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USING ODA TO PROMOTE PRIVATE INVESTMENT FOR DEVELOPMENT: POLICY GUIDANCE FOR DONORS

This policy guidance for donors on using ODA more effectively to promote private investment for development is preliminary and circulated for comments prior to the meeting of the DAC on 17 January 2006. Prepared by DAC Secretariat [as document DAC/DCD(2006)5], it builds on the joint report of the Development Assistance and Investment Committees presented to the 2005 OECD Ministerial Council Meeting [see: C(2005)61].

The Working Party of the Investment Committee, at its meeting on 15 December 2005, heard a presentation of this document and agreed to provide written comments. Delegates are invited to do so no later than end-January 2006.

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USING ODA TO PROMOTE PRIVATE INVESTMENT FOR DEVELOPMENT:

DRAFT KEY MESSAGES

1. Investment rates in many developing countries are far too low. Mobilising more domestic and foreign private investment is imperative for promoting the broad-based and sustainable growth that will help drive poverty reduction. Developing countries and their donor partners need to do much more to address the constraints holding back investment, and to do it better, for longer periods and in a more strategic way.

2. A review of past practices highlights that:

i. Donors are supporting a vast range of activities – at the macro-economic, enabling environment and enterprise levels – that affect investment levels. They spend around 20% of their aid on these. But little evaluative material on the impact of interventions on mobilising investment is available.

ii. Insufficient attention has been given to enterprise and supply-side capacity development, and to promoting the institutional and policy reforms that lie at the heart of efforts to promote private sector development.

iii. Donors have focussed too much on assisting specific types of firms (e.g. certain sizes, activities or sectors). Experience has shown this can lead to market distortions and poor sustainability.

3. To help developing countries mobilise more investment, and improve the effectiveness of interventions that support this objective, donors need to:

i. Reduce dispersion by using analyses of the detailed country and sector-specific constraints to doing business to focus and co-ordinate their efforts on removing binding constraints to investment.

ii. Build capacity of governments and private sector and civil society organisations in developing countries to carry out assessments, implement reforms and monitor results.

iii. Pay greater attention to the determinants of domestic investment by making markets work better for the poor, tackling constraints to women's entrepreneurship, reducing barriers to formalisation, encouraging competition, promoting environmental sustainability, developing the financial sector, expanding access to affordable infrastructure and unleashing the economic potential in rural areas.

iv. Strengthen the capacities of firms in developing countries to respond to new investment opportunities, including those created through stronger international trade and investment linkages, and to enter into and expand business relationships with foreign investors.

v. Avoid providing direct subsidies and use more market-based approaches to supporting firms. In post-conflict and other situations where this may not be feasible in the short-term, work in parallel to rebuild a supporting institutional environment for the private sector.

vi. Promote structured and inclusive public-private dialogue, at national and local levels, so as to bring micro and small entrepreneurs and informal firms and workers into consultation and decision-making processes, thereby helping to build demand for reform.

vii. Evaluate the cumulative impact of interventions on mobilising investment, share lessons on what to do and not to do and record and share examples of successful and unsuccessful practices.

4. Donors also need to change the way they do business. They need to have access, individually or collectively, to an appropriate range of aid instruments. Their internal systems should not work against staff pursuing longer-term and riskier interventions. Staff working on the range of subjects relevant for mobilising investment should be well co-ordinated. More flexible means of engaging with and learning from all parts of the private sector in developing countries may need to be developed. Finally, more of the goods and services that donors procure can be sourced on competitive terms in developing countries, to support local private sector development.

USING ODA TO PROMOTE PRIVATE INVESTMENT FOR DEVELOPMENT:

PRELIMINARY POLICY GUIDANCE FOR DONORS

5. Too many developing countries are not on track to reach the Millennium Development Goals (MDGs) by 2015 and need to pursue better and more sustainable ways of reducing poverty. If progress continued on present trends, some countries in Sub-Saharan Africa would not reach the MDGs for over a century (see Box 1). The private sector has an important role to play in the war on poverty because mobilising more domestic and foreign private investment is imperative for promoting the broad-based and sustainable growth that will help drive poverty reduction. As a result, there is increasing demand for guidance on how to promote much faster and more poverty reducing patterns of economic growth and on the use of aid instruments that support productive sectors. Official development assistance (ODA) can support efforts by developing countries to address the barriers that are holding back higher levels of private investment and its contribution to reducing poverty. This document provides guidance to members of the OECD's Development Assistance Committee (DAC) on using ODA more effectively to mobilise private investment for development (investment-enhancing ODA).

Box 1. Regional trends in growth and poverty reduction are uneven

Economic growth has begun to take root in developing countries since the mid-1990s although its pace and impact on poverty reduction has been uneven. Spurred by China's performance, the fastest growth over the 1990s was in Asia, which increased by over 6%, and where the share of people living on less than USD 1/day fell from 30% to 15%. Growth in Sub-Saharan Africa was negative on average and the share of people in extreme poverty rose from 47% to 49%. Extreme poverty remained at 11% in Latin America where growth was slow.

Source : Operationalizing Pro-Poor Growth Research Program 2005, *Pro-Poor Growth in the 1990s*, World Bank, Washington D.C.

6. A first set of policy lessons on the role of ODA in mobilising private investment found that bilateral and multilateral donors are supporting a vast range of activities - at the macro-economic, enabling environment and enterprise levels - that affect investment levels. They spend a significant share of their aid - around 20% - on these (see Box 2). But little evaluative material on the impact of these interventions on mobilising investment is available. To improve the effectiveness of these efforts, donors' interventions should be more strategic, better co-ordinated and guided by more systematic learning of lessons on what works best to mobilise investment, what doesn't and why.[1]

Box 2. A significant share of aid expenditures help to mobilise investment

The 2005 World Development Report found that "assistance provided by major bilateral and multilateral donors for investment climate improvements averaged USD 21 billion per year between 1998 and 2002 -- or about 26% of all development assistance. The bulk of that assistance went to infrastructure development."

The World Bank's methodology can also be used to determine how much of the bilateral ODA provided by the 22 DAC member countries goes towards mobilising investment in developing countries. DAC donors spent between about USD 8 and USD 10 billion per year between 2001 and 2003, or 15% to 20% of their bilateral ODA. Infrastructure development was again the largest component.

Source : World Bank (2004), *World Development Report 2005: A better investment climate for everyone*, The World Bank/Oxford University Press, Washington D.C./New York and OECD.

1. See: OECD (2005), *The DAC Journal*, Volume 6, No. 2, OECD, Paris.

I. Using ODA to mobilise investment: What to do

7. In countries where growth is high, total domestic and foreign investment often exceeds 25% of GDP. But, in Sub-Saharan Africa, gross fixed capital formation has hovered at around 18% of GDP for the last two decades. Since the financial crisis in 1997, investment rates in developing countries in Asia (excluding China and India) have remained at around 21%. This shows that developing countries and their donor partners need to do much more to address the constraints holding back investment, and to do it better and for longer periods. Paying greater attention to the determinants of domestic investment and strengthening the capacities of the local enterprise sector to respond to new investment opportunities, including those created through stronger international trade and investment linkages, should be high priorities. Long-standing approaches - such as using ODA to encourage small firms from OECD countries to invest in developing countries – should be abandoned if they have not resulted in cost-effective, significant and sustainable increases in employment and investment in developing countries.

8. To help developing countries improve the **enabling environment** for investment, development agencies should support interventions that contribute towards achieving four intermediate objectives:

i. **Lower the costs of investment.** This refers to the costs of production and of doing business (e.g. the costs of complying with the policy, legal and regulatory framework in which the private sector operates, including the extra costs created by inadequate infrastructure, crime, corruption and excessive red tape). High costs reduce profits and so discourage investment. They also create disincentives for firms to formalise.

ii. **Reduce risks.** This involves policy and institutional reforms that improve the stability of the investment climate and the predictability of returns on investment, including by making the implementation of regulations established by national and local governments more predictable. A well-functioning financial market is crucial for financing long-lived assets and managing the risks associated with creating firms and expanding production, especially for the many small domestic firms that rely on internally generated cash flows and money provided by family and friends.

iii. **Improve competition.** A more competitive investment climate improves efficiency, encourages innovation and can be the most important factor driving productivity improvements in the short run. This often calls for the sequenced removal of policies or laws that protect markets or allow anti-competitive behaviours by public or private sector actors. A competition law and policy can help curb uncompetitive practices, engender a culture of competition and enhance the predictability of returns on investment.

iv. **Develop capacity.** There is a need to support initiatives that build up the capacity of public and private sector stakeholders to implement policy reforms and improve their ability to cope with constraints and changes in the business environment.

a) Key challenges

9. Much is already known about what should help mobilise private investment. To flourish, the private sector requires a stable and predictable investment climate that comes from macro-economic stability, good public governance, strong rule of law, functioning markets and institutions, affordable and accessible infrastructure and political and social stability. But country contexts differ – including the size and maturity of their markets and governance conditions - as do the needs and especially the risks faced by domestic and foreign investors. To improve the investment climate, reform programmes should contain an appropriate mix and sequence of approaches, developed on the basis of an analysis of the country and sector-specific constraints on business, at national and local levels, and an assessment of the country's

competitive advantage. Reforms are often political as well as technical in nature and so can need political will, drive and leadership in order to take on entrenched interests and inertia.

10. Using ODA to mobilise investment entails several **challenges** for developing countries and development agencies:

i. **Private investors are diverse.** It is important to recognise the diversity of private investors - domestic or foreign, large or small, formal or informal – when assessing barriers to investment. Priority areas for interventions are likely to be different for each group and need different responses. For example:

  - Most firms in developing countries are **small and medium-sized enterprises (SMEs)** whose specific needs include expanded access to financial services and support to participate in processes that set the strategic framework for national development. SMEs can also need greater access to the associations and enterprises that will help them improve their competitiveness and raise their capacity to link up with larger firms, both domestic and foreign. A disproportionate number of women-owned businesses are SMEs. To help unleash women's entrepreneurship, specific, targeted initiatives may be needed to address gender biases that prevent women's enterprises from making their full contribution to growth and poverty reduction. Fixed business costs weigh more heavily on SMEs and so there is a case for introducing graduated schedules of payments (e.g. taxes, registration fees) or regulatory requirements based on firm size, rather than exemptions which can create disincentives for firms to grow or lead to unfair competition.

  - The **informal economy** forms a large and, in some cases, growing part of the economies in many developing countries. It is a safety net for those who lose or cannot find work in the formal economy and includes a disproportionate number of women and people from disadvantaged groups. But informality is not conducive to sustainable growth and poverty reduction – it distorts markets, excludes people from basic protections and reduces revenues for social and other public expenditures. There are substantial assets held in the informal economy that could be more productively used. Formalisation also brings benefits for firms which they are often not aware of including greater access to the resources that will enable their business to grow. It also helps them better deal with risk and vulnerability. To promote movement along the gradual path towards a greater degree of formality, developing countries should address such constraints as regulatory and administrative barriers, fees and financial requirements, corruption in public administration, socio-cultural attitudes and a lack of key business services; reforms that will help spur economic growth more generally. Development agencies need to ensure that their efforts to improve livelihoods for those in the informal economy do not hold back tendencies towards greater formalisation.

  - **Foreign direct investment (FDI)** should be encouraged, not only for the extra capital it brings, but also because it produces positive externalities in the form of technology transfer and spillovers that can lead to better human capital formation, deeper international trade integration and a more competitive business environment. There are four main determinants for attracting FDI: i) market size and growth prospects; ii) natural and human resource endowment; iii) physical, financial and technological infrastructure; and iv) openness to international trade and access to international markets. Some of these can be improved through ODA. In the least-developed countries, which have still to benefit from sizable FDI inflows, particular efforts appear necessary to improve the functioning of financial markets, expand infrastructure and increase skill levels. Foreign investors often have difficulties in adequately assessing the risks of doing business in developing countries. Making accurate

information on market conditions and experiences of other foreign investors more readily available will help address this. Where risks are real rather than perceived, business would like donors to look more to the possibilities of helping with risk mitigation schemes.

ii. **Trade liberalisation may need complementary policies.** Trade and investment are closely linked and complementary activities for modern business operations. For potential foreign investors, the ability to import and export freely is a critical aspect of the business environment. In the long-run, greater openness accelerates growth and leads to greater competition and efficiency in domestic and international markets. But, in the short-run, trade liberalisation may either increase welfare for the poor (if they are employed in export sectors or consume previously protected products) or decrease welfare for the poor (if they are employed in protected sectors or consume goods destined for export). Complementary measures can help the poor adjust to structural changes. With careful sequencing, reforms can create opportunities for the poor. To help firms in developing countries participate in global markets that require adherence to high business standards, donors can promote adoption of responsible business practices in such areas as labour relations, the environment and anti-corruption.

iii. **Natural resources can be a mixed blessing.** Abundant natural resources provide a basis for growth in many developing countries and investment can help expand these countries' primary export sector. But some of these countries experience a "resource curse" and grow more slowly than those with fewer natural resources. As demand for commodities may remain strong for some time, further investments to expand extractive industries can be expected. Developing value chains that link natural resources up to processing activities using domestic suppliers of goods and services will help produce higher returns, create more jobs and ensure that the resulting growth is broader-based and more sustainable. It is important that extra revenues that governments may receive through royalties and taxes do not reduce pressures to reform.

iv. **Expectations need to be kept realistic.** Developing countries vary enormously - from small island states or land-locked mountainous regions to some of the largest and most populous nations on the planet. Their potentials for mobilising private investment differ. We now know more about the institutional and policy reforms that should improve the necessary conditions for investment. However, we are less clear about how to bring about the conditions that will lead to more investment, particularly in countries that appear to have low growth potential. This highlights the importance of working both on the enabling environment as well as strengthening the supply-side capacity of the local private sector, and of promoting entrepreneurship and innovation through research, technology transfers, making access to finance and other inputs cheaper and less cumbersome, and reducing the costs and formalities associated with creating and closing firms.

v. **Sustainable reforms can involve difficult and time-consuming processes.** Successful reforms of the investment climate call for on-going processes of institutional reform, policy adjustment and engagement with a wide range of private sector representatives. In OECD and non-OECD countries alike, such political processes can be difficult. There is a need to know more about how best to manage such complex processes, overcome resistance to change and catalyse local demand for change that will help mobilise investment. Ultimately, success in the private sector should be based on rules rather than personal connections and influence. Donors need to stay the course and support "change agents" within the public and private sector and civil society.

b) Enhancing the contribution of investment to reducing poverty

11. To ensure that increasing levels of private investment lead to **greater reductions in poverty**, thereby making growth faster and more sustainable as well, policies need to ensure that poor men and women can participate in, contribute to and benefit from the growth process:

i. Obstacles that limit the poor's **access to markets**, employment and business services need to be removed. The poor may also need help to increase their assets and legal rights. To ensure that reforms translate into development results, efforts are needed to ensure that poor people are aware of the availability of services and of their rights.

ii. **Women** meet specific constraints to participating in labour, financial, goods and services markets because of social norms, biases, prohibitions and gender divisions of labour. This jeopardises efforts to spread the benefits of growth among the poorest. Policies that can help expand female participation in markets and make the creation or formalisation of women's enterprises easier include increasing access to health care and infrastructure that meets women's needs, lowering fertility rates, expanding school enrolment for girls and supporting laws that reduce gender discrimination in pay and working conditions.

iii. The poor are heavily dependent on natural resources and **environmental** costs bear hardest on the poor. Environmental degradation is not the inevitable cost of economic development. Rather than trying to mitigate the environmental impact of policies and projects, developing countries and their donor partners should use tools such as Strategic Environmental Assessments to help make informed choices. Central to such an approach is effective governance and fiscal policies that change incentives in favour of environmental sustainability and growth.

iv. A well-developed **financial sector**, including a more integrated micro-credit sector, can expand access to an array of financial services (such as payment instruments, saving facilities, credit and insurance) for poor people and micro-entrepreneurs. In countries with less developed financial sectors, donors should give priority to helping create a conducive enabling environment, through support for regulation, supervision and promotion of financial systems. In more sophisticated economies, donors can give higher priority to supporting policies and projects that extend the provision of financial services to the poor and small firms, on terms and conditions more adapted to their needs. Expanding access to banking facilities for the many "unbanked" in developing countries - through outreach, use of ICTs and more cost-efficient and transparent services – will also help channel remittance payments more cost effectively and enhance their contribution to mobilising investment.

v. Inadequate and insufficient **infrastructure** is a major obstacle to growth, trade and investment and raises the production and transaction costs of doing business. Investments in transport, energy, water and ICT services are also essential to bring poor people closer to local, national, regional and global markets. To meet the infrastructure challenge in developing countries, four guiding principles should be applied: i) use partner country-led frameworks as the basis for co-ordinated donor support; ii) enhance infrastructure's impact on poor people; iii) improve management of infrastructure investment, to achieve sustainable outcomes; and iv) increase infrastructure financing and use all financial resources efficiently. To help meet this challenge, private sector participation in infrastructure investment needs to increase.

vi. There has been considerable underinvestment and disinvestment in **agriculture**, especially in Africa. Yet agriculture remains a key sector because enhancing growth prospects, productivity and diversification will contribute significantly to poverty reduction. Most poor people in developing

countries engage in private sector activities through farming and associated agribusiness. Increasing access to markets and assets, improving access to productivity-enhancing technology (especially for small produces and agribusinesses) and boosting investment in power, irrigation and road infrastructure are critical for releasing the economic potential in rural areas and expanding the domestic private sector.

II. Using ODA to mobilise investment: How to do it

a) Improving the management of aid projects and programmes

12. A systematic and comprehensive approach to providing investment-enhancing ODA should connect anticipated outcomes and impacts to interventions that address specific constraints or barriers to investment. A four-stage approach can be used involving: i) an assessment of the conditions for private investment; ii) the design of reform programmes; iii) the implementation of reform efforts; and iv) measuring the impact of reform on private investment. In many developing countries, donors act too independently and sometimes compete to fund projects. To make the most of their comparative advantage and avoid duplication, donors should co-ordinate more at each of the four stages.

Assessment

13. To better pinpoint reforms that should lead to lower costs, reduced risks or improved competition, development agencies should support and build up capacities in developing country governments, the private sector and civil society organisations to carry out assessments, either alone or jointly with international experts, of conditions for investors. As private business knows best how to evaluate the investment climate, assessments should include consultations with business as well as business associations that are independent of government and truly representative of the interests of the private sector, not just specific industries or types of firm. It is important that assessments unearth more than generic issues and identify detailed, country and sector-specific constraints. Anonymous surveys can allow firms to provide more honest and useful responses. Assessments should pay special attention to the variations in conditions that may exist for domestic and foreign investors, and between formal and informal enterprises, and consider how regional integration can be enhanced. Gender analysis tools can help ensure that woman's roles as consumers, workers and entrepreneurs are taken into account in the design of programmes. The results of assessments should be publicly distributed and debated, including in the media, to promote dialogue among stakeholders, to raise awareness about the importance of private investment and the conditions that affect investment levels and to catalyse demand for reform. A new assessment tool that can also be used is the Policy Framework for Investment (see Box 3).

Box 3. A new assessment tool: The Policy Framework for Investment

The *Policy Framework for Investment* is intended to assist governments to create an environment that attracts domestic and foreign investment, taking into account the broader interests of the communities in which investors operate. The *Framework* helps countries to develop a sound investment environment by fostering an informed process of policy formulation and implementation across government agencies. Based on best practices drawn from OECD and non-OECD experiences, it proposes a set of practical policy considerations in ten inter-related areas that, beyond stable macroeconomic conditions, contribute to such an investment environment. Governments can consider these policy considerations in country self-evaluation and for reform implementation, in regional co-operation and peer reviews and in multilateral discussions.

A checklist of questions in each of the following ten policy areas is included in the *Framework*: i) investment policy; ii) investment promotion and facilitation; iii) trade policy; iv) competition policy; v) tax policy; vi) corporate governance; vii) corporate responsibility; viii) human resource development; ix) infrastructure and financial services; and x) public governance. The *Framework* also provides explanatory background material on the issues at stake.

Design

14. The aim of the design stage should be to create demand for reform by building in incentives for stakeholders to take ownership of the reform process. When designing programmes, development agencies should collaborate closely with governments, the private sector, civil society and other development agencies and use the results of assessments conducted. It is important to identify reliable, representative and accountable domestic partners who can drive reform programmes. Development agencies should support their efforts and act as catalyser for change. The establishment of platforms and fora for dialogue is needed to promote and facilitate the engagement of representatives of all private sector actors. Reform programmes should be closely connected to broader national development strategies, such as private sector development, competitiveness or national, locally driven poverty reduction strategies, and to annual budget plans. This can help programme partners to see the relevance of investment climate reform and the contribution this makes to broader social and economic agendas. New regulations should only be introduced if absolutely necessary, and ideally integrated with existing legislation. Regulations should not be introduced if they cannot be implemented and enforced at a reasonable cost. Regulatory impact assessments (RIAs) on policies and proposed laws can help governments understand the ways the private sector will be affected.

Implementation

15. Following through to ensure that reforms are implemented is essential and often depends on capacity constraints being addressed and behavioural changes occurring. Communicating information about reforms taking place, for example through the media or by making information available in local languages, supports implementation efforts. When implementing activities, and to enhance long-term sustainability, development agencies should support, add value to and improve reform processes begun by local partners, particularly developing country governments, rather than try to lead reform processes themselves. A financial contribution from domestic partners for a programme can be a sign that the reform has strong local ownership and should take root. Starting with a package of achievable changes and building on successes can help spark a virtuous cycle of improvements, but it is also important to create expectations that there will be steady progress in implementing reforms. Development agencies should co-ordinate their reform efforts across all levels of intervention, and at national, sub-national and local levels. Care should be taken to ensure that key priorities are agreed on and that reform programmes are harmonised, in accordance with the principles set out in the *Paris Declaration on Aid Effectiveness*.

Monitoring and evaluation

16. Development agencies should ensure that their programmes are regularly monitored and evaluated against indicators established in the design phase that are agreed on by their reform programme partners. Although the ultimate impact of successful reform will be a rise in the levels of private investment and a reduction in poverty, development agencies should be rigorous in their efforts to measure the impact reform programmes are having on the capacity of the government to design, enforce and review their policy, legal and regulatory framework, as well as on the private sector's ability to participate in on-going reform efforts in an informed and strategic way. When improvements to the investment climate will take considerable time, donors can draw out a small number of critical components of a programme and track progress with these over time. Greater efforts appear necessary to gauge the cumulative impact on mobilising investment of the variety of interventions supported by donors (see Box 4). Added attention to evaluation will allow better identification and greater sharing of lessons learnt and experience on how – and how not – to use ODA to mobilise investment for development and which kinds of intervention work best in which circumstances. Developing a common knowledge management system that records examples of successful and unsuccessful approaches would be valuable.

Box 4. Improving the investment climate: Findings from an evaluation

The World Bank Group has carried out one of the few evaluations of the combined impact of a donor's various interventions on improving the investment climate. The evaluation identified four main challenges for the World Bank Group as it attempts to achieve better outcomes with its investment climate activities:

i) **Focus on reforms at the institutional level more than at the policy level.** Institutions – the "rules of the game" – are key to the quality of the investment climate. Strategies for improving the investment climate have suffered from a lack of knowledge about what kinds of institutional arrangements will work in different environments and about the dynamic process of change that is needed.

ii) **Customise interventions to country needs.** The quality of the investment climate varies significantly across countries (and even within countries), regions and industries. There is a need to understand better, using local knowledge and expertise, country-specific constraints and opportunities as well as country-specific institutional designs.

iii) **Political economy and the sequencing of reforms.** The feasibility of reform depends on the political economy of the reform process, and sustainability hinges on broad stakeholder support. There is a need to assess the capacity and incentives facing public sector organisations to implement reforms, and be aware of the likely winners and losers an the political strength of key groups.

iv) **Organisational challenges for donors.** The broad nature of the investment climate as a topic and the need to work with both the public and private sectors can create internal organisational challenges for donors. For example, sector strategies need to be consistent with each other, and strategies and practice should be harmonised. At the country level, investment climate strategies need to be integrated across sectors and different operational units.

Source : The World Bank Group (2005), *Improving investment climates: An evaluation of World Bank Group assistance*, The World Bank Group, Washington D.C.

b) Cross-cutting concerns

17. **Developing the capacity** of people, organisations and society to manage their affairs better is a central and cross-cutting element of all development efforts, including investment-enhancing ODA. To support capacity development, donors should: i) recognise that capacity development is necessarily an endogenous process and that strong local engagement is the key; ii) encourage the emergence of country-led, demand-driven capacity strategies; iii) take the local context as the starting point; iv) think and act within longer time frames; v) provide aid on a predictable medium-term basis; vi) avoid undermining local institutions; vii) recognise that capacity is one of the keys to unlocking economic growth; viii) acknowledge that capacity to manage complex changes and to assume ownership of and be accountable for policies is as essential as capacity for policy implementation and service delivery; and ix) design coherent strategies for making use of the diaspora and for reducing brain drain. Donors' support should be embedded in a comprehensive medium to long-term framework that involves less risk aversion (e.g. by avoiding the use of project implementation units) and greater strategic engagement.

18. Structured **public-private dialogue** is a means to bring different stakeholders together to identify policies and institutional reforms that promote entrepreneurship and help mobilise private investment. A good balance within the dialogue process is key, to ensure that the voice of some does not drown out the voice of others. Donors can promote public-private dialogue by supporting the establishment and operation of dialogue processes in developing countries, including new styles of processes that become available through greater access to ICTs. Special efforts should be directed at helping poor entrepreneurs to participate and promote their interests because established consultation fora tend to include large firms and promote vested interests. To do this, donors can support, in a time-bound and strategic way, the emergence

and strengthening of organisations, at national, sub-national and local levels, that represent the interests of micro and small entrepreneurs and of informal firms and workers. Business associations and trade unions can be important drivers of change but are often institutionally weak and sometimes non-existent. Donors should stay clear of imposing their own agendas on dialogue processes or of creating situations where participants respond more to donors' priorities than to their own constituencies.

19. There is a consensus among donors on the need to move towards more market-based and sustainable approaches to providing **support to firms**. To avoid distorting markets, donors can promote demand-driven initiatives and apply the following criteria when providing support to firms: i) focus on the causes of problems; ii) promote a level playing field; iii) avoid or minimise subsidies; iv) apply output-based aid principles; and v) have a clear exit strategy. In situations, such as following conflicts or natural disasters, where market-driven approaches may not be applicable in the short-term, donors should expect to shift gradually to a market-based approach that aims to rebuild the supporting institutional environment for the private sector.

c) Some implications for donors

20. Development agencies potentially have a wide selection of ODA **instruments** at their disposal including the direct supply of goods or services, free-standing technical co-operation, grants, concessional loans, equity acquisitions and guarantees. However, few DAC Members use all of these instruments and the use of some, such as concessional loans or equity acquisitions, may be limited to a development bank, a development finance institution or another specialised agency. Given the variety of domains that need to be addressed to mobilise investment, there is a risk that relying on a few aid instruments may inhibit the effectiveness of donors' efforts. DAC members should consider whether the selection of aid instruments at their disposal, including through co-ordinated arrangements with other donors, is right for reaching their objectives, especially in addressing, albeit indirectly, the private sector.

21. A greater focus on mobilising investment may require development agencies to review whether they need to **change the way they do business**:

i. Donors should ensure that their internal incentive and evaluation systems do not work against staff pursuing longer-term, programmatic and possibly higher risk interventions. Institutional and policy reforms are not one-off events and efforts may not come to fruition within a donor's typical three or four-year programme cycle, or the period of one staff member's posting to a developing country.

ii. Staff working on private sector development, agriculture, infrastructure, public governance, capacity development, environment and gender are often located in different organisational units and sometimes in different organisations only loosely associated with the core ODA programme. To mobilise investment more effectively, these staff need to work in close association and, ideally, under a common strategic framework.

iii. Staff may need more training on how to select appropriate aid instruments to reflect differences in a country's business environment and stage of development.

iv. There may be a need for some donors to develop new and more flexible approaches to engaging with the private sector in developing countries, including by encouraging their public sector partners to do so.

v. Donors can help develop the local private sector by procuring as many goods and services as possible in developing countries, subject to value-for-money considerations. Donors can encourage their suppliers and contractors to adopt responsible business practices.