive of PSD, as noted in the following recommendations.

Recommendation 1: That the Bank's adjustment and public sector restructuring loans give increased attention to the creation of a macroeconomic, regulatory, and public sector environment conducive to PSD. Adjustment operations are the natural vehicle for translating analytical insights on the enabling environment into effective policy dialogue and financial support. A recently published report on adjustment lending reviewed the design and implementation of structural and sectoral adjustment operations (including macroeconomic management, reform of incentives, and public sector restructuring).[1] This report therefore concentrates on those aspects of the enabling environment most directly dealing with PSD (especially regulatory controls and privatization).

Recommendation 2: That the Bank Group, led by IBRD and IDA, give greater attention to the legal and regulatory constraints to PSD. More research, country-specific economic and sector work, and lending activity should be devoted to this area, including such issues as streamlining regulatory procedures, reforming investment and labor regulations, protecting the public interest, fostering competition, clarifying property rights, and removing limitations on the ease of entry and exit of large and small enterprises.

Recommendation 3: That the Bank Group expand and intensify its support for privatization of state-owned enterprises. The Bank should expand its research and advisory capacity on privatization, especially as regards the institutional and incentive framework. It should also increase its supportive role in the analysis of the legal and regulatory environment for privatization and its capacity to provide technical operational support in the design of components for country economic and sector work and for structural and sectoral adjustment loans dealing with privatization.

IFC should expand its capacity to provide technical assistance and advice to governments and to the Bank in this area, as well as its capacity to finance and underwrite particular privatization transactions. IFC should explore the possibility of setting up a specialized staff unit for this purpose. At the request of member governments IFC should be eligible to provide advisory services (in this and other areas) funded under Bank loans and IDA credits. MIGA can also provide guarantee coverage to foreign investment in support of privatization.

Supporting Services

Support to public agencies for the efficient provision of supporting services (infrastructure, education, health, and so forth) remains an essential component of the Bank Group's support for growth, development of the private sector, and reduction of poverty. In addition, the Bank Group can expand and inten-

1. World Bank Country Economics Department, *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series 1 (Washington, D.C.: World Bank, 1988).

sify its activities to ensure that the potential contribution of private enterprises in the efficient provision of such services is fully realized.

Recommendation 4: That the Bank undertake research and policy work on the appropriate role of the private sector in providing infrastructure and social services. The Bank already has undertaken studies on this question for some sectors (for example, housing and urban bus transport), but the scope of such research and policy work should be extended to all major sectors.

Recommendation 5: That the Bank prepare policy papers for each sector to provide operational guidelines on how the Bank Group can ensure that the private sector becomes more involved in financing and operating infrastructure and social services. This work would also draw on IFC's limited involvement in the infrastructure and social services sectors and in turn would seek to provide guidance for an expansion of IFC's activities in these areas.

Recommendation 6: That the Bank in its public expenditure or investment reviews for particular countries explicitly consider ways to increase private sector participation in the provision of infrastructure and social services. Increasing private sector involvement in the provision of services offers an opportunity not only to increase efficiency within the sector, but also to reduce government spending during periods of fiscal austerity.

Financial Sector Development

The development of the financial sector and capital markets in developing countries is one of the most important ingredients for successful and healthy growth of private enterprise. The economic crises of the 1980s in many developing countries have demonstrated the weaknesses in the financial sector. Unless these weaknesses are addressed in a synchronized way with macroeconomic reforms, the effective contribution of the private sector will be limited.

Recommendation 7: That the Bank, supported by the IFC staff, expand and extend its program of adjustment lending in support of financial sector reform. Basic financial reform is essential for a return to solid growth. It typically involves the reform of inefficient banking systems, directed and subsidized credit streams, poor disclosure and audit requirements, and locked-in lending institutions unable or unwilling to take losses. The expanded initiatives in financial sector adjustment lending need to be supported by efforts to develop operational staffing capacity, by increased research, and by country economic and sector work.

Recommendation 8: That the Bank and IFC extend and intensify their support for the development of capital markets in developing countries to mobilize both domestic and external resources in support of productive activities, especially in the private sector. The Bank's involvement in this area is related to its efforts to reform the policy and regulatory environment of capital markets. IFC is also active in this area, often in collaboration with the Bank. IFC has extended its support for capital market development through innovative initiatives supporting new private institutions that provide various types of capital market instruments (new types of debt securities, equity), services (securities companies and merchant banks), and funds providing linkages with foreign markets.

Development Finance Institutions

The Bank has financed the private sector primarily through a variety of development finance institutions (DFIS). IFC is a shareholder in some of these, but in recent years the Bank has been the main source of funding and support for these institutions, the large majority of which are government-owned. The record of the 130 or so institutions supported by the Bank or IFC is, at best, mixed. There are some notable successes, but many are in serious trouble and of questionable viability and vitality. Another form of Bank financing for DFIS is the so-called apex loan (a loan to one institution that in turn on-lends the funds to other domestic financial institutions). Although apex loans have achieved some sectoral objectives, they have also distanced the Bank from basic problems and deficiencies in some participating intermediaries.

Recommendation 9: That the Bank Group, led by the IBRD and IDA, undertake an in-depth review of DFI lending. This review would draw on and update the 1985 internal policy paper on DFI lending. It would, among other things, be designed to reassert standards that put more focus on the financial integrity of the DFI, the capability of its management, the linkages of the DFI to domestic capital markets, the suitability of its structure to adapt to rapidly changing environments, and its sustainability in the long term. This review is all the more urgent in view of the current forecast of increased Bank lending through financial intermediaries.

Recommendation 10: That the Bank, with inputs from IFC, develop a country-specific strategy for Bank Group support to intermediaries. This strategy would be developed as part of the overall country strategy for PSD. It would lay the basis for turning, over time, government-dependent intermediaries into more self-sufficient market-based entities, particularly in countries where the financial sector is maturing. Within such a strategy, DFI lending by the Bank should typically aim to address the systemic financial or institutional problems that impede the country's financial intermediaries—those directly supported by the Bank, as well as others—from playing a more effective and self-sustaining role in mobilizing and intermediating financial resources. As a complement to Bank intervention, IFC should continue to press forward with its program of diversification that supports a variety of specialized capital market institutions. IFC's role is particularly important in assisting capital market development and in supporting intermediaries that are maturing and approaching private markets, that do not have access to government guarantees and finance, or that are permitting IFC to serve a market segment that would not otherwise be served. The IFC's skills and experience in this area should be made available to the Bank when they are helpful in resolving particular problems relating to Bank-financed intermediaries.

Recommendation 11: That the Bank Group develop a systematic and consistent approach to subloan pricing in DFI lending. Present Bank policy is either that sub-borrowers assume the foreign exchange risk on Bank funds or that the pricing in local currency reflect the real marginal cost of those funds. Increasingly in DFI lending by the Bank, governments cover all or part of the foreign exchange risk. Depending on how subloans are priced, there can be a difference in the terms of Bank-sourced and commercially sourced funds to end-users. In some cases, lenders that are not government-guaranteed may be crowded out by government-guaranteed, Bank-sourced funds. Care should be taken that such crowding out does not occur. This requires that within the context of market-based pricing, appropriate country-specific methodologies be developed and applied for dealing with the foreign exchange risk of DFI lending. The policy review of DFI lending (recommendation 9) should provide the general methodological framework and options, while the country-specific strategies for DFI lending (recommendation 10) should reflect agreement within the Bank Group on the particular subloan pricing options appropriate for the country concerned.

Direct Financing

Direct financing of industry by the Bank has declined substantially, and most of what is currently done involves restructuring operations in the public sector. This trend is appropriate in view of IFC's increasing capacity and the Bank Group's general policy stance that the public sector should minimize its direct involvement in the productive activities of the industrial sector if there are more efficient alternatives available.

Recommendation 12: That IFC be the appropriate Bank Group vehicle for the direct financing of private industrial projects. The Bank may be called upon, together with IFC, for some direct financing of large private projects where both institutions are needed. The Bank would also continue selective direct financing and restructuring of public industrial enterprises. Bank involvement should normally be restricted to cases of significant restructuring of public industrial enterprises, especially those in which eventual privatization is a possibility. In financing state enterprises more care is needed to limit such financing to those cases where the entity will become an efficient producer and where more efficient private sector activity is not crowded out. Occasionally it will also make sense for both the Bank and IFC to be involved in a private sector project that could not effectively be put together without both institutions, and policies should be flexible enough to support such collaboration.

Support for Small Entrepreneurs and Technological Development

The scope for effective direct intervention by the Bank Group in support of small entrepreneurs and technological development so far appears to have been limited. Research and operational experience indicate, however, that the enabling environment—particularly the business climate, the openness of the economy, and the absence of burdensome regulatory restrictions—is the major factor that determines whether or not small enterprises and domestic technological development can thrive.

Recommendation 13: That the Bank seek to strengthen the enabling environment for small entrepreneurs and technological development as part of its research, policy, and operational work and that both the Bank and the IFC continue to explore ways to strengthen their direct support in these areas. Direct support for small entrepreneurs should build on an analysis of what has and has not worked in the

past and on the evolving experience of IFC with leasing companies, venture capital operations, and its initiatives in Africa and the Caribbean designed to help small firms. Intensification of the dialogue with nongovernmental organizations in this area is also needed. As for technological development, there is scope for the Bank to continue to support the improvement of research and scientific capabilities in the developing world through lending that benefits institutions of higher learning and research. IFC should also continue to explore ways to assist its clients to locate, evaluate, and acquire new or mature technologies.

Foreign Direct Investment

In many member countries the need and desire for foreign direct investment has grown, especially as the availability of foreign commercial bank financing has been severely curtailed. The advent of IFC's Foreign Investment Advisory Service (FIAS) and MIGA is a direct response of the Bank Group to this development. Foreign direct investment brings risk capital, management, and technology, and in a number of countries the process works well. In others, however, although policymakers want the benefits of such investment, the framework and environment for it are poor, and the amount of foreign direct investment has been limited.

Recommendation 14: That the Bank Group, especially through IFC and MIGA, strengthen its efforts to promote the flow of foreign direct investment to developing countries. These efforts would bring into play a wide range of support functions including loans, investments, and guarantees, as well as advisory and informational activities directed both to host countries and to foreign investors. The Bank can also play a more effective supporting role by promoting a macroeconomic environment that will encourage and give confidence to foreign investors. Its adjustment lending in particular should give increasing attention to policy constraints to foreign direct investment in specific countries.

Recommendation 15: That IFC and MIGA develop a single, jointly managed delivery system for advising governments on the broad range of issues related to encouraging foreign direct investment. IFC, through FIAS, already has an advisory capability in this area stemming from IFC's long history of work with foreign investors in its member countries. At the same time, MIGA has a broad mandate in this area. Development of a joint advisory service would be most appropriate.[2]

2. This recommendation has been implemented since the Review Group submitted its report.

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