



## **IDA13**

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# **Note on IDA13 and Private Sector Development**

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## **Note on IDA13 and Private Sector Development (PSD)**

### **1. Introduction**

IDA Deputies have paid particular attention to the topic of private sector development over the past few IDA replenishment exercises. IDA12 consultations included a requirement that the World Bank Group prepare a PSD strategy. At the IDA13 meeting in Ethiopia in June, 2001, Deputies re-stated the importance of PSD to successful poverty reduction. They emphasized in particular the need to draw on the respective advantages of the members of the World Bank Group to promote private sector development and they called for greater PSD orientation in country work programs.

This note reviews some of the main strategic thrusts of the proposed WBG PSD strategy which is currently being finalized. It then identifies some innovative initiatives which are key to the implementation of the proposed PSD strategy and the way in which IDA resources could be used to maximize the effectiveness of these initiatives in mobilizing market mechanisms and private sector resources for poverty alleviation in IDA countries.

### **2. Main Thrusts of the Proposed PSD Strategy**

The proposed strategy looks at PSD as a cross-cutting issue rather than a traditional sector. PSD is about "a way of doing things" with relevance for any sector, such as energy or agriculture. The PSD strategy discusses how to tap the power of market mechanisms and private initiative to reduce poverty.

First and foremost, the strategy emphasizes the importance of the investment climate for growth and poverty reduction: to improve decision-making on programmatic assistance and capacity building the strategy proposes systematic assessments of the investment climate across countries and over time. This work is expected to be an integral part of the CASs.

Two additional objectives are also being pursued by the strategy: first, to shift performance risk from domestic taxpayers in developing countries to private parties where these are better able to bear or manage risk; and second, to facilitate transparent targeting of subsidies embedded in WBG products to intended beneficiaries and purposes. In order to meet these objectives, the strategy recommends that direct assistance to private firms be carried out in ways that unbundle the subsidy contained in WBG financial products and make this subsidy available in a transparent manner to address market failures and benefit poor citizens. The strategy also advocates implementation of a mechanism to support the production of outputs rather than inputs in order to improve the delivery of services that depend, in part, on public subsidies. It is proposed that implementation will initially commence on a pilot basis.

Three types of initiatives described below – investment climate assessments, output-based aid approaches, and various forms of support to SMEs – foster application of the main principles identified in the PSD strategy and could greatly benefit from access to IDA resources. Other PSD activities could certainly benefit from similar IDA-support as well. The choice to focus the

present note on investment climate assessments, output-based aid, and support to SMEs was driven by the fact that improving the investment climate is an overriding priority of the PSD strategy and by the fact that substantial work has already been carried out with respect to the output-based aid and SME initiatives: concepts and conditions for success are well defined, and a positive track record of experiences has already been established.

### **3. Proposed Initiatives**

#### **3.1. Investment Climate Activities**

What specific activities could be supported through the use of IDA resources ?

The PSD strategy proposes to conduct systematic firm-level investment climate surveys and to complement them with assessments of policy implications. The surveys would be conducted with the help of local institutions and would thus contribute to capacity-building. Such surveys and assessments should link the policy and institutional environment in a country to the performance of firms. Carefully designed survey tools would enable analysis of the differential impact of the investment climate on different types of economic actors, such as small and medium enterprises, or male and female entrepreneurs.

Regular, standardized surveys would allow the systematic study of how policy changes affect firm performance and hence growth and poverty reduction, which is particularly relevant for IDA countries. Comparisons among countries and tracking changes over time are critical for such systematic study. Over time, this would help improve the design of government policy and supporting assistance programs. Such analyses would be complemented by WBI's work on indicators of the quality of governance.

What is the economic rationale for supporting those activities and how can sustainability concerns be addressed ?

The centrality of work on a sound investment climate has been clearly established – an assessment of the investment climate in a country is required that captures the key drivers of growth and hence poverty reduction. Work on the investment climate is about public policy for the private sector and the supporting institutions. It is a multifaceted endeavor and requires, in particular, integration with work on governance and legal system reform as well as financial sector reform. It is therefore expected that this endeavor will be a systematic part of the CASs.

Special emphasis is to be placed on improving the investment climate in support of poverty reduction, i.e., to extend the effective reach of markets. This requires, in particular, the removal of unjustified entry barriers for firms, particularly small and medium-sized ones. Furthermore, the contracting and property rights framework needs to be put in place such that entrants can operate effectively.

*What activities are currently ongoing ?*

A new joint investment climate unit of the Development Research Department and the Private Sector Advisory Services Department (PSAS) has been established to co-ordinate investment climate activities across the Bank Group and to spearhead an effort to develop a minimum standard investment climate survey methodology and to help implement it. Such surveys would be equally valuable for other development institutions and could help improve donor co-ordination at the country level.

To start the process in FY02 some 5 to 8 surveys are being started using existing trust funds and special research funds that are currently being solicited and in collaboration with the regions. Survey activities are underway for India and Morocco and are to be started for China, Ethiopia and Nigeria, with Brazil, Serbia and Mozambique being further candidates.

It is proposed to build up over time to a level of about 20 surveys per year by FY04 to cover some 100 countries on roughly a five-year cycle. Roughly, a survey of the investment climate that links investment climate variables to firm-level productivity would cost about US\$250,000 to administer and evaluate. Total costs would thus be in the order of US\$5 million annually.

*What are the specific operational mechanisms through which IDA resources could be used to support those activities ?*

IDA resources could be used to directly support the carriage of investment climate surveys and assessments in IDA countries just the same as any ESW work. Investment climate surveys and assessments will only be useful if they inform policy and capacity-building operations. Their results need to be integrated into integrative due-diligence ESW products, such as Country Economic Memoranda and programs supported by WBI, and should routinely inform the development of CASs. Consultative country-driven processes such as PRSP and CDF should routinely cover the investment climate and elicit views from the private sector.

Policy-based lending would be a major vehicle for advancing investment climate reforms. Policy-based lending may happen in various forms including programmatic lending or financial intermediary operations that focus on policy development and institution-building. Equally important are efforts to build institutions and capacity via technical assistance operations and free-standing advisory services, for example by the SME department, the Foreign Investment Advisory Service or MIGA's Investment Marketing Services.

*What is the amount of funding that could be used ?*

Funding could be considered for:

- surveys of investment climate in IDA;
- integrating the survey work into investment climate assessments which feed into due diligence - economic analysis and inform country strategies; and

- policy based lending and technical assistance operations to advance investment climate reforms and institution building.

### **3.2. Output-Based Aid and Basic Services**

What specific activities could be supported through the use of IDA resources ?

Improving the coverage and quality of basic services like water and sanitation, electricity, transport and telecommunications is essential to sustainable poverty reduction. These services were once seen as the exclusive preserve of public sector monopolies. Particularly over the last decade or so, however, experience has shown that the private sector can play an important role in augmenting capacity and introducing improved incentives for efficiency. When services can be provided on a commercial basis with cost-covering user-fees—as is now the case for most telecommunications services and increasingly the case for electricity and other infrastructure services—the main pre-requisite for private sector involvement is an appropriate policy and regulatory environment.

For many basic services, however, some degree of financial support may be justified to address affordability or public good concerns. Traditionally, development assistance for this purpose has been used to finance inputs consumed by public sector service providers, whether this take the form of power plants, water pipes, hospitals or schools. Mixed results have led to increasing interest in approaches that combine public financing with private sector (including NGO) service delivery. The most promising of the new approaches—"output-based aid"—delegates service delivery to third parties under contracts that tie provision of financial support to the outputs or services actually delivered. This financial support may complement or substitute for contributions from users. By shifting performance risk to the private sector, accountability for performance and incentives for efficiency are improved. This approach also improves the targeting of financial support and creates opportunities for mobilizing private financing in support of development objectives.

Output-based aid schemes can be tailored to the characteristics of particular services and implementation environments. The core requirements are well-designed contracts and a mechanism for monitoring performance. Financial support is typically disbursed through a dedicated fund structure that may be combined with technical capacity to support the design and implementation of contracts. In low capacity environments, service monitoring may be contracted-out to private firms, NGOs or communities.

What is the economic rationale for supporting those activities and how can sustainability concerns be addressed ?

Output-based approaches involve a sharp focus on the policy rationale, targeting and sustainability of public financial support. For basic infrastructure services like rural electrification and water and sanitation, the main rationale for financial support will be affordability concerns of particular segments of society. For some education and health services, policy rationales may also include positive externalities or public good characteristics. Sustainability concerns can be addressed in various ways. In some cases, financial support may be tied to the making of household connections to targeted communities, with ongoing

consumption financed by user fees. In other cases, consumption support may be time-bound to facilitate a transition to cost-covering user fees, as was done in IDA's support for water sector reform in Guinea, for instance.

*What activities are currently ongoing ?*

Output-based approaches have been successfully implemented in a range of sectors and country environments, including rural telephony in Peru, road maintenance and rehabilitation in Argentina, secondary education in Colombia, and health services in Nicaragua. The full potential of output-based aid approaches has yet to be explored, however, and the PSD strategy recommends that the WBG start implementing such approaches on a pilot basis. Various pilot output-based aid projects are currently being pursued, including rural electrification in Mozambique, water supply in Cambodia and Paraguay, and a range of basic services in Bangladesh.

*What are the specific operational mechanisms through which IDA resources could be used to support those activities ?*

IDA support for output-based approaches may take the form of credits or grants to finance the provision of public financial support, complemented by technical assistance to design and implement schemes. The IFC may complement IDA by providing financing for private sector providers. When required, MIGA or IDA may provide additional risk mitigation.

Most of the schemes are likely to involve intermediation, either because numerous smaller sub-projects are involved, or because a stream of performance-based payments needs to be made over a period of time. In these cases, the intermediary might be a government ministry or a specialized fund, and work is under way to identify options for contracting out fund management. Fund structures should enable resource mobilization from other sources, including other donors and local taxpayers.

Examples of possible approaches would include the following:

- IDA contributes to a sector or theme-focused fund that disburses through numerous sub-projects. This might be a national rural electrification scheme, a rural telecom scheme, a multi-infrastructure scheme, a social-fund type structure, etc. Financial support could be allocated through the sub-projects in various ways, including through concessions awarded on a least subsidy basis and with payment contingent on achieving pre-specified results. Those payments might be tied to connections or some other measure relevant to the service and development objective involved.
- IDA supports a specific concession by providing financial support in a transparent manner based on performance. For example, a mechanism to supplement an operator's revenue over a transition period during which consumer tariffs are being raised (as in the case of the Guinea water lease) can be put in place alongside a traditional lease or concession. In these cases, the fund might make disbursement conditional on the operator meeting various coverage targets and quality standards. Such a fund might be integrated into the concession or operate in parallel, and

thus ensure that firms other than the concessionaire could draw on the available financial resources.

- IDA supports mechanisms designed to increase user choice with respect to education and health services. Here, the IDA resources would go to the education or health ministries, or to fund structures overseen by them, and be used to compensate service providers who provide services below cost to targeted beneficiaries. The Bank has some experience funding scholarship schemes, and output-based approaches would build on relevant lessons of operational design.

*What is the amount of funding that could be used ?*

There is potential to expand significantly the number of projects implemented through output-based aid approaches. Building on experience with the initial pilots, it is conceivable that one-third to one-half of the resources allocated for basic services under IDA-13 could be implemented through output-based aid approaches.

### **3.3. Providing Support to SMEs**

*What specific activities could be supported through the use of IDA resources ?*

Three broad types of activities could benefit from IDA resources:

- Provision of Business Development Services (BDS): At the enterprise – or micro-level – BDS encompass: training; consultancy (both pre-investment business planning and post investment business operation); technology development and transfer; business linkages (supply linkages, clusters, incubators etc). At the institutional - or meso-level - they concern intermediary institution-building including membership organizations and service delivery organizations. Matching grants or other demand-driven mechanisms can be used to put market power in the hands of the SMEs, thereby making the service provider more demand responsive.

- Financial intermediation for SMEs: IFC efforts to increase availability of capital through direct lending to SMEs has proved to be expensive and inefficient. A more effective way to leverage World Bank Group resources is through capacity building support to local financial intermediaries and products. This may include: (i) capacity building to existing financial institutions to assist in downscaled lending through training in SME lending credit appraisal methodologies; (ii) establishment of new financial institutions such as micro-enterprise banks, stock exchanges, credit bureaus, financial apex organizations, or the transformation of non-financial institutions such as NGO micro-finance programs into commercial operations; and (iii) mobilization of new financial products which include local currency facilities and alternative financing instruments such as leasing, factoring, and venture capital.

- Establishment of an enabling environment for SMEs: SMEs' lack of bargaining power and financial clout to reduce, resist or absorb the high transactions costs arising from the inhospitable investment climates that often prevail in their countries leads many of them to remain informal. This in turn limits their access to many BDS and financial services and marginalizes their role in

the policy dialogue process with governments. SME technical assistance programs, therefore, need the flexibility to address not just targeted financial and business development service providers but also a broader range of business enabling environment factors. These factors include, for example: (i) legal and regulatory provisions (e.g., commercial laws, registration, licensing and inspection regimes); (ii) policy initiatives which affect SME performance (e.g., competitiveness, taxation, labor and trade policy reform); and (iii) mechanisms to enable SME to participate in and influence the decision and policy-making process.

*What is the economic rationale for supporting those activities and how can sustainability concerns be addressed ?*

The important role that BDS can provide to profitability and enterprise growth is not always fully understood by an SME. For many BDS services some degree of public financial support may be justified to address these sorts of information imperfections. Properly designed implementation mechanisms (e.g., with reliance on matching grant schemes) can improve the targeting of the financial support and ensure relevance to the client. Performance requirements built into contracts that tie payments to the outputs or services actually delivered can, in addition, improve the quality and effectiveness of the services. At the institutional level, capacity building support to business and trade associations presents, for its part, public good characteristics. The critical requirements for such capacity building programs are transparency and time-bound financial support with long-term sustainability premised on strong membership core funding augmented with user-fees flowing from demand-driven programs.

Extending financial services to poorer and under-served segments of the society is a public policy priority for a number of IDA countries. Financial support to capacity building programs designed to provide banks with the required analytical tools and systems provides an important means to foster increased provision of these financial services. Sustainability objectives would be addressed first by the limited and transparent nature of the financial support (which would require cost-sharing with targeted financial institutions) and the priority attached to the commercial viability of SME lending programs to be supported. Specialized vehicles such as micro-finance institutions, micro-enterprise banks, credit unions or commercially-oriented NGOs will, however, often be better positioned than commercial banks to provide micro-finance services. Financial support to those entities would be provided on a time-bound and sliding scale basis and specific performance criteria would be used to ensure that viability requirements are being met along with outreach goals. As to the mobilization of new financial products, it can require both financial capitalization and institutional capacity building. The financial support would, in conjunction with financial and business strategy commitments from the private partner institution, aim to address informational and barrier to entry constraints. As in the previous cases, the overall program package would link declining payment arrangements to commercial and institutional performance targets.

Finally, there is a public good rationale for institution and capacity building efforts that serve to level the “investment climate” playing field and foster increased SME participation in the formal economy. In all instances, public financial support – whether financed by government or donors – needs to be transparent and linked to objectives that can be demonstrably achieved and sustained.

*What activities are currently ongoing ?*

Through existing Project Development Facilities (PDFs) now in place or being established in many of the principal IDA regions (East and South Asia, Central Asia, Balkans, Africa) and through other World Bank and IFC operations, new-form BDS schemes are being implemented. These include innovative new big-small firm linkage programs in IDA countries such as Kazakhstan, Mozambique, Zambia, Nigeria, Chad and Cameroon. To achieve increased cost effectiveness and outreach, the PDFs are striving to leverage their roles through increased wholesaling of their support to local and other independent organizations. This currently includes the Rice Millers Association in Cambodia, the Employers' Confederation in Bosnia, as well as the STEP and FATE foundation initiatives in Nigeria where these organizations are being provided with upfront support to assist in the provision (and roll-out) of good quality low-cost advice to local small entrepreneurs. New global partnerships are also being established with best practice BDS organizations such as FUNDES International through the SME Department Capacity Building Facility (CBF). These partnerships will assist the WBG as it seeks to strengthen BDS product innovation and program delivery capabilities.

The SME Department has been successfully piloting bank capacity building programs for downscale lending in a number of countries over the past year (Vietnam, Indonesia, China, West Africa) and is currently developing a global partnerships with best practice institutions through the CBF. The SME Department has already established global partnerships with a number of other institutions (IPC/IMI, ACCION, FINCA, SME Institute) to support IDA in establishing new financial vehicles and institutions and to transform existing ones. Recent experiences in this area include the establishment of IPC/IMI microenterprise banks in a number of Balkans Countries, the implementation of a FINCA program in Central Asia and support to ACCION to assist it to extend its services to Africa.

There are a wide range of enabling environment and capacity building initiatives underway across the World Bank Group operations. SME country mapping exercises have laid the groundwork for some of these initiatives, such as, for example: business association capacity building in support of the Business Adjustment Credit being designed in Bosnia-Herzegovina; the local economic development program about to be implemented in Kosovo; and the legal and associated institutional reforms – particularly in relation to leasing and secured transactions laws and pledge registries - in countries such as Macedonia, Kosovo, and Kyrgyz Republic. Capacity to meet a growing demand for these types of initiatives will be further enhanced by the global partnerships that are being established with a number of entities with expertise in the areas of institution and capacity building, such as Fundes International, the Soros Foundation, the International Chambers of Commerce, the Danish Confederation of Industries, the Canadian Manufacturers and Exporters Association, the Irish Development Agency and Enterprise Ireland, Scottish Enterprise, and the Centre for International Private Enterprise (CIPE).

*What are the specific operational mechanisms through which IDA resources could be used to support those activities ?*

IDA support for SME financial and business services can take the form of credits or grants to finance the part of the cost of the relevant initiatives described above, together with the financing of complementary enabling environment and meso-level institutional capacity building programs.

*What is the amount of funding that could be used ?*

There is potential to expand the range of SME-related programming. This is based on the results of SME country mapping done to date in over twenty IDA countries, the potential displayed by the pilots and partnerships being mobilized through the CBF and through consultations underway with specific client institutions in a number of other countries and with World Bank and IFC country units (in the context of their private sector development strategy, CAS and PRSP work and specific operations\deals currently being designed). Up to \$100-150 million of the anticipated IDA XIII resources could be effectively used over the forthcoming three year period to support SME development through this range of initiatives.

#### **4. Conclusion - Potential Benefit of IDA Support to Investment Climate Activities, Output-Based Aid, and SME Support Initiatives**

The forms of IDA support identified above present three main types of benefits:

- They are particularly well suited to leverage private sector as well as civil society's resources. High quality investment climate work is essential to maximize the poverty alleviation impact of private sector activities. Output-based approaches are specifically aimed at expanding the scope of services which can be provided by private companies in a commercially viable way. Support to SME activities, for its part, is tailored to increase the effectiveness of private providers of business development services, private micro-finance institutions, or trade associations and other entities active in promoting business environment reforms.
- They promote greater accountability with respect to the use of IDA resources. All activities described above require that clear and monitorable deliverables be identified prior to the disbursement of IDA funds. This approach would go a long way in meeting the requests of IDA shareholders and tax payers for greater emphasis on demonstrable development results.
- Output based aid and SME initiatives, in particular, reduce the amount of debt incurred by WBG client countries. These activities seek to replace subsidized lending by narrowly targeted grants. They contribute, therefore, to minimize the amount of public debt incurred by poor countries and to reduce the risk that further debt relief initiatives will be needed in the future.

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