# PRIVATE SECTOR DEVELOPMENT STRATEGY – DIRECTIONS FOR THE WORLD BANK GROUP



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# PRIVATE SECTOR DEVELOPMENT STRATEGY-
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## ACRONYMS

| | |
|---|---|
| AAA | Analytic and Advisory Activity |
| ARPP | Annual Review of Portfolio Performance |
| CAE | Country Assistance Evaluations |
| CAS | Country Assistance Strategy |
| CDF | Comprehensive Development Framework |
| CGAP | Consultative Group to Assist the Poorest |
| CEMs | Country Economic Memoranda |
| DEC | Development Economics |
| EBRD | European Bank for Reconstruction and Development |
| ESW | Economic Sector Work |
| FACS | Firms Analysis and Competitiveness Survey |
| FIAS | Foreign Investment Advisory Service |
| FSAP | Finance Sector Adjustment Program |
| FSE | Financial Sector |
| HD | Human Development |
| HNP | Health, Nutrition and Population |
| IBRD | International Bank for Reconstruction and Development |
| IDA | International Development Association |
| IFC | International Finance Corporation |
| IMS | Investment Marketing Service (MIGA) |
| MFIs | Micro-finance Institutions |
| MIGA | Multilateral Investment Guarantee Agency |
| NGO | Non-governmental Organization |
| OBA | Output-Based Aid |
| OD | Operational Directive |
| OECD | Organization for Economic Co-Operation and Development |
| OED | Operations Evaluation Department |
| OEG | Operations Evaluation Group (IFC) |
| OP | Operational Policy |
| PARIS21 | Partnership in Statistics for Development in the 21st Century |
| PREM | Poverty Reduction and Economic Management |
| PRG | Partial Risk Guarantee |
| PRSP | Poverty Reduction Strategy Paper |
| PPI | Private Participation in Infrastructure |
| PPIAF | Public-Private Infrastructure Advisory Facility |
| PSAS | Private Sector Advisory Services |
| PSD | Private Sector Development |
| PSI | Private Sector Development and Infrastructure |
| QAG | Quality Assurance Group |
| RD | Rural Development |
| ROSC | Review of the Observance of Standards and Codes |
| RPED | Africa Regional Program on Enterprise Development |
| SME | Small and Medium Enterprises |
| UNCITRAL | United Nations Commission on International Trade Law |
| WBG | World Bank Group |
| WBES | World Business Environment Survey |
| WBCSD | World Business Council for Sustainable Development |
| WBI | World Bank Institute |

# PRIVATE SECTOR DEVELOPMENT STRATEGY - DIRECTIONS FOR THE WORLD BANK GROUP

## EXECUTIVE SUMMARY

### I. The Role of the Private Sector in Development

i. Private sector development (PSD) is about promoting growth, reducing poverty and helping people improve their quality of life. It is a way of doing things across sectors. Private initiative, unleashed in competitive markets, is key to promoting growth and poverty reduction, in parallel with public sector efforts. Tax revenues generated by private markets are critical to support public expenditure programs. All this has been the experience in developed countries and is now increasingly evident in the developing world.

ii. PSD is about a good balance between the complementary functions of the state and the private sector. It is about judicious refocusing of the role of the state, not about indiscriminate privatization. Sound government policies that provide room for private initiative and that set a regulatory framework, which channels private initiative in ways that benefit society as a whole, are critical. This in turn requires institution- and capacity-building. Within this framework, direct public support to private firms may be desirable to enable entrepreneurs to enter markets or open up new ones.

iii. Public policy for the private sector and direct support to the private sector need to form part of a comprehensive approach to development and reflect country and sector conditions. Private sector development strategies for individual countries need to be owned by the respective governments. Detailed country- and sector-specific recommendations on PSD approaches should thus build on country-driven consultative processes such as the Comprehensive Development Framework and Poverty Reduction Strategy Papers.

### II. PSD and Poverty

iv. Private sector development (PSD) is critical for poverty reduction in two major ways. First, private markets are the engine of productivity growth and thus create more productive jobs and higher incomes. Second, complementary to government roles in regulation, funding and provision, private initiative can help provide basic services that empower the poor by improving infrastructure, health and education – the conditions for sustainable improvements of livelihoods. Reform processes including deregulation or privatization should also be used pro-actively to enhance environmental sustainability.

## A. Opportunity - Extending the Reach of Markets

v. The creation of more productive jobs and of entrepreneurial opportunity are key measures to help poor people realize their potential. To this end, there needs to be a sound investment climate and it needs to extend to the areas, where the poor live, particularly the 1.2 billion who live on less than US$1 per day and who work mainly in private firms and farms, mainly in the informal sector.

vi. **Enhancing the investment climate.** Critical features of a sound investment climate include a sensible governance system that allows firms and farms to pursue productive activity without harassment, contracts and property rights to be respected and corruption to be reduced. Equally important is an infrastructure that allows private entrepreneurs and their employees to operate effectively. Competition and, where necessary, regulation are essential to channel private initiative in socially useful directions. A sound financial sector is required to allow firms to enter the market and operate effectively as well as to help restructure failing firms. A stable macro-economic environment and an economy, which is open to trade are also elements of a good investment climate. Overall, enhancing the investment climate is about better public policy for the private sector, including the required supporting institutions.

vii. Poverty reduction requires that institutional and policy improvements extend to areas, where poor people live. Programs to reduce bureaucratic obstacles faced by small entrepreneurs and to provide property rights to poor citizens in urban and rural areas are needed as well as financial sector reforms and improvements in logistics chains. This would provide an environment of opportunity, which coupled with investment in human capital, can provide poor people with a route out of poverty.

viii. **Direct public support to firms.** To complement investment climate improvements and to help unleash supply response, direct support is sometimes appropriate for formal small and medium firms as well as entrepreneurs in informal settings, for example, in rural areas. Such support may comprise both finance and advice, for example, rural credit and extension services. Several decades of attempts to provide such support have shed light on the key success factors. First and foremost, successful direct support to firms requires a sound investment climate that provides incentives to use public support well. Second, both financial and advisory support needs to be aligned with market forces. Financial terms of loans and investments should not be subsidized. Any subsidy should be transparently targeted at institution-building and capacity-building purposes that justify subsidy on grounds of externalities, for example, some forms of vocational training.

## B. Empowerment – Improving Access to Basic Services

ix. Next to jobs and income growth, basic services are crucial for poverty reduction. In addition to the public sector, the private sector has a role to play in the provision of both infrastructure and social services. Where it makes sense, private participation is

often best introduced by new entry of private providers, many times by small or medium scale local entrepreneurs. Some form of private participation in various infrastructure sectors has been actively pursued by over 150 governments during the last two decades. Both successes and failures have led to a more balanced assessment of required policy measures, in particular government regulation. Private participation in the social services, while de facto widespread, remains a highly contentious issues.

x. **Infrastructure.** In low-income countries, poor people have very limited access to modern infrastructure. In particular, where state sponsored systems do not reach many people, the only alternative for poor citizens are private forms of service delivery. Yet, in many countries governments prohibit private entry into areas where the private sector can enhance access to services, for example, in electricity distribution in off-grid areas. Hence, unjustified entry barriers to private firms should be removed.

xi. More generally, private participation can successfully improve access to infrastructure services (telecommunication, energy, transport, water), where workable competition can be introduced, for example in many telecommunication systems. In non-competitive markets, case by case decisions are required to assess whether public or private provision may be preferable depending, in particular, on whether more risks for commercial performance can be shifted effectively to the private sector. At the same time, appropriate regulatory regimes are required to exercise necessary governance functions for both public or private provision.

xii. **Social Services.** The challenge is to build nation-wide systems that provide affordable quality access, in particular, free access to basic health and primary education. This requires policy development, institution-building and capacity-building in the public sector. Government policies may also be required to support funding of programs that have positive externalities, for example, vaccination programs, or funding of schemes to address affordability concerns. Public provision of basic services is also a key component of developing a nation-wide health or education system.

xiii. At the same time, poor citizens, de facto, depend in many cases on private (for-profit or not-for-profit) forms of service provision in health and education. More than half of all basic health services are provided by private parties in low-income countries and, in Sub-Saharan Africa, about a third of primary education is provided privately. This reflects lack of access to publicly provided services or choices by poor people to bypass them.

xiv. While government policy aims at creating health and education systems that provide affordable access to services, poor people should, in principle, have the choice to seek out private providers, when they have no other option or when they prefer them, even if they charge for their services. Some limits on choice are nevertheless justified. For example, in health care the introduction of insurance systems may require obligations to insure on both the individual and the insurer, in particular, to prevent high-risk people from falling through the cracks of the system. More important, for low-income countries,

there may be some restrictions on choice in education systems, where reasons exist to fear that school choice might entail socially divisive education systems.

xv. In the medium to longer term, attempts to improve access to service using both public and private provision are appropriate, depending on country and sector-specific conditions. As far as private service provision is concerned, it has a continued role to play in the social sectors. Many countries in both the developed and developing world routinely make use of private provision, particularly for health services, where private practice and private hospitals are widespread in addition to public providers. Moreover, public policy and funding functions are separable from provision of the service. Governments thus have the option to tap private initiative, while providing funding to deal with affordability concerns. Private provision is thus one of the tools for governments in their effort to build out social service systems that provide universal access.

## III. Proposals

xvi. In support of the strategic directions, set out above, the following measures are proposed.

### A. Extending the Reach of Markets.

xvii. **Investment climate.** Investment climate issues are to be part of systematic and regular analysis in preparation of country strategies and will be considered routinely in the Bank Group's country assistance strategies. To improve the investment climate, the strategy suggests continued deployment of policy-based lending operations as well as capacity-building efforts, particularly to reduce unjustified obstacles to private business and to establish secure property rights for poor people. In addition, other operations should be designed to help improve the investment climate as well.

xviii. To focus these efforts and achieve better results it is proposed to conduct systematic investment climate surveys and assessments that allow i) better identification of the features of the investment climate that matter most for productivity and hence income growth, especially for poor men and women, ii) tracking of changes in the investment climate within a country, and iii) comparison of countries or regions within countries.

xix. **Direct public support to firms.** Continued support to entrepreneurs, including rural credit and micro-finance is often suggested, with a focus on small and medium firms and farms. Based on lessons of experience, to help improve the performance of public financial and advisory support for private entrepreneurs and for firms of all sizes, the PSD strategy proposes disciplines on the World Bank Group to ensure that the financial terms of credit are not subsidized and that credit is preferably provided via the IFC, so as to limit the exposure of domestic taxpayers in poor countries to credit risk. Subsidies to stimulate supply response by private firms should be targeted transparently

in ways that are performance-based, and to purposes that truly justify a subsidy, such as, some types of institution- or capacity-building or other activities with identifiable externalities.

xx. To this effect it is proposed that the operational policy that governs financial intermediary operations of IBRD and IDA (OP 8.30) be redrafted and administered so as to cover intermediary operations for rural credit and social development/social funds, which previously escaped such discipline. For IFC it is proposed to require a minimum target rate of return on its lending and investment business that reflects its full risk-adjusted weighted average cost of capital. Subsidized operations, as is already the case for capacity-building for SMEs, should be funded transparently out of net income.

## B. Access to Basic Services

xxi. **Infrastructure.** The strategy proposes continued support for private participation in infrastructure focusing on establishing the framework, under which private provision is likely to make a positive contribution, and on improving regulatory regimes and building institutions and capacity effectively to supervise the private sector. Efforts would focus on providing broader and better access to services, which will help, in particular, women. As appropriate, such support to private participation in infrastructure will supplement government programs, which will continue to be supported by the Bank Group.

xxii. Beyond improving existing approaches, it is also proposed to develop principles for regulatory regimes that reflect emerging best practice and would help improve the transfer of that best practice to policy-makers and regulators world-wide.

xxiii. **Social sectors.** The Bank Group's incipient work on private participation in the social sectors is to continue, for example, IFC's investments in private health and education projects. Furthermore, the strategy notes the role that private parties, be they for-profit or not-for-profit, can play in providing service and that several countries have shown interest in tapping private initiative for the provision of social services.

xxiv. As previously called for by the Bank's existing health and education strategies, the PSD strategy thus proposes to complement the Bank Group's work on public policy and institution-building with more assessment of options for private provision drawing, where appropriate, on the experience with private participation in infrastructure. The Bank Group would, in any case, continue to provide unabated support to public services in health and education, in particular in pursuit of free access to basic health care and primary education.

xxv. **Output-based aid.** The strategy also proposes special efforts to focus interventions on development results, particularly improved access to services, and on improved targeting of government funding schemes. To this end, the strategy proposes to pilot programs and/or projects that disburse public funds backed by donors under schemes that have been termed "output-based aid". Essentially, public funds would be

disbursed when results are achieved, for example when water and electricity are flowing to customers, rather than when infrastructure facilities are being constructed. Public funding would be justified where externalities or redistribution objectives exist. Aid funds could finance such public funding schemes. Essentially they would thus help enhance the purchasing power of consumers. Services could be free to poor users or available at reduced cost depending on the type of service, resources availability and ability to pay. Providers of services including both for-profit and not-for-profit organizations would then take more of the risk of performance under a variety of contract structures. If service providers fail, investors should suffer rather than taxpayers in poor countries. Public providers may also compete under such schemes, where the playing field can be level and credible arm's length contracting relationships can be established. However, in this case taxpayers bear the ultimate risk of failure. The basic approach holds promise as shown by a variety of experiments in both low and middle income countries – typically initiated by governments or NGOs without World Bank participation – with the goal of getting ever closer to achieve the outcomes that matter to citizens.

xxvi. Output-based aid approaches pose much the same contracting and regulatory challenges as private participation schemes in infrastructure. More experience is needed to assess how useful output-based aid can be and, accordingly, this strategy recommends an evaluation of the design and development effectiveness of the proposed pilots in the medium term.

## IV. Implementation, Monitoring and Evaluation

xxvii. Implementation of the strategy is to be based on country-driven consultative processes like the CDF and PRSP, which are then to be translated into the CASs. Implementation will be facilitated by regional implementation programs, which are to be out in place during the next two years, starting with Africa, East Asia and South Asia.

xxviii. To monitor progress, the strategy proposes an annual review of significant PSD components of all Bank operations. Scorecards would capture key features of the performance of such components and their impact on poverty reduction, including impact on access to service, affordability, and the environment. In addition, full cost-benefit studies would be pursued to assess the outcome of selected, critical PSD policies and projects. A special evaluation would be conducted for output-based aid pilot projects by FY05.

# PRIVATE SECTOR DEVELOPMENT STRATEGY – DIRECTIONS FOR THE WORLD BANK GROUP

## I. THE ROLE OF THE PRIVATE SECTOR IN DEVELOPMENT[1]

1. Large-scale poverty reduction is now possible within a human lifespan. A number of developing countries have been able to double per capita incomes within a decade, for example, Botswana, Chile, China and Thailand. This is a phenomenon of the late 20th century. Before, it took significantly longer for countries to double per capita income. For example, the lead country of the 19th century, Britain, at the time needed some 60 years to double per capita income. Today, countries have the potential of adopting best practices already developed elsewhere to enhance productivity growth and thus incomes more rapidly.

2. But the way out of poverty is not automatic and is not completely understood. It is clear that development is a multifaceted process, not a purely economic one. Development requires effective ways of learning, scope for initiative, institutions that allow citizens to work together and ways to include all citizens to enable them to escape from poverty. As pointed out in the recent World Development Report on Poverty,[2] opportunity, empowerment and security for citizens are all critical dimensions required for poverty reduction.

3. Nations that have managed to conquer poverty have developed an intricate division of labor, where both private and public institutions play a complementary role. Successful nations have seen the extent and effectiveness of state involvement rise. State involvement has focused more and more on policy, regulatory and funding functions, particular the transfer payments that underpin the welfare state. At the same time, market-friendly policies have supported productivity growth that has raised incomes and enabled funding of the welfare policies. Private organizations have also become larger and more complex, reflected, for example, in the observation that average firm sizes grow as economic development proceeds. Large, complex organizations, such as the modern state and the business corporation, have thus taken on increased prominence.

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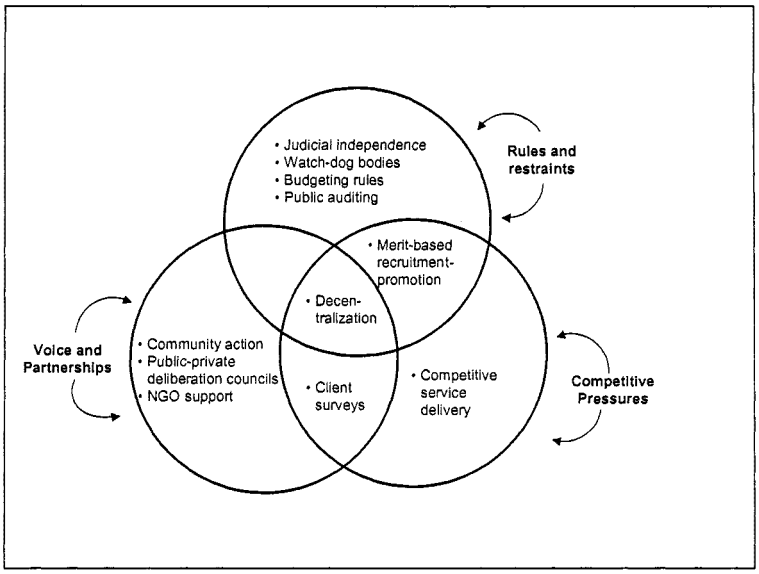
[1] Since the mid-1980s, a growing number of documents by the World Bank and other development institutions have explored at length the dimensions of private sector development and its relevance to the development process [African Development Bank (1997); Asian Development Bank (2000); AusAID (2000); EBRD (1999); IADB (1996); Norway Ministry of Foreign Affairs (1999); OECD (1994a); UK-DFID (2000)], including the recent OED Review of Private Sector Development in IDA 10-12 [World Bank (2001a)]. Most recently, the World Development Reports of 2001 and 2002 have respectively discussed the relationship between private markets and poverty reduction and the role of institutions in a market economy [World Bank (2001b); World Bank (2002)]. In preparation of this strategy document, a number of background papers have been prepared that review extensively the dimensions of PSD and existing evidence on effectiveness. The main papers underpinning the preparation of this strategy document are listed in Annex II.

[2] World Bank (2001b).

4. The power of public and private organizations requires in turn checks and balances to focus them on serving people. In successful nations an intricate set of rules has developed that constrain and direct the power of organizations. The design and supervision of the rules requires in turn processes that reflect the interest of citizens, such as the ability to voice concerns effectively. To some degree, power can also be kept in check by competitive processes. The World Bank's Strategy for "Reforming Public Institutions and Strengthening Governance"[3] sets out the relationship between "rules and restraints", "voice and participation" and "competition", whether in the political sphere or the market. As that strategy paper points out, "public sector reform and private sector development are intimately interconnected".

**Figure 1: Mechanisms to enhance state capability – three drivers of good governance**




Source: World Bank (2000a).

5. Markets and market-type mechanisms play a particular role in the development process by balancing co-operative features with competition. For markets to function, they require rules that market participants adhere to. They thus require co-operation in this respect and institutions enforcing the rules when co-operation breaks down. At the same time, markets thrive on competition as long as the rules are respected. The rules require processes that set, adjust and monitor them. Organizations are needed to carry out these functions. Rules, processes and organizations make up institutions, including markets. Critical features of the institutional underpinning of markets are functioning property rights and contracting systems as well as a framework of commercial, environmental, health and social regulations that limit what owners can and cannot do with their property.

6. Given the rules that define and protect property rights and contracts, market participants are free to compete. Competition provides opportunity to innovate, to learn and to adapt solutions to special situations and in response to customer demands. But

[3] World Bank (2000a).

effective competition also constrains the ability of firms to earn excessive profits. The rules that markets are based on and competition are both disciplines on organizations. Markets are flexible institutions that can be used by policy-makers to direct private initiative into socially useful directions. The most recent World Development Report on Building Institutions for Markets[4] characterizes in detail the institutional features of markets and the opportunities and challenges in exploiting the power of markets for public policy.

7. Large parts of economic activity are best organized in markets. Markets have proven effective in creating opportunity for citizens to obtain jobs, increasing incomes based on productivity growth, and producing the goods that people want to buy. Functioning markets are thus a critical mechanism to help reduce poverty. Key to effective markets is an investment climate that provides i) sound rules for the market, ii) the expectation that the rules will be adhered to both by market participants and the state, and iii) physical access to the market. Macro-economic stability, well-defined property rights, a sound judicial and contracting system, a reasonable level of certainty about government policy, functioning financial institutions and a good physical infrastructure, such as a transport system, are all ingredients of a sound investment climate.

8. For development institutions that seek to reduce poverty, the challenge is to improve the functioning of markets, and to enable all citizens to participate in markets so that they can benefit from better jobs and exploit entrepreneurial opportunities. That means in particular a better investment climate for small and informal entrepreneurs, including farmers, who typically have least access to economic opportunity. It also means support, particularly, to small entrepreneurs to avail themselves of new opportunities.

9. While participation in domestic markets is important, so is access to international markets. Better integration with the global economy facilitates the flow of goods, capital, technology and ideas. It facilitates the acquisition of good practices and expands the space in which entrepreneurial talents can flourish. Private sector development efforts should thus take cognizance of regional and global linkages.

10. Opportunities also exist to exploit private initiative to increase access to basic services. The public goal of providing universal, affordable access to basic infrastructure and social services is often best pursued by focusing the state on policy-making, regulatory and financing functions, while exploiting private initiative to provide the service, alongside public provision.

11. The precise role that markets can play and the scope for improving service delivery by tapping private initiative varies from country to country and from sector to sector. It is critically dependent on political, social and economic starting conditions. Key factors include:

[4] World Bank (2002).

- the level and location of capability in the concerned country and sector to deal with the functions of policy-making, contracting, regulation, funding and provision of goods or services;
- the credibility of the institutions comprising the governance system in committing to rules and policies; and
- the degree of access to private financing for projects or private firms in domestic or foreign financial markets.

12. It is clear that an effective public sector is needed if private initiative is to be tapped and channeled in socially useful ways. The public and private sectors thus need to play a complementary role. However, there is no simple typology of country situations that sets out the right balance between the role of the state and the private sector for all cases. In each case, the approach has to be based on the best possible understanding of a country and sector situation. Key ingredients to reach the best possible understanding are on the one hand consultation processes that lead to a better understanding of the issues at hand and a better reflection of citizens' desires. On the other hand, an awareness of options for reform and the capacity of policy-makers and institutions to implement such reforms are essential. Private sector development measures – like any other intervention to promote development – should thus be derived from consultative processes at the country level, such as the preparation of a Comprehensive Development Framework (CDF) for the country and/or of Poverty Reduction and Strategy Papers (PRSP). Recent work on involving private sector perspectives in these processes are sketched in Box 6 (page 33).

13. Private sector development (PSD) is thus part of the overall development agenda. It needs to fit into an overall strategy and complement in particular the improvement of governance systems. It is as much about public policy for the private sector as about helping private parties to make best use of new opportunities created by policy. The private sector is not a sector like transport or education. PSD is about a way of doing things. Overall, PSD is about tapping private initiative for promoting growth, reducing poverty and helping people improve their quality of life.

## II. PSD AND POVERTY REDUCTION

14. A PSD strategy can support poverty reduction in two basic ways. Most importantly, by improving the investment climate the reach of markets can be extended so as to provide greater job and income opportunities for poor people. In addition, markets or market-type mechanisms can help governments empower poor people by providing better basic services.

## A. Extending the Reach of Markets

15. The hope of the world's poor to escape from poverty is critically dependent on their ability to obtain jobs that help them raise incomes. Private markets are critical mechanisms to help create such jobs. Private firms, small and large, operating in competitive markets are the engine for job creation and income growth and thus provide the opportunity to escape poverty (Table 1).

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

| Country | Period | Job Creation (thousands) | | Ratio Private to Public Job Creation |
|---|---|---|---|---|
| | | Private | Public | |
| México | 1989-98 | 12,431.0 | 143.0 | 87:1 |
| Costa Rica | 1994-98 | 238.0 | 12.0 | 20:1 |
| Turkey | 1987-92 | 1,490.0 | 91.0 | 16:1 |
| Kenya | 1993-98 | 173.0 | 13.0 | 13:1 |
| Guatemala | 1994-98 | 47.0 | 4.0 | 12:1 |
| Bolivia | 1994-97 | 181.0 | 18.0 | 10:1 |
| Uruguay | 1987-92 | 127.0 | 27.0 | 4.7:1 |
| Gabon | 1992-96 | 4.7 | 1.3 | 3.6:1 |

Note: This table is limited to the few countries for which changes over time in job creation are documented for the entire public sector, including state-owned enterprises.
Source: Pfeffermann (2000).

16. Poverty reduction requires that entrepreneurs set up businesses where poor people can work. Most of poor people live in rural areas. Typically they work in very small informal businesses, for example as farmers or day laborers. It is thus particularly important to improve the investment climate such that people in rural areas as well as small and informal businesses benefit from the development of markets.

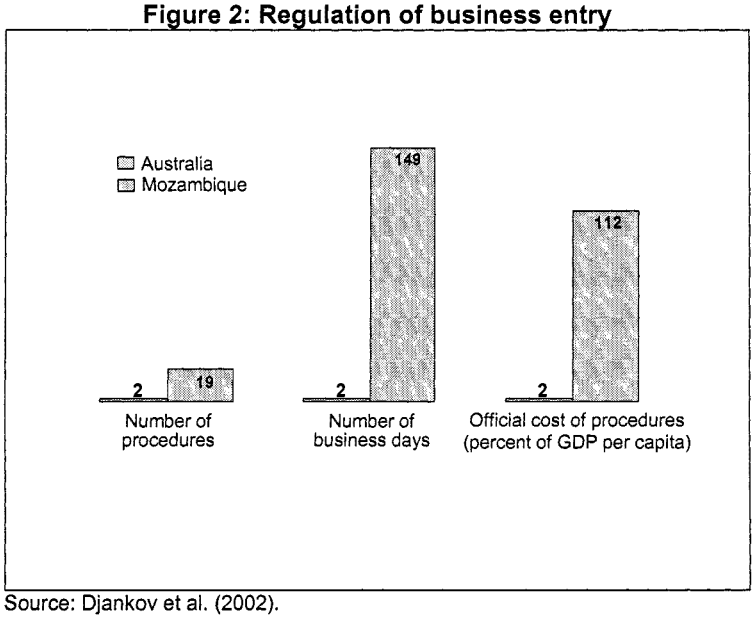
17. Special attention also needs to be given to the specific problems faced by women who often have lesser access to productive resources, such as land and credit. Women entrepreneurs play an important role in many societies, such as in Africa. In South Asia, where the bulk of micro-credit has gone to women micro-entrepreneurs, studies have shown that increases in women's income tend to be better correlated with increases in family welfare than similar increases in the income of men.[5] However, the entrepreneurial potential of women is often left unutilized due to cultural, policy and institutional biases that limit their access to property and productive resources.[6]

18. A number of related interventions are required to allow poor people to benefit from markets. Opportunities need to be opened up for small entrepreneurs. Many times they are discriminated against and bureaucratic obstacles ("red tape") make it difficult to establish thriving businesses (Figure 2). The costs of overcoming such red tape are often

[5] Murdoch (1999).
[6] World Bank (2001l)

disproportionately large for small entrepreneurs. At the same time, large politically well-connected incumbents may try to block the most successful new businesses.

**Figure 2: Regulation of business entry**




Source: Djankov et al. (2002).

19. For small firms to operate well, they also need to be able to conclude contracts with others that allow them to acquire new techniques and practices, to invest and to sell. This requires effective property rights. Significant scope exists to strengthen the property rights of poor people. For example, rights to land in many rural and urban areas are not well defined and may be allocated to poor people via simple titling schemes.[7] This provides poor people with assets that can eventually be used as collateral to support finance for new investments. The importance of opening up opportunity for poor people by removing red tape and by empowering them with access to property rights has been advocated most prominently by Hernando de Soto.[8] Removal of bureaucratic obstacles and strengthening of property rights can be particularly helpful for the informal sector, which is a major source of income for many poor people.

20. When firms can enter the market, when they have well-defined and protected property rights and when they can contract effectively, they are in a position to interact with other businesses or individuals, for example as buyers, sellers, borrowers or contractors. Access to markets tends to provide better and more varied goods and services at more advantageous prices. Effective markets can also provide firms with new technology and organizational innovations that raise productivity and hence incomes. To make use of such innovations, entrepreneurs and employees need to be trained. Sometimes the training may be provided by larger firms, with whom they contract,

[7] World Bank (1998a).
[8] de Soto (1989).

sometimes it may be provided by vocational training programs.[9] More generally, a sound education system is important to create the capability to respond to new opportunities.

21. To be able to apply new methods and expand, firms need to be able to obtain finance. The most important source of finance for investment – even in larger firms with access to formal financial markets – is internally-generated cash. To be able to use such funds for investment, firms need to be free from arbitrary taxation and other arbitrary charges that expropriate the gains from successful investment and work. A sound legal and governance environment is thus critical.

22. Access to formal financial institutions is facilitated when firms have property rights that can be collateralized and when the legal and contracting environment renders loan and equity contracts enforceable. In addition, financial institutions are needed that have the capability to deal with small firms. This may require special credit procedures, better information systems and organizational innovations that allow cost-effective interaction with clients. At the same time, improvements in the financial sector should render credit decisions less dependent on whether firms are politically well-connected.

23. Finally, firms require functioning logistic chains to bring goods to market and obtain inputs for production. Physical infrastructure is needed for transport, for example, rural roads. Warehouses are needed for storage and sorting. Procedures are required to clear customs and other inspections. Functioning documentation systems are needed to support effective contracts. In many cases one or several parts of a logistics system is characterized by "bottlenecks". For example, farmers may depend on a single access road or a single warehouse or a particular communication system for contractual information. Where such bottlenecks exist, it often happens in poor countries that private or public parties extort rents. For small firms to benefit from access to markets, there need to be systems to provide non-discriminatory access to bottlenecks. Such access may be protected by the state or, for example, producer organizations such as co-operatives.

24. In general, markets and entrepreneurship arise in many different settings and often in very trying governance environments. Yet, for markets and the private sector to develop their full potential, sound policies and institutions are required. As mentioned before, this includes macro-economic stability as well as a number of institutional pre-requisites, most importantly a reasonable governance system that promotes adequate property rights and security of contract within a framework of regulations that pursue sensible social and environmental goals underpinned by a functioning legal system and curtailment of corruption.[10] All this points to the importance of building an effective state (at all levels of government, including central, state and local) that can create the setting for markets and entrepreneurship to flourish. Where states are successful in creating a strong investment climate, poverty reduction is greatly facilitated (Figure 3).[11]

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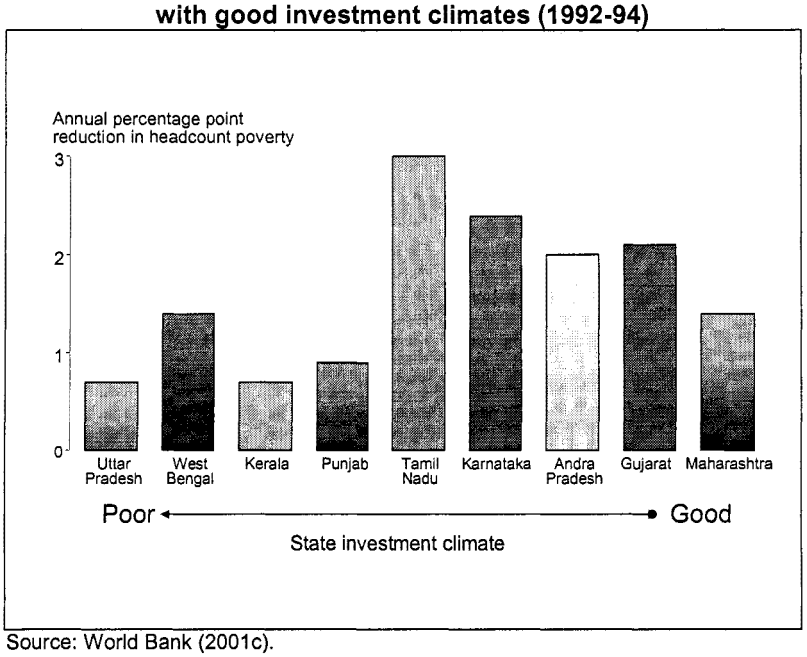
[9] Batra and Tan (1995).
[10] World Bank (2000a); World Bank (2002).
[11] Stern (2001).

**Figure 3: Poverty reduction was higher in Indian states with good investment climates (1992-94)**




Source: World Bank (2001c).

25. Within the rules set by policy, markets develop their full power when competition is promoted; this implies customer choice, removal of unjustified entry barriers, as well as institution of "hard budget constraints" for private organizations that do not perform, i.e., clear limits to bail-outs.[12] Competition allows individual firms to experiment and innovate, to adapt to local circumstances and to local knowledge. As a result, competition tends to promote innovation and the spread of best practice, the key ingredients of productivity and income growth. At the same time competitive forces limit profits – on average – to normal rates of return required to remunerate owners of firms for the risks they take.

26. Domestic competition is an important factor in making the most of access to international markets.[13] Productivity growth can be facilitated by access to foreign goods and services and to foreign investment. Liberalization can help unleash competitive forces, open up new markets for developing country products and services and promote the transfer of know-how and technology to developing economies. Domestic competition is important to translate such new opportunities into productivity improvements rather than protection for private market power.

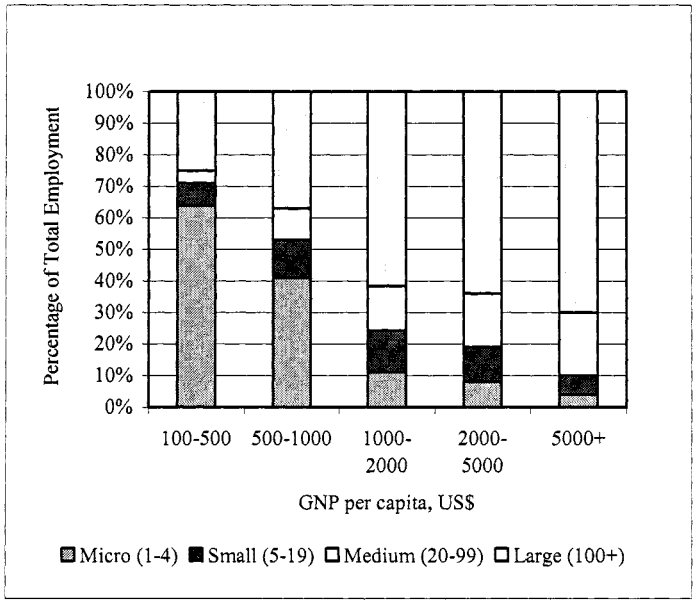
27. The success of privatization in potentially competitive sectors, such as manufacturing, agriculture or mining activities depends on whether real competition is allowed. Free entry and hard budget constraints prevent public monopolies from being simply transformed into private ones and ensure that necessary restructuring takes place. Competition is thus a key ingredient to render privatization beneficial. At the same time,

[12] Galal et al. (1994); Kikeri (2001); Macedo (2000); Megginson and Netter (2001); Sachs et al. (2000); Sheshinski and Lopez-Calva (1999); Shirley and Walsh (2000).
[13] Stiglitz (1998).

competition without privatization is rarely effective as governments are reluctant to allow new entry and are tempted to bail out failing state-owned enterprises.[14] The introduction of competition without privatization can, however, induce important efficiency improvements in public enterprises when they believe that eventual privatization is likely.

28. Firms not only compete, they also complement each other. Small firms bring new approaches. Large firms tend to be more productive than small ones and support new firms, for example, through subcontracting arrangements and with trade credit. As economies grow richer, the average firm size increases (Figure 4). Firms from developed areas within or outside a country tend to be most productive and are able to bring best practice to new areas. Altogether, a level playing field for firms of all sizes is most conducive to growth. In particular, barriers to entry of small and medium domestic formal or informal firms or entrepreneurs and of productive firms from developed areas tend to retard growth.[15] When such barriers are not removed, comparatively large incumbent firms that are politically well-connected tend to dominate. Competition is thus undermined. The market power of such firms tends to reduce productivity growth. Their political influence tends to protect them against failure when they do not perform, often via preferential access to bank credit. The resulting vicious circle sets back job creation and reduces entrepreneurial opportunities for small entrepreneurs as well as innovation from new foreign firms. Pro-competition policies are thus important.

**Figure 4: Distribution of employment by firm size and GNP level**




Source: Snodgrass and Biggs (1996).

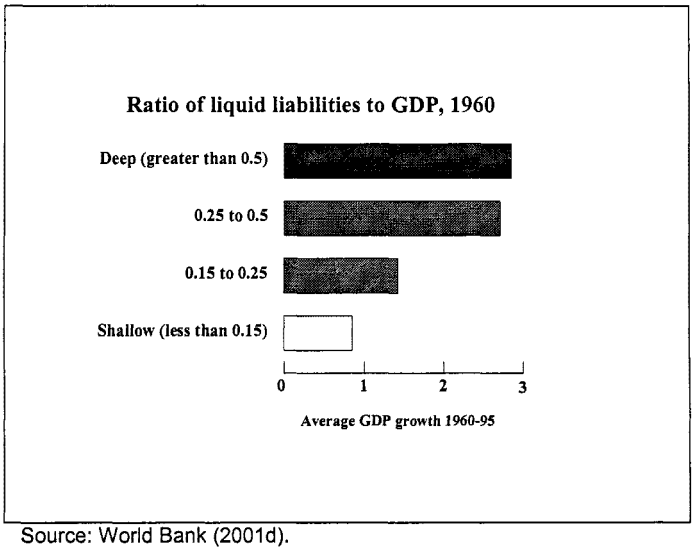
29. Growth is enhanced when a sound financial sector supports entry of promising firms and reallocates resources away from failing or under-performing firms to more

[14] Ibid.

[15] Audretsch (1991); Baily et al. (1992); Batra and Mahmood (2001); Caves (1998); Jovanovic (1982); Liedholm and Mead (1987); Roberts and Tybout (1996).

promising ones, a function typically best fulfilled by private financial institutions.[16] A well-functioning financial sector operating at arms-length from political and corporate interests is thus part and parcel of pro-competitive policy regimes. Recent studies trace the link between deeper financial sector development and economic growth (Figure 5).

**Figure 5: Financial depth generates subsequent growth**




Source: World Bank (2001d).

30. Last but not least, a dynamic private sector is needed to generate tax revenues to fund public functions, not least the provision of universal, affordable access to basic services.

## B. Basic Service Delivery

### 1. Access to infrastructure

31. Most poor people in developing countries have little or no access to efficient infrastructure services. Water is typically supplied by private water vendors or obtained from rivers, boreholes, etc. Electricity is only available to a small part of the population. For example, in Sub-Saharan Africa, the public electricity grid reaches only about 10 percent of the population on average. Poor households thus typically obtain energy services from firewood or kerosene. Public transport services are also often spotty or unavailable for the poorest. The burden of coping with inadequate infrastructure, whether this be collecting water or firewood or walking long distances to markets, falls disproportionately on women. For the few services available to poor people, they typically pay a high unit price. For example, water bought from vendors costs some 10 to 40 times as much as water supplied by modern water pipeline systems.Typically, government polices aim at expanding access to infrastructure services and at rendering it affordable. Yet, progress has been slow in a number of the poorest countries. De facto,

[16] World Bank (2001d).

poor people often resort to private service providers. However, a number of countries prohibit entry of private providers of telecommunication services, electricity distribution and water pipeline systems. Such prohibitions, in a number of instances, equate to a denial of service. Countries that have allowed private entry have seen service expand (Box 1). Hence, unjustified entry barriers should be removed. This would allow in particular local small scale providers to enhance service provision in the near term.

**Box 1: Access to services: the role of small-scale providers**

For many poor households in developing countries the prospect of access to infrastructure services from formal networks remains distant. The magnitude of the access deficit is often so great that, even with thorough-going reform, universal network access could take many years or even decades. And in many cases the prospects of establishing functioning, credibly independent regulatory systems in the near-term acts as a serious brake on the rapid mobilization of private finance for service expansion. Very often, the best prospects for service improvement in the short and medium term come instead from small-scale service providers.

Poor people in developing countries already rely extensively on small-scale provision – buying water from vendors, candles or kerosene from local merchants, urban transport services from combi buses or jeepneys. But these services often operate in the shadows of the black market, at risk to expropriation and mafia-style monopolization that can push up prices and push down quality. Where entry by small-scale providers is permitted and open to competition, experience suggests that better, cheaper services can follow. In Kenya, where the grid reaches less than 2 percent of the rural population, photovoltaic cells supplied by small local companies have begun bringing electricity to rural households – with more technical and financing options and reduced costs becoming available as the market expands. While per kW costs remain high relative to grid power, they still represent significant per unit savings over alternative energy sources. In Hargeisa, Somalia, private owners of power generators with excess capacity have emerged as key service providers following the destruction of public power facilities during the civil war – supplying around 10,000 households at a flat daily rate of US$0.35 per light bulb. In Cambodia, which has one of the lowest electrification rates outside Sub-Saharan Africa, hundreds of small private providers offer services ranging from battery recharging sites to fully metered electricity provision for entire communities. These providers now serve an estimated 115,000 customers – more than one-third of all electricity customers nation-wide. In Mogadishu, Somalia, in the absence of any formal telecommunications regulation, active entry and competition has driven down the price of international calls from US$1.50 per minute to around US$1.00 per minute – a price that remains high, but not out of line for the region as a whole. In Paraguay, small competing water companies called "*aguateros*" have dramatically increased access to piped water by peri-urban households, at prices not significantly higher than local utility prices. The *aguateros* are now being considered as service providers in rural areas, under a proposed least-subsidy bidding scheme to promote rural water access. In Guatemala City, around 20 independent water vendors, many belonging to a formal federation, supply clients with holding tanks, including poor communities that have constructed communal holding tanks. And in Teshie, a suburb of Accra in Ghana, tanker companies have reached a formal arrangement with the local public utility for the purchase of bulk water for distribution to households that currently lack connections. In each case, the effect is to open up better options for those who lack access to conventional utility services.

Source: Solo (1998) on Paraguay water; Kariuki and Acolor (2000) on Ghana water; Hankins (2000) on Kenya PV; Marchal et al. (2000) on Somalia electricity.

32. At the same time, government capacity should be strengthened to meet essential social concerns and enable them to deliver on the promise of universal access to basic services. Where small scale entry is allowed, regulatory regimes can be designed in a way to meet essential concerns while providing a base on which to build more sophisticated systems over time. For example, scrutiny of non-essential quality and price issues can be calibrated to the level of policy concern involved, and may differentiate between areas served by formal network providers and other areas. There are also options for regulatory agencies to develop more flexible approaches for engaging low-income consumers and small-scale providers in the regulatory decision-making process. The many design variables in this area can be brought together to take account of the circumstances of each sector and implementation environment.[17]

33. To some degree, recent technological change has brought down the optimal size of service providers. For example, wireless telephony and electricity turbines can be cost-effective technologies at relatively small scale. Hence, private small scale entry may in such situations not only constitute a near term remedy to enhance access, but also be compatible with efficient long-term sector development. Yet, in large parts of the infrastructure sectors large-scale solutions remain important and require complex system development. This places even greater emphasis on the need to build government capacity to guide such system development.

34. In building out modern infrastructure systems, there are a number of options for governments to introduce markets or market-type disciplines and thus to enhance efficiency. In some segments of infrastructure systems, it is possible to introduce head-to-head competition ("competition in the market"), for example, in much of telecommunications, in larger energy generation systems, among gas producers in larger natural gas systems, and in road-based transport systems.[18] Where head-to-head competition can be introduced, private ownership is typically an efficient tool as governments tend to be tempted to bail out or otherwise favor state-owned enterprises and thus undermine effective competition.

35. In other segments of infrastructure, natural monopoly characteristics pre-dominate, i.e., the service is best delivered by a single supplier. For example, it would be inefficient to lay competing water pipelines into houses. In such situations, governments can consider options to introduce competition "for the market". In this case, competing providers would bid for the right to provide a service.[19] The most efficient provider would be chosen and supervised by some form of public regulatory institution. Such competition for the market need not require full privatization, but can be implemented to varying degrees under a range of contractual options from management contracts to full concessions. Whether such schemes perform better than full provision by state-owned

[17] See Section D in Annex IV. In particular, see papers presented at PPIAF Conference on "Infrastructure for Development: Private Solutions and the Poor," held in London on May 31-June 2000. The papers are available at http://www.ppiaf.org/conference/newindex.htm. For graduated approaches to regulation dependent on the state of governance, price and quality/environment, see paper by Warrick Smith (2000); see also Brook and W. Smith. (2001).

[18] Newberry and Politt (1997).

[19] Klein (1998), Laffont and Tirole (1993)

enterprises depends in particular on whether performance risk is effectively shifted from taxpayers to the private shareholders of the company that enters into a concession-type arrangement.

36. In all cases, infrastructure system development requires upgrading the contracting and regulatory capacity of the state. The regulatory functions – setting and monitoring prices, quality and sometimes quantity – have to be fulfilled regardless of ownership. Combining responsibility for service provision and service regulation involves a blurring of roles and an inherent conflict of interest, and often leads to under-performance in both functions. Certainly, there are many instances of governments having greater difficulty regulating state-owned firms than private ones where problems can manifest themselves in inadequate enforcement of environmental or quality regulations, as well as pressures to hold regulated tariffs below sustainable levels to meet short-term political interests. However, when the benefits of a clearer demarcation of roles are outweighed by the net transaction costs of interaction between government agencies and private parties, state provision may be preferable. Where to draw the line between public and private provision needs to be assessed case by case, having regard to the characteristics of each sector and implementation environment, as well as on judgments about the relative significance of potential market and government failures.

37. In some cases, policy-makers worry that private providers are simply not willing to enter a market. Private firms in sectors with large sunk costs, such as in many infrastructure sectors, are typically reluctant to enter high-risk markets. Once they have constructed infrastructure facilities, they are highly vulnerable to some form of expropriation, for example, via non-payment of bills. Hence, they tend to shy away from making large investments in high-risk environments. Yet, experience suggests that even in very difficult environments local private providers are willing to enter with small scale investments (Box 1). These entrepreneurs are able to assess and manage relevant political risks better than, for example, foreign firms. At the same time the type of service they provide is likely to be more costly and of lower quality than modern infrastructure systems. In difficult environments, including reconstruction programs, case by case judgments are required to chose among different forms of provision including state provision.

38. Private participation in infrastructure can help poor people by tapping private initiative to extend access to basic infrastructure and reduce costs. Competition "in the market" tends to improve access. Where competition "for the market" prevails, service coverage targets for private firms can be used to bring about improved access to services, for example, water supply. Where modern water systems extend service to additional poor customers, typically in peri-urban areas, prices paid by poor people drop precipitously by factors of ten or more, as poor people are no longer dependent on expensive private water vendors. As mentioned before, the truly poor are rarely connected to modern infrastructure systems. They either receive no service or often expensive service from small private providers. In many cases, extending access of modern services to poor people tends to address affordability issues at the same time and helps in particular women, who often bear a disproportionate responsibility for securing

water or energy for their household.[20] Modern services also help cope with environmental issues, for example, excessive fuel wood utilization, and health concerns, for example, diseases due to burning dung.

39. Affordability concerns that cannot be addressed by access to better and cheaper services can in principle be addressed by public funding schemes. This is compatible with PSD-type interventions, wherever performance risk for delivery of the subsidized service(s) can be shifted to private parties, while using public funds to support poor people. Essentially, subsidies then enhance the purchasing power of poor people and the quality and/or cost of the service is improved by using private providers. Competition among private parties for the right to supply poor people limits private profit to normal rates of return and ensures that any subsidy benefits the customer.

40. Generally, provision of service is separable from funding of the service. Even if a service is provided privately, funding may in a number of cases better be dealt with by public agencies based on some form of public finance. A whole range of options is available to combine private provision with public funding schemes in ways that marry the objectives of greater service delivery efficiency via private provision and support to poor people so as to render services affordable. Public funding schemes may target poor people or provide certain types of service at the same price for all (including free-to-the-user service).

41. Targeting is always challenging. Studies suggest that in traditional infrastructure systems subsidies typically accrue to the better-off.[21] More importantly, many of poor people cannot benefit even from effective subsidy systems, like life-line tariffs, because they are not connected to the system and pay typically much higher prices for substitutes to modern infrastructure services. Hence a prime goal is to expand access to lower cost services – even if this does not involve subsidies, including through small scale entry of private providers (Box 1). Beyond this, and as long as resources are scarce, further efforts to target poor people better are needed.[22] Targeting can attempt to reach poor people directly as a function of their income as in the Chilean water subsidy system.[23] However, this tends to be expensive and hard to manage. Other options rely on the use of more easily measured proxies for low income (Box 2). An example is targeting subsidies or subsidized service to an area where poor people pre-dominate, such as the rural village telephony program in Peru.[24] Alternatively, a type of service can be provided that poor people are more likely to use than the rich, for example, stand-pipes for water. The funding of the subsidy also presents various options ranging from cross-subsidies, where other users pay a "tax" on their service, to funding from the general budget.

[20] Brook and W. Smith (2001).
[21] World Bank (1994a).
[22] World Bank (2001b).
[23] Gómez-Lobo (2001).
[24] Brook and S. Smith (2001).

**Box 2: Some general principles on how to target subsidies**

Even when poor people cannot be identified individually by administrative means, subsidies can be designed to reach poor people.

- *Self targeting.* Programs can be designed to ensure "self-selections" – say, by paying wages below prevailing market rates. The Maharashtra Employment Guarantee Scheme in India relies on providing work that only poor people would find attractive.[25] In infrastructure lower quality services such as water stand-pipes or public payphones are likely to lead to self-selection of poor people, as wealthier households prefer their own household connection.
- *Geographic targeting.* Subsidies can go to specific location, so that rural and remote areas receive most of the benefits. This works best if the correlation between poverty and location is high – less well if poor and non-poor live close together. It also works best if the subsidy is attracted to goods that are hard to transport, such as direct services in education and health.
- *Commodity targeting.* Subsidies should go to commodities that poor people consume proportionately more of than other people, ensuring that they will receive most of the subsidy. Food and primary education usually rank high on this criterion as well as basic infrastructure services.

Source: World Bank (2001b); Brook and W. Smith (2001).

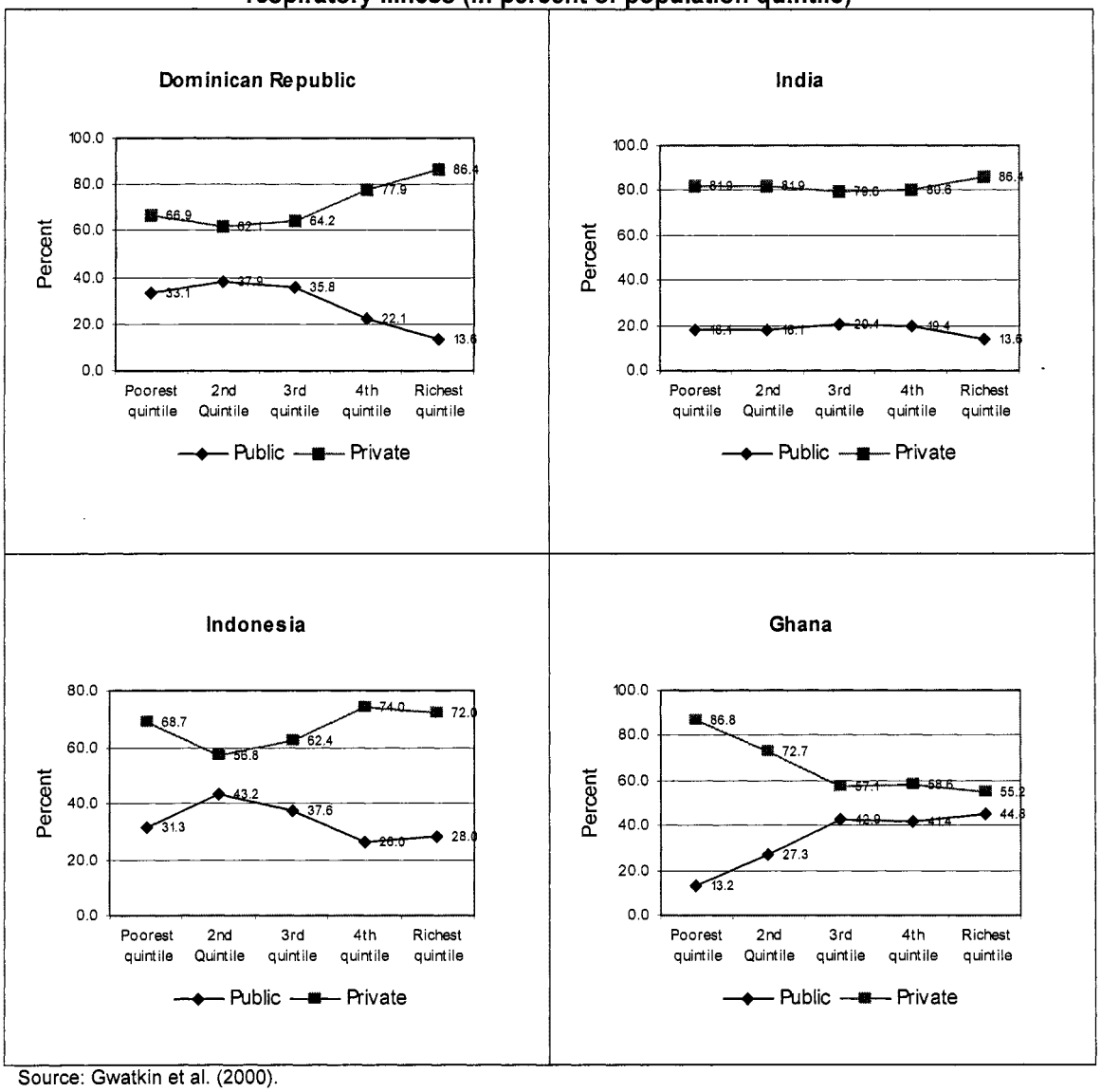
### 2. Access to social services

42. The critical development challenge in the social sectors is to build nation-wide systems that provide affordable quality access, in particular free access to basic health and primary education. This requires policy development, institution-building and capacity-building in the public sector. Government policies may also be required to support funding of programs that have positive externalities, or funding of schemes to address affordability concerns. Public provision of basic services is also a key component of developing a nation-wide health or education system.

43. Along side the public sector, private providers play an important role in many low-income countries. Many poor people in these countries receive basic health services from private providers, sometimes over 80 percent (Figure 6). In low-income country, citizens also pay themselves for more than half the health services they receive[26]. About a third of primary education is – on average – provided by private providers in Sub-Saharan Africa, in extreme cases about 80 percent (Figure 7). Private providers in the field of health and education typically comprise a mix of traditional service providers, not-for-profit organizations and for-profit entrepreneurs (Box 3). In many cases people also pay directly for private education. Where poor people take recourse to private providers, they do because state provision simply does not reach them, or because they prefer private providers, bypassing public facilities that provide low quality service.

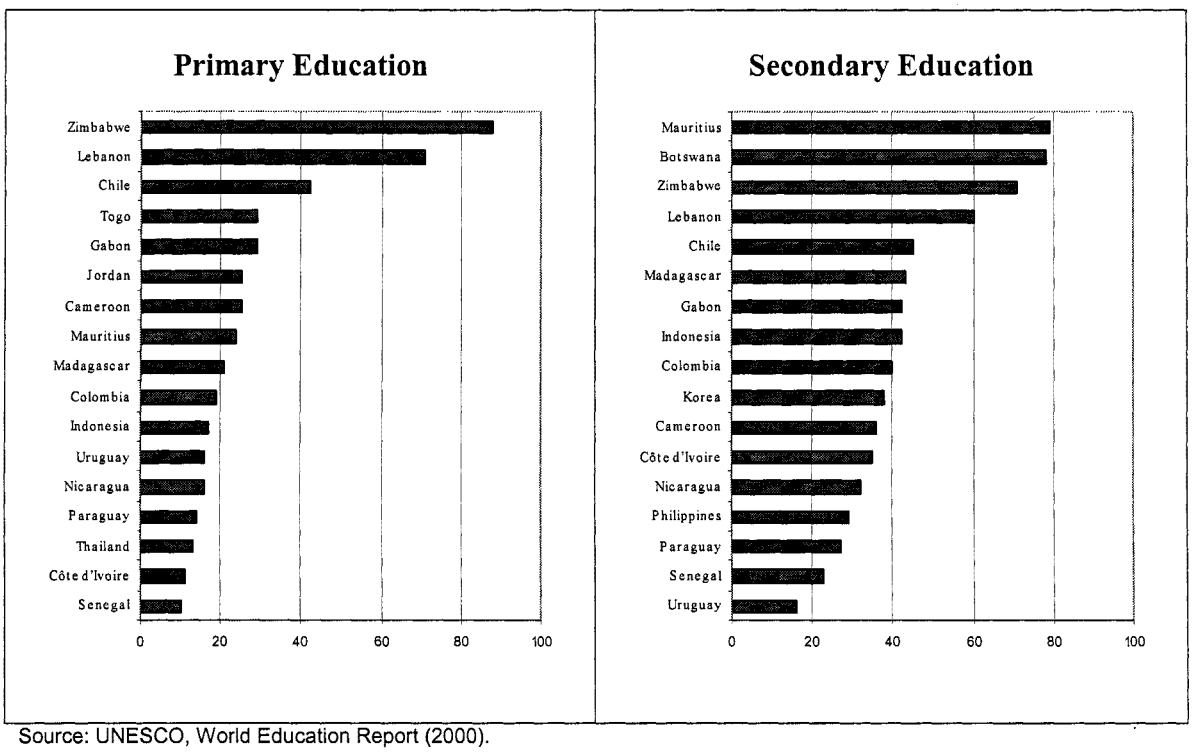
[25] Ravallion (1999).
[26] Filmer et al. (1997)

**Figure 6: Use of private vs. public facilities by poor people for treatment of acute respiratory illness (in percent of population quintile)**




Source: Gwatkin et al. (2000).

**Figure 7: Enrollment in private schools, 1996 (percent of total enrollment)**




Source: UNESCO, World Education Report (2000).

**Box 3: Private sector organizations**

Both for-profit and not-for-profit organizations form part of the private sector. As the Bank's education sector strategy points out, "*Private* is a broad concept and includes religious, NGO-run, community-financed, and for-profit institutions".[27] All these organizations form part of a continuum. Not-for-profit organizations make profits like any other firm, but they may not have "owners" to whom profits are distributed. The boundary between donations, membership fees and payment for service rendered to third parties is also rather fluid. Within both for-profit and not-for-profit organizations there are many types of very different organizations. Among not-for-profits, we find advocacy organizations as well as service providers. A similar spectrum exists among for-profits, which include newspapers with an editorial and opinion-making policy as well as manufacturing firms. Both for-profit and not-for-profit organizations can be subjected to competition, which provides them with the incentive to perform, whether performance means maintaining credibility for an advocacy organization or product quality for a service provider. Hence, they have a strong advantage over state-owned firms that are typically hard to subject to competition even in sectors where that might in theory be

[27] World Bank (1999a).

possible, because governments tend not to let state-owned firms fail when they do not perform. For-profit firms have more diverse and flexible funding options, but they may not be trusted as much as not-for-profit firms. In sectors where consumers place a premium on trust, for example, in health and education services not-for-profit providers may be able to out-perform for-profit firms under competitive conditions. Hence, competition between these different forms of incorporation should, in principle, be allowed.

44. While some states have de facto not been able to provide adequate service, unregulated markets by themselves will also not provide the type of services required. Some parts of basic health care have benefits beyond the direct customer. For example, vaccination benefits many citizens, not just the vaccinated person, because it reduces the chances for an infection to spread. Thus markets may well under-provide vaccination. Customers of health services also have difficulty judging the type of service they require and its quality. Governments can help by providing better information and regulating the provision of care. Where governments or other funding systems (including private insurance systems) fund health care, there are also incentives on providers to inflate costs that need to be stemmed by appropriate regulation. Where health insurance systems exist, unregulated insurers have an incentive not to insure bad risks. At the same time, people feeling healthy may choose not to insure themselves, but become a liability for the state when they become ill nevertheless. Hence, mandatory insurance systems may be required and regulation of insurance providers.[28]

45. Education also has important benefits transcending the individual and may thus be under-provided by markets. To some degree, school choice may be desirable, but it may in some cases lead to social segmentation or undesirable ideological or religious polarization.[29] Hence, regulation may be advisable. Citizens may also have trouble judging the quality of education and would benefit from public provision of information and quality regulation and some standardization, for example of curricula.[30]

46. Altogether, strengthening the capability of the state to develop and supervise health and education systems is thus critical. The policy role, the regulatory role and the funding role are clear tasks for the state and cannot be fulfilled by private, unregulated markets. The government has a unique role in promoting universal access to basic social services. Major capacity- and institution-building of public sector agencies is required to fulfill this role.

47. While government policy aims at creating health and education systems that provide affordable access to services, poor people should, in principle, have the choice to seek out private providers, when they have no other option or when they prefer them, even if they charge for their services. As part of the effort to build better social service systems, governments have various options to utilize private service providers to expand access, improve efficiency and reduce the demand on tenuous state capacity and

[28] Barrientos and Lloyd-Sherlock (2000).
[29] Carnoy (1997); Krashinsky (1986).
[30] Levin (1991).

institutions. In particular, they may rely on not-for-profit organizations and cooperatives who are, or could be, important providers of social services in many countries. Public funding functions are separable from the provision of services. Governments thus have the option to tap private initiative, while providing funding to deal with affordability concerns. As with infrastructure, the most appropriate boundary between state and private provision need to be assessed case by case, having regard to the characteristics of each service and implementation environment, as well as judgments about the relative significance of potential market and government failures.

48. Recourse to private providers and competition is, however, not just a measure of last resort for weak governments. In many developing and developed countries, health systems typically allow private practitioners to provide basic service and private hospitals to provide clinical services. In education systems, there tends to be a greater role for the state in provision relative to health. Evidence for both developing and developed countries suggests that private providers can provide quality service at low cost.[31] This is not to say that private providers are in all cases systematically better than public providers, but under appropriate regulatory regimes they can enhance service. Without appropriate government stewardship and regulation there is a risk that informal private markets may provide low-quality services.

49. But here as well, a number of countries allow private schools and school choice for parents, particularly at higher levels of education – sometimes among private providers sometimes among state providers or a mix of both.[32] Typically, the rich have a degree of effective school choice, because they can move to the best school districts, which drives up real estate prices and prevents access by poor people to those schools. Opening up school choice to all can help provide greater opportunity for poor people. For example, in the Netherlands parents choose among private schools that are publicly funded and remunerated as a function of attendance. Thus, in addition to state provision PSD approaches have potential to help provide access to social services. The challenge is to find the right mix of private and public provision that increases access to services of adequate quality. Country and sector specific conditions will largely determine the right mix.[33]

## C. PSD and Environmental Sustainability

50. The economic growth of recent decades has placed unprecedented strains on the natural environment. At the same time, the innovation supported by private markets combined with the regulation of those markets has so far been able to cope with a number of the resulting environmental problems, for example, natural resources scarcity. However, concerns persist that continued deregulation and privatization may harm the environment and thus undermine living conditions, particularly for poor people. The negative effects of private markets can be reduced by subjecting private organizations to

[31] Cangarajah and Ye (2001); Filmer et al. (1997); Hoxby (2000); Lockheed and Jimenez (1994).
[32] IFC (2001a); OECD (1994b); Patrinos (2000).
[33] Harding and Preker (forthcoming).

norms that address environmental concerns. As pointed out before, such norms qualify and often restrict the property rights held by private parties.

51. Some norms may be followed largely voluntarily, supported by strong underlying ethical beliefs of market participants. To some degree, competition can be used to provide firms with incentives to maintain reputation and hence provide quality to its customers. Interest in maintaining a decent reputation provides the basis for the phenomenon of "corporate responsibility", which drives large visible multinational corporations to adopt global operating standards and practices that exceed legal or regulatory requirements in a number of host countries.

52. Yet, in other cases penalties may more routinely be required to enforce regulations or mixes of taxes and subsidies to provide adequate incentives. Such regulations condition the property rights of private parties. Wherever possible, markets can then bring their innovation powers to bear on finding the best solution to meet the objectives of the regulation. Where economic instruments are used, such as taxes and subsidies or tradable property rights that create markets in scarce resources, environmental goals may be achieved at least cost.

53. The environmental performance of public enterprises in a number of countries, particularly in non-market economies, suggests that regulation of private firms is likely to be a relatively effective way for such countries of combining economic growth with sensible environmental standards. In particular, in a number of countries private firms may be easier to regulate than public ones due to the arms-length relationship between them and the authorities.[34] They may also have stronger incentives to conform to regulations as the impact of penalties and economic incentives affects the personal wealth of investors.

54. PSD approaches should be integrated with pro-active approaches to shape the policy framework so as to enhance cost-effective protection of the environment. Reform processes associated with the creation of markets or privatization may in fact hold opportunity to reshape environmental policy. For example, in many cases, private investors will require clarification of responsibilities for past environmental liabilities associated with an asset sale and for future environmental impact of operations. More generally, deregulation processes may affect the choice of technology, for example, in the power sector they tend to shift generation from hydro and nuclear towards natural gas. Reform efforts should take such effects into account.

[34] Dasgupta and Wheeler (1997); Hartman, Huq and Wheeler (1997); Wang and Wheeler (1996).

# III. PRIVATE SECTOR DEVELOPMENT ACTIVITIES OF THE WORLD BANK GROUP[35]

## A. World Bank Group PSD Activities – Historical Trends

55. Private sector development has been at the center of the World Bank Group's activities since the beginning. In the Bretton Woods world of pervasive capital controls, the World Bank focused on its special ability to move funds across heavily controlled borders. This resulted in on-lending operations to the private sector in developing countries. The IFC was set up in 1956 to help promote cross-border capital flows without government guarantee in support of private investment. The ICSID was set up in 1966 to facilitate the settlement of international investment disputes between states and foreign investors.

56. During the 1960s and 1970s, as state-led development and import substitution policies were pursued world-wide, the WBG started to focus on "development" rather than promotion of private capital and investment. IDA was established in 1960 and the bulk of the Bank's lending went to public sector agencies. After the1982 debt crisis, the WBG shifted emphasis towards macro-economic stabilization and opening up economies to trade and foreign investment. Adjustment lending with conditions on general policy reform grew in importance. FIAS, the foreign investment advisory service was created in 1986, and MIGA, the Multilateral Investment Guarantee Agency in 1988. In a parallel development, the liberalization of cross-border capital flows spread across all OECD countries and some developing countries during the 1980s, laying the ground for the subsequent rise in private capital flows.

57. The WBG's focus on stabilization and openness was gradually complemented by an emphasis on what later came to be called private sector development. Following the reorganization of 1987, "private sector development" became one of several "programs of special emphasis". The Bank's lending program shifted away from areas where private firms could find private financing. Disenchantment with the performance of on-lending operations of Bank loans to private firms led to the "Levy report" of 1989 and the subsequent decline of such operations.[36] Towards the end of the 1980s, the Bank's disappointing experience with state-owned enterprise reform shifted attention to privatization.

58. In the 1993 re-organization of the Bank, private sector development became an organizational principle with the creation of private sector development divisions and departments throughout the Bank. With the establishment of the Finance and Private Sector Development (FPD) vice-presidency in the re-organization of 1993, the Bank tried to take on a more activist role again. On-lending operations, particularly to SMEs, were again promoted. So-called "second generation" reform projects were initiated focusing on detailed reform of markets, including technology and competition policy, rather than

[35] This section is based on the PSD strategy background paper: World Bank (2001e).
[36] World Bank (1989).

broad macro-policy frameworks. In 1999, a new SME department was created as well as several new joint Bank/IFC departments.

59. At the same time, the Bank Group started paying greater attention to institutional development and to addressing the social costs of PSD-interventions, such as privatization-related labor retrenchment. There was also increased concern about environmental and social sustainability issues. Issues of transparency and corporate governance also started getting highlighted, especially after the East Asian crisis.

60. All in all, the trend in IBRD/IDA has been to emphasize policy reform and to withdraw from direct support to state-owned enterprises and individual investments that the private sector might be better placed to undertake (Figures 8 and 9). IFC has emerged as the main instrument for direct assistance to private firms. This trend is reflected in all sectors of the WBG's work, albeit in varying degrees. Over the last two decades, there has been a shift in lending and guarantee activities from IBRD to IFC and MIGA. The share of lending/guarantee products by IFC and MIGA in total Bank Group financial products has increased more than seven times over this period – from 3.3 percent in 1980 to 25 percent in 2000.

**Figure 8: Composition of World Bank loans in telecommunication sector: 1980-2000**

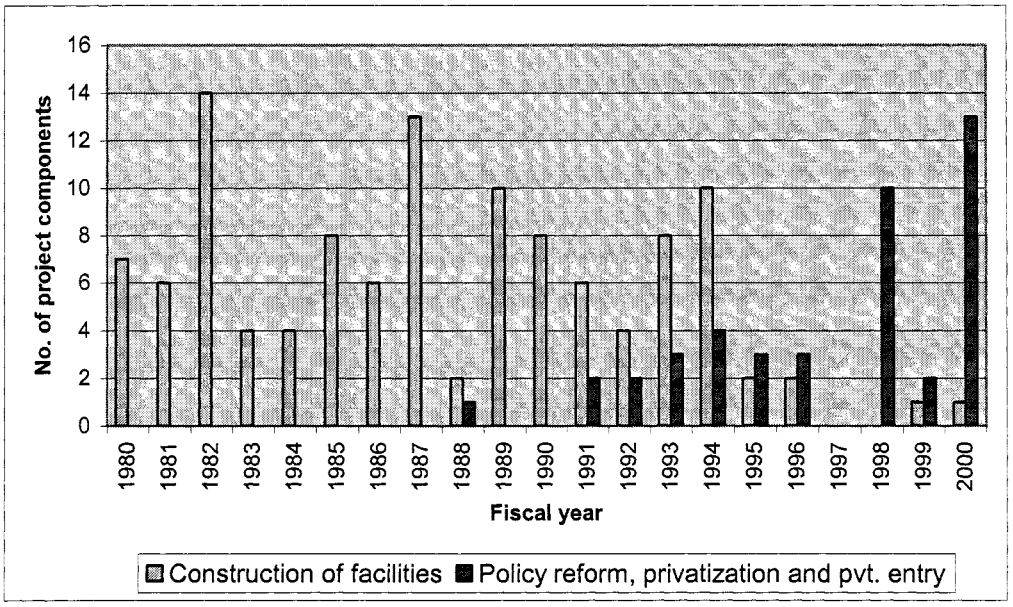
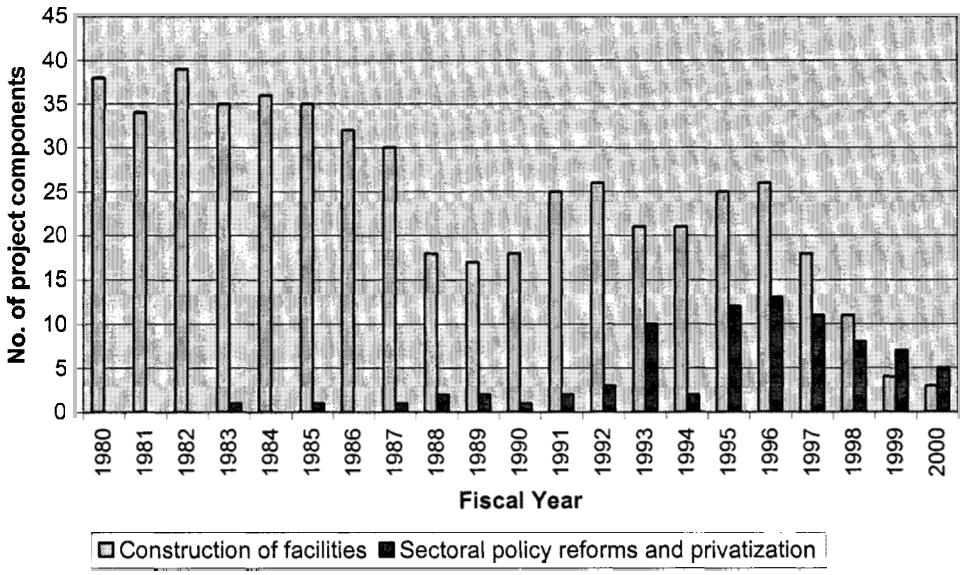


**Figure 9: Composition of World Bank loans in power sector: 1980-2000**




61. **WBG lending and guarantees for PSD has doubled in real terms since FY80.**[37] Much of this increase is due to the expansion in IFC investments and MIGA guarantees. IFC investments increased four and a half times in real terms between FY80-00 and, by FY00, accounted for 56 percent of total World Bank Group lending and guarantees for PSD. MIGA, non-existent in FY80, accounted for 25 percent of the Bank Group's financial support to PSD. Increasing IFC investments are indicative of the sharply increased access of IBRD borrowers to capital markets and commercial project financing over the past two decades. Reflecting the same trend, IBRD lending for PSD has declined in real terms, and in FY00, was about one-third the level in FY80. In low-income countries, for most of which market access has not improved commensurately, real IDA lending for PSD doubled over the same period. In FY00, IBRD and IDA lending for PSD together amounted to one-sixth of the Bank Group's PSD oriented lending and guarantees (Figure 10). World Bank Group financial support for PSD has increased at a faster rate in recent years than total lending and guarantees. As a result, the share of total lending and guarantees going in support of PSD almost doubled between FY95 and FY00; from 16 percent to 30 percent (Figure 11).

[37] See page 4 and Annex 3 of World Bank (2001e) for a description of the methodology underlying these estimates.

**Figure 10: World Bank Group lending and guarantees for PSD: 1980-2000 (in constant 2000$)**

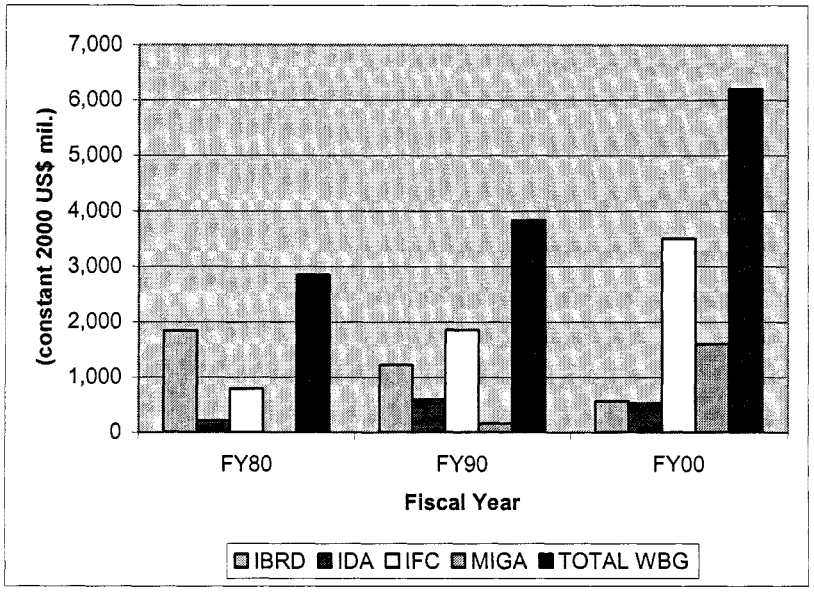
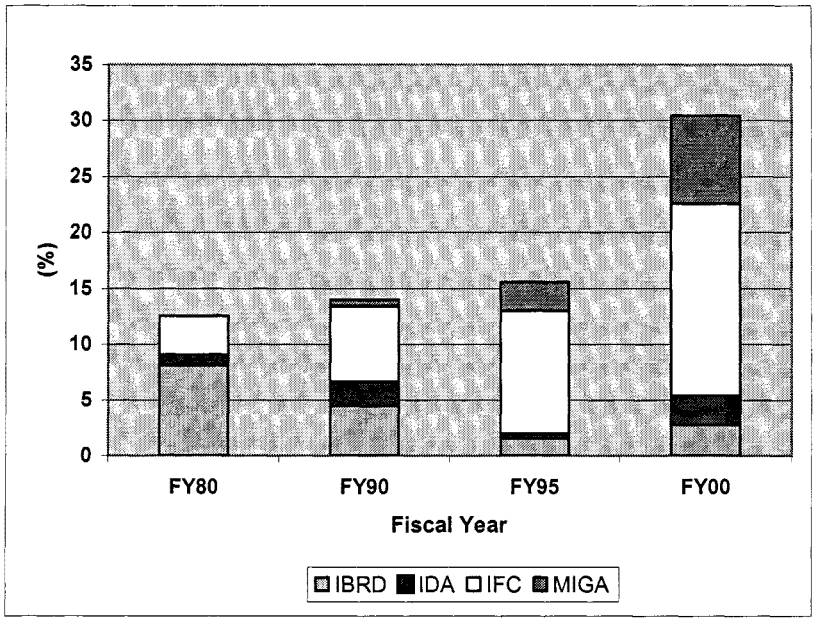



**Figure 11: World Bank Group lending and guarantees for PSD as percent of total WBG lending and guarantees: 1980-2000**




62. **Adjustment lending.** Adjustment loans (and associated technical assistance loans) have supported a wide range of PSD activities during the last two decades, with the emphasis shifting from the mere adoption of policies and the passage of laws to their implementation and to institutional development, capacity building, and improvements in procedures and systems. Adjustment lending conditions supporting reforms in regulatory

framework and competition policies rose from 7 percent of total PSD conditionality in FY80-88 to 32 percent in FY98-00.[38]

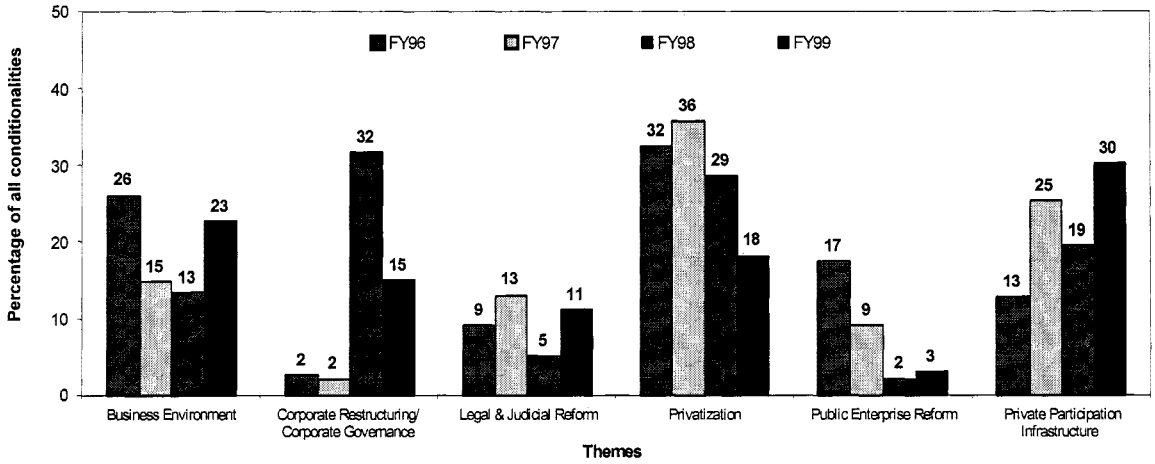
63. Overall, in the 1980s, the Bank emphasized the need to establish economic incentives for private sector development through macroeconomic stability and appropriate relative price changes.[39] In the late 1980s and early 1990s, the reform agenda expanded to emphasize the microeconomic and institutional reforms that could build markets, improve their functioning, remove government constraints, and better integrate policy reforms. In the middle to late 1990s, as developing countries faced the increasing challenges of globalization and the liberalization of trade and capital flows, the Bank responded by helping countries adopt measures to enhance competitiveness and global integration, good corporate governance, corporate restructuring, and debt work-outs (Figure 12). For instance, the share of conditionalities related to private participation in infrastructure as a part of adjustment lending more than doubled between FY96 and FY99, involving the privatization of infrastructure enterprises, sectoral reforms to allow new private entry, and development of regulatory frameworks and institutions. By contrast, the privatization of non-financial and non-infrastructure enterprises and public enterprise reforms, once important components of adjustment operations, steadily declined in importance in the late 1990s.

64. There is growing emphasis in PSD-related adjustment loans on borrower ownership, institutional development, capacity building and addressing the social costs of reforms. It is also being increasingly recognized that many PSD reforms require an implementation period longer than that provided by a single quick-disbursing adjustment loan.

[38] World Bank (2001f).

[39] For a fuller overview of experience with PSD reforms supported by adjustment operations, see World Bank (2001f).

**Figure 12: PSD conditionalities in adjustment lending, FY96-99**




## B. Current PSD Activities of the World Bank Group

### 1. Financial interventions

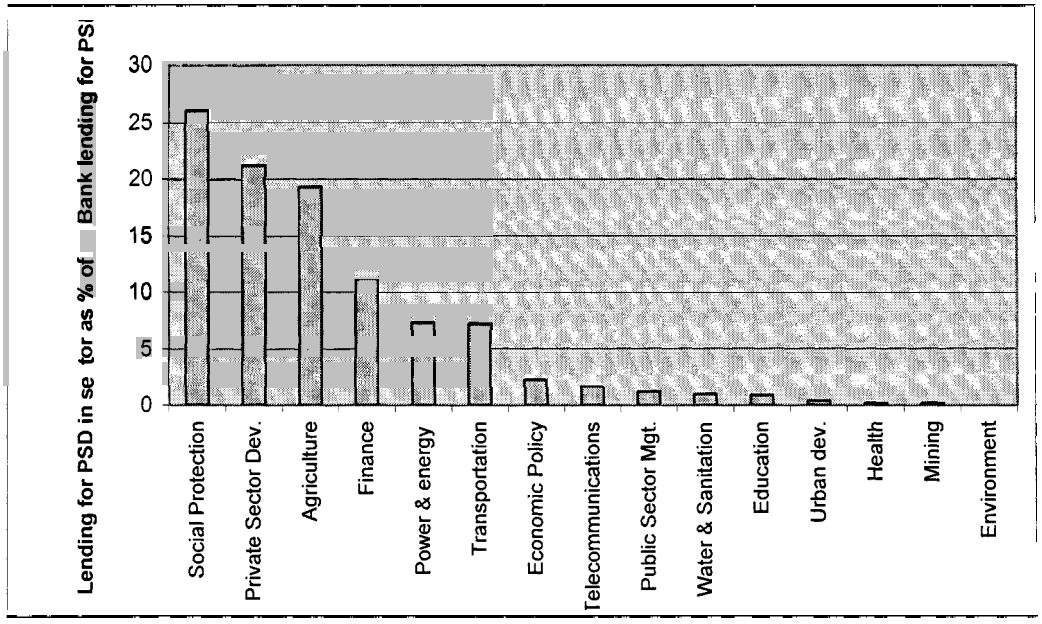
65. **IBRD/IDA project lending.** A number of lending operations of IBRD and IDA support private sector development. A portfolio review conducted in March 2001 in preparation for this strategy identified about 260 active Bank projects with substantial PSD components. These accounted for US$6.5 billion in committed lending; this is 6 percent of the total committed loans of the Bank. About 60 of these projects are classified as PSD projects in the Bank's project classification scheme. The rest are categorized under other sectoral or thematic heads but have significant PSD components.

66. PSD-related interventions fall into four categories based on their objectives: i) improvements in the investment climate; ii) privatization and concession-type arrangements; iii) direct assistance to enterprises; and iv) social funds.

67. Investment climate interventions aim to enhance deregulation and competition, by ensuring a legal and regulatory framework that encourages competitive provision of goods and services, property rights and corporate governance, and development of institutions related to PSD. The spectrum of privatization actions supported include management contracts, leases, concessions, Build-Operate-and-Transfer (BOTs) operations and outright divestiture. Direct assistance to private firms include lines of credit to financial institutions which then on-lend to private companies, provision of technical assistance such as business advisory services, matching grants facilities, project financing facilities for infrastructure projects and guarantees. Finally, social funds typically support small projects in infrastructure, social services, training and micro-credit. They support the PSD agenda by developing alternative, non-governmental delivery mechanisms.

68. **PSD activities are carried out all over the Bank. Almost all sectors of the Bank** have some PSD activity. However, private sector approaches are more common in some than in others. Projects with PSD components under three sectoral categories, i.e., social protection, PSD and agriculture, account for roughly two-thirds of all Bank PSD-related loan commitments (these estimates are for the end of the first quarter of 2001). Projects in finance, electric power and energy, and transportation account for another quarter of loans committed (Figure 13).

**Figure 13: Bank lending for PSD: sectoral breakdown**




69. **IBRD/IDA adjustment lending.** Today, adjustment lending supports a PSD agenda that enhances the foundations of a positive investment climate in the Bank's client countries: a wide array of procedural, regulatory and legal reforms have come to the fore that are critical to foster private-sector led growth – including removing exit and entry barriers, reducing market rigidities, simplifying tax systems, safeguarding property rights, and liberalizing trade barriers (Figure 12). Adjustment lending has become an important vehicle for promoting private participation in infrastructure, focusing on privatization of infrastructure enterprises, sectoral reform to allow new entry and development of regulatory frameworks and institutions.[40] To attract private investment, adjustment lending programs support the implementation of a number of key measures to strengthen the investment climate. These measures focus on competition policies and strengthening competitiveness through i)regulatory reform; ii) improving logistics and reducing transaction costs; iii) strengthening inter-firm linkages and government-business consultations; and iv) supporting global integration through institutional and policy reforms for greater export orientation, corporate governance and foreign direct investment.

[40] Of the 52 adjustment operations with PPI components approved during FY88-00, 28 were approved in FY99-00, most of which are multisectoral.

70. The poverty impact of PSD reforms supported by adjustment operations has also received increased attention, minimizing the costs of reforms to poor people and ensuring that poor people benefit from reforms.[41] A growing number of these operations include explicit components to address the social impact of the reforms (including the provision of severance payments, counseling, retraining, and redeployment of retrenched staff).[42] Most Private Participation in Infrastructure (PPI)-related adjustment operations now explicitly address the issue of protecting or expanding poor people's access to infrastructure services following the entry of private providers. Measures include market reforms, improvements in the regulatory framework, inclusion of pro-poor provisions in contracts with private providers, and establishment of special funds (e.g., rural electrification or telecom funds targeted to the needs of remote and poor regions). Reflecting the lessons from earlier privatization efforts,[43] there is also growing emphasis in PSD-related adjustment loans on borrower ownership, institutional development, and capacity building. A review of recent adjustment operations with PSD components suggests that there are increasing efforts during the preparation of adjustment loans to bring a wider range of stakeholders on board and to strengthen country capacity.[44] The importance of reflecting, through a more realistic and flexible design of adjustment operations, that many PSD reforms require a long implementation period is being recognized. Other lessons that are increasingly taken into account include the importance of better risk assessment, greater use of performance indicators, and cost-effective supervision.[45]

71. **IFC investments.** IFC attempts through its investments to help develop the private sector through innovative projects which demonstrate the viability of various types of investments and investment structures. By doing so, it seeks to stimulate further private sector growth as others emulate these activities. IFC investments go to a variety of sectors but some sectors dominate. At the end of FY00, IFC's total committed portfolio (including guarantees and risk management products) stood at US$13.8 billion, 4.5 percent higher than in FY99. About two-thirds of this was concentrated in three sectors: financial sector, which includes financial services and collective investment vehicles, infrastructure and manufacturing.

72. The financial sector is the fastest growing area of IFC involvement; end-FY00 commitments to this sector was about double that at end-FY96, while overall IFC commitments was only 38 percent higher. Other sectors which have grown recently include infrastructure and the social sectors. Investment in infrastructure has increased rapidly as more and more countries have opened up infrastructure sectors to private

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[41] World Bank (2001f).
[42] Recent examples of adjustment loans with such components include the Turkey Economic Reform (2000) and the Utar Pradesh Fiscal Reform and Public Sector Restructuring Credit (2000).
[43] World Bank (1996), and World Bank (2001f).
[44] As an example of complementing policy reforms with the development of complementary institutions and the adoption of related regulations, the 1998 Korea SAL I recognized that effective implementation of the competition policy agenda would require substantial institutional strengthening of the Korean Fair Trade Commission, involving enhanced policy analysis and evaluation capacity, provision of timely information to the market, and greater operational capacity and transparency.
[45] World Bank (2001f).

participation. Investment in the social sectors have grown at an annual compound rate of 23 percent during FY96-00; however this is from a small base and these sector still accounted for only 0.8 percent of IFC's commitments at the end of FY00. Sectors which have grown relatively slowly during FY96-00 are chemicals and petroleum, oil, gas and mining, and food and agribusiness. Textiles and tourism have actually declined. Manufacturing in general remains important in IFC's portfolio (17.2 percent of end-FY00 commitments) but is a declining business line.

73. IFC's latest strategy, articulated in the 2001 paper *IFC: Strategic Directions* signaled a change in its strategic focus.[46] It calls for a move towards areas with high multiplier effects, i.e., whose impact goes well beyond the capital investment. It calls for increased intervention in frontier countries (high risk/low income countries with very limited access to foreign capital and/or undeveloped domestic financial markets) and in frontier regions or sectors within other countries. Five sectors of emphasis were identified: domestic financial institutions, infrastructure, information technology and communications, SMEs and the social sectors (health and education). IFC lending patterns had started changing even before the *Strategic Directions* formally endorsed the change in strategic focus. Approvals to targeted sectors had increased significantly during the 1990s, from 46 percent in 1990 to 78 percent in 2000. Much of this increase relates to financial markets. However, during the same time, IFC's investments became increasingly concentrated in the relatively low-risk countries. The proportion of approval (by volumes) going to high-risk countries declined from 52 percent in 1990 to 28 percent in 1999 before rising to 40 percent in 2000.[47]

74. Lending priorities are changing within sectors. For example, in the financial sector, the emphasis has shifted from creating specialized financial institutions to more broad-based efforts at promoting efficient, competitive and innovative local financial markets. Credit lines are declining in importance and emphasis is shifting to providing institutional support to strengthen financial institutions. In the area of SME support, there is a shift from direct investment support to SMEs to "wholesaling" SME support through financial intermediaries.

[46] IFC (2001b).

[47] The decline until 1999 happened largely because some of the most important IFC clients, such as Argentina and Brazil, ceased to be high-risk countries during this period.

75. **MIGA guarantees.** MIGA's activities have expanded significantly in recent years. By the end of FY00, MIGA had 152 member-countries, up from 121 at the end of FY94. Sixty-nine countries, including 28 IDA-eligible countries, have benefited from MIGA guarantees by FY00 compared to 26 in FY94. By March 31, 2000, i.e., in just over ten years of its existence, MIGA had underwritten nearly 300 projects covered by over 450 individual guarantees. The number of guarantees issued per year nearly doubled from 38 in FY94 to 72 in FY99 before dropping to 53 in FY00. The value of new guarantees issued has more than tripled between FY94 and FY00, from US$372 million to US$1.6 billion. Gross exposure was US$4.4 billion at the end of FY00.

76. MIGA's guarantee portfolio has diversified over time. The share of the top 10 countries, on a net exposure basis, dropped from 73 percent in FY94 to 48 percent in FY2000. The share of the top five countries dropped from 51 percent to 33 percent over the same period. The combined share of financial, manufacturing, and mining sectors was about 62 percent in FY00, down from 87 percent in FY94. The sectoral diversification reflects the growing importance of infrastructure projects, particularly in the power and telecommunications sectors.

### 2. Non-financial activities

77. The World Bank Group is involved in a wide range of non-lending activities related to PSD issues. Historically, the most important of such activities had been advisory services (to governments, private sector institutions and firms), economic and sector work, research and training. Arbitration, standard setting and ratings have emerged as an important area in recent years. As the Bank Group increasingly recognizes the potential for synergy in working with partners, partnerships and consultations with the private sector have also become important. Another growing area of the Bank Groups' non-lending work on PSD issues is knowledge management and knowledge sharing. Some of the traditional areas of the Bank Group's work, such as advisory services, is also assuming greater importance as the Bank transforms itself into a knowledge organization. Provision of training to external clients is taking on a new character with increased focus on institutional capacity building (see Box 4 for examples of PSD-related non-financial work of the WBG).

**Box 4: Examples of World Bank Group's non-financial activities**

*Advisory services*
- SME project development facilities
- Foreign Investment Advisory Services
- MIGA's Investment Marketing Services (incl. Investment Promotion Agencies Network - IPANET)
- Privatization-related advice
- Corporate governance related advisory work

*Arbitration, standard setting and ratings*
- International Center for Settlement of Investment Disputes
- MIGA efforts in dispute resolution
- Reports on the observance of standards and codes (ROSC) initiative (e.g. Corporate governance; insolvency regimes)
- Environmental and social safeguards

*ESW and diagnostic assessments*
- Economic and sector work
- Private sector assessments
- SME country mapping exercises
- Corporate governance assessments

*Research*
- DEC research on PSD issues
- RPED program in Africa region
- Europe and Central Asia region studies on post-privatization performance
- IFC Economics Department research on PSD issues

*Training, capacity building and knowledge dissemination*
- PSD-sector board sponsored training courses
- WBI training courses
- Training provided by other departments on PSD topics
- International Training Courses for Utility Regulators

*Partnerships and consultations*
- International Forum for Utility Regulation
- Collaboration with OECD on corporate governance
- Land and Real Estate Initiative
- Business Partners for Development
- Private sector consultations

78. The World Bank Group has been involved in a wide range of partnerships with the private sector and other stakeholders on PSD-related activities (Box 5). It has also been instrumental in fostering public-private consultations in client countries and ensuring a stronger voice of the private sector in discussions on national development strategies. In addition, it has developed a tradition of consulting with a wide range of stake-holders on PSD-related issues at both the country and global levels (Box 6.).

**Box 5: Partnerships**

The Bank Group is involved in a number of partnerships that deal with PSD issues and/or involve the private sector. Typically, these partnerships have one or more of the following goals: support policy development and capacity-building, or promote corporate social responsibility.

*Policy development and capacity-building:* One of the oldest partnerships in the PSD area is the Foreign Investment Advisory Services (FIAS). A multi-donor facility, its aim is to help developing country governments improve the climate for foreign investment in their countries through a range of products, including diagnostic studies, review of the legal and regulatory framework for investment and technical assistance to put reform programs in place. The World Bank is a founding-member of the Public Private Infrastructure Advisory Facility (PPIAF), a multi-donor technical assistance facility aimed at helping developing country governments improve the quality of their infrastructure through private sector involvement. The Bank led the formation of the International Forum for Utility Regulation, an umbrella structure to support capacity-building for utility regulators, as well as the South Asian Forum for Infrastructure Regulation and the African Forum for Utility Regulation. The World Bank has collaborated with the OECD and other donors to establish the Global Corporate Governance Forum to provide a network to promote global, regional and local initiatives that aim at improving the institutional framework and practices of corporate governance. In the area of micro-finance, the World Bank played a major role in the establishment of the Consultative Group to Assist the Poorest (CGAP). A consortium of 29 bilateral and multilateral donor agencies, CGAP's mission is to improve the capacity of microfinance institutions to deliver flexible, high-quality financial services to the very poor on a sustainable basis. Most of CGAP's activities are carried out with partners such as other donors, MFIs or consulting firms. FIAS, MIGA/IMS, UNCTAD and UNIDO have established in FY2000 a joint Multi-Agency Technical Assistance Program focusing on least-developed countries. The Program coordinates advisory assistance that these four units offer to selected LDCs, through regular exchange of information on country programs. In addition, FIAS and UNCTAD provide on a regular basis feedback on their respective works, such as FIAS's Occasional Papers, and UNCTAD's Investment Policy Reviews and the World Investment Reports. The WBG has worked with UNCITRAL on a legal guide for privately-financed infrastructure projects. It also collaborates with the UN and other international financial institutions on issues related to private participation in infrastructure.

*Corporate social responsibility partnerships*: The World Bank Group is involved in a number of partnerships with the private sector, as well as other entities, whose aim is to promote environmental and social sustainability. Examples include the World Business Council for Sustainable Development (WBCSD) where the World Bank and the United Nations Environment Program (UNEP) are working with the private sector in the cement and fertilizer industries to promote good environmental management practices and guidelines and the Prototype Carbon Fund, which was established in 1999 with the objective of mitigating climate change. Another example is the Global Alliance for Workers and Communities involving the World Bank's Business Partners for Development Global Program for Youth and Development, Nike, Mattel, the MacArthur Foundation, and the International Youth Foundation. The initiative was formed in April 1999 to provide young adults involved with global manufacturing in Asia ways to improve their lives, workplace and communities.

**Box 6: Private sector consultations**

The WBG has been involved in a range of initiatives aimed at giving greater voice to the private sector in policy making. These initiatives have been taken at various levels – country, regional and global – and included the establishment of forums for private sector representatives to express their views on issues important to them and for government to obtain feedback on on-going or contemplated policy initiatives.

At the country level, several initiatives have helped in setting up or strengthening public-private consultative mechanisms. The approaches include: i) catalyzing consultations by focusing attention on critical constraints to PSD through Private Sector Assessments and other economic and sector work; ii) supporting consultation, acting as "honest broker" between business and government, and providing technical support to consultations, and iii) ensuring follow-through, by building agreed-upon actions of consultative groups into country lending programs, country dialogue, and adjustment lending conditionality. An example of the first approach is Morocco. Here, a Private Sector Assessment done in 1998 stimulated the Prime Minister to appoint a Consultative Committee on PSD to help map out a PSD strategy. An example of both the first and second approaches is Senegal. Here, a Private Sector Assessment motivated the President to create a Growth and Competitiveness Review Group in 1994 composed of representatives of employers' associations, labor unions and Government, to address major constraints to competitiveness and ensure full ownership of reforms by government and the private sector. The World Bank helped in many ways, including access to foreign expertise and best practices, teleconferences, study tours and expert visits and external financing of consulting services and selected operating costs. Finally, in several countries, the consultations generated recommendations which subsequently fed into World Bank projects. In Senegal, a Private Sector Adjustment and Competitiveness Credit incorporated recommendations from the Growth and Competitiveness Review Group. In Uganda, the Private Sector Committee contributed to the design, and monitored progress, of a World Bank competitiveness project. In Armenia, a business advisory council was created by the Prime Minister in connection with preparatory work for a World Bank structural adjustment operation.

Some of the WBG's efforts at fostering private sector consultations have been at the regional and global level. Regional initiatives include support provided to several regional enterprise networks in Africa and regular dialogue with organizations of foreign investors, such as the Corporate Council on Africa and Private Undertakings in Africa (recently re-named Private Initiative in Africa). These have been useful forums for monitoring concerns of investors, including foreign investors, and discussing their recommendations. An example of WBG-supported consultative mechanisms at the global level include the private sector advisory group for the Global Corporate Governance Forum.

In addition to consulting with the private sector and fostering public-private consultations in client countries, the WBG also consults with other stake-holders on issues relating to private sector development issues. Such consultations also take place at various levels. An example of such a consultation at the country level is a meeting held in Kampala in 1998 with Ugandan parliamentarians on issues related to privatization. Examples at the global level include a dialogue on privatization with a group of about 50 NGOs in 1997 and with more than 30 trade union representatives in 1999.

### 3. Addressing sustainability issues

79. The World Bank Group is increasingly working on harnessing the role of the private sector in promoting sustainable development. The concept of a "triple bottom line" that recognizes the financial, environmental and social aspects of business, is gaining popularity in the private sector. The Bank Group, which has moved from a do-no-harm approach to a more proactive stance on sustainable development, is trying to further this trend through a number of activities.

80. In addition to work on environmental and social safeguards (Box 7), IBRD/IDA activities include lending projects that address the environmental implications of privatization, and development of environmental guidelines on the regulatory framework for the private sector. The Bank is also engaging in a variety of partnerships with private companies promoting corporate social responsibility (Box 5).

**Box 7: Environmental and social safeguard policies of the WBG**[48]

Environmental Assessment, OP4.01

Natural Habitats, OP4.04

Pest Management, OP4.09

Forestry, OP4.36

Safety of Dams, OP4.37

International Waterways, OP7.50

Indigenous Peoples, OD4.20

Involuntary Settlement, OD4.30

Cultural Property, OP4.11

Child and Forced Labor, Policy Statement (applicable only to IFC)

81. IFC has embraced the "triple bottom line" principle. Its *Strategic Directions* Paper states that IFC will "seek to use its base of pioneering experience to influence the actions of its private sector investment partners and to create demonstration models for others to emulate".[49] IFC will continue to provide leading edge expertise in project structuring for environmental and social sustainability in IFC's direct investments, expand the scope of this influence in projects with specific environmental objectives, and share knowledge on environmentally and socially sustainable development. Examples of IFC activities in promotion of sustainability include establishment of the Renewable Energy and Energy Efficiency Fund to promote investments in environmentally friendly technologies, and the launching, in 1998, of the "Good Practice Manual: Doing Better Business through Effective Public Consultation and Disclosure".

[48] MIGA follows IFC policies on all safeguards.
[49] IFC (2001b).

# IV. LEARNING FROM THE PAST

## A. PSD Portfolio Performance in the World Bank Group

82. Recent ratings by the Bank's Quality Assurance Group (QAG) indicate that Bank projects with PSD components have tended to perform better than the average Bank project. At the end of the first quarter of 2001, about 9 percent of active Bank projects with PSD components (about 260 projects) were classified as being "at risk", compared to about 14 percent for all Bank projects. However, a QAG review of the quality at entry of 14 PSD projects found quality to be poorer than for the average Bank project.

83. A recent OED review of 76 completed IDA projects with PSD components found 86 percent of the projects to have satisfactory outcomes, 55 percent to be sustainable and 37 percent with a substantial institutional development impact – roughly the same proportions as all completed Bank projects in IDA countries.[50] The projects with business environment components had the highest rate of satisfactory outcomes while Private Participation in Infrastructure (PPI) projects were the most likely to be sustainable and had the highest rate of substantial institutional development impact.[51]

84. No comprehensive review has been done of the content, relevance and effectiveness of the Bank's ESW work on PSD issues. Country Assistance Evaluations carried out by OED have found that, while the Bank's PSD-related ESW/AAA was generally very relevant and of good quality, there are many cases of insufficient ESW which lowered the quality of the Bank's strategy and lending work.[52]

85. The majority of IFC's operations have satisfactory development and investment outcomes. An evaluation of 176 randomly-selected operations, approved during 1991-94, showed that two-thirds of the operations had a successful development outcome, and that sound financial performance of IFC projects tends to be correlated with good development outcomes. Benefits from IFC supported investments have mostly accrued to governments, customers and employees, as competition ensured that rates of returns to shareholders remained at normal levels.[53] IFC's portfolio has traditionally achieved respectable rates of return in the order of 8 percent on equity, but since the Asian crisis of 1997/8 return on equity has dropped to around 5 percent due to deteriorating portfolio quality.[54]

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[50] World Bank (2001a).

[51] Ibid. Note that the ratings pertain to the entire project; individual component are not explicitly rated. A project could have a satisfactory outcome with some components rated not satisfactory. However, a detailed examination by OED of 52 IDA projects with business environment components revealed only 5 in which any of the components had apparent outcome ratings that differed in direction (i.e., satisfactory instead of unsatisfactory or the reverse) from the rating for the project as a whole (see page 5, footnote 8, of afore-mentioned OED review).

[52] Examples of OED Country Assistance Evaluations which suggest inadequate PSD-related ESW include those for Albania and Kazakhstan.

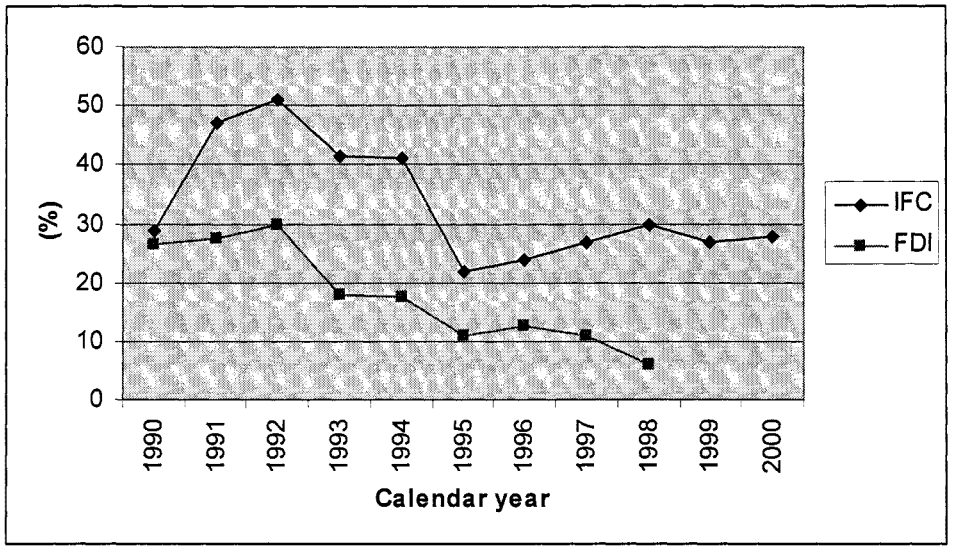
[53] IFC (2001c).

[54] IFC (2000).

86. A recent evaluation of 52 MIGA projects (accounting for 75 percent of all MIGA projects approved between FY90 and FY96) suggests that by and large MIGA interventions have achieved their intended outcomes. In particular, MIGA has been quite effective in fulfilling its primary mandate, i.e., catalyzing investment flows to the client countries.[55]

87. Overall, WBG activities have been designed to complement and support private investors rather than displacing them. For IBRD countries, World Bank loans are falling rapidly as a share of total private lending to such countries. At the same time, IFC and MIGA have helped catalyze private investment in more risky environments. During the 1990s, a higher proportion of IFC's investments have gone to high-risk countries than is the case with private FDI flows (35 percent vs. 28 percent during 1990-98). There may have been cases where the Group has lent or invested in countries or firms that might have had access to commercial markets, or had written political risk insurance that might have been provided by private insurers. However, overall, the World Bank Group appears to have supported the development of cross-border private investment and has crowded in private investment rather than crowding it out.

**Figure 14: Share of high risk countries in private FDI flows and IFC investments: 1990-2000**




Source: IFC.

[55] Gerald West and Ethel Tarazone (2001). MIGA's average "Investment-Exposure" ratio, i.e., the ratio of total investment facilitated by MIGA assistance to MIGA's own exposure in the project, is 6.73, higher than the originally expected ratio of 4.48 for these projects.

## B. Development Impact

### 1. The primacy of the investment climate

88. Several studies suggest that the development impact of PSD activities of the Bank depends on the overall quality of the investment climate. OED Country Assistance Evaluations (CAE) have looked at broader development impact rather than judging projects on whether they achieved their stated goals. The recent OED review of PSD in IDA countries concludes from several OED Country Assistance Evaluations for IDA countries that "IDA focused too narrowly on projects and did not tackle such fundamental constraints to PSD as the appropriate role of the state, financial sector reforms, institutional, legal and regulatory bottlenecks, and the policy environment".[56] Outcomes for PSD projects thus broadly reflect the general pattern for Bank projects, which tend to achieve their immediate goals but have a more moderate development impact. A similar point emerges from the analysis of SME projects. Evaluations of past SME projects reveal mediocre results, especially for those operating in a poor investment climate. Rural credit performance also suffered from poor investment climates and institutions. These findings highlight the importance of a comprehensive look at the various dimensions of the investment climate while designing PSD interventions.

89. There is evidence that PSD operations focusing on improvements in the investment climate have had very high rates of satisfactory outcomes.[57] What is, however, lacking is systematic tracking of the quality of investment climates across countries and regions. Past efforts by the WBG during the last decade such as "Private Sector Assessments" have failed to yield systematic results. Funding was driven by country program concerns, which might not value tracking of the investment climate on a regular schedule. Execution was uneven, reflecting idiosyncrasies of task managers and funding sources. Multiple, not comparable, survey methodologies were used as part of assessments of the investment climate in different parts of the WBG, for example, the FACS survey (DEC), the WBES (IFC, PSAS), the Regional Program for Enterprise Development of the Africa region (RPED) plus several other ad hoc variants of surveys or rating schemes used within the WBG, not to speak of the many other approaches followed by other agencies.[58]

90. No rigorous effort has yet been made to analyze the relationship between the Bank Group's PSD work in different countries and improvements in the countries' investment climate, partly due to the lack of detailed measures of the investment climate. Nevertheless, existing evaluations are consistent with the overall story about "aid effectiveness" investigated by the Bank. Results from the Bank's study on aid effectiveness overall show that official investment in developing countries stimulates private investment when the policy environment is sound or at least moving in the right

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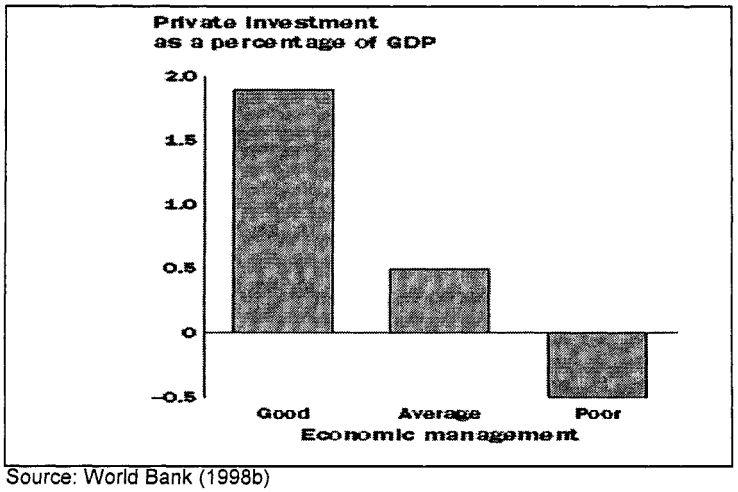
[56] World Bank (2001a).
[57] World Bank (2001a).
[58] The World Bank has developed a number of databases of indices, namely: *The World Bank's World Business Environment Survey (WBES); The World Bank's Competitiveness Indicators; and the World Bank Institute's Worldwide Governance Research Indicators Dataset.*

direction.[59] In such cases, on average, every dollar of "aid" is associated with an increase of 1.90 dollars of private investment. In cases where the policy environment is bad, private investment is reduced by 0.50 dollars for every dollar of aid.

**Figure 15: Marginal impact on private investment of a percent of GDP in aid**




Source: World Bank (1998b)

91. This means that improvements of the investment climate are paramount to achieving development impact. At the same time, as mentioned above, OED evaluations suggest that the Bank neglected reforms of the basic business environment in a number of countries. Presumably this is in part because fundamental reforms are difficult to effect due to opposition by vested interests in the countries concerned – as pointed out in the World Development Report of 2000.[60] But it also reflects a focus of efforts on direct support to firms and a neglect of reforms of the basic policy and institutional environment. Where the Bank has made a concerted effort to deal with policy development and capacity building, as in private participation for infrastructure in IDA countries, institutional development impact has been more respectable. Also, operations, undertaken particularly in the Eastern Europe and Central Asia region, to strengthen the institutional underpinnings of markets, such as land registration and titling systems, secured transaction reform for movable property and bankruptcy systems, have yielded better results.[61] Likewise, the free-standing advisory services by the Foreign Investment Advisory Service have been evaluated as effective in advancing the reform of the investment climate in a joint study by OEG/OED in 1998.[62]

### 2. Privatization into competitive sectors

92. Privatization efforts have been widespread during the 1990s, particularly in the transition economies. Reviews conducted outside the Bank of privatization results in the competitive sectors show that privatization has been a very robust policy in the sense that

[59] World Bank (1998b).
[60] World Bank (2001b).
[61] World Bank (2001a).
[62] World Bank (1998c).

private enterprises typically performed better than state-owned ones. An OED review of 1994 found very mixed performance of Bank support to privatization reflecting the nature of the surrounding policy framework, degree of government commitment to privatization and institutional constraints.[63] The recent OED review of PSD project performance in IDA countries found that privatization efforts often worked at the firm level, but were not necessarily associated with macro-economic and distributional improvements.[64]

93. Altogether, the evidence suggests that privatization in competitive sectors is basically a sound policy. However, the full promise of privatization has only been fulfilled adequately when a basic policy framework was in place that allowed entry of new firms and imposed hard budget constraints on privatized firms. Weak corporate governance systems have allowed controlling managers or owners to expropriate minority-shareholders, but have not prevented the formation of effective shareholder control. Whether the new concentrated ownership led to effective and beneficial firm restructuring has been critically dependent on the existence of hard budget constraints. In particular, where banks accommodated inefficient privatized firms – as to some degree in the Czech Republic – such soft budget constraints rather than the weak corporate governance system has undermined efficient restructuring and worsened income distribution.

94. The establishment of a sound competitive policy framework requires political commitment. Equally, government capacity is needed to carry out complex privatizations, which call for detailed attention to managing the social consequences of privatization, such as labor redundancies, in cases where overstaffing is prevalent.

### 3. Direct support to firms

95. The direct support of private firms with credit and advice has not only been ineffective when the investment climate was weak, but also when the design of operations was flawed. The financial support to larger private firms, SMEs, micro-finance schemes and rural borrowers has typically resulted in mediocre outcomes, when based on credit with subsidized interest rates. Incentives to divert such subsidized credit to powerful parties or to support substandard projects have reduced effectiveness. [65] Sustainability is also problematic when firms or intermediaries remain dependent on subsidies.

96. Where control groups have been used to assess whether direct support to firms by development institutions has been effective, two results appear to dominate. Subsidized credit does not lead to superior firm-level performance and the provision of finance in weak investment climates is ineffective.[66] In part, the latter result is reflected in the fact, that even ostensibly un-subsidized credit in economies with weak financial systems ends

[63] World Bank (1994b).
[64] World Bank (2001a).
[65] Batra and Mahmood (2001).
[66] Caprio and Demirguç-Kunt (1998).

up as non-performing assets in banking systems, where borrowers are well-connected and de facto do not pay back their full obligations.

97. The recent strategy paper on SMEs reflects the lessons of experience as do various analyses of rural credit and the best practice recommendations for micro-finance.[67] Credit operations for private firms should be un-subsidized. This requires sufficient flexibility in interest rate policy, in particular the revision of usury laws that hamper the development of micro-finance operations. As laid down in current Bank policies (OP 8.30), on-lending operations should focus on policy development, institution- and capacity-building. Institution- or capacity-building may or may not require provision of credit to firms or intermediaries. Free-standing capacity-building assistance for intermediaries, possibly accompanied by performance-based grants as in the case of micro-finance may be the appropriate approach (Box 8). In the case of IFC, evaluations of direct financing of SMEs suggest that such financing is costly and ineffective in meeting the needs of the clients.[68] IFC has thus recently changed its strategy for supporting SMEs. There is, for example, a shift to "wholesaling" SME support through financial intermediaries, moving away from direct investment support to SMEs. The results of this shift in strategy have not yet been evaluated.

**Box 8: CGAP's performance-based investments**

CGAP is a consortium of 29 bilateral and multilateral donors who support microfinance. With a team of microfinance specialists housed in the World Bank, CGAP serves the microfinance industry, donors and microfinance institutions (MFIs) through the three categories of services provided: technical tools and services, training and capacity building, and technical advice and exchange. CGAP also has a small grant facility that provides funding for these activities and for strategic investments in MFIs. A large part of CGAP's mission is to promote "best practice," especially in the way donors support MFIs. Using its grant fund, CGAP has developed an investment-style approach to grant-making that ties tranched funding to institutional performance. The key focus is on the achievement of financial performance measures that will enable the MFI to reach sustainability and thus significant numbers of poor clients.

The performance contract that accompanies CGAP's equity-like funding leaves the use of funds entirely at the discretion of management; reporting, monitoring, and continuation of disbursements are tied to the MFI's fulfillment of performance thresholds at the institutional level. These thresholds are designed to lead the microfinance institution to "full financial sustainability", the ability to cover all costs including the commercial cost of funds. They generally step up over time and include indicators such as profitability, efficiency (cost per dollar lent), portfolio quality, and growth (numbers of clients

[67] World Bank (2000b).
[68] Webster et al. (1996).

reached). Because most of a microfinance institution's funding is usually soft, achievement of full financial sustainability implies that it will generate substantial surpluses that will be retained to fund yet more services to poor clients.

CGAP's investment in Compartamos in Mexico illustrates the effect of such leverage. Compartamos works with very poor women in Mexico's most destitute regions. Its early funding consisted mainly of two large grants, US$1 million from a private Mexican banker and US$2 million from CGAP. Six years later, its client base has multiplied five-fold. More than half of its portfolio of 65,000 borrowers is funded, not by grants, but by retained surpluses that it has generated over the period. Now the NGO has invested in a new licensed finance company which will expand the same business. About half of the investment in this finance company came from commercial sources. Under prudential norms, it can leverage the capital of its investors up to five times by selling bonds to the public. Thus, each dollar that CGAP put into Compartamos in 1995 now translates into as much as twenty dollars of microloan service to poor clients. Looked at from this perspective, it becomes clear that it was not important how Compartamos spent CGAP's money (as long as it was legal). Rather, what made this investment successful was that they kept loan repayment at very high levels and stayed on track to financial sustainability, without abandoning their social mission. Thus, CGAP made continued disbursements contingent on their maintaining a specified delinquency rate and a specified improvement in their adjusted return on assets as they grew.

98. Direct advisory services to SMEs and farmers have also been plagued by problems. Publicly provided advice has often been of low quality and not responsive to demand. In other cases, advice has been more competent, but expensive and available only to a few clients. For example, projects supported by IFC's project development facilities are heavily subsidized and reach a very small number of relatively larger firms. The cost effectiveness of these interventions remains unclear and has not been rigorously evaluated. The emerging consensus of the community of practitioners has been expressed in recent guidelines for small enterprise development by the Committee of Donor Agencies.[69] Essentially, advisory support of all types should be linked better to demand and rely on market-based delivery systems as well. The WBG's new SME strategy will drive this process further through new approaches, policies and instruments.[70] The work of the project development facilities is being re-oriented in order to increase their outreach, improve cost recovery and broaden their impact. These facilities will increasingly focus on capacity- and institution-building, and in providing inputs to programs aimed at improving the investment climate. These activities may be more appropriate for targeted subsidies than the traditional work of these facilities.

99. In some cases, one way to provide financial support for such advisory services may be partially to subsidize small firms and farmers with demand-side subsidies such as vouchers or matching grants to enhance their demand for advice in a way consistent with their own preferences. Generally, matching grant schemes risk funding expenditures that firms would have made anyway. Hence, they should only be considered when clear market failures suggest that firms are likely to under-utilize or under-provide particular

[69] ILO (2001).
[70] World Bank (2000b).

services, for example staff training in cases where the main benefits from training cannot be captured by the firm. A few evaluations of such matching grant schemes exist and show results broadly consistent with this reasoning. A successful program exists in Mexico[71] supporting training by small firms, but in other cases evaluations are less favorable, e.g., for a matching grant scheme in Mauritius.[72]

### 4. Private participation in infrastructure

100. Private participation in infrastructure (PPI) schemes have been introduced in over 150 countries during the 1990s – often driven by fiscal constraints and efforts to improve efficiency. Yet, compared to privatization in competitive sectors, like manufacture or agriculture, the introduction of private participation in infrastructure has been less easy to manage and presents more risks.

101. In a number of cases, governments pursued private infrastructure ventures to avoid extra fiscal burdens. A case in point are several independent power projects. At the time of reform, typically user fees to retail consumers were not at levels that were sufficient to cover all costs including the cost of capital of investors. Governments were often politically not willing or able to introduce cost-covering retail tariffs. Hence, private investors asked for government payment guarantees and, eventually, taxpayers had to pay anyway. Such schemes amounted to a large degree to expensive off-balance sheet borrowing by governments. The Asian crisis of 1997/98 revealed the underlying weaknesses of many projects.[73]

102. This experience demonstrates the importance of sound policy reform before introducing private participation in infrastructure. As in the case of privatization in competitive sectors, the establishment of a competitive market structure appears to be the best way to obtain efficiency benefits from privatization. In telecommunications, power generation, natural gas production and road-based transport existing studies carried out outside the Bank show that there are ways of introducing effective competition that generate net efficiency benefits, including in developing countries.[74] Yet, the recent examples of Brazil and California also demonstrate that a consistent overall reform package is required. In both cases, retail tariffs were not allowed to adjust to market forces. In California, wholesale markets were rendered excessively volatile and subject to strategic manipulation due to market design.[75] In Brazil, wholesale markets were not allowed to function.

103. Large parts of infrastructure are natural monopolies, for example, water pipeline systems or power distribution systems. Competition in the market is then not feasible. To some degree, competition for the market can be introduced by letting private parties

[71] Tan (2001).
[72] Biggs (1999).
[73] Klein (1999).
[74] Gray (2001)
[75] World Bank (2001g).

bid for the right to deliver service. Existing studies suggest that such schemes can yield significant benefits. In part, the benefits have obtained, because privatization meant that private firms could retain earnings and expand and improve service, where governments had previously been tempted to starve state-owned enterprises of cash.[76] In part, the benefits are due to shifting performance risk to private shareholders. Cost savings in well-managed schemes tend to range from 5 to 30 percent.[77]

104. Effective approaches require sound contracts, regulatory rules and regulatory capacity. Full privatization may not always be the right approach, but a variety of concession-type arrangements may be appropriate. OED reviews of PPI schemes also emphasize the need to pay special attention to sector reform, institution- and capacity-building. At the same time contracting and process management skills in government need to be developed to deal with complex contracting or privatization processes and the attendant restructuring processes. Where government capability is weak, contracting and regulatory skills can be out-sourced to some degree. However, in some cases governments may not be able to set up the institutions and develop the skills to regulate private providers well. In these situations governments face a dilemma. The regulatory functions need to be fulfilled whether providers are in the public or private sector. In such situations the real alternative is not between public and private provision, but between regulated or unregulated provision. Case by case decisions are required taking into account sectoral characteristics and the balance between likely market or government failure.

105. Within the Bank, efforts to improve regulatory regimes have so far translated into relatively positive operational results. OED has rated PPI projects as most likely to be sustainable and as having the highest rate of institutional development among PSD interventions.[78]

### 5. Private participation in social sectors

106. OED reviews of health and education projects and programs have noted the large role that private service provision de facto plays in many developing countries. The reasons are that public delivery systems in several countries do not extend to poor citizens and even if they do that in some countries, poor people frequently bypass public facilities to seek private care.[79] The evaluations also point out that "an input-oriented approach [for health, nutrition and population (HNP)] does not achieve the institutional, management, and systemic changes needed to sustain impact over the long run".[80] For education projects OED also finds that "soft" components (teaching-learning, curriculum development, staff development) are difficult to design and implement.[81]

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[76] Galal (1994).
[77] Gray (2001).
[78] World Bank (2001a).
[79] World Bank (1999c).
[80] World Bank (1997).
[81] World Bank (1999a).

107. An OED review in the mid-90s found that an increasing number of projects examined non-governmental roles. Yet, none of 68 completed HNP projects included financing for privately-owned facilities or activities.[82] The IFC has since set up a department for social sector investments. Both the recent health and education sector strategies of the World Bank have called for greater attention to tapping private initiative for the delivery of social services, as does the recent IDA PSD review carried out by OED.

108. A research study that evaluated a Bank-supported voucher program for secondary education in Colombia found that the program successfully increased attendance of pupils from poor neighborhoods in private secondary schools.[83] Bank research and other studies suggest that private provision in health and education can be beneficial.[84] At the same time, contracting and regulatory challenges are clear and require emphasis on institution- and capacity-building in client countries. The challenge for the World Bank Group is thus to engage with options for private participation and to help build the policy and institutional environment that will render them successful.

## V. GOING FORWARD – THE PSD PROGRAM

109. This PSD strategy builds on existing strategy documents of IBRD/IDA, IFC and MIGA.[85] It sketches the wide range of WBG interventions in support of PSD, which are more fully discussed in the background papers to the strategy and a series of recent toolkits (Annex IV). The program, however, does not present multi-year budget and project proposals for the WBG as a whole or for parts thereof. This will be implemented through IFC and MIGA strategy papers as well as IBRD/IDA sector strategy papers on traditional sectors, such as transport or rural development. The strategy does, however, set out time-bound next steps to pursue the various proposals including the translation of the strategic directions for PSD in regional implementation programs.

110. The strategy recognizes that PSD is not a sector, but a cross-cutting issue. It is about "a way of doing things" that can have relevance for any sector such as energy or agriculture. And the pursuit of private sector development is not a goal but a means to do things better. PSD issues also relate closely to issues such as financial sector development, labor markets, the global trading and investment regime and policies governing social and environmental sustainability. The PSD strategy and its program are consistent with recent strategies in all these areas, namely the "Strategy for the Financial Sector", the "Social Protection Strategy: From Safety Net to Springboard", and the Bank's environment strategy "Making Sustainable Commitments: An Environment Strategy for the World Bank" as well as the Social and the Rural Development Strategies currently under preparation. The strategy thus fits into the web of strategy papers guiding WBG operations. A review of fifteen existing sector strategy papers of the World Bank

[82] World Bank (1997).
[83] Angrist et al. (2001).
[84] Cangarajah and Ye (2001); Filmer et al. (1997); Hoxby (2000); Lockheed and Jimenez (1994).
[85] World Bank (1999b); IFC (2001b); MIGA (2000).

(listed in Annex III) shows that the current PSD strategy is consistent with those sector strategies, which include those on health and education.[86]

111. The strategy also proposes new approaches for deploying instruments of the WBG in ways that better complement private initiative and help improve the division of labor within the WBG. The strategy also proposes new or stronger disciplines on the WBG. To improve decision-making on programmatic assistance and capacity-building, it is proposed to conduct systematic assessments of the investment climate across countries and over time. For project finance activities, market-type disciplines on the WBG are proposed of a type that the WBG has been recommending to client countries for some time. The proposals are based on arguments about the World Bank Group's comparative advantages. Central to the new proposals are measures to shift performance risk further from domestic taxpayers in developing countries to private parties, where these parties, be they small or large for-profit or not-for-profit organizations, appear better able to bear or manage risk. At the same time, the proposed measures would facilitate the transparent targeting of subsidies currently embedded in WBG products to intended beneficiaries or purposes. The proposed new measures include:

- Systematic surveys of the investment climate;
- Output-based aid; and
- "Commercial disciplines" on direct support to the private sector.

112. The new measures would enhance selectivity by subjecting project decisions by the WBG to stronger market-type tests and by rendering the allocation of financial flows and subsidies more transparent.

113. The key proposals have been discussed with a range of stakeholders, including governments, multilateral agencies, private firms, trade unions and non-governmental organizations. A companion paper describes the extensive external and internal feedback on the key proposals in the proposed strategy, which were made public in a discussion paper dated June 1, following Board discussion on May 23, 2001.[87]

## A. Extending The Reach of Markets

114. The fundamental thrust of the PSD strategy is to bring the benefits of markets to help poor people. This requires a comprehensive approach. It involves policy development and institution- and capacity-building for the public sector to foster a sound investment climate. It also means supporting the development of entrepreneurs through direct financial assistance and capacity-building.

[86] A background paper summarizing what various WBG sector strategies say about PSD was submitted to the Executive Directors of the World Bank Group in May 2001: World Bank (2001h).
[87] World Bank (2001i).

### 1. Fostering a sound investment climate

115. The centrality of work on a sound investment climate has been clearly established. Going forward, additional emphasis is to be given to the topic in line with lessons learned. 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. The recent strategy papers on "Reforming Public Institutions and Strengthening Governance" and the "Strategy for the Financial Sector" set out approaches that are part and parcel of the investment climate agenda.[88] This basic approach needs to imbue work on both urban and rural areas. The next update of the rural sector strategy would translate the basic approach for rural areas.

116. 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. This task, in particular land titling schemes, can be very complex. The World Bank Group is involved in a wide range of work in the area of property rights that seek to establish or strengthen formal and informal institutions which define property rights and facilitate contracting and enforcement. Specific activities include cadastre mapping in urban and rural areas, strengthening of cadastre institutions, establishing or streamlining asset registration systems, strengthening registry offices, modernizing title registry record management, and development of valuation capabilities. Operations in the ECA region on registration and titling and in Peru on streamlined property rights registration for urban dwellers with unclear property rights provide examples to follow. A recent activity in the agricultural sector is market-assisted land reform. This has the potential for improving the rural poor's access to land without the political resistance of other approaches to redistributing land. The WBG has also developed the "Land and Real Estate Assessment (LARA)" tool for diagnosing land and real estate markets. The WBG's work in helping to strengthen property rights is likely to grow in the future and will involve a greater focus on the differential access of women to such rights.

117. Privatization operations should be continued for competitive sectors, such as agriculture, manufacturing or mining and focus on the establishment of a surrounding policy framework that allows effective entry and establishes hard budget constraints. Environmental issues should be tackled pro-actively when privatization and deregulation processes are designed and implemented.

118. An effective legal system is not only intrinsically valuable but also a critical dimension of a sound investment climate. It promotes development by protecting persons and their property, allowing peaceful resolution of disputes, facilitating economic exchange, and letting citizens hold their government accountable. The WBG is involved in a wide range of work in helping countries carry out legal and judicial reform, including

[88] World Bank (2000a); World Bank (2001j).

assistance to amend a country's law to improve the business environment and improve investment, harmonize law for internal consistency, or adapt law to contemporary conditions. The WBG also helps with strengthening existing legal institutions by rehabilitating or building court buildings, training judges or funding the publication of judicial decisions. These activities will continue.

119. To design an appropriate assistance strategy, an assessment of the investment climate in a country is required that captures key factors driving growth and hence poverty reduction. The precise approach to reform of the investment climate will vary from country to country. Consultative country-driven processes such as PRSP and CDF should routinely cover the investment climate and elicit views from the private sector. Recent work on best practice for private sector consultation should be followed (Box 9).[89] Beyond one-off consultations, sustained efforts are currently underway for consultation with the private sector, for example in Africa. In consulting with the private sector care should be taken to elicit views from a spectrum of opinions including smaller entrepreneurs and preferably from companies that explored entry options, but did not pursue them.

**Box 9: Good practices in consultative mechanisms**

*Cross-country experience with public-private consultative mechanisms suggest that a number of pre-requisites need to be satisfied in order to have effective consultative mechanisms:*

- *There should be political will to engage in serious consultations. However, consultative mechanisms can help build political will;*
- *Consultative mechanism participants should be able to make credible commitments;*
- *Reform objectives should be well defined and specific;*
- *Internal processes and procedures should be transparent and participatory;*
- *There should be an independent and adequately financed secretariat;*
- *Consultative mechanism membership should be authoritative and representative;*
- *There should be follow-up procedures for monitoring agreements; and*
- *Consultative mechanism objectives and activities should fit with what is achievable in a given economic, political and social context.*

Source: Biddle and Stone (2001).

120. Complementing the consultation process and to help operations focus on priority issues, it is proposed to conduct systematic firm-level investment climate surveys that feed into the assessments of policy implications. The surveys 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

[89] See also Section A.4 in Annex IV.

female entrepreneurs. This will help focus attention to the problems specific to particular groups, such as lesser access of women to credit and property rights. Issues related to the informal sector and the rural sector, both major sources of income for poor people, will also be addressed. The work on the investment climate will thus build upon the WBG's recently approved strategies on gender issues and SMEs, the up-coming update to the rural development strategy, and WBG's work on micro-finance and urban development.

121. The surveys will be conducted with the help of local institutions and would thus contribute to capacity-building. There will be close collaboration with governments as well as other donor agencies and existing work by them will be drawn upon to define the scope of the surveys and to complement the survey findings. Efforts will also be made to engage local think-tanks, universities, consulting firms, private foundations and private sector collective bodies, such as chambers of commerce and industry. Involvement of private sector collective bodies in the surveys and assessments is likely to add considerable value to the process as well as enhance the private sector's ownership of subsequent policy and institutional reforms.

122. The WBG, working primarily through the WBI, will help build capacity in client countries to carry out investment climate surveys and assessments. WBG's knowledge management efforts will include the dissemination of good practices in survey methodology and assessment tools, and findings from the work on investment climate in various countries.

123. 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.[90]

[90] See Section A.1 in Annex IV.

**Box 10: Existing efforts to analyze the investment climate**

In an increasing number of countries, efforts are underway to collect and analyze firm-level data that would allow more effective investment climate assessments. New insights about the process of economic growth and the development of markets and firms have started to be generated from such data sets during the 1990s, starting in OECD countries and a few developing countries.[91] In a way, there is now an incipient movement to establish micro-economic level statistics and assessments to understand growth processes just as macro-economic statistics were developed after World War II to assess issues of overall economic stability. This is also reflected in private sector efforts to design indicators of the investment climate, which are, however, as yet incomplete and judgmental.[92]

124. Investment climate surveys 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 development policy reviews and programs supported by WBI. The surveys and assessments should not be seen as merely an addition to the battery of ESW but as a critical source of information to feed into other ESW. Analytic work on the investment climate should thus be carefully programed in the context of the overall ESW program for a country. Investment climate considerations will be a critical element of the comprehensive analysis underpinning CASs, and given heightened attention in WBG support to, and assessment of, CDF exercises and PRSPs. In-country stake-holders preparing PRSPs may also make use of the results of the investment climate surveys and assessments.

125. Building on these assessments, it is expected that 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. A significant part of the WBG's existing work on policy reforms, such as that on privatization, competition policy, de-regulation and strengthening of property rights, will help improve the

[91] See Caves (1998) for a survey of databases on turnover and mobility of firms in a selection of OECD and developing countries. Iqbal and Urata (2001) have put together a collection of papers that examine the evolution of small and medium enterprises in East Asia. The Africa Regional Program on Enterprise Development (RPED) consists of several components: i) collection and analysis of enterprise survey data; ii) in-depth case studies focusing on finance, technological capability and business strategy; and iii) cross-country studies of issues related to firm dynamics. A complete list of RPED studies is available at http://afr/aft2/pvtsect/RPED/listof.htm.

[92] See A.T. Kearney, *FDI Confidence Index 2001*; A.T. Kearney, *Globalization Index 2001*; The Economist Intelligence Unit (EIU); *Euromoney*, "Country Risk Rankings"; The Fraser Institute, *Index of Economic Freedom*; Freedom House, *Country Ratings*; The Global Economic Forum, *The Africa Competitiveness Report 2000*; The Global Economic Forum, *The Global Competitiveness Report 2000*; The Global Economic Forum, *The Environmental Sustainability Index 2000*; The Heritage Foundation, *Index of Economic Freedom 2001*; The International Institute for Management Development (IMD), *World Competitiveness Yearbook 2001*; *Institutional Investor*, "Country Credit Surveys"; Moody's *Sovereign Ratings List*; The PRS Group, *International Country Risk Guide*; PriceWaterhouse Cooper, *Opacity Index*; Standard and Poor's *Sovereign Ratings List*; Transparency International, *Corruptions Perception Index 2001*; UNDP, *Human Development Report*; The Tuck School of Business, *Emerging Market Access Index*.

investment climate in client countries. The Bank and the IFC's emerging corporate governance program would also feed into the overall reform of the investment climate (Box 11). It is expected that future operations in these areas, drawing upon findings of analytic work on the investment climate, will have a greater focus on the impact of reforms on poor people.

126. 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 and MIGA's Investment Marketing Services.[93] IFC's project development facilities, for example, provide technical assistance to banks, training to SME managers and providers of business development services, and help strengthen business associations. Many of these activities are carried out in collaboration with partner organizations. IFC's SME Capacity Building Facility, launched in July 2000, funds pilot projects implemented by external partners.

**Box 11: Corporate governance**

The activities of the Bank in corporate governance focus on the rights of shareholders, the equitable treatment of shareholders, the treatment of stakeholders, disclosure and transparency and the duties of board members. The bank assists its client countries in the assessment of their corporate governance institutional frameworks and practices through the preparation of country assessments using the OECD Principles of corporate governance as benchmark. To date, ten assessments have been completed including Brazil, India, Turkey, Poland and the Philippines. Ten countries are in the pipeline for FY02 including South Africa, Morocco, the Czech Republic and Korea. The assessments have been carried out within the framework of the joint Bank-Fund initiatives on the *Financial Sector Assessment Program* (FSAP) and the *Reports on the Observance of Standards and Codes* (ROSCs).[94] The assessments have a number of operational applications. The assessments underpin policy dialogue and strategic work (input into CAS in Egypt) and programmatic operations (Brazil, Croatia), and provide input to technical assistance and capacity building efforts. Such operations include the setting up of institutes of directors in the MENA region and in Sub Saharan Africa. In addition, the Bank entered into a partnership with the OECD to organize Regional Roundtables on corporate governance to disseminate best practice and increase the ownership of reform in developing countries and transition economies. Finally, the Bank has launched the Global Corporate Governance Forum, a multi donors Trust Fund to disseminate best practice, foster academic research and provide co-financing for follow up operations to diagnostic work.

127. WBG management has established a new joint investment climate unit of the Development Research Department and the Private Sector Advisory Services Department (PSAS) 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. The core survey instrument has been prepared. Such surveys would be equally valuable for other development institutions and could help improve donor co-ordination at the country level.

[93] See Sections A.2 and A.5 in Annex IV.
[94] See Section A.6 in Annex IV.

128. A balance will have to be struck between a manageable core set of issues to be addressed in all surveys and a broader set of issues reflecting institutional priorities and specificities of country situations. The effort is to be coordinated with other development institutions and among relevant groups in the WBG, including the regional PSD units, SME, FIAS, MIGA, PREM, FSE, IFC, LEG and WBI. To anchor this type of donor co-ordination and to provide a regular funding base for a sustained systematic survey effort, a new multi-donor funding scheme could be developed. This would harmonize and leverage existing funding schemes for survey efforts, limit duplication and contribute to the dissemination of information and analysis collected in this way.

*Management intends to pursue the following work program to institute a minimum standard system for surveying the investment climate.*

- *Workshop with interested development institutions to discuss common operational and funding approach by Fall 2002.*
- *Starting in FY03, results of investment climate surveys to be integrated into core due diligence products such as CEMs and to inform the development of CASs.*

### 2. Direct support for private firms

129. Lessons from past operations suggest that, in particular, subsidized financing terms have often not promoted productive investment and operations. Likewise, business development services that do not make use of market-based approaches have typically failed to be cost-effective. The new SME strategy of the WBG recognizes this and is to promote unsubsidized financial operations as well as market-based approaches to business development services. Evaluation results of IFC operations by OEG also suggest that projects with sound developmental impact tend to be financially sound as well.[95] In the context of providing direct support to private firms, poverty alleviation would best be pursued by providing well-targeted, time-bound subsidies that help create effective access to credit, via institution- and capacity-building, while allowing financial terms, including interest rates, at market terms. This approach has become best practice for micro-finance operations and helps develop access to credit while reducing incentives to abuse subsidized credit for well-connected parties (Box 8).

130. **Lending to private firms by IBRD/IDA.** Currently, both the IBRD/IDA and IFC finance private firms. The IBRD and IDA finance firms backed by government guarantees, whereas the IFC takes the credit risk of its decisions. IBRD/IDA funding of private firms, typically via on-lending through intermediaries, have over the 1990s lost importance as a result of disappointing performance. Yet, still some US$0.5-0.7 billion per year are on-lent to the private sector, the bulk of it for rural credit schemes and lending to small and medium-sized firms. In practice, most of these operations escape the disciplines of OP 8.30 on financial intermediary lending. OP 8.30 requires that on-

[95] IFC (2001c).

lending occurs at or near market rates and that operations are aimed at improving policies in the financial sector and institutional development of intermediaries. IBRD/IDA on-lending can sometimes play a useful role in country dialogue and policy reform.

131. **In order to improve their performance with respect to the past, it is proposed to** clarify and closely monitor the implementation of OP 8.30 in order to ensure that all such future operations are under the discipline of OP 8.30, including on-lending operations for rural and social investment funds. The Vice President of the Financial Sector Network would decide upon the application of OP 8.30, involving IFC in the process. For all such operations, IFC would have first right of refusal, such that on-lending is preferably conducted without exposing domestic taxpayers in client countries to the credit risk of private firms. This would not preclude the IBRD or IDA from carrying out such operations, if IFC were to decide not to do so. (As on-lending occurs at or near market rates, the subsidy element contained in IBRD or IDA funds is de facto unbundled and typically passed to government.) The Vice President of the Financial Sector Network would lead a clarification and revision of OP 8.30 for approval by the Executive Directors by the Summer of 2002.

*The FSE Sector Board would draft appropriate amendments to OP 8.30 for approval by the Executive Directors by the Summer of 2002 and monitor its implementation.*

132. **Lending to private firms by IFC.** IFC benefits from non-payment for the opportunity cost of capital and tax privileges. To this degree it is subsidized. Based on the empirical evidence that suggests subsidized finance is often not developmental, it is proposed explicitly to unbundle subsidies from IFC financial products that support private firms and to allocate such subsidies more transparently to purposes that merit being supported with subsidies.

133. The particular scheme proposed for IFC distinguishes between the portfolio of "commercial" operations, on which the Corporation should on average earn the risk-adjusted weighted average cost of capital that is appropriate for IFC (Box 12), and the portfolio of activities that deserve to be subsidized. An example of an activity worth subsidizing is the work on leasing laws that tends to be pursued in conjunction with IFC financing for leasing operations in client countries.

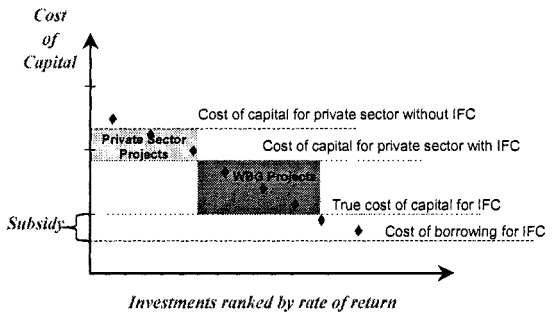
**Box 12: IFC's role and its cost of capital**

Development institutions such as the IFC have special relationships with governments. This allows them to reduce political risks (mainly expropriation risks including currency transfer and breach of contract) associated with investing in a country – given a particular policy environment. Private co-financiers benefit from such risk mitigation ability of development institutions.

IFC may also help improve the policy environment itself. The government may be willing to adjust policies, when the IFC is involved as an investor in a particular project. In this case policy reform can be shown to translate immediately into additional investments. The government can use this approach to enhance the credibility of its policy announcements. Such projects are typically called demonstration projects. In sum IFC helps rendering good projects possible by reducing political risk. The IFC is able to reduce the political risk thanks to its special relationship. In other words it has a lower risk-adjusted cost of capital than private firms that cannot reduce such risks. But this is not an argument to say that the IFC should earn less than its risk-adjusted cost of capital.

Figure 16 shows in simplified fashion the impact of an IFC-type organization. Without IFC the private sector would face a high risk-adjusted cost of capital. In the figure only one project by private investors would happen, where the rate of return exceeds the cost of capital. When IFC improves the investment climate, the risk adjusted rate of return of the private sector drops and private investors can carry out more projects by themselves. Yet, there are also some special demonstration projects, where IFC can still reduce the cost of capital below that of the private sector and these could then be supported by IFC without crowding out the private sector. However, IFC should earn its risk-adjusted cost of capital on the portfolio of commercial projects.

**Figure 16: The cost of capital and the role of direct financial support to private firms by the IFC**




134. For the aggregate commercial portfolio of IFC it is proposed to set a minimum target rate of return that covers the actual cost of debt and the opportunity cost of equity capital for the IFC, i.e., the full risk-adjusted weighted average cost of capital. As the return on equity is not distributed to shareholders, it would then be available explicitly to subsidize purposes that deserve subsidies, such as institution-building, capacity-building and support for special environmental and social standards, for which there is no "business case". The proposed scheme would also allow IFC to focus its subsidies on

appropriate activities in low-income countries, while it continues to play its risk-mitigation role in middle income countries. The overall minimum return target would allow the Executive Directors to benchmark IFC's portfolio performance, just as aggregate rate-of-return targets for private companies. Internally, IFC would need to cascade down the target to individual departments and operations taking into account market conditions.[96] In doing so, IFC should ensure that the added value it brings to private investors is fully priced into its products. In sum, the proposed rate-of-return discipline would render decisions more transparent and, in this sense, constitute a more principled application of existing policies rather than a fundamental new departure.

135. Earning a profit equal to the full weighted average cost of capital would be fully consistent with – indeed, it is an important part of – the developmental mandate of IFC for its loan and equity investments. For such projects, IFC provides political risk comfort to investors, takes special risks that others cannot handle such as extending maturities in emerging markets and play trailblazer with its demonstration projects. In all these cases, IFC would help realize good projects that the private sector by itself might not have undertaken. The portfolio of these projects should return their full cost of capital, because there is no special argument for subsidy involved.

136. **IFC would thus operate under three basic disciplines. As in the past, it would** continue to avoid crowding out the private sector and to seek additionality in its projects (e.g. positive economic rate of return, compliance with social and environmental safeguards as well as minimum corporate governance standards). In addition, it would need to earn at least the full risk-adjusted cost of capital on its portfolio of commercial operations. The latter discipline would prevent the pursuit of substandard projects, and would address the charge made by some critics that the IFC is interested in enhancing corporate welfare rather than the reduction of poverty in member countries.

137. **None of this would change the overall financial resources at the disposal** of IFC, but it would force more disciplined choice of projects and more clearly justified allocation of subsidies.

*IFC management intends to pursue the establishment of practices that would effectively unbundle the subsidy embedded in its products. This may involve*

- *accounting separation between commercial and subsidized operations of IFC;*
- *a specific target return for IFC commercial operations ;*
- *a decision-making mechanism to justify and allocate subsidies; and*
- *a timetable to phase in the new disciplines.*

[96] Commercial discipline exists in IFC's operations today in a number of forms, including minimum financial and economic rates of return for projects, which would remain, and would be adjusted in light of the aggregate corporate profitability objective.

*IFC would report on progress and implications for the Corporation's business program (end 2002).*

*IFC management intends to continue to engage other IFIs on harmonizing disclosure rules and safeguard policies and discussions regarding expected rates of returns.*

## B. Improving Basic Service Delivery

### 1. Private participation in infrastructure

138. **Private participation in infrastructure (telecommunications, energy, transport,** water and sanitation) holds promise to improve service delivery. Even more so than in sectors like agriculture or manufacturing key efforts of the World Bank Group need to focus on establishing adequate market structures and regulatory regimes that are able to channel private initiative in socially useful directions. The lessons of experience point to the importance of effective competition (either "in the market" or "for the market") the need for sound contracts and regulatory arrangements, and the need to shift performance risk to private shareholders. This also implies that government guarantees should only be issued or supported where they support such risk shifting and do not expose taxpayers to undue risk.[97] This basic principle should, in particular, guide the use of IDA guarantees.

139. **Development of regulatory regimes for infrastructure.** The development of sound regulatory systems, comprising rules, agencies and processes, is critical to effective and sustainable delivery of infrastructure services, and to successful private participation in infrastructure (PPI). Regulatory regimes need to strike a balance between the interests of consumers and investors in a fair, transparent and sustainable way, while providing incentives for efficiency. To support the investment required to expand and improve infrastructure services, regimes need to be credible to investors while being accepted as legitimate by the population. Experience shows that regulatory regimes that meet these tests cannot be transplanted uncritically from one country to another, and often require significant customization to take account of local priorities and institutional conditions. Moreover, newly established regulatory agencies often require significant support as they pioneer new and challenging roles in complex sectors.

140. **So far, the WBG has undertaken a range of activities to help client countries** develop effective regulatory regimes. A body of analytical work, including toolkits, has helped to distill lessons of experience and notions of best practice in designing effective regimes, particularly measures to bring benefits to poor people.[98] Training and capacity building programs have been developed that have been attended by regulators from most client countries (Box 13). Operationally, policy-based lending and project lending support the development of regulatory regimes in client countries.

[97] Relevant principles and practices for government guarantees are discussed in Irwin et al. (1997).
[98] See section C of Annex IV.

**Box 13: Regulatory capacity building**

Beginning in the early 1990s, governments worldwide began embracing a new model for delivering infrastructure services which involved improving the government's capabilities as a regulator of services that were delivered primarily by private firms. As part of this process, nearly 200 autonomous regulatory agencies for infrastructure have been established in developing and transition economies.

The Bank has complemented its advisory activities on the design of regulatory systems with support to capacity-building efforts for new regulators. In addition to assistance provided at the country-level as part of its lending activities, the Bank has pioneered a number of broader capacity-building programs in this area.

In 1996, the Bank established the International Forum for Utility Regulation (IFUR) as an umbrella structure for learning and networking initiatives for regulators. The first major initiative was a two-week training program, developed in partnership with the University of Florida, focusing on the needs of regulators in water, electricity, gas, and telecommunications. Since 1997, this twice-yearly program has been attended by over 900 regulators from 115 countries. A complementary program aimed at the specific needs of transport regulators was launched by WBI in 1998, and has since reached some 350 participants.

These initiatives are being complemented by regional initiatives in South Asia and Africa. The South Asian Forum for Infrastructure Regulation (SAFIR) was launched in 1999 and offers training programs as well as other learning and knowledge-sharing support to regulators. Three two-week training programs have been held todate, reaching around 200 participants from eight countries. The African Forum for Utility Regulation (AFUR) was launched in 2000 to provide a mechanism for sharing experiences and information on particular regulatory issues. The second meeting of AFUR, held in Accra in May 2001, drew together 62 participants from 37 regulatory agencies in 23 countries to explore strategies for engaging consumers in the regulatory process. A third meeting of AFUR is scheduled for Dakar in November 2001.

In addition, the WBI provides support to regulatory research centers, providing a resource for regulators, expanding expertise and research capability on local regulatory issues and providing training for staff of regulatory agencies. Packages of assistance have been provided to research centres in Latin America, West Africa and China. Other initiatives in this area include the development of extensive web-based resources for regulators.

141. Going forward, the work on regulatory regimes should be further strengthened. This would involve a continuation of efforts to distil emerging lessons of experience, and to provide best practice information and capacity-building support to client countries. Particular emphasis needs to be placed on adapting approaches to countries with limited institutional capacity, on measures to address the needs of poor people, and on emerging issues such as the development of transnational regulatory arrangements. Bank operations would continue to give priority to regulatory issues. These efforts would be complemented by ongoing support to key partnerships such as the Public-Private Infrastructure Advisory Facility (PPIAF) (Box 14) and the International Forum for Utility Regulation (IFUR).

**Box 14: Partnering to help governments take advantage of private participation in infrastructure**

The Bank Group works closely with its development partners in helping governments use private participation to improve the quality and coverage of their infrastructure. Foremost among these partnerships is the multi-donor Public-Private Infrastructure Advisory Facility (PPIAF).

Building on and complementing the Bank Group's Infrastructure Action Program, PPIAF was established in 1999 as a joint initiative with the Governments of Japan and the United Kingdom with a specific focus on helping developing countries reduce poverty and achieve sustainable development through private participation in infrastructure. PPIAF's membership has since grown to also include Canada, France, Germany, the Netherlands, Norway, Sweden and Switzerland, as well as the Asian Development Bank and the United Nations Development Program. PPIAF finances technical assistance to help client governments design infrastructure development strategies that take advantage of private sector involvement; build consensus for reform approaches; design and implement policy, regulatory and institutional reforms; and build government capacity in managing and regulating private infrastructure arrangements. PPIAF also has an important mandate to identify and disseminate emerging best practices in private participation in infrastructure in developing countries, including through publication of case studies and "toolkits" as well as sponsoring workshops and conferences. During FY01, PPIAF provided US$19M in funding for 74 activities in more than 39 countries. PPIAF is governed by a Program Council representing all participating donors and is administered by a dedicated Program Management Unit which has regional coordination offices in Africa and Asia.

142. After two decades of reform in a variety of institutional settings, there is now a high degree of consensus on the key elements of effective regulatory systems for infrastructure. Elaboration of that consensus in the form of a set of voluntary principles may assist governments in framing their regulatory policies, provide support to regulators, and help to promote a more transparent and predictable regime for investors. The perspectives of relevant stakeholders in the regulatory process would need to be reflected and adaptation to country and sector differences would need to be addressed.

*Management has requested the PSAS department to explore the feasibility of developing principles for regulatory systems in infrastructure by Summer 2002.*

143. **Direct support to investors.** Through the political risk guarantee programs of the IBRD/IDA and MIGA and through the financing activities of IFC, the WBG would also continue to support private participation in infrastructure. Such direct support of private firms should focus on demonstration projects that establish the credibility of sound regulatory regimes. Care should be taken to foster competitive approaches and to shift commercial risks (construction, operation and market risk) from taxpayers to private shareholders as much as possible.

### 2. Private provision of social services

144. Given the fundamental responsibility of governments to ensure affordable and universal access to basic social services, the WBG will continue to provide unabated support to public services in health and education, in particular in pursuit of free access to basic health care and primary education. Improved delivery of social services, as a means to ensuring universal access to basic services, will remain the fundamental goal of the WBG's work in the social sectors. This will require considerable work in the public sector, supplemented by efforts to promote private participation, including participation by not-for-profit providers.

145. Alongside the public sector, the private sector has played an important role in providing health and education services in a number of developing countries for many years. It has supplemented the public sector's efforts to ensure universal access to basic services. As shown in various studies and as pointed out in the Bank's health and education strategies, private provision of service holds potential for service improvement in a number of cases.[99] Yet, efforts by the WBG to understand the role of the private sector better and to consider approaches on how best to tap private initiative so as to improve health and education systems and improve affordable access are incipient. As called for by the recent health and education strategies, the challenge is to strengthen analytical work and to broaden the options for engaging with private forms of provision in a way that is consistent with overall social sector policies.

146. In tackling this agenda, there needs to be a clear recognition that issues of service funding and provision need to be distinguished. Affordable access to basic social services is a priority in helping poor people and empowering them. Where government funding schemes tackle issues of affordability or externalities, private provision may still be tapped to deliver services in addition to public service providers. As mentioned most recently in the Bank's education strategy, ""private" is a broad concept and includes religious, NGO-run, community-financed, and for-profit institutions". Particularly in the social sectors, not-for-profit organizations, including cooperatives, that may command special trust among clients can make, and are making, a substantial contribution to service delivery.

147. Several governments have shown interest in exploring options to tap private initiative for social service provision. In response to their interest and in addition to its work with the public sector, the WBG can play an important role in assisting client governments assess the potential role of private sector involvement and to establish appropriate enabling environments. This will involve clarifying the strengths and weaknesses of alternative forms of private involvement, market structure arrangements, regulatory approaches, strategies for promoting universal service, and financing approaches. The Bank's Human Development Network is preparing detailed toolkits on

[99] Cangarajah and Ye (2001); Filmer et al. (1997); Hoxby (2000); Lockheed and Jimenez (1994).

private participation in health[100] and is developing web-based information systems on private participation in education such as Edinvest.[101]

148. Drawing on relevant experience in private participation in infrastructure, the Bank would focus on developing policies, institutions and capacity to support effective and useful private forms of participation in the health and education sectors. Typically, this would be operationalized in programmatic lending or technical assistance work. At the same time, it may be possible in certain cases to support private forms of participation directly. IFC has established a department in April 2000 that supports financing of health and education projects. IFC health and education strategies set out the approaches to provide support to private organizations. It may also be possible in some cases to apply output-based financing schemes, such as have been developed by some governments and not-for-profit organizations. These are discussed below.

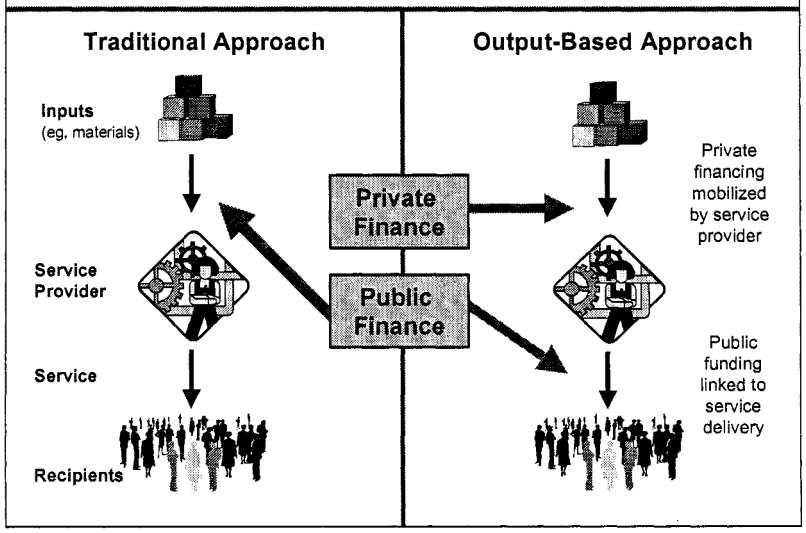
### 3. Output-based aid – tapping private initiative for public services

149. Traditional project finance by development institutions has often focused on financing inputs, for example, the construction of a water pipeline or a school. Operation and maintenance of the system were then left to public organizations, which have often suffered from weak incentives to deliver sustained quality service. Problems with input-based approaches have been noted regularly in evaluations by OED.

150. Contracts that shift the responsibilities for operation and maintenance (in addition to investment responsibilities) to investors (for-profit or not-for-profit) hold promise for sustained service improvements due to performance-based incentives and accountability. Governments can support the shift of performance risk for service delivery to investors by disbursing funds against achievement of contractually agreed outputs, for example the delivery of water to particular customer groups at agreed quality standards and for agreed prices.[102] Investors would need to seek a level of financing for the construction, operation and maintenance of the project in question that adequately exposes shareholders to commercial risks (Figure 17). Development institutions can in turn help governments finance their expenditure obligations and render government promises of future payment credible, where needed.

[100] Harding and Preker (forthcoming).
[101] Edinvest is located at http://www.worldbank.org/edinvest/
[102] Public funding of this type would need to be justified as a way to support distributional objectives or to deal with externalities of service provision.

**Figure 17: Traditional vs. output-based approaches**




151. Output-based approaches try to improve efficiency and accountability for service provision by shifting more responsibilities to the service provider. Outputs that are contractually definable are more or less close to the ultimate outcomes one would like to achieve via the service provision, e.g. better health via better sanitation. A shift from input to output-based disbursement is thus a step towards outcomes, but no more. It is an attempt to push the frontier of client and results orientation.

152. Output-based schemes allow indicators that are deemed adequate to be used to establish contractual discipline to achieve agreed results. Many of the contractual and institutional design issues are challenging, particularly monitoring arrangements, contracting processes, regulatory oversight and financing schemes. Critical is the availability of success indicators that are meaningful for assessing the development impact of a project. Ideally, indicators of ultimate outcomes would be used, but in many cases intermediate output indicators will be the best measure of success available. Such indicators need to be monitorable and independently verifiable. Issues of choice of indicator and measurement are, of course, not specific to the proposed output-based schemes, but for all efforts to measure and assess results. Ways to enhance monitoring capacity, for example, by involving NGOs in monitoring or contracting out some functions or training officials are just as applicable to output-based approaches as they are to other efforts to track results and to reward on the basis of performance. What output-based approaches offer beyond other efforts that focus on results, is the use of contractual discipline and the scope for competition for service provision.

153. Many infrastructure projects can be operated under output-based schemes. These are simply variants on concession-type arrangements or regulated utilities, with the special twist that public funds are used to finance all or part of the payments when agreed results are achieved. Relevant indicators and their measurement need to take into account the characteristics of each sector and the policy objective behind the public funding.

154. Proper attention will need to be given to the justification and sustainability of public funding, and to the legal and regulatory set-up of these schemes. Relevant and useful insights can be gained from experience with similar issues in the context of private infrastructure arrangements. Schemes of this kind are already being used to improve the provision of a wide range of basic services, including rural telecommunications in Peru, road maintenance in Argentina, basic health services in Haiti, public health services in Nicaragua, and education services in Chile (Box 15). Many of the examples involve small domestic service providers. The experience with attempts to introduce private participation in infrastructure (PPI) in IDA countries during the 1990s suggests that there is considerable scope for successful implementation of contracting and regulatory schemes for private providers. As mentioned before, the recent evaluation of PPI projects under IDA 10-12 ranks them highest among all forms of project intervention at par with micro-finance. The adoption of output-based aid schemes will also help bring to the fore-front regulatory and institutional development issues that remain hidden under traditional approaches and thus focus attention to resolving these issues.

**Box 15: Output-based aid**

Output-based aid (OBA) is a strategy for improving the delivery of services that depend at least in part on public financing. In contrast to traditional approaches of channeling support to inputs consumed by public sector providers, OBA delegates service delivery to third parties under contracts that tie payment to the outputs or results actually delivered. The approach thus helps to shift performance risk to the private sector, and in so doing can help to sharpen the targeting of development outcomes, sharpen incentives for efficiency, and mobilize private finance in support of development objectives.

OBA schemes may take many forms. In Peru, a special telecommunications fund subsidizes public pay phones for low income rural communities. The subsidies are offered by the government to private operators through competitive tenders. The obligation is to provide a pay phone for 20 years in each rural locality listed in the tender and the operator requiring the lowest subsidy to do this wins the contract. Part of the subsidy is paid out on award of the contract, part once the equipment is installed and the rest in semi-annual installments, contingent on the operator complying with specified service performance standards. In Romania output-based contracts between local health authorities and family doctors combine per-capita payments for their registered patients with capped fees for preventive services. Doctors compete for patients, and to get paid they must provide documented evidence of registrations and the volume of fee-based services. The goal is to encourage responsiveness to patients (in contrast with the former system where local hospitals employed family doctors on salary and assigned patients to doctors), and to create incentives for performance related to key public health outcomes (e.g. immunization) and health care access (e.g. more rural services). At the same time these contracts try to avoid the budget problems associated with unconstrained fee-for-service remuneration occurring in some OECD countries.

Variations on these schemes have been applied to a wide range of public services in developing countries, with encouraging results.

Source: Brook and S. Smith (2001).

155. Where local financial markets are not well developed to fund such projects, the disbursement schedule for subsidies could be frontloaded somewhat so as to render financing more manageable, while still maintaining adequate financial exposure of the

private provider to maintain incentives to perform. Particularly in IDA countries, it would be important to credibly guarantee that subsidies will actually be paid when due. IDA could thus support output funding, while IFC could help fund private providers without government guarantees, leading to a better and new division of labor between the Bank and IFC. Public funding arrangements for output-based aid projects should be an integral part of the overall budgetary process of the government and subject to appropriate fiscal controls. Donor funds for OBA schemes disbursed directly to the ultimate recipients should also be subject to appropriate control procedures for public funding and guided by public policy. It will be important to ensure that public funding for subsidies is programed at appropriate levels, based on the scope of the schemes and average subsidies required. In cases where public funding is not expected to be permanent, it will be desirable to have a clear strategy for its phase-out. Under adequately designed and supervised contracts, investors could then assume the risk of failure as opposed to taxpayers under traditional forms of development finance (Box 16). Generally, output-based financing schemes provide development institutions a good instrument to support the introduction of private participation in service provision.[103]

156. In particular, output-based forms of project finance could be used to address affordability concerns better. All forms of subsidy schemes could be supported ranging from means-tested targeting of specific customer groups to broad-based subsidies to all consumers of a service that may be bid out on the basis of the least subsidy. Any combination of user fees or tax financing can be supported to establish the necessary cash flow for a project or a whole program of investment as output-based schemes separate decisions on provision and funding of services. Output-based aid schemes are consistent with a wide range of financing options, including free service provision. Subsidies should preferably go to consumers rather than providers. Public providers may also compete under such schemes, where the playing field can be level and credible arm's length contracting relationships can be established. However, in this case taxpayers bear the ultimate risk of failure.

[103] As used in this strategy paper, output-based aid is a contractual discipline for the provision of services and should not be confused with adjustment-type operations where funds are disbursed to borrowers after successful implementation of specified reforms.

**Box 16: Output-based aid: design issues and options**

Some of the key issues that need to be addressed in designing any output-based aid scheme include:

- *What services should attract public funding or subsidies?* This requires consideration of matters such as the rationale for public financing, budget constraints and sustainability issues. In some cases, subsidies might be more appropriately directed to household connections to basic services, rather than ongoing consumption.
- *Who will be eligible to receive services that attract public funding, and how will they be targeted?* Approaches range from means-testing of individual households to reliance on proxies such as area of residence or level of usage.
- *Who will be eligible to provide the services?* This requires consideration of matters such as minimal technical qualifications. Potential providers might include the local or international for-profit firms as well as not-for-profit oragnizations.
- *Will services be provided in a competitive or monopolistic market?* In some cases, it may be feasible to allow eligible recipients to choose from a number of potential suppliers, while in other cases monopoly provision may be justified and the benefits of competition are tapped primarily by bidding for the right to serve the market.
- *How will key performance standards be defined?* There are many dimensions to this question, including the extent to which the standards focus on ultimate outcomes, the nature and quality of inputs utilized, or variations on these.
- *How will payment be tied to performance and structured?* Particularly when new assets are to be financed to enable service delivery, an important issue will be the extent to which some proportion of the total payment may need to be paid up-front, in anticipation of delivery.
- *How should the scheme's administrative arrangements be structured?* Issues to be considered include the scope of the scheme in terms of sectors, service areas, and funding sources, as well as the allocation of various functions, including service monitoring.

157. The involvement of private firms should ideally rely on competitive disciplines to ensure that subsidies are applied to intended purposes and not to enhance private firms' profits excessively. Where these disciplines are inadequate, they may need to be supplemented by government regulation, whether of prices or other aspects of the functioning of the market. Disbursements of funds under output-based schemes may still be directly to private firms – just as, for example, IDA funds may currently be disbursed directly to contractors for civil works or equipment. However, competitive disciplines would ensure that the profit margins would be bid down to normal levels and that the subsidy would eventually be reflected in lower prices to customers or lower cost to taxpayers.

158. Pioneering work has been done in defining performance standards, structuring payments in a way to mobilize an adequate supply response, and crafting implementation arrangements to meet local institutional constraints, including in some cases the

contracting out of monitoring functions to NGOs. A review of selected experience and key design challenges has been prepared as background to this strategy paper.[104]

159. The full potential of output-based aid approaches has yet to be explored (Box 17). The WBG could play an important role in supporting progress in this area. IDA/IBRD could provide the financing for the subsidy payments in the form of loans or grants; assist governments in designing effective schemes; and help to identify and disseminate emerging lessons of experience within and across sectors and regions. IFC can provide financing to private service providers and, when required, various parts of the WBG might offer guarantees and other risk mitigation products.

*Management intends to pursue a program of pilot output-based aid projects, with particular emphasis on those supporting the provision of basic public services. Potential pilot operations are being identified in a variety of sectors (in particular in infrastructure) and regions. The first cohort of such operations is likely to be approved by the end of FY03 and the early phase of their implementation completed in FY05. An evaluation of design and early implementation experience of the first cohort of pilot projects will be scheduled for FY05. A status-report on the number and nature of OBA pilots approved, and in the pipeline, will be provided in FY03 as part of the first progress report on the PSD strategy.*

**Box 17: Output-based aid: assessing approaches**

The design of output-based aid schemes will typically involve tradeoffs between competing objectives. Progress in applying the key principles can be measured at the level of individual schemes against several criteria:

- *Targeting of development outcomes*—reflected in the approach to designating eligible recipients and in the role of outcome-related performance measures.
- *Accountability for results*—reflected in the extent to which payment depends on achievement of the specified results.
- *Incentives for efficiency*—reflected in the form and extent of competition and of contract-based incentives.
- *Opportunities for innovation*—reflected in the balance between input-, output-, and outcome-related performance measures.
- *Mobilization of private financing*—reflected in the amount of private financing leveraged by the public resources.

[104] For a fuller discussion of output-based aid approaches, see Brook and S. Smith (2001). See also Gómez Lobo (2001).

# VI. CO-ORDINATION OF PSD APPROACHES ACROSS THE WBG AND STRATEGY IMPLEMENTATION

## A. The Division of Labor in the WBG

160. **General division of labor between IDA/IBRD and IFC and MIGA.** The broad division of labor in the WBG with regard to PSD is as follows. IBRD/IDA focus on investment climate and related institution building, improvements of governance, legal and regulatory systems, financial sector policies and public financing. IFC pursues demonstration projects that promote the credibility of government policies, provides additional financial services in local markets and provides political risk protection to co-financiers. Its strategy is to deploy its instruments such that they support relevant institution building particularly in the financial sector and for small and medium enterprises. MIGA provides focused political risk guarantees, institution-building and investment promotion assistance. Particularly in IDA countries, the proposed strategy should lead to better complementarities between IDA and IFC. IDA could support institution- and capacity-building including through the use of targeted subsidies and guarantees, while IFC could help mobilize private finance without exposing the domestic taxpayer to credit risk. Output-based aid schemes would be particularly suited for such complementary approaches among parts of the World Bank Group.

**Box 18: Beyond debt relief**

The PSD strategy and the deployment of instruments under output-based aid projects is meant to support ways of providing financial assistance to low-income countries in such a way that domestic taxpayers are not exposed to undue risks arising from public debt. Where development institutions are able to support output-based aid projects, this would shift performance risk to private investors. Where development institutions like IFC that finance the private sector without government guarantees undertake to finance projects, they take the credit risk and not the domestic taxpayers. Where development institutions provide grant funding, contractual disciplines such as output based aid may be desirable to ensure effective utilization of grants. In these ways the PSD strategy could support improved risk allocation for development assistance in the WBG and beyond. This should be of particular importance in moving beyond debt relief because ways would need to be found of providing development assistance with better incentives for good utilization and less exposure of domestic taxpayers.

161. Output-based aid would further focus IDA/IBRD on supporting policy development, programmatic assistance and capacity-building as well as support to public finance and subsidy schemes targeted at public goods and/or poor people. Unbundling of subsidies embedded in IFC products would render interventions more transparent.

162. **Co-ordination of WBG guarantee operations**. The Executive Directors adopted a joint approach to WBG guarantee products, based on a paper presented to the Board in December 2000:

"The World Bank guarantee is expected to complement other Bank Group instruments, adhering to the principle of market first, MIGA/IFC instruments second, and Bank guarantees (with the sovereign counter-guarantee) last. This concept of "Hierarchy of Instruments" has been useful as a general organizing principle, and will continue to be used. However, the application of this concept has been more difficult. Implementation has been complicated by the fact that governments, arrangers and developers have their own views, sometimes strongly held, as to which instruments they prefer for particular deals. At times, the three Bank Group institutions were each independently engaged on the same projects, thereby giving mixed signals to the market regarding the application of the hierarchy of instruments.

Discussions have been held between IFC, MIGA, and the Bank over the last few months with the aim of further clarifying the rules of deployment of Bank Group risk mitigation instruments where there is potential for duplication and competition. These discussions have indicated that the Bank's PRG should be considered for deployment when one or several of its features (explicit counter-guarantee, booking on Bank's balance sheet and specific remedies attached, influence of the Bank, linkage to the Bank's sector dialogue, conditionality) are critical from a risk management and/or market point of view to achieve private financing objectives. Thus, the deployment of PRGs would generally be considered for transactions where one or several of the following conditions are met:

- Transactions in sectors in early stages of reform, where the risk of reversal is seen as significant;
- Riskier and larger size operations, where booking of the risk on Bank's balance sheet, with remedies attached to Bank operations, is seen as preferable from a risk management perspective; and
- Operations highly dependent on Government support and/or undertakings, where the explicit counter-guarantee and the clout of the Bank are seen as critical to mobilize private financing."[105]

163. **Co-ordination of WBG advisory services.** IFC and the Bank have taken various steps to improve co-ordination of advisory services in the PSD area. Two joint departments focusing on advisory services were established in January 2000, the SME department and the Private Sector Advisory Services Department. The former integrates the central SME unit of the Bank and the IFC SME activities. The latter integrates the former PSD department of the Bank, the Corporate Financial Services Department of IFC and the joint Bank/IFC Foreign Investment Advisory Service (FIAS). Synergies between IFC and the Bank are being developed. Reporting on progress on the implementation of this and other institutional reforms decided on the basis of the 1999 PSD Board report is done as part of a separate process.[106]

[105] World Bank (2000c).
[106] World Bank (2000d).

164. The relationship between FIAS and MIGA's Investment Marketing Service (IMS) has also been addressed. FIAS provides policy advice to governments on how to attract foreign investors in ways that benefit the host country. MIGA/IMS tends to operate downstream from FIAS helping countries promote investments based on the policy and institutional framework promoted by FIAS. MIGA/IMS and FIAS have developed a new protocol, which entails systematic exchange of client requests for advisory services, agreements on the division of labor (FIAS conducts "upstream" policy work, MIGA advises on investment promotion programs) and regular (quarterly) meetings among managers and key program staff to harmonize work plans and agree on joint activities where appropriate.

## B. Implementation

165. **Integrating the PSD strategy into country and sector strategies.** At the operational level, the core responsibility for integrating the PSD agenda in our country-level dialogue and operations lies with the Regions. Regional Vice Presidencies, assisted by PSD units, will continue to play a critical role by developing (with inputs from other parts of the WBG) regional implementation programs for this strategy to be completed in FY03 and FY04. These programs would cover the expected operational program and its consequences for budgets and staffing. They would build on an ongoing portfolio and staffing review for PSD by the Sector Board. The Africa, East Asia and South Asia regions will prepare the first implementation programs to be completed in FY03.[107]

166. Regional PSD units will also continue to lead PSD operations and increasingly provide PSD inputs into operations managed by other units such as PREM or HD. As the central anchor has been substantially reduced, regional PSD staff will increasingly take the lead in promoting the PSD agenda in a wide range of operations and AAA. PSAS (the anchor unit) will maintain and develop a capacity to provide catalytic operational support to the Regions, primarily in the core areas presented in this strategy.

167. At the country level, country directors and country teams will continue to address PSD issues in the context of the Bank's country assistance strategies (CASs), as well as in their dialogue with clients (including the CDF and PRSP processes), as they tend to do at present. Investment climate surveys and/or assessments would be an integral part of the diagnosis underlying every CAS. CASs and PRSPs will be the main vehicles by which investment climate assessments will be integrated with lending projects and technical assistance operations. Investment climate survey results, as well as other PSD-related analytic work, will be available as inputs to the PRSP process and may be used in developing PSD priorities for the respective countries. CAS's will draw upon the country-specific PRSPs, as well as the WBG's PSD strategy, in formulating country-specific PSD strategies (Box 19). The profile of PSD issues in CASs will be reinforced

[107] This PSD strategy paper does not contain detailed multi-year projections of PSD projects by region. This should be done under the relevant sector strategies such as rural development, transport or health and in the context of regional implementation programs.

following a relative neglect in the past. Preliminary findings associated with the upcoming CAS Retrospective Review (July 1999 - December 2000 CAS cohort) already indicate a noticeable improvement in the treatment of private sector development issues in more recent CASs, and, as expected, significantly better treatment in joint Bank Group CASs than regular Bank-only CASs. Regional management will ensure that the proposals set forth in this strategy are integrated in the country and regional strategies, work program agreements and budgets, in particular as regards approaches to improve the investment climate.

**Box 19: The PRSP process and PSD strategy**

The PSD strategy of individual countries will be driven by the country's PRSP process. Governments, in collaboration with various stake-holders, would formulate the development goals, at both macro and sectoral levels, and identify the relative roles of the public and private sectors in achieving the goals. The assignment of the relative roles will depend on country and sector specific conditions. It is expected that various segments of the private sector in a country, i.e., large and small companies, rural and urban enterprises, NGOs and the commercial private sector, will be adequately represented and engaged in the PRSP process. Findings of existing analytic work, such as investment climate surveys or assessments, will be available to inform the work of preparing PRSPs.

The WBG may further the treatment of PSD issues in the PRSP process in various ways, including a) helping to build capacity of domestic stake-holders to carry out the required analysis, including strengthening of relevant statistical systems; b) sharing of knowledge on analytic methods, cross-country studies on PSD-issues and best practices in PSD interventions; and c) commenting on PRSP-related documents prepared in-country.

Once the PRSP is completed for a country, it will set the context for the WBG to formulate its assistance strategy in the PSD area. Drawing upon the PRSP, as well as the global PSD strategy of the WBG, individual CASs will articulate the PSD approaches and priorities to be followed in the WBG's assistance program for each country.

168. At the sector level, the PSD dimension will be strengthened in the relevant sector strategy papers, with inputs from the PSD Sector Board and anchor unit (PSAS). This will, in particular, be the case for the sectors highlighted in this strategy, including the social sectors and PREM.

169. The implementation of the PSD strategy will be supported by operationally relevant training programs designed and delivered jointly by WBI and PSI for WBG staff as well as client countries, including new programs focusing on OBA and investment climate issues and facilitation of in-country dialogue with the private sector (Box 20).

**Box 20: WBI learning programs**

The WBI has developed a training program on "market solutions for development", which will be a central component of a joint PSI/WBI learning strategy and will facilitate the implementation of the PSD strategy. The program will encompass client training and staff training, as well as technical assistance and advisory services for implementation of reforms. The integrated learning program will be designed to build the necessary skill base in the WBG as well as in client countries to support : (i) implementation of PRSPs and CDF approaches, including participatory CAS preparation; (ii) implementation of programmatic and multisectoral approaches to lending which are likely to include a training component for PSI related issues; (iii) creation of a favorable investment climate; (iv) output-based aid; and (v) collaborating with DEC to carry out state-of-the-art research and enterprise surveys with regard to the investment climate.

The learning program, which has been developed on the basis of formal needs assessments, consultations with the regions and the sector anchors, and information provided by course evaluations over the past 4 years, consists of activities in four areas: i) awareness raising among policymakers, private sector, the media and academics; ii) skill development and program-driven technical assistance for current practitioners responsible for the implementation of policy reforms as well as for the next generation of decision makers; iii) assistance in action-oriented program design and reform implementation; and (iv) research and development to provide a sound basis for development of learning products and materials on cutting-edge issues. To achieve the maximum flexibility, the program consists of a menu of modules consistent with the needs assessment and the specific needs of countries and regions. WBI implements many of its activities in collaboration with partners both in the developed and developing world and with both individual institutions as well as networks of institutions. Examples include the infrastructure finance training courses, which are delivered in partnership with the IIM-Ahmedabad, the Administrative Staff College of India and State Bank of India; The Arab Fund for Social and Economic Development in MENA; and the Development Bank of Japan. Programs in the area of corporate governance are delivered in partnership with the Joint Vienna Institute, OECD/WBG Secretariat on the Global Corporate Governance Forum, the network of Corporate Director Institutes in Asia, and the network of centers on Corporate Governance in Russia and the Central African Republic. Such partnerships will continue to be important in WBI's activities. Indeed, a medium-to long-term objective of the proposed learning program would be to assist countries build local capacity through joint learning, joint teaching and joint research by experts from developed countries and developing countries. Special efforts will be made for local partner institutes to take over the training activities once a core mass of local trainers and researchers have acquired the necessary skills and expertise. This would facilitate the establishment of local capabilities to find local solutions to policy formulation and implementation in the process of market reform and PSD.

WBI programs will continue to have strong leverage with World Bank operations. For example, some of the regulation activities are being organized directly in support of Bank operations, or in preparation for Bank operations, more particularly in LAC and Africa. Similarly, corporate governance activities are being organized directly in support of operations in East Asia, South Asia, and in ECA.

170. The PSD sector board will review, in collaboration with the other sector boards, progress in adopting PSD approaches across all networks, building on the project review conducted in preparation for the PSD strategy as well as reviews of the treatment of PSD issues in the CDF, PRSP and CAS processes. This would form part of the Annual Review of Portfolio Performance (ARPP), the periodic reviews of the implementation of the Comprehensive Development Framework, and the CAS Retrospective Reviews. More generally, the PSD sector board would work with the other sector boards on promoting PSD approaches in the Bank's work and ensuring consistency between the PSD strategy and the relevant sector strategies. This includes a strategic staffing review. To facilitate WBG consistency and cooperation, IFC and MIGA will continue to participate in PSD sector board meetings.

*Regional management will prepare regional PSD strategies and action plans to operationalize this WBG PSD strategy during FY03 and FY04.*

171. **WBG coordination.** Implementation of the PSD strategy across IBRD/IDA and IFC is led and supervised by the Managing Director for PSD of the IBRD/IDA and Executive Vice President of IFC. Co-ordination with MIGA is maintained through multiple mechanisms, including the guarantee committee (for guarantee operations) and the protocol between MIGA and FIAS (for investment promotion activities). The PSD Sector Board — which includes representatives from all Regions, PSAS, SME, Legal, WBI and IFC, as well as participation from MIGA — will continue to play an important role in coordinating PSD approaches within IBRD/IDA and across the World Bank Group. Responsibility for implementation of the main proposals is described in the highlighted sections of this paper and summarized in the attached Implementation Matrix.

172. **Partnerships.** To render implementation of the PSD strategy more effective the World Bank Group will use several partnership approaches:

- Service delivery partnerships involve the private sector in the provision of services, for example under output-based aid schemes;
- Policy development and capacity-building partnerships help shape the policy and institutional framework for the private sector (Box 5); and
- Corporate responsibility partnerships strengthen voluntary mechanisms to enhance environmental and social sustainability (Box 5).

173. The PSD Sector Board will review the WBG's partnerships in the PSD area with a view to identify duplications, synergies and missed opportunities. The Business Partnership and Outreach Group, with the help of WBI would lead at the global level and PSD units in the Bank Regions at the regional level, in collaboration with WBI, IFC and MIGA at all levels. Among the areas of increased emphasis will be the development of new partnerships with other multilateral and bilateral agencies active in PSD, including the UN.

174. **Consultative processes.** Particular attention will be given to ensuring greater participation of the private sector in consultative processes such as PRSP and CDF exercises. A recent World Bank assessment of the CDF experience indicates that progress in this area has been limited even in the CDF-pilot countries despite the recognition, in the CDF, of the critical role of the private sector in development (Box 21). Specific ways in which the role of the private sector in such processes could be enhanced include the following: i) assistance in clearly articulating the role of the private sector in development; ii) help in mobilizing a broader set of private sector actors, including small enterprises, and increasing their role in the formulation and implementation of national poverty reduction strategies; iii) strengthening the institutional basis for following up on PSD-related recommendations put forward by participants in consultations; iv) catalyzing collaboration between donors on PSD issues; and v) providing support to developing monitoring and evaluation capacity in the area of PSD.

**Box 21: The private sector and the Comprehensive Development Framework**

The CDF principles envisage an active participation of the private sector in dialogue with government and other stakeholders in elaborating a long-term, holistic development vision and translation of that vision into medium-term strategies. This follows from the critical role the private sector is expected to play in the development process.[108] In recent years, some countries have made progress in incorporating private sector inputs into the formulation of their development strategies. An example of a CDF-pilot country which has actively sought to integrate public-private sector dialogue into the overall development plan is Vietnam. Here, WBG initiatives helped catalyze the establishment of the Private Sector Forum (later renamed Business Forum) as a vehicle for permanent involvement of investors, both foreign and domestic, in the national development debate. Action on implementing the recommendations of the private sector has, however, been slow. There has been relatively greater progress in Uganda where the government has involved the private sector, through the Private Sector Foundation, in analysis and diagnosis of national development issues and in consultations. The Foundation has participated actively in poverty reduction strategy consultations and in ensuring that the private sector's role is addressed in the country's PRSP.[109]

[108] The recent World Bank report "*Comprehensive Development Framework: Meeting the Promise?- Early experience and emerging issues*" states "Few countries have been able to bring about long-term sustainable growth without a major contribution from the private sector. The limited resources and capacity of the state in poor countries has resulted in poor quality services or no services at all. This implies that the role of the private sector in service delivery is critical". See World Bank (2001k).

[109] World Bank (2001k), Section V.

> However, overall, there is significant room for improving the nature and extent of the involvement of the private sector in the CDF process. The recent World Bank assessment of the experience with the CDF in 46 countries states that "In many of the 46 countries, the private sector's role is not fully addressed in their country's strategies, reflecting a history of mutual distrust and misunderstanding between government and business, and a lack of clarity on the likely influence of the private sector in the national development process. In only a third of the 46 countries is the private sector playing an active role in national dialogue processes."[110] The report also states that "It is the large firms and their associations that are the major, and sometimes only, representative of the total private sector in many of the 46 countries."

175. Some of these goals would be achieved through a continuation of the existing efforts in partnership-building and fostering consultation. In addition, the PSD strategy and related background work strengthens the case for deepening the involvement of the private sector in the CDF, PRSP and CAS processes. Background work on developing the conceptual framework for PSD, the on-going work on developing the framework for investment climate analysis, and the various toolkits on PSD topics will be widely disseminated, and complemented by WBI's capacity-building exercises (Box 19), to enable the private sector in the client countries better articulate their potential contribution to the development process and in particular to the PRSP exercise. The Business Partnership and Outreach Group will expand its partnership-building efforts to get a broader segment of the private sector involved in national dialogues on development issues. Existing work on building public-private consultations will be strengthened to help build the institutional basis for follow-up to private sector recommendations. Partnerships with other donors will be expanded at the country level to ensure greater collaboration and sharing of experience on PSD issues; work on the investment climate will be a particularly useful vehicle for promoting such collaboration. Finally, the work on developing score-cards and other monitoring and evaluation techniques for PSD projects in the WBG (see below) could be the basis for developing monitoring and evaluation tools for use in individual countries. Efforts will also be made to ensure that on-going initiatives at developing statistical systems, such as PARIS21 (Partnerships in Statistics for Development in the 21st Century) initiative, give due weight to PSD topics.

176. **Funding implications.** Most actions proposed are to be covered from existing budgets in IFC, MIGA and the Bank through internal reallocation. This includes reallocation for support to output-based aid schemes, support for work on private participation in the social sectors and the recent creation of a joint DEC/PSI unit for investment climate (see implementation matrix below).

177. The investment climate unit would design, promote and supervise the survey effort, help with investment climate assessment work in the Bank, and discharge the standard "anchor" functions for investment climate work (knowledge management, training, cross-support, quality assurance). Beyond this and going forward, the only

[110] Ibid.

special funding issues for the PSD strategy arises from the call for systematic investment climate surveys.

178. During consultations, some donors indicated that such surveys would be a useful basis for their own program decisions and that they would wish to participate in a joint mechanism to develop and finance them. Within the Bank, the regions would be major users of survey work. They would fund assessments and other economic and sector work that makes use of the surveys reflecting specific country demands. Country departments would also be the source of funding for translating survey results into operational activities based on regional strategies, PRSP consultations and the CAS process. To anchor this collaborative effort that spans the interest of the Bank and other development institutions, it is proposed to fund the surveys and their interpretation under a special multi-donor funding vehicle with significant regular contributions by the WBG.
To start the process in FY02, some 5 to 8 surveys are being undertaken 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. From FY03 onwards, it is proposed to consolidate funding possibly as part of a proposed DEC trust fund (policy for development) and taking into account existing donor funded programs such as the Regional Program for Enterprise Development of the Africa region.

179. 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.

180. Assuming that donors provide US$3 million per year to support these surveys, the Bank's contribution would be US$2 million in additional funding from the Bank's administrative budget. It is proposed to start off with a Bank contribution of US$2 million in FY03 as a sign of commitment to donors and to allow the survey program to expand to some 10 new surveys in FY03. Final agreement on this proposal would be sought as part of the FY03 budget decision. During calendar year 2002, donor funding would be sought and a cost-sharing model with regions would be developed to mainstream and embed the survey work in country programs. Reaching the targeted level of 20 surveys would depend on the level of support from donors as well as country conditions.

181. **Measuring results – scorecards for PSD projects and programs.** All projects with significant PSD components would maintain scorecards as agreed at the time of project or program approval. IFC is implementing a scorecard program under its current strategy, which will reflect financial performance and development impact. IBRD and IDA PSD projects would develop scorecards at the time of project approval and establish baseline information under guidelines approved by the PSD Sector Board. Scorecards

may also be prepared for MIGA operations. Typically scorecards would show (where relevant and feasible):

- achieved economic rates of return;
- changes in financial performance of the assisted entity;
- changes in indicators of productivity;
- indicators of changes in access to services provided to low income groups;
- information on charges imposed on low income groups and/or subsidies provided;
- total amount of subsidy provided directly or embedded in financial products;
- indicators of environmental impact;
- indicators of improvement in the investment climate; and
- indicators of the impact on institution-building

*In its periodic review of projects with PSD components, the PSD sector Board would review the scorecards and report on overall implementation and results.*

182. **Measuring results – cost-benefit analyses**. By nature, many scorecards will fall short of a full-fledged cost-benefit analysis. To provide a deeper understanding of the results of PSD approaches and to sharpen the interpretation of scorecards, selected cost-benefit analyses based on explicit counterfactuals would be conducted for projects or programs suggested by the PSD sector board in conjunction with DEC/OED. Such cost-benefit analyses would focus on projects/programs supporting basic service delivery including output-based aid schemes as well as SME projects and micro-finance schemes.

*A program of cost-benefit analyses for PSD interventions is to be developed between PSD Sector Board and DEC/OED.*

183. **Risks.** The main risks for the strategy are in less than satisfactory implementation of the key proposals.

184. The core work on the investment climate might either suffer from insufficient co-ordination of approaches within the WBG or inadequate or excessively variable funding. The strategy tries to address these risks by putting in place a co-ordination and monitoring structure, spearheaded by a joint DEC-PSAS investment climate unit. The risk of excessively variable funding is to be dealt with by the combination of dedicated funding for parts of the investment climate work (surveys and overall co-ordination/ monitoring) and country-program-driven funding for assessment work and consequent operations.

185. Another risk to implementation might be that output-based aid schemes are more demanding of staff resources and country institutional capacity than expected. Experience with similar projects (private participation in infrastructure schemes) suggests the Bank Group has access to the necessary resources, and that suitable

institutional capacity can be built in client countries. Given the novelty of the output based aid proposals effectiveness of staff and client training will be critical to implementation. The proposed approach of starting with some pilot projects should help identify any resource and capacity gaps and allow corrective action.

186. The historically contentious nature of some of the issues involved in private sector development, particularly the potential role of private participation in the social sectors, raises reputational risks to the Bank Group. This will put a premium on careful dissemination to external stakeholders of the key messages of the strategy as well as the evidence on private sector development contributions to growth and poverty alleviation, and on incorporating the lessons of experience in design and implementation of new operations.

187. **Progress report on implementation of PSD strategy.** A progress report on the actions set out in this strategy (see summary matrix) will be provided to the Executive Directors periodically, the first one in March 2003.

# ANNEX I: IMPLEMENTATION MATRIX

**(New activities proposed in the Strategy are in italics. The list of on-going activities is an illustrative, rather than a comprehensive, list of WBG activities related to PSD. Details on the WB activities will be provided in the regional PSD strategy implementation plans. Details on IFC and MIGA activities are provided in IFC, *IFC Strategic Directions* and in MIGA, *MIGA Review 2000*)** [1]

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| Investment climate | Economic and sector work, such as: | | | | | |
| | • Corporate governance assessments | 14 corporate governance assessments expected to be completed by end of FY02. Another 10-15 planned for FY03. | | Regions/PSD | | |
| | • SME country-mapping exercises | 9 new maps expected to be completed in FY02; exercise will continue next year and will include both new maps and updating of old ones. This work will be coordinated with work on investment climate surveys. | | Regions/SME | | |
| | • Legal and judicial sector assessments | Legal and judicial sector assessments and other diagnostics have been, and are being, conducted. | | PREM/LEG | | |
| | Consultations with the private sector | Consultations are currently carried out with private sector representatives at global, regional and country levels. These activities will expand and be systematized. Efforts will be made to engage a wider range of private sector actors. | | Regions/PSD/IFC/FIAS/ MIGA | | |

[1] The activities mentioned in this matrix will be guided by the principles laid down in this strategy.
[2] Details on responsible MD/VP, funding implications and staffing implications are provided only for proposed activities, not on-going work.

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | Policy-based lending to promote reforms, such as on: | | | | | |
| | • Competition law and policy | Competition policy issues will continue to be addressed in the WB's lending program. FIAS has identified FDI and competition policy as a new area of emphasis. Its work will feed into lending programs. | | Regions/PSD/PREM/FIAS/ LEG | | |
| | • Simplification of business procedures | Will be dealt with primarily through policy-based lending. | | Regions/PSD/SME | | |
| | Removal of barriers to investment | FIAS's advisory and diagnostic work will feed into this. FIAS is strengthening existing products and developing a few new areas of emphasis. The SME department's work, as well as the WBG's work on micro-finance will also contribute to this. | | Regions/PSD/FIAS/MIGA/S ME | | |
| | • Legal and judicial reforms | Several active and pipeline projects in PREM and LEG. address these issues. In addition, some projects managed by other sector families address legal reforms related to their sectors. These activities will continue. | | Regions/LEGl/PREM | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | ▪ Financial sector development | Dealt with largely by the financial sector family. There are currently about 110 financial sector projects (90 active and 20 in the pipeline), several of which support policy reforms aimed at improving financial systems. IFC's transactional work in the financial sector will provide inputs for designing WB's policy reform programs. | | Regions/FSE/IFC | | |
| | Strengthening property rights regimes | Several projects in urban development and rural development, and a few in other sectors, address these issues. This will remain an important area of work. | | Regions/PREM/RD/Urban/LEG | | |
| | • Corporate governance | Policy reforms aimed at improving corporate governance is likely to become increasingly important in the WBG's work, drawing upon in many cases on in-depth corporate governance assessments. | | Regions/PSD/PREM/IFC/LEG | | |
| | Institution- and capacity building exercises, such as: | | | | | |
| | • Development of investment promotion agencies | FIAS and MIGA-IMS will continue to work in these areas. MIGA's TA activities focus on investment promotion intermediaries, sectoral ministries and other investment agencies. It is also increasingly focusing on internet-based information dissemination, through initiatives such as PrivatizationLink and IPAnet. These activities will continue. | | Regions/FIAS/MIGA-IMS | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | • Development of financial institutions and markets | This will continue to be one of IFC's priority activities. In addition to its work on commercial banking and leasing, IFC will be increasingly involved in helping institution and market development in areas such as small- and micro- enterprise finance, insurance, contractual savings and pensions, housing finance and fixed income securities. WB will also have significant involvement in institutional development in the financial sector. | | Regions/FSE/IFC | | |
| | ▪ Corporate governance | IFC will continue to be involved in a wide range of activities in this area including improving corporate governance practices and policies in IFC's investee companies and development of information services to improve transparency of companies. WB will also continue to be involved in capacity-building activities, e.g. helping to establish and strengthen institutes of directors. | | Regions/PSD/IFC | | |
| | ▪ International trade | The WBG, in collaboration with several international agencies including the WTO, is involved in a program, "Integrated Framework For Trade-Related Technical Assistance" aimed at helping least developed countries to enhance their capacity to better integrate with the global economy. This work will continue. | | DEC/WBI | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | • Strengthening of cadastral agencies | Will continue to be an important activity in the urban and rural development families. | | Regions/PREM/RD/Urban | | |
| | • Strengthening of courts and other legal institutions | Several stand-alone judicial reform projects and other projects with judicial reform components (on-going and planned) address this subject. Most of these projects are in the LEG network. These activities will continue. | | Regions/LEG/PREM | | |
| *Investment climate surveys* | • *Note on minimum standard survey methodology*<br>• *Workshop with interested development institutions to discuss common operational and funding approach*<br>• *Incorporation of standard survey results in CAS and core due diligence products* | *Completed*<br>*Fall 2002*<br>*From FY03* | *Woicke/Shafik* | *Regions/PSAS/DEC with SME/ MIGA/ WBI* | *Design costs covered by reallocation of funds under PSAS restructuring and DEC budget*<br>*Future costs of survey program (FY03 onward) of about US$2 million dollars per year, to be funded from Bank budget.* | *Joint DEC/PSAS unit set up beginning of FY02*<br>*PSD staff re-allocation to survey work would be needed over time and training* |
| Direct support to private enterprises | Investment operations such as:<br>• On-lending operations | Several WB projects, managed by a number of sector families, have on-lending components. These will increasingly be brought under the disciplines of a revised OP8.30. | | Regions/FSE/PREM/PSD | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | • Micro-finance projects | There are currently over 100 active WB projects with a micro-finance component; several of these are stand-alone projects. Micro-finance will continue to be an important area of WB lending. | | Regions/FSE/PREM/PSD/RD/IFC | | |
| | • Rural finance projects | There are currently about 150 active WB projects with a rural finance component. These are spread over several sectoral families. This will continue to be an important area of WB lending. | | Regions/FSE/RD | | |
| | • Investments in private firms | This is the main activity of IFC. IFC will continue to help finance firms in a wide range of sectors through instruments such as loans, syndicated loans, equity, quasi-equity and risk management products. It will also continue to channel a large chunk of its financing through financial intermediaries; e.g. through credit and equity lines to banks, private equity and investment funds, and leasing companies. | | IFC | | |
| | • Guarantee operations | MIGA's guarantee portfolio is likely to both grow and become diversified in the coming years, with an increased emphasis on IDA countries, SMEs, complex infrastructure projects, and facilitation of investment flows among developing countries. IFC will continue to offer credit | | MIGA/IFC/PFG | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | | enhancement structures for debt instruments in the form of partial credit guarantees. The WB will continue to offer partial credit guarantees, partial risk guarantees and policy based guarantees. | | | | |
| | Technical assistance operations, such as: | | | | | |
| | • Project development facilities, business advisory services, matching grant schemes | Project development facilities will continue to be a core component of the WBG's on-the-ground work with SMEs. They will seek to increase their outreach, improve cost recovery and broaden their impact. They are broadening their product range beyond firm-level support activities to emphasizing capacity- and institution- building. Business advisory services will increasingly be market-driven. | | Regions/PSD/IFC/SME | | |
| | • Capacity building of micro-finance institutions | This will continue to be a major area of CGAP's work. IFC's SME Capacity Building Facility will also contribute. Individual lending projects of the WB will have components dealing with this. | | Regions/CGAP/RD/IFC | | |
| *IDA/IBRD on-lending operations* | *WBG management to revise OP 8.30 so as to cover all on-lending operations including rural and social sector operations* | *Summer 2002* | *Goldstein, Ramphele, Zhang* | *FSE* | *Covered by existing funding* | |
| Privatization | Economic and sector work | Mainly done at the country level, focusing on constraints to privatization and impact of | | Regions/DEC/PSD | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | | privatization. | | | | |
| | Policy-based lending to promote privatization | This work, which includes reforms of policy, legislation and regulatory framework, will continue, relying mostly on WB policy-based loans. | | Regions/PSI/PREM/LEG | | |
| | Institutional development, such as strengthening of privatization agencies | This will continue to be done largely through stand-alone TA loans or TA components of policy-based loans, and WBI training programs | | Regions/PSI/PREM/WBI | | |
| | Transaction-specific advice | IFC will continue to provide this service. PSAPT is currently carrying out about 10 assignments; another 4-6 expected in FY02 and 10-12 in FY03. | | Regions/PSAS/IFC | | |
| | Dealing with social and environmental aspects of privatization | Several on-going as well as planned privatization projects have components dealing with labor retrenchment. These are mostly policy-based loans. However, several investment loans, especially in the infrastructure sectors, are also dealing with this. A number of projects are also addressing the environmental implications of privatization. | | Regions/PSD/HD | | |
| | Investments in privatized enterprises | Several IFC projects involve investments in privatized enterprises. Privatized enterprises | | IFC/FSE | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | | also benefit from WB projects, in particular credit line operations. | | | | |
| Private participation in infrastructure | Economic and sector work | Country Framework Reports will continue to be a major vehicle for analyzing the policy, regulatory and institutional environment for PPI. PPI issues will also continue to be addressed in other ESW, such as CEMs and PERs. | | Regions/PSI/PREM | | |
| | Policy-based lending to promote reforms | Policy reforms will continue to be dealt with in policy-based loans as well as in investment loans. | | Regions/PSI/PREM | | |
| | Regulatory framework capacity-building | This will continue to be a growing area of work in PPI and, in addition to individual projects, will continue to be addressed through a number of global and regional programs, in partnership with others. | | Regions/PSI/WBI | | |
| | Investments in private firms in infrastructure | This is a major activity of IFC and will remain important in its portfolio. In addition to IFC's direct investments in infrastructure firms, both IFC and the WB will continue to support infrastructure funds, including some targeted at small-scale infrastructure firms. | | Regions/PSI/IFC | | |
| *Principles for regulatory systems in infrastructure* | *Paper on proposed approach* | *Summer 2002* | *Woicke/Shafik* | *PSAS* | *Covered by reallocation of funds under PSAS restructuring* | *No staffing implications* |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| *Output-based aid* | *Pilot projects for output-based aid focused on basic public services in a variety of sectors and regions* | *Underway*<br>*Evaluation of design and early implementation experience with first cohort of pilot projects by FY05* | *Woicke/Shafik* | *Regions/PSAS/WBI* | *Covered under current operational budgets and reallocation of funds from PSAS restructuring* | *Training for infrastructure staff in place. Training for social sector being developed.* |
| Provision of social services | Economic and sector work such as:<br>• Private market assessments for health and education | The HD network will carry out these assessments. | | HD | | |
| | Policy-based lending for promoting reforms | Policy reforms will continue to be dealt with in policy-based loans as well as in investment loans. | | HD/PREM/PSD | | |
| | Investment (lending and equity) in private health or education facilities | IFC investments in these areas are expected to grow, in line with the implementation of IFC's health and education strategies. | | IFC | | |
| | Capacity-building of public and private institutions | WB projects in the social sectors typically contain components aimed at strengthening public sector institutions. Some of these address public sector capacities related to private provision. Several Bank projects are also assisting private providers, especially NGOs, build capacity. Depending on demand at country-level, more projects on the social sectors may address such capacity-building issues in the future. | | HD/PREM | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| | Transfer of best practices | Will be addressed through knowledge management activities of the PSI and HD networks, and WBI-sponsored training programs. | | PSAS/HD/WBI | | |
| *Commercial disciplines for IFC* | *Review, as part of IFC Strategic Directions paper, of options for unbundling of subsidies, including:*<br>• *accounting separation between commercial and subsidized operations of IFC;*<br>• *a specific target return for IFC commercial operations;*<br>• *a decision-making mechanism to justify and allocate subsidies; and*<br>• *a timetable to phase in the new disciplines* | *End 2002* | *Woicke* | *IFC Strategy Department* | *Covered by IFC funding* | *No staffing implications* |
| | *Continued dialogue with IFIs on consensus terms (disclosure rules, safeguard policies, rate of return policy)* | *Ongoing* | *Woicke* | *IFC Strategy Department* | *Covered by IFC funding* | *No staffing implications* |
| *Regional PSD implementation programs* | *Elaboration of regional programs to implement the PSD strategy* | *Completed for all regions by end FY04, with three regions starting preparation in FY02 (Africa, East Asia and the Pacific, and South Asia)* | *RVPs* | *Regions* | | |
| *Monitoring PSD dimension of Bank* | • OED /QAG evaluations and monitoring of PSD | On-going; detailed in OED/QAG programs | | OED, QAG | | |

| SUBJECT AREA | ACTION | TIMELINE | RESPONSIBLE MD/VP[2] | RESPONSIBLE UNIT/SECTOR/NETWORK | FUNDING IMPLICATIONS[2] | STAFFING IMPLICATIONS[2] |
|---|---|---|---|---|---|---|
| *operations* | operations<br>• *Review by PSD Sector Board of scorecards for projects with significant PSD components*<br>• *Development of program of cost benefit analysis for PSD interventions* | programs<br>• *Annual Review*<br>• *Summer 2002* | *Shafik* | *Regions, PSD Board, DEC, OED, WBI.* | *Covered by existing operational funding* | *Training in use of scorecards* |
| *Progress report on implementation of PSD Strategy* | *A progress report on the actions set out in this strategy will be provided to the Executive Directors periodically* | *First one in March 2003* | *Woicke* | *PSD Board, IFC Strategy Department, MIGA* | *Covered by existing operational funding* | *No staffing implications* |

## ANNEX II: BACKGROUND PAPERS PREPARED FOR PSD STRATEGY PAPER

1. Private Sector Development: Entrepreneurship, Markets and Development – A Discussion Paper – SecM2001-0303, May 2001.

2. Private Sector Development: Activities of the World Bank Group – SecM2001-0305, May 2001.

3. Private Sector Development Strategy – Issues and Options – A Discussion Document – SecM2001-0302, May 2001 (basis for external discussion).

4. Private Sector Development: The Role of Private Sector Development in Past Strategy Papers – September 6, 2001. http://rru.worldbank.org/Strategy/documents/PSAS-Annex_Strategy_Paper1-Sept6.doc

5. Contracting for Public Services: Output-Based Aid and Its Applications – October 2001. http://rru/obabook.asp

6. Direct Support to Private Firms: Evidence on Effectiveness – December 2001.

7. Privatization in Competitive Sectors: The Record So Far – October 2001. http://rru/Strategy/documents/Privatization%20paper%2010.26.doc

8. Private Participation in Infrastructure: A Review of the Evidence – October 2001. http://rru/Strategy/documents/PPI%20A%20Review%20of%20the%20Evidence%20Version%203R%20a.doc

9. Improving Access to Infrastructure, Services by the Poor: Institutional and Policy Responses – October 2001. http://rru/Strategy/documents/Background%20PSD%20PB-WS.doc

## ANNEX III: LIST OF STRATEGY PAPERS

The following strategy papers were reviewed in preparation for the Private Sector Development Strategy paper.

- Health, Nutrition and Population Sector Strategy, 1997.
- Education Sector Strategy, July 1999.
- Environment Strategy for the Energy Sector: Fuel for Thought – An Environmental Strategy for the Energy Sector, June 2000.
- Information and Communication Technology Sector Strategy Paper, January 2000.
- Water and Sanitation Quality Improvement Plan FY00-02, January 6, 2000.
- Cities in Transition: A Strategic View of Urban and Local Government Issues, March 2000.
- Small and Medium Enterprise Development Strategy, Business Plan and Budget, May 2000.
- Rural Development: From Vision to Action, 1997 and Update July 13, 2000.
- Social Protection Strategy: From Safety Net to Spring Board, August 2000.
- Sector Strategy Paper: Reforming Public Institutions and Strengthening Governance, A World Bank Strategy, October 2000.
- Cities on the Move: Draft Urban Transport Strategy Review, November 2000.
- Engendering Development: Through Gender Equality in Rights, Resources and Voice, 2001.
- Renewing our Energy Business: Draft Strategy for Discussion (presentation), January 2001.
- Making Sustainable Commitments: An Environment Strategy for the World Bank 2001.
- Strategy for the Financial Sector, August 2001.

# ANNEX IV: TOOLKITS AND PRACTICAL GUIDES FOR POLICY DESIGN AND IMPLEMENTATION

## A. Investment Climate Policy

### *A.1 Governance and Anti-Corruption*

**Step-by-Step Guide to the Implementation of the New Empirical Tools for Anti-Corruption and Institutional Reform**
Website of World Bank Institute's Anti-Corruption and Governance
http://www.worldbank.org/wbi/governance/guide.htm

*This guide describes with concrete examples the characteristics and implementation procedures of WBI's governance and diagnostic tools.*

### *A.2 Small and Medium Enterprise Development*

**Business Development Services for Small Enterprises: Guiding Principles for Donor Intervention.**
Prepared by the Committee of Donor Agencies for Small Enterprise Development, World Bank, Washington D.C.
International Labor Organization, Geneva, 2001.
http://www.ilo.org/public/english/employment/ent/papers/guide.htm

*A guide for donors, practitioners and governments on effective methodologies for supporting services aimed at developing small enterprises.*

**SME Country Maps**
**SME Department**
**International Finance Corporation, Washington D.C.**
http://www.ifc.org/sme/cm/

*Drawing heavily on the operational work and knowledge of the WBG and others, the SME Department is developing SME country maps which are designed to bring together essential information about priority needs of SMEs that must be addressed in the client countries. They highlight the four principal areas of focus of the World Bank Group's SME strategy: the business environment, access to capital, access to business development services and access to information and technology. The maps are used as a diagnosis tool, a knowledge management tool and a programming tool for policy interventions.*

### *A.3 Microfinance*

**Microfinance Handbook: An Institutional and Financial Perspective**
Ledgerwood, J.
World Bank, Washington D.C., 1998, ISBN 0-8213-4306-8

*A technical manual aimed at assisting microfinance practitioners in the design and implementation of their activities. It covers issues in microfiance provision, in designing and monitoring financial products and services, and in measuring performance and managing viability.*

**The website of CGAP (Consultative Group to Assist the Poorest) also provides a number of background papers on the role of the financial regulators in supporting the development of microfinance.**
http://www.cgap.org/

### *A.4 Consultation with the Private Sector and Enterprise Surveys*

The following are a series of papers and presentations that provide guidance on when and where to use an enterprise survey, how to design and implement the survey, and how to use the findings of the survey:

**Business-Government Consultative Mechanisms for Market-Oriented Reform (presentation)**
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/documents/consmech.ppt

**FAQ On Enterprise Surveys**
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/faq-bea.htm

**Listening to Firms: Assessing Constraints to Private Sector Development through Firm-Level Surveys**
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/documents/Listen_firm.pdf

**Regulatory Impact Assessment With "How to" and Examples From Canada and Mexico (presentation)**
Andrew Stone
Washington D.C., World Bank.

**Using Firm-Level Surveys in Private Sector Assessments (presentation)**
Andrew Stone
Washington D.C., World Bank.
http://www1.worldbank.org/beext/resources/documents/Survey_PSA.pdf

### *A.5 Investment Promotion*

**MIGA Investment Promotion Toolkit: A Comprehensive Guide to FDI Promotion**
Multilateral Investment Guarantee Agency
Multilateral Investment Guarantee Agency, Washington, D.C. February 2001. ISBN 0-8213-4933-3

*This toolkit offers a comprehensive compilation of international best practices in investment promotion, with the objective national and local investment intermediaries to attract and retain foreign direct investment.*

**Marketing a Country: Promotion as a Tool for Attracting Foreign Investment**
Louis T. Wells and Alvin G. Wint
FIAS Occasional Paper No. 13. International Finance Corporation, Washington, D.C., April 2000

*This paper provides guidance on the promotional techniques and structures that countries can employ in their competition to attract foreign direct investment.*

### *A.6 Corporate Governance*

**ROSC - Corporate Governance and the International Financial Architecture**
http://www.worldbank.org/ifa/rosc_cg.html

*The web site of the ROSC initiative (Reports on the Observance of Standards and Codes) provides updates on best practices in corporate governance, and a template which is being used as the diagnostic for corporate governance regimes in client countries.*

### *A.7 Privatization*

**The Case-by-Case Approach to Privatization: Techniques and Examples**
Dick Welch and Olivier Frémond
World Bank Technical Paper No. 403. World Bank, Washington, D.C., March 1998.

*This paper identifies the key steps for privatization, describes sale options and the processes for carrying them out, and examines special conditions. It outlines how governments should undertake case-by-case privatization by identifying basic principles and common challenges, describes various methods for valuing state enterprises, and explains the role of financial advisors.*

## B. Contracting for Service Provision

### *B.1 General Guides to Contract Design and Implementation*

**Concessions for Infrastructure: A Guide to Their Design and Award**
Celine Levesque, Michel Kerf, David Gary, Timothy Irwin & Robert Taylor
World Bank Technical Paper 399. World Bank, Washington, D.C., March 1998, ISBN 0-8213-4165-0.

*This book covers key issues in the designing, awarding, implementing and monitoring of infrastructure sector concessions.*

**Designing Output-Based Aid Schemes: A Checklist**
Warrick Smith
In Contracting for Public Services: Output-based Aid and its Applications; edited by Penelope Brook and Suzanne Smith. World Bank, Washington, D.C., 2001

*A detailed checklist for the design and implementation of output-based aid schemes.*

**A Guide for Hiring and Managing Advisors for Private Participation in Infrastructure**
PPIAF / World Bank, Washington, D.C., 2001

*This toolkit seeks to assist governments in hiring and managing economic consultants, financial advisors and legal experts, as well as other specialist expertise needed to design and implement private infrastructure reforms.*

**Bidding for Concessions**

Michael Klein
Policy Research Working Paper 1957. World Bank, Washington, D.C., August 1998

*A guide to key issues in the design of bidding and rebidding processes.*

**Labor Redundancy, Retraining and Outplacement During Privatization**
Antonio Estache, Jose Antonio Schmitt de Azevedo and Evelyn Sydenstricker
Policy Research Working Paper 2460. World Bank Institute, Washington, D.C., October 2000

*A guide to the design of labor redundancy programs based on experience with railway privatization in Brazil.*

### *B.2 Sector Specific Toolkits and Guidelines*

**Toolkits for Private Sector Participation in Water and Sanitation**
Transport, Water and Urban Department, World Bank
World Bank, Washington, D.C., 1997

*A set of toolkits intended to assist governments in designing and implementing private sector contracts in the water and sanitation sector. The toolkits look at how to choose a privatization option, how to hire advisers and design a transaction process, and what to look for in management, concession and BOT contracts.*

**Private sector participation in municipal solid waste management: Guidance Pack**
Sandra Cointreau, Prasad Gopalan and Adrian Coad
SKAT, St. Gallen, Switzerland, 2000 (in collaboration with the World Bank)

*A toolkit designed to assist solid waste managers and key decision makers in municipalities of low- and middle income countries to decide whether to involve private sector participation and if so, how to do it and is based on a wide range of case studies and extensive international experience.*

**Port Reform Toolkit**
World Bank
World Bank, Washington, D.C., 2001

*The Port Reform toolkit is designed to lower the learning curve for institutional renewal by providing background information, concrete examples, specific tools and methods which policy makers and reformers require to proceed with port reforms.*

**Best Methods of Railway Restructuring and Privatization**
Ron Kopicki and Louis S. Thompson
CFS Discussion Paper Series #111. World Bank, Washington, D.C., August 1995

*A practical reference work for policy makers on the restructuring and privatization of railways – including rail enterprise reform, and the design of institutions to carry out restructuring and privatization.*

**Privatization and Regulation of Transport Infrastructure: Guidelines for Policymakers & Regulators**
Antonio Estache and Gines de Rus (eds.)
World Bank, Washington, D.C., June 2000. ISBN 0-8213-4721-7

*Covering airports, seaports, railways and toll roads, and drawing on the experience of almost two decades of restructuring and private participation in these sectors, this book provides lessons and guidance on the design of privatization reforms, and ongoing sector regulation.*

**A toolkit is also near completion on private participation in toll roads.**

**Private Sector Participation in Health Handbook**
April L. Harding and Alexander S. Preker (editors)
Health, Nutrition and Population Department, The World Bank, Washington D.C.
Forthcoming.

*The handbook provides a comprehensive guide for policy-makers and health sector analysts on policies for enhancing the contributions of private health care providers, both for profit and non-profit, to health sector objectives.*

## C. Regulation

### *C.1 Regulatory System Design*

**Utility Regulators: Decision Making Structures, Resources, and Start-up Strategy**
Warrick Smith
Viewpoint 129. World Bank, Washington, D.C., October 1997

*This paper provides guidance on three issues in the design of a regulatory agency: decision-making structures (including the number of decision makers,*

*the basis for selecting them, the role played by stakeholders, and the regulatory and appeals processes) resources (including human resources, funding), and start-up strategy.*

**Utility Regulators: The Independence Debate**
Warrick Smith
Viewpoint 127. World Bank, Washington, D.C., September 1997

*This paper explains the requirements for establishing independent regulatory agencies, including formal safeguards, and suggests possible paths of transition for setting up such agencies.*

**Utility Regulators: Roles and Responsibilities**
Warrick Smith
Viewpoint 128. World Bank, Washington, D.C., September 1997

*This paper sets out three main issues in defining a utility regulator's role: the scope of its coverage, its role in relation to ministers, and its role in relation to other regulatory entities such as the competition agency or agencies dealing with environment or health and safety.*

**Regulating Utilities:Thinking About Location Questions**
Warrick Smith
World Bank Summer Workshop on Market Institutions. Mimeo, World Bank, Washington, D.C., July 2000

*This paper covers issues relating to the location of regulatory authorities within a country's institutional framework. Specifically the author addresses two questions: (i) which tier of government should have responsibility for regulating utilities (ii) should regulatory agencies be created on an industry-specific or broader basis.*

### *C.2 Regulatory Rules and Their Implementation*

**Resetting Price Controls for Privatized Utilities: A Manual for Regulators**
Richard Green and Martin Rodriguez-Pardina
World Bank, Washington D.C., March 1999. ISBN 0-8213-4338-6

*This manual describes the task that an economic regulator should undertake when revising price control for a regulated company, and provides practical guidance for new regulators on the implementation of these tasks.*

**Telecommunications Regulation Handbook**
Hank Intven, Jeremy Oliver, Edgardo Sepulveda
InfoDev. World Bank, Washington, D.C., November 2000

*The authors describe major regulatory practices in telecommunications sectors around the world. The focus of the Handbook is on practices that promote the efficient supply of telecommunications services in a competitive marketplace.*

**Information, Accounting, and the Regulation of Concessioned Infrastructure Monopolies**
Phil Burns and Antonio Estache
Policy Research Working Paper 2034. World Bank Institute, Washington, D.C., December 1998

*Information that private operators of infrastructure monopolies provide regulators can and should be used to address technical issues and monitor performance. The authors examine the ways such information can and should be generated, especially through the accounting requirements a regulator can impose on private operators of infrastructure concessions.*

## D. Service Access for poor people

**Energy and Development Report 2000: Energy Services for the World's Poor**
ESMAP, World Bank
World Bank, Washington, D.C., 2000

*This report focuses on energy and poverty alleviation. The report considers the challenge of expanding access for low-income households and communities in developing countries, and looks at how to use market structure and regulatory reform to facilitate technological and commercial innovations in serving the people.*

**Extending Telecommunications Beyond the Market: Toward Universal Service in Competitive Environments**
Bjorn Wellenius
Viewpoint 206. World Bank, Washington, D.C., March 2000

*Competitive markets go a long way toward making telecommunications services available throughout the population. But governments often seek to extend access to services beyond what the private sector will provide on its own. This paper outlines options and best practices for service expansion policies in developing countries.*

**Designing Output-Based Aid Schemes: A Checklist**
Warrick Smith
In Contracting for Public Services: Output-based Aid and its Applications; edited by Penelope Brook and Suzanne Smith. World Bank, Washington, D.C., 2001

*A detailed checklist for the design and implementation of output-based aid schemes.*

**Infrastructure for Development: Private Solutions and the Poor**
http://www.ppiaf.org/conference/presentations.html

*This web site gathers papers and presentations from a PPIAF/DfID/World Bank funded conference held in May/June 2000, focusing on policy and practical issues in expanding services to people through private sector participation in infrastructure.*

*Papers include:*

**Impact of Market Structure on Service Options for the Poor**
David Ehrhardt

*Improving choice is key to improving services. This paper looks at how pro-competitive reform of existing networks and liberalization of entry by new service providers can improve the services available to low-income households.*

**Regulating Infrastructure for the Poor: Perspectives on Regulatory System Design**
Warrick Smith

*The design of regulatory systems in developing countries draws heavily on developed country models and experience. This paper looks at how regulatory*

*rules, agencies and processes might need to be designed to address the needs of poor people in developing countries.*

**Measuring the Impact of Energy Intervention on the Poor: An Illustration from Guatemala**
Vivien Foster

*To date, very few infrastructure reforms have included systematic efforts to assess the impact of reform on access to services by poor people. This paper looks at options for building impact indicators into reform projects at an early stage, using sample indicators from the energy sector in Guatemala.*

**Utility Privatization and the Needs of Poor in Latin America: Have We Learned Enough to Get it Right**
Antonio Estache, Andrés Gomez-Lobo & Danny Leipziger

*Efforts to reform utilities can affect poor households in varied, often complex, ways. This paper looks at how governments can improve the chances that poor households will benefit from reform – in particular by promoting competition, and adopting responsible redistribution policies.*

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