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# PROMOTING PRO-POOR GROWTH: POLICY GUIDANCE TO DONORS ON SUPPORTING PRIVATE SECTOR DEVELOPMENT

**Draft report submitted by POVNET**

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# PROMOTING PRO-POOR GROWTH:

# POLICY GUIDANCE TO DONORS ON SUPPORTING PRIVATE SECTOR DEVELOPMENT

## KEY POLICY MESSAGES

1. As the major contributor to economic growth and employment creation, the private sector has a central place in renewed efforts to reduce poverty and achieve the Millennium Development Goals (MDGs). Developing country governments have a strong interest in fostering a business environment that enables the private sector to flourish and fulfil its role as the main engine of growth.

2. It is important to recognise that the private sector consists of more than formal businesses. Individuals and households, from rich to poor, also operate as private economic actors when they consume goods and services, sell their labour, farm or produce goods and services. Reducing poverty requires greater efforts to address the needs and maximise the contribution of the many informal enterprises, family-run farms and self-employed men and women that conduct business in developing countries.

3. There is growing recognition that in pursuing a pro-poor agenda for private sector development what matters is the degree to which economic growth provides opportunities for the poor, and the extent to which poor men and women can take advantage of those opportunities. This emerging agenda is more holistic and broader than the previous agenda, which often focussed mainly on supporting enterprises considered important for the poor. Experience has shown some shortcomings with such interventions, which have sometimes created market distortions or not been sustainable as a result of attempts to "pick winners" or to use public sector agencies or donors to provide services.

4. Through the work of a Task Team on Private Sector Development, the OECD's Development Assistance Committee (DAC) has generated some policy guidance for donors aimed at increasing the impact of private sector development on poverty reduction. This guidance is based on an analytical framework report, "Accelerating Pro-Poor Growth through Support for Private Sector Development",[1] as well as work on a series of important topics. These were: i) removing barriers to formalisation; ii) implementing competition policy; iii) promoting the supply-side response; iv) the financial sector's contribution to pro-poor growth; v) enhancing women's market access; and vi) constructing inclusive public-private dialogue.

5. For the private sector to deliver pro-poor growth, five interlinked and mutually reinforcing factors need to be in place: i) providing incentives for entrepreneurship and investment; ii) increasing productivity through competition and innovation; iii) harnessing international economic linkages through trade and investment; iv) improving market access and functioning; and v) reducing risk and vulnerability. These factors are brought about and influenced by policies and institutions, including "rules of the game" and mechanisms for their conception, application and enforcement.

6. Institutional and policy reforms are consequently at the heart of efforts to reduce poverty through private sector development. Such reforms are often difficult and time-consuming - involving interaction between the state, the private sector and civil society - and require a careful mix of contestation and negotiation to overcome resistance to change. Structured and inclusive dialogue processes can facilitate negotiation and encourage monitoring by the private sector to ensure that reforms are implemented. The formulation of national development plans, including poverty reduction strategies (PRS), provides an

1. This report is available from the Internet at: http://www.oecd.org/dataoecd/53/21/34055384.pdf.

opportunity to institutionalise engagement between different parts of society and to follow through on the priorities set. Currently, many PRSs do not include benchmarks for private sector development, nor do they involve the private sector or civil society sufficiently in the design of interventions or the monitoring of outcomes.

7. To increase the impact of private sector development on poverty reduction, donors should help to bring about systemic change that alters the incentives for the private sector (the risk-to-reward ratio), including by encouraging the public sector to foster a more conducive enabling environment. This is done by increasing the capacity of governments at all levels to promote pro-poor market outcomes such as more jobs, better returns on goods sold, greater affordability of essential goods and services and reduced exposure to risks. Donors should also support "change agents" within the public and private sectors and civil society. Accelerating the development of markets the poor depend on should be a high priority.

8. Donors should revisit how they are supporting private sector development in developing countries. A "business-as-usual" approach will not be enough to generate the higher and more inclusive growth patterns needed to make substantial and sustainable inroads into reducing poverty. Based on recent work in the DAC, key policy messages can be highlighted in three domains:

**General approaches to promoting development of the private sector**

- ***Encourage entrepreneurship and investment by lowering the risks and costs of doing business, including by removing barriers to formalisation.***
- ***Identify and unlock the potential for economic development in sectors and regions where the poor are concentrated.***
- ***Use market-based approaches as a way to address obstacles to market development - including support for the promotion of competitive markets and the development of financial markets - and avoid the risks of market distortion if providing direct support to firms***.

**Approaches that donors can emphasise in their policy dialogue with developing countries**

- ***Mainstream strategies for private sector development into national development frameworks such as national development plans and poverty reduction strategies (PRS).***
- ***Link and, to the extent possible, merge private sector development and governance programmes under a comprehensive strategy and advocate the use of key analytical tools, especially gender analysis tools.***
- ***Facilitate structured, inclusive and effective public-private dialogue as a main element in institutional reform; organised at national, sub-national and local levels, as well as between these levels. Pay attention to risks and mitigate these by carefully sequencing reforms.***

**Approaches that will help donors increase the leverage of their private sector development activities on reducing poverty**

- ***Integrate private sector development as a central theme of donors' strategies – be they at agency, country or regional levels.***
- ***Improve and formalise effective donor co-ordination, alignment and harmonisation mechanisms.***
- ***Consider organisational changes to facilitate greater internal co-ordination and build up and integrate analytical capacity in related areas including governance, gender and the environment***.

# PART I

# OVERVIEW

9. The world over, the private sector is the major contributor to economic growth and employment creation. Promoting a more dynamic and vibrant private sector consequently has a central place in renewed efforts to reduce poverty in developing countries and achieve the Millennium Development Goals (MDGs). But there is a need to revisit how donors are supporting private sector development. A "business-as-usual" approach will simply not be enough to generate the higher and more inclusive growth patterns needed to make substantial and sustainable inroads into poverty reduction.

10. Governments have a strong interest in fostering a business environment that enables the private sector to flourish. In addition to formal businesses, individuals and households, from rich to poor, operate as private economic actors as well when they consume goods and services, sell their labour, farm or produce goods and services. For the private sector to expand in developing countries and fulfil its role as the main engine for growth, efforts must be made to address the needs and maximise the contribution of the many informal enterprises, family-run farms and self-employed men and women that conduct business there.

11. Expanding market access to all private sector actors and improving how markets function can lead to such results as more jobs, better returns on goods sold, greater affordability of essential goods and services and reduced exposure to risk. These outcomes influence the rate and pattern of economic growth. For growth to be "pro-poor", the rate has to be high and sustainable and the pattern broad and inclusive. Institutions[1] and policies shape market outcomes and so determine the degree to which they are pro-poor. What is less clear, and merits further investigation, is how best to overcome resistance to change and bring about the institutional and policy reforms that will lead to more pro-poor market outcomes.

12. There is increasing recognition of an emerging pro-poor private sector development agenda that acknowledges that what matters is the degree to which economic growth provides opportunities for the poor and the extent to which poor men and women can take advantage of these opportunities. Economic and social development are thus interlinked and should be addressed together. Donors may need to pay greater attention to growth and its determinants than they have in recent years.

13. This report provides donors with guidance on increasing the impact of private sector development on poverty reduction. It introduces the analytical framework previously published as "Accelerating Pro-Poor Growth through Support for Private Sector Development"[2] and provides practical guidance on six of the many important issues highlighted in the analytical framework.[3] The six issues that have been considered in detail, and on which Hot Topic papers are presented in Part II of this report, are:

i) **Removing barriers to formalisation,** which examines what has been learnt about addressing the main barriers to the formalisation of enterprises.

ii) **Implementing competition policy in developing countries,** which demonstrates the harm that can be caused to poor people and developing countries by inadequate competition.

iii) **Promoting the supply-side response: Business development services and financial assistance,** which discusses market-based approaches to providing financial and technical support to firms.

iv) **The financial sector's contribution to pro-poor growth,** which highlights the importance of extending the provision of financial services to the poor.

v) **Enhancing women's market access,** which considers access to labour, financial, goods and service markets from a gender perspective.

vi) **Constructing inclusive public-private dialogue,** which reviews this form of structured interaction that can help reduce resistance to change and lead to institutional and policy reforms.

14. Section I of this Overview describes the private sector's role in promoting pro-poor growth. Section II introduces the six Hot Topic papers. Section III presents the main policy implications for donors.

## 1. The role of private sector development in promoting pro-poor growth

### *a) Accelerating pro-poor private sector development*

15. At a general level, growth requires macroeconomic stability maintained by low budget deficits, low inflation and a stable and transparent currency regime that yields competitive exchange rates. Peace and political and social stability are additional requirements because war, social conflict and crime prevent most private sector actors from exploiting their potential and contributing effectively to growth. A healthy and educated labour force also facilitates growth. But, in many developing countries, human capacity development is being undermined by the effects of HIV/AIDS and pandemic diseases.

16. More specifically, for the private sector to deliver pro-poor growth, a set of interlinked and mutually reinforcing factors needs to be in place to allow private sector actors, including the poor, to participate in and benefit from growth. These five factors, which are brought about and influenced by institutions and policies, are to:

i) **Provide incentives for entrepreneurship and investment.** Entrepreneurship and investment contribute to growth by increasing the productive capacity of the economy, creating jobs and introducing technologies. Rates of entrepreneurship and investment reflect the risks and costs of doing business. Risks are lower when economic policy-making and implementation are transparent, property rights are secure and transferable, and contracts enforceable. Costs fall when starting, operating and closing a business is less bureaucratic and inexpensive, corruption is lower and private sector actors can access financial services and affordable infrastructure. High risks impact heavily on poor entrepreneurs because they cannot easily change sector or move somewhere else. The poor also only have a low level of savings and assets to fall back on. High costs of doing business can drive the poor into the informal economy. The way market regulating, facilitating and promoting organisations work, formally and informally, determines the risks and costs of doing business. Institutional and policy reforms can thus lead to enhanced access for all private sector actors to well-functioning markets for capital, labour and natural resources.

ii) **Increase productivity through competition and innovation.** Competitive firms find better ways to produce and distribute goods and services, innovate, and drive lower productivity activities out of markets so as to allocate resources to more productive uses. Competition benefits farmers, entrepreneurs and consumers, from rich to poor, through lower prices, better quality and improved choice of inputs and products, as well as more indirectly, through its impact on productivity, investment and living standards. A clearly defined competition law and policy can help curb uncompetitive practices, including in sectors that the poor participate in or interact with (e.g. transportation, wholesale and retail trade and infrastructure services). Innovation is fostered through access to knowledge about technologies, management techniques and practices. Business linkages and clusters, often facilitated by business associations, help to disseminate knowledge and technologies. This enables specialisation and flexibility, improves the productivity of all private sector actors and increases returns on investment. The poor may, however, lack access to such networks. Reforms that expand access to business associations and clusters, especially those in which informal firms and workers participate, help poor men and women gain better access to the knowledge and technologies that will increase their productivity.

iii) **Harness international economic linkages.** International trade helps economies to focus on their comparative advantages and increases competition for domestic businesses. Greater trade integration can also stimulate foreign direct investment (FDI), which raises productive capacity but also tends to produce benefits through the transfer of knowledge and skills. In many developing countries, an expansion in infrastructure services may be required to improve the investment climate and harness international linkages more fully. Strengthening linkages between multinational enterprises and domestic firms contributes to productivity increases and, in those domestic sectors likely to involve the poor, can accelerate pro-poor growth. At the same time, deeper international integration creates risks for the poor as it can also result in contraction in traditional sectors in which the poor conduct business or are employed. It is therefore critical to anticipate and mitigate the possible impact of trade policies on the poor, with the local context determining priorities and the sequencing of change. By careful sequencing, to create opportunities for the poor, and the enhancement of access to skills training and capital and other resources, institutional and policy reforms can help the poor to diversify activities, change to new revenue earning activities or move geographically. Safety nets may nonetheless be required for those who stand to lose from greater international linkages.

iv) **Improve market access and functioning.** The critical mechanism through which the poor participate in, and benefit from, growth are the markets for the productive resources and goods and services that they rely on most for their livelihoods and consumption needs. But, in many developing countries, market failure is widespread and the poor cannot access markets on equal terms to the rest of the private sector. Women can encounter specific constraints in participating in markets. Institutions and policy reforms play a key role in improving the terms on which the poor can access markets. For instance, formalisation of businesses can generate more formal employment as well as increase market power within value chains. A competitive banking system, with expanded access to private credit on terms and conditions more adapted to the needs of the poor, can help the poor move into higher value-added activities. Investments in and private provision of basic services and infrastructure, including through public-private partnerships, can help develop linked markets. Returns to the poor should increase through promotion of the use of technical standards, dissemination of technical and market information and provision of extension services through market-based approaches.

v) **Reduce risk and vulnerability.** The poor are particularly vulnerable to man-made shocks and natural disasters. When crises occur, the poor may consume or sell, at the same time as others, their livestock and other assets. The running down of assets, combined with disadvantages linked to gender, ethnicity, HIV/AIDS, sickness or old age, can result in the poor becoming caught in "poverty traps" from which it may be impossible to escape. In the absence of private insurance schemes and publicly provided safety nets, poor people tend to adopt livelihood strategies to manage and cope with the risks and vulnerabilities they face. While these strategies are understandable from a survival perspective, they may prevent poor people from fully participating in and benefiting from the opportunities that growth offers. Servicing the needs of the poor is unlikely to be a high priority for the insurance industry in developing countries but markets for risk insurance, for instance for drought and livestock, are grossly underdeveloped and this hinders pro-poor growth. Similarly, greater access to savings instruments could provide poor people with a buffer against adversity but could also lead to higher incomes, by enabling the poor to mitigate some risks.

### *b) Reforming institutions and policies to deliver pro-poor change*

17. Institutions and policies result from the interaction of the state, the private sector and civil society. For example, governments exercise influence over the political economy of growth: who gets what and how. The private sector often focuses on how business-friendly institutions are; i.e. the incentives for entrepreneurship and investment. For many civil society organisations, the main concerns are the broader social and economic outcomes of growth. Institutions and policies develop as a result of compromises made by each party, depending on their respective strengths. Thus, the *status quo* reflects the current political settlement.

18. Reforming institutions and policies can involve difficult and time-consuming processes and require a careful mix of contestation and negotiation to overcome resistance to change. Structured and inclusive dialogue between the public and private sectors can facilitate such contestation and encourage monitoring by the private sector, which can help ensure that decisions made are implemented and can be modified if required. Three factors influence the impact that institutional and policy reforms may have on improving the enabling environment for pro-poor private sector development:

- The effectiveness of both private and public representative organisations and awareness at different levels (national, sub-national and local) of the real, practical and underlying issues that constrain pro-poor private sector development.
- The ability to transfer these issues to the appropriate decision making levels in both private and public sector organisations.
- The translation of constraints or issues into appropriate policies, plans and strategies to address and resolve them.

19. The poverty reduction strategy (PRS) process provides an opportunity to institutionalise engagement between different parts of society and to follow through on the implementation of the priorities set. However, PRSs do not always include benchmarks for private sector development, nor do they involve the private sector or civil society sufficiently in monitoring outcomes. To the extent possible, stakeholder engagement should bring in the views of beneficiaries, including the poor, to help influence the future course of action and thereby set in motion a process of improving institutions and policies.

### *c) The role of donors in promoting pro-poor private sector development*

20. The emerging pro-poor private sector development agenda is more holistic and integrated and broader than the previous agenda, which often focussed on supporting private sector enterprises considered important for the livelihoods of the poor, particularly small enterprises and agribusinesses. Experience has shown some shortcomings with such interventions, including some that result in market distortion or poor sustainability through attempts to "pick winners" or to use public sector agencies or donors to provide services.

21. To increase the impact of private sector development on poverty reduction, donors should help to bring about systemic change that alters the incentives for the private sector (the risk-to-reward ratio), including by encouraging the public sector to foster a more conducive enabling environment. This is done

by increasing the capacity of governments at all levels to promote pro-poor market outcomes and by supporting "change agents" within the public and private sectors and civil society. Systemic change is likely to involve a combination of institutional and policy changes aimed at accelerating the development of markets the poor need to improve their livelihoods.

22. Donors should regard private sector development as a major, if not central, part of the country assistance they provide. This may require development agencies to realign their approaches, introduce organisational changes and ensure that their incentive and evaluation systems do not work against staff pursuing longer-term, programmatic and possibly higher risk interventions with high potential impact. As in other domains, donors should co-ordinate their actions in order to promote complementarities and increase the combined impact of their interventions.

## 2. Main messages from Hot Topic papers

23. To provide more specific guidance to donors on increasing the leverage of private sector development on poverty reduction, the Development Assistance Committee's (DAC's) Network on Poverty Reduction considered six issues in greater depth: i) removing barriers to formalisation; ii) implementing competition policy; iii) promoting the supply-side response; iv) improving the financial sector's contribution to pro-poor growth; v) enhancing women's market access; and vi) constructing inclusive public-private dialogue. These are Hot Topics because they are areas where there is a need for further reflection and better understanding, and where guidance can help donors achieve a larger pro-poor impact. The aim of the work is to provide some guidance in such strategic areas, rather than attempting to present comprehensive solutions.

24. This section introduces each Hot Topic paper by illustrating its relevance for pro-poor growth, outlining some of the challenges, debates and controversies and suggesting how donors can intervene.

### *a) Removing barriers to formalisation*

25. The informal economy forms a large part of the economies of many developing countries and provides employment and income to many poor households, including those who lose or cannot find work in the formal economy. It includes a disproportionate number of women and people from disadvantaged groups. But informal economic activities are not a long-term solution to reducing poverty. Development of the formal private sector has the potential to create more stable jobs and to deliver sustainable growth and welfare. The benefits associated with formal enterprises and jobs include: better paid and higher quality jobs, increased investor confidence, a broader tax base, a reduction of the cash economy (with increased resources for intermediation by the formal financial sector) and a stronger social contract between citizens and their state.

26. The heterogeneity of the informal economy and varying donor emphases have created a variety of approaches to understanding and addressing the informal economy. Two potential conflicts have emerged: i) improving livelihoods within the informal economy while encouraging greater formalisation; and ii) improving employment conditions for informal economy workers while increasing the competitiveness of the local private sector.

27. By supporting efforts to reduce barriers in a number of domains, donors can help informal enterprises move along the continuum towards a greater degree of formality. These barriers include: regulatory and administrative hurdles, fees and financial requirements, corruption in public administration, socio-cultural attitudes, lack of key business services, and criminality. Initiating dialogue with participants in the informal economy is critical as it will help enable governments to understand the specific constraints

that informal firms face and why there may be resistance to formalisation. While much is known about how barriers restrain private sector growth, there is little specific research on why firms do not formalise.

***b) Implementing competition policy in developing countries***

28. Competitive markets are not only more efficient in producing and distributing goods and services and in allocating resources, they are essential for markets to work better for the poor. Competitive markets are more likely to provide the poor with opportunities to be employed or to start their own business. The impact on developing countries of a lack of competition can also be significant. For example, research[4] suggests that 16 international cartels overcharged developing countries between USD 16 billion and USD 32 billion in 1997 and that prices fell by 20% to 40% following the break up of the cartel.

29. A competition policy and law may seem to be a luxury for developing countries short of finance and skilled people but the potential gains can be enormous. For small countries that are members of regional groups, a regional competition policy could enhance the impact of domestic laws. Also, there is no necessary conflict between a new competition law and existing industrial policy: well-designed competition and industrial policies can and should be complementary. Nevertheless, more empirical research on the effects of increasing the intensity of competition would be of value and could help decision making on how to sequence reforms that promote greater competition.

30. Donors can assist developing countries to adopt appropriate competition regimes. Technical assistance and capacity building should be targeted at formulating competition policy and strengthening the institutions responsible for enforcing the competition law. Competition should be "mainstreamed" in all sectors in order to spread a culture of competition. In addition, to guide future actions, empirical research on the impact of competition policy and law in developing countries should be encouraged.

***c) Promoting the supply-side response: Business development services and financial assistance***

31. Improving the business environment in developing countries is not sufficient to spur sustainable, poverty reducing growth and needs to be accompanied by interventions to promote supply-side responses. Lack of access to various kinds of services is a critical constraint on the development of enterprises and improving firms' access to business development services is a core instrument for promoting income and employment generation for poor people. The same applies to financial services where a deepening of markets is an important element in many programmes aimed at stimulating pro-poor growth.

32. The key challenge for donors is to find the right balance between providing subsidised or even free goods and services, which can deliver short-term outcomes, and supporting more market-driven and sustainable approaches. While there is now a consensus among donors on the need to move towards more market-oriented approaches, opinions differ on how to do this in practice. For example, although there is recognition that market-based approaches have limitations, there are different assessments of the appropriate criteria for diagnosing such situations and of the measures to take when markets fail.

33. To avoid causing market distortions, donors should apply the following criteria when providing support to firms: focus on the causes of problems, promote a level playing field, avoid or minimise subsidies (which should be provided to end users), apply output-based aid principles and have a clear exit strategy. There may be situations when, in the short-term, market development approaches are not applicable, especially in post-conflict situations or after natural disasters, but donors should nonetheless expect to shift gradually to a market-based approach that aims to rebuild the supporting institutional environment for the private sector.

### d) The financial sector's contribution to pro-poor growth

34. The financial sector can have a direct impact on poverty reduction in two ways. First, a well-developed financial sector can provide the poor with access to a larger array of financial services, such as payment instruments, saving facilities, credit and insurance. Second, a sound financial sector reassures private investors and creates opportunities for investments to provide basic services to the poor. There are also indirect benefits including maintaining economic stability, securing financial transactions, mobilising external and domestic savings and improving the efficient allocation of capital.

35. Donors have tended to adopt two approaches to developing sound financial markets. Some have given priority to actions related to the enabling environment and institutions for the development and deepening of the financial sector. Others consider that direct interventions cannot be discarded, provided precautions are taken to avoid market distortions, and have sponsored direct interventions as well, by providing credit lines to banks and microfinance institutions or funding guarantee schemes.

36. When designing strategies for financial sector development, donors should encourage and help developing country governments to collect data on access to financial services, improve the capabilities of supervisory and regulatory authorities, strengthen financial intermediaries, support prudent mobilisation of savings and remittances, bridge the gap between banks and microfinance institutions and include financial sector issues in PRSP documents.

### e) Enhancing women's market access

37. Gender-specific exclusions and inequalities – stemming mostly from biases, social norms, prohibitions and gender division of labour – disadvantage women and girls. As a result, lower investments are made in the human capital of women and girls and their access to labour, financial, goods and services markets is limited. This jeopardises any effort to spread the benefits of growth among the poorest and so severely hinders the effectiveness of institutional and policy reforms aimed at promoting pro-poor growth.

38. An entitlements approach focuses on increasing women's access to resources and inputs that enable women to enter markets, raise their productivity or scale up their existing activities (micro-credit is an example). Capabilities projects provide resources and services that increase women's ability to deploy their existing resources or enter new markets (training and workforce development projects are an example). Donors need to be flexible in helping partners design and implement interventions with an appropriate mix and sequence of approaches. These depend on various context and country-specific circumstances that need to be analysed and considered in each case.

39. At the policy level, donors should promote the emergence of a conducive enabling environment by supporting policies that remove or ameliorate structural barriers to women's participation in markets. Gender analysis tools should be applied when developing interventions for private sector development to ensure that women's roles as consumers, workers, entrepreneurs and social actors are taken into account.

### f) Constructing inclusive public-private dialogue

40. Public-private dialogue brings different stakeholders together to identify policies and institutional reforms that can promote private sector development. Well-organised public-private dialogue can allow the poor to voice their needs and concerns and ensure that local-level issues are fed into higher-level policy process, including the preparation of national poverty reduction strategies.

41. Public-private dialogues can make an effective contribution to private sector development if they involve well-organised, capable and accountable private sector organisations and participants that are

committed to the process and are able to contribute effectively. The inclusion of a third, neutral party may facilitate such processes.

42. Special efforts should be directed at helping poor entrepreneurs to participate in dialogue processes and promote their interests. To do so, donors can support the emergence and strengthening of private sector organisations at national, sub-national and local levels that represent the interests of micro and small entrepreneurs and of informal firms and workers. However, 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 those of their own constituencies.

### 3. Policy implications for donors

43. Donors seeking to increase the leverage of private sector development on reducing poverty can pursue a range of issues as part of their policy dialogue with partner countries, setting priorities and determining an appropriate sequence based on an analysis of the local context. Donors can also examine their own organisational arrangements and internal practices to determine whether some realignment may be needed to be better able to increase the impact of their private sector development activities on poverty reduction.

44. The analytical framework and Hot Topic papers point to a number of policy recommendations that donors may wish to take account of. Practice and experience to date show that the following general approaches tend to bring about more sustainable and pro-poor outcomes in private sector development:

i) **Encourage entrepreneurship and investment by lowering the risk and costs of doing business.** Low entry and exit barriers, predictable rules of exchange, secure and transferable property rights, enforceability of contracts and a lower level of corruption are conditions under which entrepreneurship and investment can produce better and more pro-poor outcomes.

ii) **Work to identify and unlock the potential for economic development in sectors and regions where the poor are concentrated.** Too often investment is lacking in regions and sectors that are too readily considered to be marginal or as having low potential, perhaps due to poor infrastructure or a lack of innovations that allow resources to be exploited in a more profitable or sustainable way. Focusing on such potential will increase the pro-poor impact of more general institutional and policy reforms and increase the prospects for poor people to grow out of poverty, including by finding new opportunities that are either outside or only partially linked to a sector or a region.

iii) **Remove barriers to formalisation.** The development of the formal private sector has more potential to deliver sustainable pro-poor growth as formal businesses have improved access to the resources that will enable their business to grow.

iv) **Advocate the use of market-based approaches as a way to address obstacles to market development and avoid the risks related to providing direct support to firms. In the design and delivery of business and financial services aimed at building up the economic capacities of the poor, focus on value chains and clusters.** Capacity building should follow an approach that helps the poor to help themselves, focuses on facilitating the development of markets in business services and commercial credit and targets value chains that provide opportunities for poor men and women. Sector-wide approaches and assistance with building up the power base of the poor in value chains and clusters have the potential to address issues and constraints at macro, meso and micro levels, resulting in systemic change.

v) **Promote competitive markets for poor consumers, with the support of a clearly defined competition law and policy.** A culture of competition, especially if supported by a competition law and policy, will facilitate well-functioning markets; and help include the poor in these markets and attract FDI more effectively. Competition will also lower the costs of doing business by stemming anti-competitive practices in the economy.

vi) **Strengthen the functioning of natural resource markets by improving legal, regulatory and administrative frameworks.** Ensuring secure and transferable ownership rights to land and work premises, in rural and urban areas, and expand access to other natural resources (such as forests, marine and inland fisheries). Enhancing transparency in land planning and promoting easy and inexpensive access to land and property registries will spur entrepreneurship and investment and expand access to capital markets, while also reducing risk and vulnerability.

vii) **Promote deeper and more competitive financial markets so as to support private sector development, enhance the productivity of other factors of production and mitigate the risk and vulnerability of the poor in case of shocks.** Access to finance and diversified financial instruments are crucial for providing incentives for entrepreneurship and investment, increasing productivity, capturing the benefits of trade liberalisation and FDI linkages and reducing risk and the vulnerability of the poor. Integration of microfinance institutions into the mainstream banking system, disaster insurance and insurance against shocks, new savings instruments and flexible delivery mechanisms can better address the risk mitigation needs of the poor, improve access of the poor to capital and increase resources available for further financial intermediation.

viii) **Advocate the use of gender analysis tools in development programmes.** Failure to focus on women's market access reduces the effectiveness of policies to promote pro-poor growth. Gender-disaggregated value chain analysis that identifies opportunities to strengthen women's participation in markets can help in unleashing women's potential to contribute to the generation of significant pro-poor outcomes.

ix) **Encourage private provision of basic services and infrastructure to the poor through public-private partnerships**. This can be done by strengthening the capacity of developing countries to provide the necessary legal, regulatory and administrative frameworks for the establishment and smooth functioning of public-private partnerships at national and local levels.

45. In dialogue and work with developing country governments, the following additional aspects are important to consider:

i) **Mainstream strategies for private sector development for pro-poor growth into national development frameworks such as national development plans and poverty reduction strategies (PRS).** Without substantial reductions in income poverty, governments will most likely be handicapped in implementing sustainable poverty reduction strategies for improving the human, political, and socio-cultural conditions of the poor, and reducing their risks and vulnerability.

ii) **Link and, to the extent possible, merge private sector development programmes and governance programmes under a comprehensive strategy**, since private sector development and governance reforms and administrative improvements are interlinked. A more holistic approach is likely to contribute to the creation of mutual trust and bridge the cultural gap between the public and private sectors. A holistic approach will also be more efficient in respect of resource utilisation on the part of the government, donors and other concerned stakeholders.

iii) **Facilitate structured, inclusive and effective public-private dialogue processes, as a key element in successful institutional reform. Organise it at national, sub-national and local levels, as well as between these levels, and sequence reforms.** The political economy of reform processes necessitates high quality and inclusive stakeholder dialogue and the building up of constituencies. To date, neither poverty reduction efforts nor private sector development strategies have taken sufficient account of the poor as part of the private sector. Unless structured and inclusive dialogue is established at all levels and between them, conditions enabling pro-poor growth may not receive sufficient consideration in private sector development and governance programmes. To help decrease vulnerability and build up coalitions around reform, the sequencing of reform processes is important.

iv) **Build capacities within stakeholder groups to organise themselves, to analyse key constraints, to participate in policy dialogue and monitoring of results and to advocate and negotiate systemic change.** Both the public and private sectors lack capacity to analyse issues and constraints and to identify appropriate responses to foster pro-poor growth. Capacity building within the public sector, including at local levels, is essential since obstacles to an enabling environment may also need to be resolved by local government officials. Governments should allocate requisite capital and operational budgets to set up administrative systems and train civil servants at national, sub-national and local levels. Private sector representative organisations also need capacity building in evidence-based advocacy and monitoring of results.

46. To improve donors' approaches and enable them to increase the leverage of their private sector development activities on poverty reduction, the following recommendations are offered:

i) **Integrate private sector development as a central theme of donors' country strategies**, combining economic and governance reform, support for private sector development and livelihoods, and risk and vulnerability interventions under a common framework.

ii) **Employ a programmatic approach**, while incorporating sufficient flexibility for implementing innovative and experimental interventions; include an exit strategy that allows ownership from the core of public and private sector entities themselves.

iii) **Consider the merits of longer-term interventions,** as reforming institutions and policies and enabling them to take root in practice requires time.

iv) **Improve and formalise donor co-ordination, alignment and harmonisation mechanisms**, to prevent overlap, omissions and conflicting programmes. Consolidate and share lessons learnt and best practices generated and contribute to commonly shared toolkits.

v) **Consider organisational changes** to facilitate co-ordination of the work of sector and skill departments within the development agency. Build up analytical capacity in related areas including governance, gender and the environment.

## NOTES

1. Institutions consist of the rules of the game and the governance exercised over them. They include social norms and values, rules and informal communication processes and are, to a large extent, determined by many historical and societal factors.

2. This report is available on the Internet at: http://www.oecd.org/dataoecd/53/21/34055384.pdf

3. Guidance on some other important issues is also available from other sources. For example, for guidance related to business development services, see the "Blue Book" published by the Committee of Donor Agencies for Small Enterprise Development (at: http://www.sedonors.org/resources/item.asp?resourceid=1). For guidance related to microfinance, see the "Key Principles" developed by the Consultative Group to Assist the Poor (at: http://cgap.org/keyprinciples.html).

4. Levenstein, M.C. and Suslow, V. Y. (2001) Private International Cartels and their Effects on Developing Countries, Background paper for the World Bank's World Development Report 2001.

# PART II

# HOT TOPIC PAPERS

*To provide more specific guidance to donors on using official development assistance more effectively to increase the impact on private sector development on poverty reduction, the DAC has explored six Hot Topics in greater depth: i) removing barriers to formalisation; ii) implementing competition policy; iii) promoting the supply-side response; iv) the financial sector's contribution to pro-poor growth; v) enhancing women's market access; and vi) constructing inclusive public-private dialogue. This series of topics is not exhaustive – some other essential subjects such as trade and labour markets are not covered – but it does include areas where donors can have a large pro-poor impact, where there is a need for further reflection and where better understanding will benefit the DAC, as well as the donor community more broadly. The Hot Topic papers are anchored in and build on the analytical framework "Accelerating Pro-Poor Growth through Support for Private Sector Development".*

## REMOVING BARRIERS TO FORMALISATION

### 1. What is the issue and why is it important?

47. The informal economy forms a large part of the economies of many developing and transition countries. It comprises 42% of value added in Africa, 41% in Latin America and 35% in the transition economies of Europe and the former Soviet Union, compared with 13.5% in OECD countries. The informal economy provides employment and income for many who lose or cannot find work in the formal economy, and it includes a disproportionate number of women, young people and others from disadvantaged groups. For example, it has been estimated that informal employment accounts for 84% of women's employment in sub-Saharan Africa.

48. There is a continuum between informality and formality, with formalisation being a gradual process. Few firms follow all the rules governing enterprise behaviour and few follow none of them. Entrepreneurs make repeated economic calculations of the costs and benefits of following the rules, and embrace formality up to the point where the potential benefits outweigh the costs.

49. In the long term, informality does not provide a solution for poverty eradication. Countries with the highest *per capita* income have smaller informal sectors, while poorer countries have higher informal economy shares of total output. Thus, while informal enterprises may provide a short-term solution to a household's livelihood needs, creating an economy with a higher proportion of formal enterprises and jobs is important to long-term welfare creation, stability and poverty reduction.

50. While formalisation by itself does not promote enterprise growth in the short run, bringing more enterprises into the formal economy over the long term should:

i) Provide higher quality, better paid, more sustainable jobs.

ii) Reinforce the social contract between citizens and their state.

iii) Strengthen the reliability of agreements between firms.

iv) Build investor confidence (and increase investment).

v) Broaden the tax base (potentially permitting lower tax rates).

vi) Increase information on local enterprises to facilitate deal-making and strengthen frameworks for policy advocacy.

vii) Reduce the cash economy and provide more resources for intermediation by the formal financial sector.

viii) Improve access to business services, formal markets and productive resources such as capital and land.

51. Formalisation may also increase welfare in some marginalised groups by confirming their right to take advantage of market opportunities.

52. There is a growing body of research on business environments and their effects on economic growth and investment. Many donors sponsor research and interventions involving informal economy enterprises. However, few studies and projects focus specifically on barriers to formalisation. The general assumption is that improving the enabling environment for all micro, small and medium-sized enterprises (MSMEs) will help informal firms move towards greater formality. This paper examines what has been learned about the main barriers to formalisation of enterprises and what good practice examples exist for reducing these barriers.

## 2. The current evidence: Informality, economic development and growth

53. The *Doing Business* initiative of the International Finance Corporation is generating benchmarks and indicators for different aspects of the business environment world-wide. Its 2005 report contains data for 145 economies on starting a business, hiring and firing workers, registering property and getting credit. Countries performing better in these areas (simpler procedures, shorter waits and lower costs, etc) have smaller informal economies. Complementary statistical analysis has shown, however, that no single indicator is a key factor in promoting formalisation. This is because countries that did well in one aspect of the business environment also did well in others, e.g. countries with high business start-up costs also had high worker dismissal costs. The effects of the various factors are therefore difficult to untangle statistically.

## 3. Barriers to formality from the entrepreneur's perspective

54. Much of the available research focuses on barriers to growth in informal and smaller enterprises, rather than on the actual formalisation decision. Nonetheless, it is reasonable to infer from the research that some barriers to growth, i.e. those that impact on the smallest enterprises, are likely to correlate with barriers to formalisation. The sub-set of material on barriers to formalisation supports this, with regulatory and administrative barriers standing out as a particular concern. Barriers to formalisation fall into several categories including: i) regulatory barriers; ii) administrative barriers; iii) fees and financial requirements; iv) corruption in public administration; v) socio-cultural attitudes; vi) lack of key business services; and vii) criminality. There is a strong global body of evidence to suggest that regulatory, administrative and financial barriers, along with corruption, have the most direct influence on the formalisation decision. Reducing these barriers will help informal enterprises move along the continuum towards a greater degree of formality.

i) ***Regulatory barriers*** are inappropriate requirements stemming from governments that do not appreciate the impact on firms (particularly smaller firms) of additional reporting, inspection and other compliance procedures. The time entrepreneurs require to maintain and grow their business is not valued. Various studies have identified burdensome and costly government regulation as the most significant determinant of informality, and as a source of corruption. In general, years of poor quality law-making in developing countries have created a tangle of complexity and inconsistency that presents an almost insurmountable obstacle to the enterprises seeking formality. Regulatory (and administrative) burdens have a strong cumulative effect on the business environment.

ii) ***Administrative barriers*** stem from the way regulations are enforced. They include: excessive paperwork, inefficiency/delayed decisions, inaccessibility of services, bureaucratic obstruction and abuse of authority. These barriers have many sources, including over-complicated regulations, out-dated ways of working, lack of capacity, over-centralisation of authority, distrust of the private sector and - linked to all of this - corruption. In many countries, little effort has been made to raise awareness among public servants of the private sector's needs, nor to create a more service-oriented culture with respect to entrepreneurs (as opposed to a culture that sees its role as one of control and enforcement).

iii) ***Fees and financial requirements*** consist of regressive fees that penalise smaller firms, overly complex tax regulations and poor tax and tariff administration. In a number of countries, initial business registration and licensing fees are set at too high a level. Informal enterprises shy away from joining tax regimes for other reasons: they are worried about tax levels; they do not understand how to comply with tax requirements; they fear the behaviour of revenue officials; or they do not believe they will receive services in return for payment. Unfortunately, little work on improving tax administration focuses closely enough on the informal economy to understand which of these obstacles are more problematic and in need of attention. Too little tax reform work considers alternative, more indirect approaches to income-based taxation, which is a burden to smaller firms.

Financial barriers are integrally entwined with regulatory and administrative barriers related to the general registration of business activity and licensing for operations in specific sectors. The main registration obstacles are excessive costs and time spent dealing with bureaucracy. Registration and licensing become confused in some developing countries: registration should be a straightforward administrative process with little discretion involved, but it often takes on aspects of sector-specific licensing, such as site visits, annual re-licensing and review by committee of the application. This can act as a significant disincentive to registration. Some countries use “licences” as a primary means of annual revenue collection for local authorities (as in East Africa). In a number of countries, entrepreneurs must travel to the capital or other distant towns to conduct these procedures.

Informality is one way of avoiding labour laws and their associated costs (social insurance, etc). In many countries businesses face major hurdles in taking on their first “formal” employee. The additional costs related to labour regulations are estimated to be the most important disincentive to participating in the formal economy for small firms in Latin America.[5] Overly rigid labour laws often hurt the people they are meant to protect, keeping employees in the informal economy and inhibiting economic growth that could create new jobs.

iv) ***Corruption*** is a major factor deterring formalisation, as businesses stay off registers and tax rolls in order to minimise contact with corrupt public officials. A study of 69 countries found a direct link between decreases in corruption and increases in the size of the formal economy. Corruption erodes the trust that businesses have in government and leads informal businesses to conclude that their long-term prospects in the formal economy are poor. Therefore, efforts to reduce barriers to growth and formalisation will be thwarted if corruption is not also tackled. Reducing and simplifying regulatory and administrative requirements diminishes opportunities for corruption, but this also explains why there can be a reluctance to pursue such reforms.

v) ***Socio-cultural barriers***. In some countries, there is a degree of resistance to formalising because of socio-cultural obstacles. The informal economy comprises strong networks of trust and interdependence, often cemented by collective historical experience, e.g. of oppression or social exclusion. When an informal entrepreneur has a history of successful trade with other informal entrepreneurs in the same social group, the motivation to formalise can be lacking. In some failed or very weak states, the informal economy is entrenched and has had for many years to self-regulate and carry out many of the functions of the state.

vi) ***Lack of key business services.*** Some argue that having more services (finance, registration of land titles, infrastructure, public procurement opportunities, management support, etc) available for formal businesses attracts informal enterprises into the formal economy. Increasing the potential benefits for formal enterprises might correspondingly increase tolerance for the compliance costs of rules and regulations. This hypothesis is compelling. Unfortunately, it is virtually impossible to prove. Whether or not formalisation has been an explicit goal of services improvement, most monitoring and evaluation of the new services did not consider their impact on formalisation, focusing instead on business income, job creation and other quality-of-life and work improvements. What little evidence could be found raises some doubts as to the strength of a service-driven formalisation motive.

vii) ***Criminality.*** Some individuals are reluctant to provide information about their personal wealth and circumstances to government officials, because they are concerned that this information may be passed to people involved in serious and organised crime and make them targets for criminal activity.

## 4. Knowledge gaps and different approaches to informality

55. While much is known about how barriers restrain private sector growth both in the formal and informal economies, there is little specific research into why firms do not formalise. Understanding is limited of which barriers are the most significant and how they impact on the decision-making process, although much can be deduced from surveys of general barriers to growth. Nor does the research have much to say about the links between formalisation and enterprise performance, or about short-term versus long-term effects.[6] There is scope for further primary research in these and other areas.

56. The informal economy is complex and donor interventions should be based on sound research. There is a risk of making false assumptions. For example, research and interviews with donors revealed a predominant view that many informal economy workers would prefer to return to formal waged employment as soon as it became available. However, there is credible evidence to suggest that this is not necessarily the case: in a recent survey in South Africa, the majority of informal sector respondents indicated that they would prefer to remain in business rather than take a job if one were available. Another recent survey of women entrepreneurs in the MSME sector in Ethiopia found that three out of four would not forego their current businesses if offered a permanent job elsewhere.

57. The heterogeneity of the informal economy and varying donor emphases have created a variety of approaches to understanding and addressing the informal economy. Two potential conflicts have emerged:

i) ***Improving livelihoods within the informal economy while encouraging formalisation.*** Some researchers and donor programmes view the informal economy as a long-term, structural feature of modern economic development. Given this, some interventions are aimed at improving the welfare of the people who find themselves in the informal economy, rather than helping them to formalise. Other donor interventions consider formalised economic growth to be a central goal of development and a primary driver of poverty reduction. These are accordingly focused on encouraging formal economy growth. In between these two views, there is a place for interventions that help actors in the informal economy to take gradual steps in the formalisation process, for instance by creating associations with a formal status to facilitate access to such services as micro-credit, insurance, land tenure and physical market places. The challenge is to determine how interventions can be devised that improve the livelihoods of the poor while not removing incentives to formalisation.

ii) ***Improving employment conditions for informal economy workers versus increasing competitiveness of the local private sector.*** Some approaches view the informal economy from a labour-market perspective and look for ways to reduce employment deficits and to improve the quality of formal work opportunities. This approach has the potential to conflict with approaches that emphasise the competitiveness of informal economy enterprises, the need for workforce flexibility to maintain comparative advantage and the need to keep employment law compliance burdens to a sensible minimum. The relatively new "Decent Work" approach seeks to strike a carefully constructed balance between helping enterprises grow while also promoting improved work conditions, but its impact is not yet well understood.

## 5. Good practice in removing barriers to formalisation

58. There are a number of ways of trying to reduce informality. The following is a summary of current donor good practice in reducing regulatory and administrative barriers to formalisation:

i) **Support broad programmes of regulatory reform. Introduce Regulatory Impact Assessments.** Institute programmes of reform that examine regulatory burdens from the enterprise point of view. Programmes should be informed by surveys of the barriers of most concern to enterprises, including those that are identified as barriers to formalisation. Choose sectors according to their capacity to generate growth and employment. New laws should be subject to assessments of their impact on MSMEs, including the formalisation decision.

ii) **Design measures to create a business-friendly culture in government and to improve service provision.** Even without significant increases in resources, there are steps that can be taken to improve the delivery of services to business by government. Donors should support efforts to create service charters in ministries and local administrations. They should also support one-stop shops in accessible locations to help firms understand and comply with their obligations and play an intermediary role between enterprises and government services, pressing the latter to improve service delivery when necessary.

iii) **Simplify official administration for businesses.** Review and reduce paperwork for businesses and make use of IT where possible. Keep official forms to a minimum. Consider exemptions for smaller firms, or more appropriate thresholds for entering into regulatory regimes.

iv) **Avoid retroactive taxation for businesses that formalise.** Enterprises will be reluctant to formalise if they fear a large tax bill.

v) **Simplify tax administration**. Tax administration is more often cited as a problem than tax rates. Consider single taxes for MSMEs as a way of reducing the number of payments. Offer different payment options, one-off or by instalment.

vi) **Share information on what taxes are used for**, and how businesses will benefit from enhanced services. Evidence suggests that compliance rates go up when businesses know what they are getting in return for their payments.

vii) **Rationalise business registration and licensing regimes**. Make registration a simple, administrative process that is separate from licensing. Use IT where possible. Separate the function of revenue generation from business registration and licensing. Remove registration from (usually overburdened) courts wherever possible.

viii) **Limit licensing to those activities where it is justified** on health, safety, environmental or other grounds. Avoid multiple licences and make it easier to submit applications. Eliminate licensing for as many firms as possible.

ix) **Make it easier to register business and producer associations.** Socio-cultural traditions can be transformed from barriers to opportunities through the formalisation of business or producers' associations. Whilst barriers to formalisation may seem insurmountable to individuals, it may be easier to encourage the formalisation of such producer groups and, through them, to make the benefits of formalisation available to individuals.

x) **Reduce registration fees and statutory requirements.** Make sure that fees are set at a reasonable level and that any requirements, e.g. for fixed premises or capital, are fully justified.

xi) **Promote labour law reform** which protects essential rights while making it easier to hire and fire workers and to employ people on flexible contracts.

59. In addition to these micro-level reforms, four higher-level business environment reforms are important to support efforts to encourage formalisation:

i) Initiating dialogue with participants in the informal economy, in order to understand their constraints (including resistance to formalisation), is vital. Town hall meetings, radio talk shows and focus groups are just some of the ways that have been used to include the informal economy in policy-making.

ii) There are decentralisation initiatives underway in many parts of the world; evidence suggests however that many local authorities are ill-equipped to undertake greater responsibilities and that they do not understand the needs of informal entrepreneurs. Worse, some local authorities view enterprises primarily as a source of short-term revenue. Donors can support programmes that build the capacity of local government to support improved services to business, enterprise growth and formalisation.

iii) Efforts to tackle corruption are likely to have a significant impact on restoring entrepreneurs' confidence in public administration and their willingness to formalise.

iv) The potential for misunderstandings around issues of informality speaks to the need for donors to co-ordinate their activities in this area, permitting a complementary, gradualist approach to formalisation.

## 6. Policy and practice recommendations for donors

60. In addition to the specific recommendations aimed at removing barriers and at supporting measures, a number of policy and practice recommendations for donors emerge:

i) Develop a commonly shared toolkit that encompasses the full range of successful donor interventions that have an impact on formalisation.

ii) Promote formalisation by creating a regulatory environment that is generally enabling.

iii) At the same time, work with willing partners to remove barriers to enterprise growth and formalisation at local level. Wholesale legal reform is not always possible, but progress can still be made to streamline administration (as through one-stop shops).

iv) Support measures to reduce corruption at the main interfaces between government and business in the process of formalisation (particularly in registration and licensing procedures).

v) Educate government officials at local and national levels about the importance of the informal economy and the role they can play in increasing formalisation by offering improved services. Demonstrate that facilitating long-term growth of the tax base is preferable to extracting short-term gains and encouraging firms to hide their activities.

vi) Ensure that programmes to increase welfare in the informal economy do not reduce incentives to formalise. In return for assistance, require a *quid pro quo* from informal enterprises in terms of movement towards formalisation.

vii) Support dialogue between government and informal enterprises (or their associations) to reveal barriers to formalisation and build trust and understanding on both sides.

viii) Consider the merits of longer-term interventions, such as reforming regulatory and administrative barriers; changing the culture of government takes time. Where longer-term interventions are not possible, adopt more modest and targeted objectives.

ix) Assess the capacity of local governments to implement policies to reduce barriers to formalisation and take steps to plug gaps between centrally-approved initiatives and local capabilities.

x) Undertake and share further research on the impact of reforms to the enabling environment on formalisation.

***Further reading***

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**NOTES**

5. See Tokman, 1992. The IDB also estimated that restrictive labour laws accounted for a 6% increase in the informal sector share of total employment in Latin America between 1990 and 1996 (cited in Krebsbach and Karen, Global Finance, 1999).

6. There certainly are cases where the costs of formalisation have reduced enterprise profits in the short run, and there are cases where investment climates are improving but informal economies continue to grow in the short run. However, there is no denying the strong correlation between proportion of GDP in the formal economy and overall economic well-being of countries, as cited at the beginning of this paper.

# IMPLEMENTING COMPETITION POLICY IN DEVELOPING COUNTRIES

## 1. Why is the topic important for pro-poor growth?

61. Achieving the Millennium Development Goals requires rapid and sustained growth in developing countries. It is now widely accepted that the private sector must be the engine of growth, and that governments must create environments that allow the private sector to flourish.

62. Competition is essential if markets are to work well for the poor. When firms have to compete vigorously, they must find better ways to produce and distribute goods and services. Competition benefits consumers both directly, through lower prices, better quality and an improved choice of products, and indirectly, through its impact on economic growth. As women constitute a larger share of very poor people, women especially will benefit from the impetus given to growth by the existence of competitive markets.

63. The provision of services by central and local governments contributes significantly to the welfare of the poor. Competition is important for the effectiveness of government procurement (for example, in the provision of rural infrastructure), as anti-competitive practices by suppliers will reduce what governments can achieve with the funds available.

64. Jobs are an important route to poverty reduction. Competitive markets are more likely to provide the poor with opportunities to be employed or to start their own small business. These opportunities include export-oriented industries. ‘Competitiveness’ is not synonymous with ‘competition’, but firms and sectors are far more likely to be competitive internationally if they operate within competitive domestic markets.

65. Competitive domestic markets benefit farmers. They will be in a more favourable position if the markets in which they buy their inputs, arrange transport of their crops to market and sell their outputs are competitive.

66. The analytical framework *Accelerating Pro-Poor Growth through Support for Private Sector Development* reflects the importance of competition policy to the poor. It discusses the effects of entry and exit barriers to entrepreneurship and the contribution made by competition to innovation and productivity.

67. Such views are complemented by a growing body of evidence on the link between growth and poverty reduction. The World Bank’s *World Development Report 2005* emphasised the importance of competition for investment and noted how competitive pressure leads to innovation, new products and new technology. When it released *Asian Development Outlook 2005* in April 2005, the Asian Development Bank headlined its view that effective competition policies are needed “if Asian countries are to maintain their high rates of growth and employment”.

68. The existence of competition policy reduces uncertainty for business and is an important element of a good regulatory package for private sector development. There are also indications that, by reducing the scope for arbitrary decisions by officials, competition law reduces the scope for corruption, which hurts the poor. However, given the practical implications of transition, it will also be necessary to adopt measures to assist any groups adversely affected by such changes.

69. Competition policy, including competition law, is needed because markets do not always work well. Anticompetitive actions by firms are one cause, but inappropriate regulations by national, state and local governments are also frequent causes of market failure.

**2. What do we know so far and/or still need to know?**

70. There is a widely held view that competition policy makes a positive contribution to economic growth. An OECD paper, based on a survey of members and invited non-members who participated in the 2002 Global Forum on Competition, concluded that: "There are strong links between competition policy and numerous basic pillars of economic development…. There is persuasive evidence from all over the world confirming that rising levels of competition have been unambiguously associated with increased economic growth, productivity, investment and increased average living standards".

71. Competitive markets allow new firms to enter, efficient firms to thrive and sub-standard firms to fail and exit. An OECD study of 53 countries conducted in 2002 found a strong correlation between the effectiveness of competition policy and growth (Dutz and Hayri, 2002). In 1999, the Australian Productivity Commission found that its National Competition Policy reforms mean that "national output [is] … 2.5% higher than otherwise – an amount equivalent to almost one year of economic growth". This estimate did not include the dynamic efficiency gains also expected to flow from the competition reforms.

72. There is increasing information on the harm anti-competitive practices in both national and international markets can do to developing countries. Examples of domestic anti-competitive practices that especially affect the poor include:

i) Ring tendering for polythene pipe supplied to the Nepal Drinking Water Corporation,[7] and for school construction in China.[8]

ii) Flower exports from Morocco being made uncompetitive by the combined effects of a trucking cartel, a freight forwarding cartel and compulsory use of the national airline.[9]

iii) Cartels of companies buying tea, sugar and tobacco forcing down returns to farmers in Malawi,[10] and cartels for retail sales of flour, bread and poultry affecting retail prices in Peru.[11]

iv) 'Bundling'[12] by dominant firms, such as the action of a gas company in south-western India forcing new customers to buy hot plates when they were connected to the gas supply.[13]

73. Studies of international cartels investigated by the European Commission and United States competition authorities illustrate their large impact on poor countries. The World Bank's *Global Economic Prospects 2003* noted that six international cartels overcharged developing countries by USD 3 to USD 7 billion in the 1990s. A 2001 paper[14] estimated that 16 international cartels overcharged developing countries by between USD 16 and USD 32 billion in 1997 and found that prices fell by 20% to 40% following the break up of the cartels. A study of cartels for aluminium, steel and heavy electrical equipment estimated that they had overcharged Kenya by USD 111 million, Zimbabwe by USD 141 million and Southern African Customs Union members by USD 1.1 billion in 1999.[15] A study of one major cartel (vitamins) found that suppliers had overcharged developing countries that lacked a competition law by more than countries that had such a law.[16]

74. Much has been written by economists on the harmful effects of monopoly on prices, output and consumer welfare. However, there has been little empirical research into the impact of competition policy on national economies and very little on the impacts on developing countries.

75. There are several possible reasons for this, including limits on the availability of data. Most developing countries have a relatively short history of competition law. Countries that have adopted competition laws since about 1990 often accompanied it with other significant policy changes including privatisation, deregulation and trade liberalisation. Separating the effects of these policies is a challenge.

76. In the case of transitional economies, the appropriate sequencing of policy changes, including the introduction of competition, is of great importance. The experiences of Russia and of Syria, for example, highlight the need for better understanding of how to introduce competition to transitional economies.

77. More empirical research on the harm caused to developing countries by inadequate competition, and on the effects of increasing the intensity of competition through the adoption of competition policy and law, would be of value.

78. Developing countries are short of finance and skilled people and must choose carefully how to use them to their best advantage. For small countries that are members of regional groups, a regional competition law could enhance the impact of the domestic law. Co-operation arrangements with developed countries could provide help with staff training through exchange programmes and information exchanges.

### 3. What are the big controversies?

79. Competition policy and law is still new in much of the world and there are a few areas of controversy. The main ones seem to be:

#### *a) Does every country need a competition law?*

80. Some people argue that if a country is open to trade and investment, it does not need a competition law. Openness to trade and investment can have large and beneficial impacts on competition. However, foreign investment can bring heightened concern in developing countries about competition and, in any case, some goods and services cannot be traded internationally. Competition policy and law can benefit all countries, whatever their size and level of development, but the law must be appropriate to their needs.

#### *b) What is the right relationship between competition law and sector regulators?*

81. Sector regulators are required where competition cannot work effectively, such as with natural monopolies. Regulated sectors generally include major public utilities that are important for consumer welfare. Decisions made by sector regulators include technical issues and pricing or profit ceilings. However, some decisions by regulators are on matters that affect competition. In these cases, their decisions should reflect competition principles. If not, there can be distortions in the use of national resources that can harm consumers, including the poor.

#### *c) Does having a competition law mean developing countries cannot have an industrial policy?*

82. Every national competition law includes some allowances for national priorities, and there is no necessary conflict between competition and industrial policy. Well-designed policies can be complementary. The 'Development Box' approach in WTO arrangements is relevant not only for industry, but also for agriculture.

***d) How should the introduction of competition policy, including its enforcement structure, be sequenced?***

83. There are specific constraints that are characteristic of the degree of development of an economy, and of its society as a whole. There is a need to investigate the extent to which a blueprint approach can be used to address the question of sequencing.

## 4. What sort of policy implications and suggestions for donors can we give?

84. The overall policy implication for donors is the need to recognise the contribution that effective competition can make to the welfare of the poor. As the 2001 Nobel Prize winner Joseph Stiglitz said: "Strong competition policy is not just a luxury to be enjoyed by rich countries, but a real necessity for those striving to create democratic market economies".

85. Increasingly, developing countries want to adopt appropriate competition regimes, but need help. Specific national issues must be identified clearly and the analysis of what help is appropriate requires close attention. In providing the help needed, it is desirable that donors harmonise their activities to avoid the possibility of duplication or of leaving gaps. There is significant scope for additional support from donors in four major areas:

***a) Policy research to build and disseminate the evidence base***

86. More empirical research on the impact of competition policy and law in developing countries, as well as on best practice, would be of considerable value. Worthwhile areas for research include the four areas of controversy previously mentioned.

***b) Culture of competition***

87. A 'culture of competition' is where the rules and benefits of competition are widely known and form a natural part of the background for decisions by firms and governments. Building a culture of competition and an effective competition regime is a long-term endeavour, and not just a matter for one-off events. Competition must be 'mainstreamed' in all sectors.

88. Advocacy is needed for a new competition regime to succeed. Politicians and officials need to understand why competition is good for the economy, and how to apply its principles to government decisions. There is a need to overcome opposition from the business sector by emphasising the benefits competition law can provide, such as cheaper inputs and the contribution competition law and policy can make to creating a good pro-investment climate.

89. Some NGOs, especially consumer groups, can be strong allies for competition policy and law because they know how it can benefit consumers. Donors could find it effective to fund relevant work by reform-minded NGOs, especially those based in developing countries. For example, DFID has funded research and advocacy programmes (such as the CUTS 7-Up projects [17]) that include participation by local consumer groups, and has funded the preparation of materials by Consumers International for use by consumer organisations.

***c) Bilateral technical assistance and capacity building***

90. Help is needed in formulating a competition policy and law, and in developing and strengthening the institutions that will enforce the competition law, including the training of specialist staff. Assistance can be provided by funding training programmes organised by the competition authority in the donor's

country, including staff exchanges, and by funding studies of barriers to competition in important sectors of the economy.

91. There is scope for donors to support proposals for roundtable forums on competition policy and law for senior policy makers from developing countries.

***d) Programme funding***

92. Donors can fund the technical assistance and capacity building programmes of international organisations (including UNCTAD, the ICN, the World Bank, the WTO and OECD) and regional organisations,

93. UNCTAD has a well-established programme of technical assistance and capacity building activities.[18] It also organises annual meetings of the Intergovernmental Group of Experts on Competition Law and Policy (IGE), a useful forum for competition officials in developing countries.

94. Membership of the International Competition Network (ICN) is open to competition authorities of all countries. A 'virtual' organisation, the ICN addresses both practical enforcement issues and policy issues, and seeks convergence of best practice. The ICN's Competition Policy Implementation Working Group seeks to identify the key elements needed for successful capacity building and competition policy implementation in developing and transition economies.

95. The World Bank is active in policy research and capacity building on competition policy issues.

96. While competition policy has been removed from the scope of the Doha Round, the WTO continues to provide technical assistance on competition to a number of developing countries.

97. 'Peer reviews' can be a valuable way to objectively assess the operation of national competition laws. Some have been undertaken by the OECD, with donor support,[19] and UNCTAD presented peer reviews of Jamaica and Kenya at its conference in November 2005.

98. Donors can assist organisations working to create a regional competition policy as part of a regional economic structure, such as CARICOM, COMESA, UEMOA and MERCOSUR. Assistance may be needed by ACP countries in identifying and negotiating their objectives in the forthcoming EPA negotiations.

## 5. Recommended best practices

99. Modern regulatory regimes for private sector development should include competition policy regimes. Some of the practices to be encouraged in the design and operation of a competition law are outlined below.

i) The design of the law should reflect the level of economic development of the country concerned, the structure of its economy and its constitution and culture. A competition law should not simply be transplanted from a developed country, or even from another developing country. A competition law should not stand alone, but should be part of a well-designed package of measures to create the right environment to allow competitive markets to benefit the poor.

ii) The introduction of competition policy should be reflected in the annual and medium-term plans and budgets of governments. Activities supported by donors should be adequately planned and appropriately monitored.

iii) The focus of a competition law should stay as close as possible to the objective of fostering competition in markets. Other social and political objectives should, ideally, be targeted through more specific measures in other legislation. Exceptions and exemptions should be minimised as competition law is most effective when applied broadly to the economy, including to state-owned enterprises.

iv) Whatever division of responsibility between sector regulators and the competition authority is chosen regarding competition issues, there should be an effective working relationship between the regulators and the authority.

v) A competition authority should be independent of government in its day-to-day decisions. This has implications for the selection of people to be appointed to the authority. The authority should have an adequate budget and should be staffed by competent officials.

vi) A new competition authority needs to prioritise its work carefully. A good rule of thumb, at least initially, is to concentrate on cases where entry barriers seem high, where prices seem high and where consumers will benefit most. These initial targets should include those with the least substantial vested interests that would oppose change. That is, to improve support from consumers and politicians for the new competition law, the competition authority should choose an early "winner".

***Further Reading***

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DFID (Department for International Development, UK) (2004), *How to support competition policy and law*. A "How to…" note in the "working with the private sector" series. Available from DFID.

Mehta, P. (ed) (2005), *Towards a Functional Competition Policy for India*. CUTS and Academic Foundation, New Delhi.

World Bank. (2004), World Development Report 2005: A Better Investment Climate – For Everyone. World Bank and Oxford University Press.

The competition sections of the websites of the OECD, the WTO, UNCTAD and the World Bank, and the website of the International Competition Network (ICN) contain extensive information that includes material on the development impacts of competition policy and law.

**NOTES**

7. Adhikan, R. (South Asia Watch on Trade, Economics and Development, Kathmandu), Presentation at FIAS Conference, Sri Lank, June 2004.

8. OECD (2002), Global Forum on Competition 2002.

9. USAID study reported at International Competition Network Workshop, Paris, Feb. 2002.

10. CUTS (Consumer Unity and Trust Society, India) (2003), Spine Chilling Experiences of Anti-Competitive Practices in Malawi.

11. CUTS (2002), Challenges in Implementing a Competition Policy and Law.

12. ‘Bundling’ involves a dominant firm compelling purchasers of the product for which it is dominant to buy another product as well, which they might not want or might be able to obtain more cheaply elsewhere.

13. CUTS (2002), Competition Policy and Law Made Easy.

14. Levenstein, M.C. and Suslow, V. Y. (2001) Private International Cartels and their Effects on Developing Countries, Background paper for the World Bank’s World Development Report 2001.

15. Jenny, F. (2002), Paper presented at WTO Regional Workshop on Competition, Mauritius, November 2002.

16. Clarke, J. and Evenett, S. (2003) The Deterrent Effect of National Anti-Cartel Laws: Evidence from the International Vitamins Cartel, Antitrust Bulletin 2003.

17. CUTS (The Consumer Unity and Trust Society) is an NGO based in Jaipur, India. The first ‘7-Up’ project undertook research and advocacy on competition policy in seven developing countries that had adopted competition law (four in sub-Saharan Africa and three in south-Asia). This two-year project, funded by DFID, concluded in February 2003. CUTS is currently undertaking ‘7-Up 2’, a study of competition policy in several countries in Asia. This project is funded by SECO (the State Secretariat for Economic affairs of Switzerland) and DFID. CUTS recently commenced ‘7-Up 3’, which will undertake research and advocacy on competition policy in seven countries in sub-Saharan Africa, and which is being co-funded by NORAD and DFID.

18. See Competition policy for Development: A report on UNCTAD’s Capacity Building and Technical Assistance Programmes (2004), http://unctad.org/en/subsites/cpolicy.

19. DFID funded the peer review of South Africa’s competition law and policy undertaken at the OECD Global Forum on Competition in 2003.

## PROMOTING THE SUPPLY-SIDE RESPONSE:

## TECHNICAL AND FINANCIAL ASSISTANCE FOR PRO- POOR GROWTH

### 1. Why is the supply-side response important for pro-poor growth?

100. The economic reform programmes introduced in many developing countries during the 1980's stressed the need for a propitious enabling environment for the private sector. Initially there were high expectations that a package of macro-economic reforms ("getting the prices right") would give quick dividends in terms of economic growth. There has been growing disappointment with the growth record in many developing countries. During the 1990's only 18 out of 117 countries with populations of more than half a million people were able to sustain growth rates exceeding those of industrialised countries.[20] Today, there is widespread awareness that much more comprehensive investment climate reforms are required and that such reforms are time consuming and challenging exercises.

101. Economic research has shown that as well as the level of economic growth, the pattern of growth is crucial for achieving pro-poor growth and reducing poverty in accordance with the Millennium Development Goals (MDGs).[21] There is a concern that the pattern of growth is not sufficiently pro-poor in a number of developing countries, which means that growth does not contribute as fully as it could to poverty reduction. An important reason is that the results of economic reforms have been weak, especially in markets and economic sectors in which a majority of poor people are active. This calls for greater focus on those markets that are important for the poor in their roles as entrepreneurs, employees or consumers.

102. Traditionally, donors have attempted to strengthen the enabling environment for the private sector by providing support to economic institutions and infrastructure. In parallel, considerable support has been provided directly to individual firms or groups of firms. Such support has included technical support e.g. business development services (BDS), often provided through public organisations or through donor projects. This support has frequently been supply-side oriented and has often included subsidies provided directly to individual firms. Financial support has also been provided for banks in the form of credit lines earmarked for specific types of company, in many cases with subsidies to reduce the cost of borrowing.

103. The rationale for direct support at the firm level has been described as follows:[22]

- Direct support may be necessary to overcome **market imperfections and/or market failures**.
- Such support may help **improve the response to reforms** in the policy environment.
- Support to business champions and leaders may **create demonstration effects** for other firms and thereby stimulate the supply-side response.

104. Over the last decade, the shortcomings of subsidised and targeted support to individual firms or groups of firms have been widely recognised. Important lessons have been learnt and many donors are now reviewing their practices in order to make their support for private sector development more strategic.

105. The market-based approach that is now emerging can be seen as a reaction not only to the shortcomings of direct support to the private sector, but also as a realisation that efforts to improve the general investment climate are not sufficient. This approach puts the focus on the supply response, especially in markets of importance for poor men and women. It aims to identify obstacles to the development of specific sub-markets and to improve the institutional environment of those markets that benefit poor people - directly and indirectly - with special attention to small and medium-sized enterprises.

106. Lack of access to various kinds of services has been shown to be a critical constraint on the development of enterprises. Improving firms' access to business development services is one of the core instruments for promoting income and employment generation for poor people. The same applies to financial services where a deepening of markets for such services is an important element in many programmes aimed at stimulating pro-poor growth. Access to other productive resources, such as land and technical knowledge, can also be critical constraints.

## 2. What do we know so far and/or still need to know?

107. Commenting on selective interventions at the firm level as a complement to broad-based investment climate reforms, the "World Development Report 2005"[23] states that "in theory, selective interventions can yield positive social outcomes. In practice, cases of unambiguous success are rare, and there are many examples of costly failures, even in developed countries with abundant technical expertise and well-established checks on rent-seeking".

108. A general problem with interventions at the firm level is that they do not address the fundamental causes of market failure, but instead provide support to reduce the symptoms e.g. lack of access to credit. They can even deepen market distortions by preventing services from becoming available at cost price. Another main criticism is that by providing assistance only to selected firms ("picking winners") donors distort the competitive environment and retard market development in specific industrial sectors. Firms benefiting from such support schemes often resist their removal.

109. Today, there is a well established consensus among donors that whenever assistance is provided at the firm level, the leverage effect of such interventions on the business environment, and on relevant markets, must be carefully considered.

110. BDS was one of the first areas in which the new market-based approach to private sector development was broadly applied. In 2000, the donor community agreed on guiding principles for BDS interventions[24] which may be summarised as follows:

i) Look at the target groups (entrepreneurs, farmers, etc.) as clients and not as beneficiaries (**demand orientation**).

ii) Develop transactional relations with clients instead of a charity relation (**cost recovery**).

iii) Supply BDS via **providers** that are themselves **business-oriented and market-led;** they may be individuals, private enterprises, non-governmental organisations (NGOs), chambers of commerce, business associations, parastatal bodies or government agencies.

iv) Strengthen the **capacity and competence of service providers** to compete successfully in a market for BDS (no continued subsidies and clear points of exit for donor-funded interventions).

v) **Stimulate the market** for BDS, e.g. through initial subsidies to clients (e.g. vouchers, matching grants or cost-sharing) for purchasing BDS on the market.

vi) **Donors should act either as facilitators or supporters** of national/local BDS-facilitators, rather than providing services directly by themselves to the target groups.

111. There is today a growing amount of experience from implementing this market-based BDS approach, some of which can be summarised as follows:

i) A high proportion of BDS donor programmes claim to address (explicitly) the poor, but empirical evidence is lacking; in general, market-based BDS for micro-enterprises, small farmers etc. still seems to be poorly developed.

ii) BDS market development for poorer target groups has increasingly been based on market-led approaches; furthermore, there is a growing awareness of the importance of separating or "unbundling" business and welfare-oriented services (including from NGOs and public service providers).

iii) Donor interventions aimed at BDS market development are increasingly directed towards agricultural sub-sectors and transformation of agricultural products in rural areas, where BDS markets are particularly weak.

iv) BDS market development is increasingly part of broader programme approaches, e.g. development of value chains and local and regional economic development (LRED) or cluster promotion. However, empirical evidence on the pro-poor impact of such integrated approaches is still lacking.

## 3. What are the controversial issues?

112. While there is now a consensus among donors on the need to move towards more market-oriented approaches, opinions differ regarding how this should be dealt with in practice. For example, although there is common recognition that market-based approaches have limitations, there are different views regarding the appropriate criteria for diagnosing such situations and the steps that should be taken when markets fail.

113. Against the background of contributing to the MDGs, donors may be tempted to strive for short-term achievements and, as a consequence, neglect the principles of the market-based approach. Considerable resources may be spent on highly subsidised or even free services and goods (e.g. fertilisers, tools or infrastructure) in order to achieve some measurable results in direct poverty alleviation. This type of intervention may threaten attempts by other donors to promote systemic and structural change including broad market outreach, sustainability and efficiency, which can only be achieved in the medium or long term.

114. For the extreme poor and particularly for vulnerable groups, e.g. persons living with HIV/AIDS and handicapped people, the livelihood services approach has proved to provide a successful mix of group delivery mechanisms, subsidies, income generation activities and social mobilisation. Key challenges for donors in this context are developing appropriate exit or graduation strategies and striking the right balance between providing "charity" and supporting more business-like and sustainable approaches.

115. A core element in the market-based approach is that the providers of financial as well as technical support to enterprises should themselves be business-oriented and market-led. Although there is common agreement that any support to such providers should be market-oriented, opinions vary regarding the design of such support. The debate on the use of intermediaries for provision of financial services is one example.

## 4. Policy implications for donors

116. The emerging approach for support to private sector development is based on the concept of systemic change; altering the incentives within markets to deliver pro-poor outcomes rather than providing direct support to enterprises.

117. The following key criteria and guiding questions may be applied by donors in connection with assessment of proposals that involve support to individual or groups of firms:

i) Define the **rationale** for intervention: The focus should be on the sources of problems, not on the symptoms. What is the market failure that justifies a direct type of intervention? Is the proposed intervention the most appropriate response to the problem? Are there any risks that the intervention in itself may cause market distortions or retard the development of markets?

ii) **Level playing field:** All firms should have an equal opportunity to access support instruments. This promotes competition and creates better chances for cost efficiency in the use of such support.

iii) **Avoid or minimise subsidies to firms and intermediaries:** The subsidy component of credit and technical assistance provision should be as close to market terms as possible. This will ensure that the assistance reaches the firms that see a real value addition from the assistance provided. Instruments that minimise the required financial inputs, e.g. guarantee schemes that share risks with commercial banks and provide them with incentives to lend to small and medium enterprises, may be useful in the appropriate context.

iv) **Provide subsidies to end users:** In situations where there is clear rationale for the public sector to provide subsidies, e.g. for social or infrastructure services, subsidies should preferably be provided in a transparent way to end users, rather than being channelled through providers of goods and services. Applied in this way, subsidies strengthen the demand for services and stimulate competition and market development.

v) **Apply principles of "output-based aid":** To support the delivery of basic services, explicit performance-based subsidies may be justified to complement or replace user-fees. Affordability issues for particular groups of users, positive externalities or the infeasibility of imposing direct user fees are examples of the types of concerns that could motivate the use of public funds to support the delivery of basic services. The principles for output-based aid have been defined by "the Global Partnership on Output-Based Aid" (see www.gpoba.org).

vi) **Clear exit strategies:** A predefined exit strategy should always be prepared in connection with support to firms.

118. There may be situations when market development approaches are not applicable. Particularly in post-conflict situations or after natural or man-made disasters, in the short term, direct firm-level assistance seems to be the most appropriate way to re-establish affected enterprises. The fundamental challenge is on the one hand to identify the right point of exit and, on the other, to find the right starting point for a gradual shift to a market-based approach that aims to rebuild the supporting institutional environment for the private sector. There is often a need to differentiate and sequence donor support depending upon the type of firm and the stage of development.

119. Direct assistance at the firm level may provide valuable learning and insights into actual business problems and policy obstacles that can play an important role in advocacy for reform by donors and private business associations.

120. In the provision of technical and financial support at firm level, donors have often co-operated with a number of different stakeholders. For this and other reasons, donor support has often been scattered and duplication is common. The market approach requires concerted efforts to align donor support with national strategies and to strengthen aid co-ordination mechanisms.

121. Donors should review the way they internally organise themselves to support private sector development. There may be possibilities to promote synergies and cross-breed experience between different types of instruments. For example, the "transaction experience" among people who are involved in support at firm level may be very useful for colleagues specialised in the development of the enabling environment. Likewise, experience of analysing market institutions may provide valuable inputs for preparation of firm-level support. At the country level, it is often important to combine and co-ordinate interventions at different system levels; e.g. support to macro-economic reforms with support at the meso (market) and/or micro (firm) level.

122. Impact monitoring should be an integral part of donor programmes aimed at market-based development of technical and financial assistance. Relevant information should be gathered regularly. Emphasis should be placed on learning rather than on proving. Amongst other measures, monitoring information should be used to keep the programme "on track", and if necessary for adjustments. The monitoring system should include indicators which allow for measuring the impact of market development on the productivity of firms and on income and employment generation, with special focus on poor women and men.

## 5. Recommended best practices

123. It is not possible in a brief paper to provide more detailed recommendations on best practice within a large knowledge area. However, there is a wealth of sources that provide guidance and best practice on various aspects of firm-level assistance. Recommendations on some titles for further reading are given below.

124. The following are some concrete examples of practices to be encouraged in the field of BDS:

i) **BDS market assessments** should take into account the livelihood systems and the views of the targeted poor, including socio-economic, cultural, gender and other relevant aspects, by making use of participatory instruments.

ii) This also applies to **value-chain analysis**, which should look into the links in the value chain and sub-sectors with a potential for value addition, thereby resulting in higher incomes and employment for marginalised populations.

iii) Special attention should be given to services of particular relevance to the poor such as: i) commercially oriented **input suppliers** to small-scale farmers; ii) **market access distribution systems**; iii) **embedded services** for rural micro-entrepreneurs and small farmers; and iv) **buyer or supplier credit schemes** linking producers to alternative financing mechanisms.

iv) **BDS in rural areas:** Poverty is particularly widespread in rural areas. At the same time, there are clear constraints regarding the absorptive capacity of urban agglomerations. Therefore, it is extremely important to make BDS markets work for the poor in rural areas. The various approaches such as the sector approach in agro-business and food-processing, value-chain development or the promotion of local and rural economic development offer ample scope for creating improved income and employment opportunities. Interventions in favour of these inter-firm relations are usually geared to the development of a competitive edge for the whole cluster, sector, industry or region, and less to individual enterprises. This may bring about the systemic change that is so greatly required.

v) **Possibilities of public private-sector partnership (PPP):** In developing value-chains as well as in local and regional development, public and private partners could join forces to provide commercial and sustainable business services in the scope of business linkages. Depending on the partners, these can also result in the provision of cost-effective, high-quality, embedded services, such as market access or extension services.

***Further reading***

Brook, P.J. and Petrie M. *Output-based aid: precedents, promises, and challenge*. Paper prepared for The Global Partnership on Output-Based Aid (GPOBA).

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The Consultative Group to assist the Poor (CGAP); *Building financial systems for the poor - Key principles of microfinance*; Washington.

The Committee of Donor Agencies for Small Enterprise Development (2001), *Business development services for small enterprises: Guiding principles for donor intervention;* Washington DC

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20. "Economic Growth in the 1990s: Learning from a Decade of Reform"; World Bank 2005 (http://www1.worldbank.org/prem/lessons1990s/index.htm).

21. Pro-Poor Growth in the 1990s - Lessons and Insights from 14 Countries. Operationalising Pro-Poor Growth Reseach Program; 2005.

22. See Snoddgrass, D. and Winkler, J. P. (2004).

23. A Better Investment Climate for Everyone; World Development Report 2005; World Bank, Washington DC; 2004.

24. BDS for small enterprises. Guidelines for Donor Intervention, Donor Committee for SED, 2000, often referred to as the 'blue book'.

# THE FINANCIAL SECTOR'S CONTRIBUTION TO PRO-POOR GROWTH

## 1. Why is the topic important for pro-poor growth?

125. First and foremost, a well-developed financial sector—understood as the central bank, commercial banks, non-banking financial institutions (which include microfinance institutions and alternative finance institutions such as co-operatives, credit unions and savings banks), as well as the financial markets—is important for promoting private sector development and subsequently the contribution of the private sector to alleviating poverty.

126. The financial sector contributes to reducing poverty and improving opportunities for the poor directly, indirectly and by making economic growth more pro-poor.

127. The financial sector can have a more direct impact on poverty reduction in two ways:

i) A well-developed financial system allows the poor to have access to financial services, which they are often denied. They need to have access to a large array of financial services, such as saving facilities, payment instruments, credit, and insurance. When the poor accumulate savings as a precaution against unforeseen events or with a view to financing investments in housing or child education, it is important for them to have their savings in liquid assets and in a safe place. They also need credit on various occasions: to finance equipment or inputs needed for revenue generating activities, to pay for education or to help them recover from difficult situations resulting from economic crises, natural disasters or health accidents. Credit is of particular importance in rural areas where farmers have to face a time lag before they receive the proceeds from selling their crops. They also sometimes suffer from drought, flood or shocks. There is increasing evidence of the ways in which financial services touch the lives of poor directly.[25] However in the absence of well-functioning formal markets, individuals and firms seek other less efficient means of risk management. Informal systems are common in the early stages of development. As they emanate from local cultures and customs, the procedures are simple and easily understood by the population, but such systems are usually characterised by high risks and usurious rates of interest.

ii) The financial sector can facilitate the financing of investments for the provision of basic services to the poor. Improving access for the poor to basic services such as water distribution, power, health services and education is necessary to reach the Millennium Development Goals. However, current volumes of official development assistance (ODA), foreign direct investment (FDI) and domestic savings fall short of what is needed to finance the corresponding investments. Additional private resources will be required to augment those coming from the public sector. A sound financial sector will not only reassure private investors but also facilitate financial flows and create new opportunities.

128. The financial sector can also contribute to poverty reduction indirectly, as a diversified and competitive financial sector plays an important role in economic development generally. Indeed, a well-functioning financial sector contributes to the maintenance of economic stability; it provides a means of payment and makes possible secure financial and commercial transactions; it helps to mobilise domestic and external savings; and it is crucial for the efficient allocation of capital to productive investments. As

growth contributes to poverty reduction, at least in absolute terms, the financial sector therefore facilitates and contributes indirectly to poverty alleviation.

129. In addition, the financial sector is essential for making economic growth pro-poor. Indeed, growth is not always pro-poor and in order for poor men and women to benefit from economic growth, the poor need to have access to markets and thereby be able to take advantage of opportunities. As highlighted in "Accelerating Pro-Poor Growth through Support for Private Sector Development" market outcomes are influenced by policies and institutions in five main areas: providing incentives for entrepreneurship and investment, increasing productivity, harnessing international linkages, improving market access and functioning and reducing risk and vulnerability. In each of these areas, the financial sector plays an important role:

i) ***Providing incentives for entrepreneurship and investment***: access to financial services ensures that entrepreneurs have the facilities with which to do business and provides credit to allow them to make productive investments (in new technology, for example); monetary and fiscal discipline is also important for providing stability and reducing risks for vulnerable people and small businesses.

ii) ***Increasing productivity***, through competition and innovation. Investments in equipment, technology or education need to be financed and are key to increasing the productivity of individuals as well as of enterprises.

iii) ***Harnessing international linkages*** to take advantage of trade liberalisation and private capital flows. Dynamic trade flows require a proper payment system as well as trade financing mechanisms. The financial sector should provide safe, cost-effective and transparent formal channels for money transfers, including remittances. Moreover, a stable financial system is important for securing FDI as well as portfolio flows.

iv) ***Improving market access and functioning***. Financial markets are one of the markets for which access is vital for the poor. By enabling the poor to draw down accumulated savings and/or to borrow to invest in income-enhancing assets (including human assets e.g. through health and education) and to start micro-enterprises, wider access to financial services generates employment, increases incomes and reduces poverty. Deepening the financial sector also gives more opportunities to the poor to have access to capital markets.

v) ***Reducing risk and vulnerability***. Financial sector policy is crucial for macroeconomic stability, in order to avoid collective bank failure, inflation or currency crises. The development of insurance services, including those serving the poor, can also mitigate risks. By enabling the poor to save in a secure place, the provision of bank accounts (or other savings facilities) and insurance allows them to establish a buffer against shocks, thus reducing vulnerability and minimising the need for other coping strategies such as asset sales that may damage long-term income prospects.

## 2. What do we know so far?

### *a) The links between financial sector development, growth and poverty reduction*

130. Despite measurement and definitional problems, most research has found evidence of a correlation between financial sector development, growth and poverty reduction.[26] It is legitimate to infer that, while there is a circular causation mechanism between financial sector development and growth, in developing countries the impact of financial sector development on growth is more important than the

reverse. There is evidence that the less developed an economy the stronger the impact of the financial sector on economic growth. In particular, it has been highlighted that a country with a high level of education cannot reap the full benefits of this unless the financial sector is reasonably well developed. It is also clear that the underdevelopment of the financial sector has a negative impact on growth. Some research goes as far as identifying a poverty trap, meaning that a weak financial sector limits the number of market players and creates a vicious circle, as low market development leads to low growth and to an even weaker financial sector.

131. Development of the financial sector has also been shown to have positive effects on poverty reduction, although it is difficult to split out the direct effect of access to financial services on poverty from the indirect effect via overall economic growth, partly because of a lack of data.

### *b) Microfinance institutions*

132. At the micro level, there is also evidence of the positive effect of providing the poor with access to the financial sector through microfinance institutions (MFI), when they are properly managed.[27] The positive role of MFIs in poverty reduction is well established and documented, even though this sector encompasses a wide variety of institutions, with differences in the quality of management and efficiency.

### *c) Deficiencies in financial sectors in developing countries*

133. Despite improvements in the last decade, the financial systems of developing countries still suffer from shortcomings and market inefficiencies that have an impact at various levels of the business environment.

*Financial systems are fragile*

134. Whatever the immediate macroeconomic and financial policy errors (exchange rate policy, for example), the 1997-98 financial crisis in Asia highlighted some fundamental flaws in developing country financial sectors. These flaws are linked to: i) problems caused by governments interfering in the allocation of resources through credit controls and regulated interest rates; ii) the lack of regulatory, accounting and operating procedures that comply with international standards, coupled with poor quality and opaque supervision and a lack of transparency; and iii) the almost systematic reliance on short-term foreign funding because local debt and equity markets are insufficiently developed.

135. Since the financial crisis of the last decade, the international community and governments have become aware of the necessity of achieving financial stability and transparency to avoid systemic risks and have been working continuously in this direction.

*Financial systems are incomplete*

136. First and foremost, formal financial systems in developing countries are incomplete and deficient. The majority of people do not have access to basic formal financial services. It is estimated that the proportion of people without a bank account reaches 90% in some African countries.

137. The weakness of the formal financial sector is a severe handicap for developing countries. Capital and money markets are still under-developed. Very few developing countries enjoy the macroeconomic stability needed to create even medium-term, let alone long-term, debt markets. They do not have government securities that can provide the reference values needed to establish an interest-rate curve and few investors are willing to invest beyond a one or two-year time horizon, most of them fearing that the large-scale macroeconomic fluctuations to which these markets are exposed will compromise returns on investments.

138. There is little competition in the financial sector, which is often dominated by a handful of foreign banks, a few residual state-owned banks and under-capitalised local banks that operate in a segmented market. It is easier to create a vigorous financial market when there is genuine competition.

139. Lending to the private sector is insufficient. There is a lack of medium and long-term lending and a lack of instruments and institutions adapted to business needs, while the cost of credit is often too high for want of competition.

140. This situation is partly the result of deficient legal and regulatory frameworks that do not ensure a favourable business environment. Arbitration procedures and court decisions are too slow and open to influence and do not provide enough certainty, especially as regards debt collection (difficulty in realising mortgage guarantees, weak property rights). Banking regulations are ill suited to medium and long-term credit, which is often treated in the same way as short-term lending. Rules on contingency provisions are too strict for small-scale transactions (acknowledgement of mortgages only, which are expensive to register) and microfinance institutions do not always have a specific regulatory status.

### 3. What is controversial—Supporting the enabling environment or direct interventions: exclusive or complementary practices?

#### *a) The case against direct intervention*

141. Direct intervention, i.e. direct financial support to enterprises, banks or MFIs, in the past has often produced disappointing outcomes and some donors tend to advise against it, giving higher priority to actions related to improving enabling environments and institutions.

142. Direct intervention may result in market distortion and crowding out of the private sector through unfair competition. Such distortions could lead to misallocation of resources, thus reducing growth. There is a risk, for instance, that donor funds provided to an individual bank would give it an unfair advantage and prevent market forces from selecting the best competitor.

143. Donor funds may be better used to help build an enabling environment for the development and the deepening of the financial sector as a whole; in other words, direct support could be a sub-optimal use of donors' funds.

144. There is a risk that direct intervention might not bring about sustainable financial sector development, meaning that the services or the financing provided may disappear when donor support is no longer available.

145. Even if they are efficient, the impact of direct interventions depends on other factors such as the existence of an enabling environment. A study[28] shows that credit guarantee schemes can be effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, but only in situations where specific factors for success exist. These factors include the existence of an open, competitive banking environment, a dynamic and/or expanding business sector and a policy environment in which initiatives are co-ordinated and other government or donor initiatives do not crowd out market-driven initiatives, in particular through the provision of subsidised credit or other financial products and services. In such scenarios, guarantee schemes have the potential to play a role of accelerator rather than driver in deepening the financial sector.[29]

### *b) The case for direct intervention*

146. While recognising the importance of the enabling environment and institutions, some donors consider that direct intervention is still beneficial, provided precautions are taken to avoid market distortion. There are a number of contexts in which direct intervention remains justified:

i) The recourse to public-private partnerships (PPPs) can lead to donors and development financial institutions (DFIs) directly participating in financing an activity or in a guarantee structure for it. PPPs are especially needed to finance infrastructure, including water or power distribution projects that are essential for increasing services for the poor. In these cases, donors' and DFIs' roles, as catalysts to attract private financing, are key. It is a good way to maximise the leverage of ODA.

ii) Appropriate interventions of donors on the market may open new channels, help develop new activities or create new instruments. For instance, providing guarantees to a special purpose vehicle issuing bonds on a local market may be a useful way of directing under-used savings towards investments and of avoiding foreign exchange risk thanks to the provision of loans in local currencies. Concessional credit lines to banks where the use of the grant is strictly limited to a specific development objective can have a strong demonstration effect.

iii) Changes in institutions or in regulation take time and while they are a necessary condition for developing the market they are not sufficient. For instance, in fragile states or in post-crisis situations, donors' direct interventions can have a powerful leverage effect on financial flows and provide an appropriate response to the emergency and the high level of risk in such situations. In less urgent cases, even if interest rates are liberalised and banks can legally extend medium or long-term loans, they are not ready to do it, due to lack of expertise, insufficient information or aversion to risk. Financial engineering introduced and supported by donors can address this, by promoting instruments such as guarantees, credit enhancements and specific financial vehicles. Microfinance is a good case in point: even in developed countries with a sophisticated financial sector, the poor have difficulty accessing financial services. All the more so in developing countries; a good competitive banking system does not guarantee that the needs of the poor will be addressed. In such countries, direct donor intervention has allowed microfinance institutions to grow, which in certain cases has attracted banks into this activity.

## 4. Best practices

147. When designing priorities for support, donors should consider the type of financial sector in which they intervene. In countries with less developed financial sectors, a pro-active approach should be applied. Priority should be given to assistance geared towards creating an "enabling environment": support for the regulation, supervision and promotion of financial systems. In more sophisticated economies, donors should be pro-active and support policies and projects that extend the provision of financial services to the poor. These types of approaches are complementary and not exclusive but some attention should be paid to the sequencing of donor support.

148. When contributing to the creation, development or strengthening of the legal and regulatory environment, which is essential, donors should closely co-ordinate their actions at a macro-level, making sure there is no overlap or contradiction between approaches. However, when donors extend support to financial intermediaries, different views and practices can foster innovation, provided that some basic principles are respected, especially the avoidance of market distortion.

149. When conditions are met for donors to play a catalytic role in building public-private partnerships by using public funding, they could consider blending concessional and non-concessional resources, setting strict rules concerning the use of concessional funding. The decision on whether to offer concessional funding should be independent of the nature (public/private) of the intermediary, but when the intermediary is a private entity great care should be taken so as to avoid market distortion. It means in particular that the concessional resources should be allocated in a transparent way to deserving beneficiaries or uses such as: i) investments aimed at strengthening the sector's environment; ii) providing services for poor people who do not have easy access to private services; iii) supporting public borrowers who implicitly play a balancing role between social action and profitable business; or iv) investments with a strong environmental and/or social impact. Finally, donors should only use concessional funding during pilot stages and seek to build sustainable solutions that will exist after their withdrawal.

150. Donors should aim for sustainable, long-term impacts from their interventions when providing financial support for small and medium-sized enterprises (SMEs). Therefore, if they provide credit lines or guarantees to financial intermediaries, it is particularly important that they cover only a portion of the risk and make sure that a significant part is borne by the lender. If such precautions are taken, this type of assistance can have a demonstration effect and help financial intermediaries to learn how to manage the risk of lending to SMEs. It can also help to build expertise and reduce information asymmetries by giving the lending institutions the opportunity to gather information on SMEs' credit worthiness.

151. When refinancing microfinance institutions, donors should avoid subsidies, except in some instances such as capacity development, and use subordinated debt instruments in local currencies. Subsidies, which may have been necessary at the beginning of microfinance, are not the right tool when it comes to mature institutions that are already sustainable and only need help to grow. Indeed, the donor's role has evolved with the development of microfinance, and donors should now aim to consolidate existing microfinance institutions and strengthen their financial and institutional viability.

## 5. Policy implications and suggestions for donors

### *a) Information on financial sectors in developing countries*

152. Designing strategies for financial sector development, and connecting the poor to this sector, requires a better understanding of initial conditions and constraints. Therefore, in order to increase the focus on the issue of access, there is a need for more information on levels of access to financial services, barriers to widening access, scale and the nature of unmet demand. Donors and DFIs should encourage the collection of such data by financial institutions or through household surveys on access to financial services.

### *b) Business environment*

153. The development, strengthening and consolidation of the institutional and legal environment is of particular importance in broadening and deepening the financial sector. The main aim of donors' interventions should be to make sure that the authorities have the willingness and all the necessary tools to develop the financial sector. They should also be encouraged to remain focused on the objective of enhancing access to financial services, including in financial sector assessments such as the Financial Sector Assessment Program (FSAP) run jointly by the World Bank and the International Monetary Fund (IMF). In this respect it is mainly the responsibility of multilateral organisations to act, for instance the IMF when it comes to monetary, financial or fiscal policies, but bilateral donors also have a role to play. They could in particular encourage the professionalisation of supervisory authorities and market regulators. They could also support the development of financial infrastructure, for instance helping to set up credit bureaux and asset registries.

154. It is also necessary, in order to improve the quality and the transparency of the financial sector, to help developing countries to implement international financial standards and codes; this concerns in particular corporate governance, international accounting and auditing systems.

### *c) Financial intermediaries*

155. Strong financial intermediaries will lead to better resources allocation. As part of a long-term strategy to make financial markets respond better to the needs and constraints of the poor, there may be a need for donors to provide support to financial intermediaries such as banks, insurance companies, institutions specialised in refinancing local authorities, and microfinance institutions. Modernisation of payment systems is also an important issue: in particular the spread of electronic money and the transfer of remittances. Donors could also consider interventions that help intermediaries that operate in sectors where returns are low or deferred, for example, education, healthcare, housing, small business, farming and refinancing.

### *d) Financial engineering*

156. Financial instruments are needed to devise innovative and well-adapted solutions, while increasing the leverage of donors' funds. This is of particular interest for the financing of investment in pro-poor infrastructure, such as water or power distribution. But it can also be of value in other instances. For example, a bank may have a portfolio with a lower risk rating than that of the bank itself; in such a case donors could help the bank to raise money through a securitisation transaction. New resources could then be tapped on more favourable terms and via the local market. It is worth promoting instruments such as guarantees, credit enhancement, specific financial vehicles and public-private partnerships as ways of increasing the leverage of public sector resources on private sector ones. In this regard, donors who can draw on the requisite specialist expertise could play the role of a catalyst: they can help structure specific financing schemes to attract other investors (foreign or local) and they bring expertise, help to create new instruments and contribute in this way to the broadening of the financial sector.

### *e) Savings mobilisation*

157. One important donor policy orientation should consist of supporting increased mobilisation of savings. This will allow the use of domestic resources available for investment as a whole, as well as helping the poor to accumulate more savings on a secured basis. To this end, donors can help to structure and develop financial markets by supporting specialised financial intermediaries and institutional investors (e.g. collective savings management instruments, life and pension insurance, pension funds)..

### *f) Remittances*

158. Migrants contribute in an important way to the informal and formal financial sectors in their country of origin. The whole system (banking, savings, and credits) needs to be adapted to allow them to contribute to the fight against poverty. A significant proportion of immigrants in host countries as well as their families in home countries remain "unbanked". Therefore, one of the major challenges confronting traditional financial institutions and other financial service providers is to integrate unbanked senders and receivers into the financial system through better outreach, new technologies and more cost-efficient and transparent services.

### *g) CGAP principles*

159. The Consultative Group to Assist the Poor (CGAP) have developed a set of Key Principles of Microfinance[30] that provide good practices for the sound development of microfinance and which most donors follow. Under these principles, three important orientations should be given particular attention.

The first is the promotion of a favourable legal and institutional environment. In this respect, it is important to support the efforts of national and regional monetary authorities to develop appropriate legal and regulatory frameworks for microfinance. Second, donors should help to consolidate existing financially viable microfinance institutions with the aim of helping them to attain a critical mass and to increase their number of beneficiaries. Third, it is advisable to promote linkages between microfinance institutions and banks to capitalise on their synergies and draw on the different skills and capabilities of each.[31]

### *h) PRSPs and financial sector policies*

160. Notwithstanding the general recognition that the development of the financial sector is important for growth and poverty alleviation, the coverage of financial sector policies in Poverty Reduction Strategy Papers (PRSPs) is very uneven and a number of PRSPs cover financial sector issues only marginally or even not at all. This calls for additional dialogue between donors and partner countries in order to raise awareness and identify objectives at the policy level.

## 6. Conclusions

161. In addition to the more traditional focus of financial sector policymakers and regulators on efficiency and stability, it is important to realise that the financial sector plays a central role in enabling the poor to participate in and take advantage of economic growth. This paper highlights the importance of focusing on ways to promote wider access to financial services for the poor. In doing so, donors will help to open up the financial sector by the provision of new funding mechanisms and the encouragement of new financial activities.

162. In designing such strategies, donors should consider the following priorities:

i) Encourage the collection of data on levels of access to financial services, barriers to widening access and the scale and nature of unmet demand.

ii) Encourage greater professionalism in supervisory authorities and market regulators and help with the implementation of international financial standards and codes.

iii) Strengthen financial intermediaries and help them to find sound instruments to serve sectors where returns are low or deferred.

iv) Play a catalytic role by structuring specific financing schemes to attract other investors or by bringing expertise, helping in the creation of new instruments.

v) Support an increased mobilisation and prudent intermediation of savings.

vi) Bridge the gap between microfinance institutions and the formal banking system.

vii) Encourage partner countries to cover financial sector issues in PRSP documents.

### *Further reading*

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26. For instance: Beck, Thorsten, Demigurc-Kunt, Asli, Levine, Ross. Finance, inequality, and poverty : cross-country evidence. World Bank Policy, research paper n°WPS3338, 2004. See also: The importance of financial sector development for growth and poverty reduction, DFID, August 2004.

27. See, Microfinance, in Parole d'Acteurs (Key players' views) n°4, Agence Française de Développement, 2005.

28. Do credit guarantees lead to improved access to financial services?, DFID, 2005.

29. A related controversial issue pertains to the treatment of guarantees in ODA accounting. Guarantees are counted as ODA only when the risk occurs (such as in the event of default), and when the guarantee is called. Considering the role of guarantees, at least as an accelerator of financial sector deepening, and more generally to leverage private local and foreign capital to finance private investment in developing countries, this accounting system underestimates the role of guarantees as a development instrument. It even may have a disincentive effect on donors in the present context of increasing ODA flows. Several DAC members have proposed changing how guarantees are recorded in DAC statistics but there is no consensus to modify the current system.

30. Building Inclusive Financial Systems: Donors Guideline on Good Practice in Microfinance, CGAP/ The World Bank, December 2004

31. Breaking Down the Walls between Microfinance and the Formal Financial System, Littlefield & Rosenberg, CGAP Paper, September 2004.

# ENHANCING WOMEN'S MARKET ACCESS AND PROMOTING PRO-POOR GROWTH

## 1. Why is the topic important for pro-poor growth?

163. The majority of workers in the developing world cluster in small and medium-sized enterprises in the private sector. They may be own-account workers in services or agriculture, or employees in small and medium-sized firms in manufacturing. Some of these enterprises are informal and unregistered, others are fully integrated into the national tax base, reporting income and expenditures and complying with laws and regulations that govern hiring, firing, production and sales. Whatever their status as enterprises, these economic activities are critical for workers and owners alike.

164. Entrepreneurship and investment influence the rate and pattern of growth, the types of forward and backward linkages that develop in an economy, the labour demanded and the human capital investment required to meet these labour demands (Ranis, Stewart and Ramírez, 2000). Rapid growth can contribute effectively to poverty reduction (OECD, 2004). If growth is broad-based and inclusive, benefiting multiple sectors and economic activities, it is likely to provide greater opportunities for the poor to increase their incomes, acquire skills and assets and transform and upgrade their livelihoods. Rapid growth is also frequently associated with greater international trade and regional development linkages (OECD, 2004). Greater integration has the potential to stimulate foreign direct investment (FDI), raise productive capacity and generate benefits that accelerate the transfer of skills and knowledge. Yet for these gains to be equitable, and evenly distributed throughout the economy, requires markets where access is unrestricted, information flows freely and competition is encouraged.

### *a) The cost of gender inequalities in market access*

165. Women are a significant entrepreneurial force whose contributions to local, national and global economies are far reaching. Women produce and consume, manage businesses and households, earn income, hire labour, borrow and save, and provide a range of services for businesses and workers. Women represent an increasing proportion of the world's waged labour force and their activity rates are rising. In Africa, Asia and Latin America, they are over one third of the officially enumerated workforce (WISTAT, 2000). Women-run businesses can be found in emerging sectors such as the production and marketing of consumer goods, commercial banking, financial services, insurance, information services, communications and transport. As owners of small and medium-sized enterprises (SMEs), women furnish local, national and multinational companies with ideas, technology, supplies, components and business services (Jalbert, 2000). These activities are likely to prove fundamental as developing economies transition from primarily agricultural to industrial production and become more urbanised. Furthermore, as economies liberalise and open their borders, women-owned and operated SMEs are engaging in international trade - enhancing the prominence and visibility of women entrepreneurs globally.

166. Even as women enter markets and engage in production, however, they may face different constraints and opportunities than their male counterparts. Social and cultural proscriptions assign productive and reproductive roles to men and women that can limit their access to markets and restrict their occupational and sectoral mobility. Throughout many countries and regions, the gender division of labour within the household underpins fundamental differences in the rights and responsibilities of men and women. In many rural societies, for example, women are responsible for household provisioning: food crop production, gathering fuel and hauling water, and caring for children and the aged. In return, men are expected to meet certain cash requirements of the household. This division of labour affects women's

ability to participate in paid employment and access education and training and influences their choice of productive activities.

167. Although there are variations across countries, social norms strongly influence men's and women's work and working environments. Some tasks and jobs are considered more appropriate for men or women and overt or covert screening filters out applicants who defy these norms. These gender norms frequently underpin sex-segmented labour markets and activities. Highly sex-segmented labour markets typically confine women workers to low-wage low-productivity employment and can limit the responsiveness of labour markets to new demands for higher skilled workers. Sluggish or unresponsive labour markets can impede adjustment, distort human capital investment and inhibit a firm's ability to switch into new activities and compete in a dynamic and globalising market.

168. Sex-segregated labour markets precipitate a number of efficiency losses that can provide a drag on growth and compound income inequality. A chief inefficiency is that sex-segregated labour markets lead to welfare losses (reducing total output) arising from the misallocation of the labour force: competent female workers are excluded from some of the more productive activities. Sex-segregated labour markets are associated with higher gender wage inequality (Cartmill, 1999; Tzannatos, 1999), which distorts investment in human capital, prioritising male income earners and undercapitalising women earners. Finally, substantial evidence suggests occupational segregation is associated with less security in employment for women and fewer prospects for promotion, as well as lower wages (Cartmill, 1999; Elson, 1999). These outcomes are likely to compound the inter-generational transmission of poverty, particularly for girls and women.

169. Highly sex-segmented labour markets and production may also compound or accentuate macroeconomic imbalances. For example, gender-based wage differences can create a competitive advantage for some semi-industrialised countries, providing a stimulus to growth - particularly in countries that have invested in assembly production with substantial, flexible, low-wage work in traded goods. Strategies based on gender-wage and gender-production inequalities can also result in a slow but steady deterioration in the terms of trade as a whole vis-à-vis industrialised countries, particularly if economic activities are concentrated in low value-added production where competition in the value chain exerts downward pressure on wages and labour costs (Cagatay, 2001:27). As the terms of trade decline the cost of importing capital and retooling or diversifying production rises. Declining terms of trade also mean declining reserves and can lead some economies to require balance-of-payments support or even default on debt service.

***b) The role for policy and programmes***

170. Development occurs within an institutional and economic environment that is similarly shaped by customs, social norms and implicit and explicit codes of conduct (World Bank, 2001). Yet social and cultural norms are not immutable: throughout history there is evidence that they are in flux. Policy and programmes can provide impetus for change - promoting greater equity and efficiency. For example, improving economic institutions, so that productivity rather than gender, race, caste or age becomes the primary criterion for employment and compensation, can contribute to overcoming barriers that exclude entry and participation. Facilitating the free flow of market information, so that it is not controlled by powerful elites, can undermine monopolies and broaden access and participation. Creating markets for child-care and ensuring household access to energy and water has the potential to reduce the domestic workload for women and girls. Facilitating access to labour markets for women can increase the returns to investing in women's human capital. Removing systematic barriers to market access for excluded groups can facilitate broad-based growth and is more likely to reduce poverty than strategies that focus on narrow market niches and existing elites, preserving privileges and potentially accentuating existing inequalities.

## 2. What do we know so far and/or still need to know?

171. Clearly, women workers and entrepreneurs are not an undifferentiated mass. Age, literacy, education, rural or urban location, ethnicity, language, health and physical well-being also influence market access. Differentiating those factors that make some women entrepreneurs and workers more vulnerable, or less able to take advantage of new and existing opportunities to expand and upgrade their activities, will prove essential for the appropriate design and delivery of policy, programmes and projects. Documenting and analysing the impact of gender barriers to market access on the economy will provide critical information about the costs of gender inequality and the trade-offs implied.

### *a) Labour markets*

172. Women and men often work in distinct activities that offer different rewards and career opportunities even though they have similar education and labour market skills. In many economies, women work in jobs characterised by low wages, high job insecurity, low levels of unionisation and poor working conditions. For example, women tend to cluster in informal employment[32] (Carr, Chen and Tate, 2000). There is also evidence, given the size, scale and location of women's small and micro-enterprises, that when they contract workers they do so informally. Consequently, women workers may face more insecure employment with fewer benefits and lower wages than their male counterparts (Charmes, 1998; Benería, 2003). Unequal access to labour markets and highly sex-segregated occupations generate a host of inefficiencies that compound gender-wage inequalities, depress investment in women's human capital and can distort market signals.

### *b) Financial markets*

173. The design and delivery of financial services greatly affects access - particularly for the poor. Financial intermediaries often require traditional forms of collateral (land, housing, machinery), for which women frequently lack title. Complicated application procedures and documentation requirements can prevent women with lower education and few skills from applying. Minimum loan sizes and inflexible repayment schedules, stipulations that may be required for efficient credit disbursement, often preclude women applicants seeking smaller loans for activities that yield income over longer or more infrequent intervals. Similarly, sectoral priorities may favour male economic activities over those of women. The lack of knowledge about women's economic activities, and documentation that can substantiate their profitability, reduce women's access to credit and insurance products. Additionally, mobility constraints that limit women's ability to travel can restrict their access to financial institutions that are not in their community or neighbourhood. Finally, where women concentrate in informal economic activities, or enter and exit the labour market more frequently to bear and care for children, they are less likely to acquire pension rights or have access to financial instruments for retirement, death and burial.

174. A dynamic financial sector is critical for sustaining long-run growth and ensuring poverty reduction. The financial sector contributes to growth by facilitating capital accumulation and investment and accelerating the rate of technological progress (DFID, 2004a,b). An efficient financial sector mobilises savings for investment, encourages inflows of foreign capital (including FDI, portfolio investment, bonds, and remittances) and optimises the allocation of capital between competing uses, ensuring that capital flows to the most productive activities. Where women may be disproportionately excluded from participating in financial markets and women's economic activities are underserved, market signals fail and capital bypasses potentially dynamic sectors and productive opportunities.

### *c) Goods markets*

175. Women and the poor may face differential access to goods markets. Markets for goods and inputs, like most markets, are frequently regulated. Trading is typically not anarchic and conventions and rules regulate participation and sales. A variety of factors may impede access to goods markets or increase the cost of entry. For example, distance from the market may limit an individual's ability to sell or purchase in that market. Women may disproportionately face mobility constraints that limit their ability to travel or sell in markets at some distance from their households and communities. The lack of permission or certification to trade in certain markets will prevent market entry: small farmers and women are typically confined to domestic markets because they do not have the required certification to trade produce internationally. The volumes traded in some markets may be too large for small producers or buyers - effectively precluding their access to large, centralised, domestic and international markets. Information may not be readily available about the type of goods sold or the prices at which they are sold - or may flow to select groups. Finally, collusive activity on the part of buyers or sellers may squeeze out competitors and prevent outsiders from gaining access to certain goods markets. These types of collusive and restrictive practices may disproportionately affect women and small producers.

176. Gender-related barriers to goods markets affect both earnings and efficiency. The costs of unequal access have implications for producers as well as households. Pro-poor growth strategies that fail to take account of how gender affects access to and outcomes in goods markets are likely to compound existing inequalities, reduce producer and consumer surplus and limit the potential to maximise value added and deepen forward and backward linkages.

### *d) Service markets*

177. Access to service markets may also be affected by gender. Service markets describe the delivery, purchase or hiring-in of activities that can enhance or transform production processes. Access to training and workforce development can upgrade skills, raise productivity and improve earnings and wages. Small business development services and information and communications technologies can provide targeted assistance to expand existing activities, penetrate new markets and improve efficiency. Extension services can increase output, diversify and improve production, reduce risk and raise the quality and price of the goods traded. Although some of these services are traded, others may be provided by governments or intermediaries, as partially or fully subsidised programmes, to fulfil distributional or efficiency goals.

178. Women may face particular barriers accessing service markets. For example, women's agricultural activities in Africa are frequently oriented towards subsistence production and domestic markets. They produce lower-value products, on smaller tracts of land, with less access to capital, labour and chemical inputs. Lack of funds and social prohibitions on engaging with male extension workers preclude many women farmers from accessing or hiring extension services that can transform their production, reducing their ability to benefit from liberalisation or respond to price signals by shifting into tradables. Similarly, because of their household and reproductive responsibilities, women workers may be less able to participate in and benefit from workforce development initiatives.

179. Where women face restricted access to service markets, their production is likely to be concentrated in lower-value, lower-return activities. The inefficiencies that this imposes upon women's businesses can also be a drag on growth, fostering uneven and unequal development.

### *e) Micro-meso-macro linkages*

180. While much is known about gender-specific exclusions and inequalities in market access, there remains a need for policy and programmatic research on the impact of these barriers to market access on

local, national and regional growth patterns. These types of analyses should focus on the micro, meso and macro linkages as well as on the implications of inequalities in market access for the intergenerational transmission of poverty.

181. Gender inequalities in market access limit longer-term growth. Understanding how women access markets as producers and wage labourers is likely to prove critical for fostering pro-poor and inclusive economic growth. Analysing where women are in the global value chain, and documenting the resources they use and transform, will provide information about how to strengthen local economies and maximise forward and backward linkages. Reducing women's barriers to market access, improving their position within the value chain and enhancing their productivity is likely to benefit local, national and regional economies as well as households.

## 3. What controversies exist?

### *a) Entitlements and capabilities approaches*[33]

182. An entitlements approach focuses on increasing women's access to resources and inputs that enable women to enter markets, raise their productivity or scale up their existing activities. Micro-credit is an example of an entitlement project that allows women to enter markets, purchase capital to raise their productivity or scale-up their existing activities. Capabilities projects provide resources and services that increase women's ability to deploy their existing resources or enter new markets. Capabilities projects typically focus on enhancing women's voice or agency and improving their bargaining power or skills. Training and workforce development projects provide a useful example of a capabilities approach that enhances women's existing skills, raising their productivity as workers and producers and enabling them to enter new labour markets and earn higher wages or overcome under- and unemployment. Donors are unclear about the type of intervention and approach to use, or the appropriate mix and sequence of approaches in different contexts.

### *b) Level of intervention*

183. Disproportionate attention may be being paid to women at the micro-level at the expense of meso- and macro-levels of intervention. Some projects and programmes respond to concerns that gender-based exclusions are more visible at the micro-level and that acting on the policy and programmatic environment to enhance women's productivity and efficiency as micro-entrepreneurs can overcome initial barriers to market access. However, micro-level activities are frequently being promoted in increasingly saturated markets where the potential to scale-up is limited.

### *c) Gender integration*

184. Many donors develop women-focused programmes as separate components of other activities or as a programme in its entirety. Fewer programmes emerge from a process of gender integration where a systematic gender analysis of inequalities in access to resources and power motivates interventions and activities. Controversies about when to target women exclusively or whether to pursue a gender approach appear to emerge from a lack of knowledge about how to undertake a gender analysis of market barriers. Similar controversies exist about whether to target mixed organisations and institutions, enhancing women's role and agency within these, or whether to invest in parallel organisational structures that are exclusively for women.

## 4. What are the policy implications and recommendations?

185. ***The failure to focus on women's market access reduces the effectiveness of policies to promote pro-poor growth***. Sex-segmented labour markets contribute to gender-wage inequality, depress investment in human capital and prevent women from entering higher productivity occupations. Market failures coupled with high transactions costs in the financial sector reduce the flow of capital to women's economic activities, contributing to underinvestment and limiting productivity and growth. Barriers to entry in goods markets frequently confine women to spot markets where monopsonists exert undue influence over prices - reducing producer surplus, depressing incomes and inhibiting further investment in women's economic activities. Service markets that bypass women curtail their ability to scale-up existing activities or augment productivity. The combined effect of these gender-based exclusions can limit local and regional growth and may contribute to macroeconomic imbalances. Growth is more likely to spur poverty reduction where inequality is low. The removal of gender-barriers to market access and gender-based exclusions will reduce inequality more effectively and can prompt more sustained poverty reduction.

186. ***Promote an enabling environment***. Policies designed to remove or ameliorate structural barriers to women's participation in markets can be particularly powerful. For instance, policies that enable women to own, buy, sell and inherit land - individually or with joint title - can increase women's access to financial markets by providing collateral. These same policies can make women's contributions in agriculture more visible, permitting them to scale-up existing production by accessing extension services that may previously have been directed at male farmers. Similarly, pro-poor policies that enhance the provisioning of household water and energy have the potential to alleviate women's time-burdens in the household enabling them to access markets and engage in remunerated productive activities.

## 5. Recommended best practices

187. ***Apply gender analysis tools to develop programmes and interventions***. Gender analysis focuses not just on women, but on the social relations between men and women. Applying gender analysis tools allows practitioners to uncover the inequalities in power that underlie gender-differentiated outcomes in markets, identify points of intervention, as well as strategies to engage potential beneficiaries.[34]

188. ***Undertake gender-disaggregated value chain analyses.*** These identify opportunities to strengthen women's participation in markets. The analysis should focus on forward and backward linkages to maximise multiplier effects in global value chains where women cluster as workers and producers. Analysing the global value chain and the rents generated provides opportunities to target assistance and inputs. The analysis may also provide policymakers with information to create incentives to reduce the number of intermediaries, increase the bargaining power of producers and ensure access-appropriate processing technology, storage and transport facilities to enable resource-poor producers to capture more of the value added in the global value chain.

189. ***Improve micro-meso-macro linkages***. Focusing on larger-scale economic activities, such as medium-sized enterprises that are owned or run by women, and supporting the development of more robust, complex markets with extensive forward and backward business linkages has the potential to improve women's access to markets along the value chain. Linking smaller suppliers and buyers can minimise predatory pricing and monopsony impacts and overcome concerns about volume and production reliability that larger entrepreneurs have regarding small entrepreneurs.

190. ***Minimise risk and vulnerability***. The character of production and labour markets is in flux. Households pursue creative strategies to preserve livelihoods and respond to exogenous shocks such as illness, death, environmental disaster and crop failure. Some interventions and support to increase market access may need to be short-run and agile: emergency food-for-work programmes; retraining for

retrenched workers; and the provision of transport and storage as nascent markets develop and deepen. Other programmes may need to create and encourage the expansion of financial instruments and social insurance to mitigate risk, insure inventories and provide access to pensions and social security.

191. ***Support entitlement as well as capabilities programmes***. Successful projects and programmes pay attention both to inputs and to the individual or group ability to deploy these inputs. Many successful interventions address both entitlements and capabilities within a single project. Programmes and projects that improve women's bargaining power with monopsonists, provide information and communications technologies that enable women producers to sell in higher value markets or purchase critical inputs can raise productivity and incomes. Programmes that facilitate access to child-care can enable women to enter markets or receive training and engage in workforce development initiatives.

192. ***Promote clustering and networking***. Groups of women producers may be able to access services collectively that they might not be able to purchase as individual entrepreneurs. This is particularly true in the informal economy. Clusters and networks of women can facilitate their access to resources and achieve economies of scale. Additionally, groups of entrepreneurs requiring the same service are usually in a better negotiating position with potential suppliers or can bargain more effectively with buyers than they could alone.

193. ***Expand access to credit and financial services***. Micro-finance remains a powerful tool to provide financial resources to the under-served and compensate for the absence of financial markets. Micro-credit can also provide an essential platform for graduating women's businesses and women's production to formal sector financial services. Offering products that include risk, inventory, health, life and funeral insurance has proven to be particularly important for poor women. Working on policy, institutional or social changes that address structural impediments to women's access to financial services can improve their ability to access markets. Among such projects are those that improve women's inheritance rights and their access to collateral resources such as land and other productive assets.

194. ***Address informality***. Women cluster in informal markets and face particular barriers to formalising production. Efforts to reduce administrative and regulatory barriers, promote tax reform that can lift burdens on smaller enterprises, and generalise access to social security, pensions and health benefits can greatly affect the terms and conditions of women's employment and enhance their security in the informal economy.[35] Additionally, lessons can be learned from the experience of the Self Employed Women's Association and Bangladesh Rural Advancement Committee[36] about organising women in the informal economy and facilitating their access to productive resources as well as critical services such as health, housing and child-care.

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## NOTES

32. See for example Women in Informal Employment: Globalizing and Organizing: www.wiego.org/.

33. This draws on Sen's entitlements and capabilities analysis of poverty and material deprivation (Sen, 1999).

34. See for examples tools developed by UNIDO (Business Development Services http://www.unido.org/), and ILO, DFID and CIDA (Trade capacity and small enterprises http://www.siyanda.org).

35. See for example Gamser, M. and D. Welch (2005) "Formalising the Informal Sector: Barriers and Possible Solutions," Development Alternatives Inc., and Bannock Consulting, Ltd., June 2005.

36. See for example http://www.sewa.org/ and http://www.brac.net/.

## CONSTRUCTING INCLUSIVE PUBLIC PRIVATE DIALOGUE

### 1. What is the issue and why is it important for pro-poor growth?

195. Whether economic growth is pro-poor depends on the extent to which the rate and pattern of growth provide opportunities for the poor and the degree to which they are able to take advantage of these opportunities. Governments in developing countries have a responsibility to ensure that a favourable business environment exist for all private sector actors. They therefore need to be aware of the key constraints for different private sector entities in realising their potential to contribute to pro-poor economic growth. Targeting services to poorer entrepreneurs, mostly composed of micro, small and medium-sized enterprises (MSMEs), informal firms and workers and smallholder farmers, is one approach towards accelerating pro-poor growth and generating employment (OECD, 2004).

196. It is increasingly recognised that private sector development is an integral part of poverty reduction strategy programmes (PRSPs). The process of conceiving the second generation of PRSPs has therefore aimed to include a wider range of private sector representatives in consultations. Nevertheless, problems that hamper pro-poor private sector development from the grassroots perspective can still be insufficiently addressed in the resulting PRSP document. Clearly, consultation of the private sector during PRSPs is not enough and needs to be accompanied by mechanisms for regular public-private dialogue (PPD) by sub-sector or at the appropriate policy level, combined with bottom-up communication processes to ensure that local-level issues are fed into higher level policy processes. Making private sector development policy more responsive to private sector needs depends on the way in which PPD is organised, especially with respect to approaches and mechanisms that ensure that MSMEs, informal firms and workers and smaller agricultural producers can voice their concerns.

197. PPD is an institutional arrangement that brings together a group of public and private sector actors. PPD discussion forums range from highly formal and structured to more informal and *ad hoc*, and initiatives may last from only a few hours or continue over several years (Bannock, 2005). Objectives of PPD include building trust and bridging gaps to laying the foundation for a joint problem analysis and identification of policies and institutional reforms that contribute to a more conducive environment for private sector development. Governments that engage in PPD are more likely to promote sensible, workable reforms, while enterprises participating in meaningful PPD processes are more likely to support these (Bannock, 2005 and Herzberg and Wright, 2005). Without a more equitable dialogue, governments tend to follow the loudest, most powerful voices, which rarely speak in the best interest of broad-based private sector growth, let alone poverty reduction. The policy process should not be limited to a small elite with privileged access to political and governance structures, but must build on structures and process that are deliberately set up to elicit citizen participation in policy formulation and implementation, and promote accountability of policy makers (Hertzberg and Wright, 2005).

198. Although not the only condition for accelerating pro-poor growth, PPD can be a first, important step in an institutional reform process aimed at improving the business environment for all. Most likely, a number of the bottlenecks identified will be known and will already have been voiced before. Reform may be blocked because 'inefficiencies' can be a source of income to some, offering opportunities for corruption or political patronage. Firms may also defend anti-competitive or rent-seeking interests. On the other hand, parts of the public sector may not understand the private sector and may not believe that dialogue is useful. At most, it may regard the private sector as a useful cash cow. Moreover, a coherent formal policy making process is lacking in many countries. For these reasons, PPD can be effective where and when there is an explicit commitment and willingness to act on its outcomes by the public and private

sector. This paper explores how, in such conditions, PPD can be organised and how donor organisations can contribute to it.

## 2. A framework for institutional analysis regarding PPD

199. Pro-poor private sector development cannot be achieved by focusing interventions on either the private or the public sector alone. Moreover, many constraints that the private sector faces can only be resolved in collaboration with the public sector. Private sector development and governance programmes should be integrated into one comprehensive intervention strategy. In such a holistic approach, PPD is a prerequisite for arriving at broadly supported institutional reform.

200. **Institutions.** In this paper, institutions are taken to be the rules, organisations and social norms that facilitate co-ordination of human action.[37] Thus, interventions to develop institutions not only address constraints resulting from the performance of organisations, such as business licensing agencies, tax revenue authorities, government ministries, chambers of commerce or producer organisations etc., but also focus on the formal and informal 'rules of the game' and social norms that influence private sector development. For example, to what extent can resource-poor entrepreneurs access business organisations and networks, do they experience barriers to access to financial services, markets, licences, information and contacts with policy makers, are these barriers different for men as compared to women?

201. **Institutionalising PPD.** PPD, as a mechanism for diagnosing the problems and opportunities for private sector development, is useful at all levels where public and private sector entities meet, be it at the national, sub-national, local or sub-sector levels. Misunderstanding, uneasy relationships and distrust between public and private sector actors is common in many countries, resulting in limited responsiveness of public sector institutions to requests voiced by some parts of the private sector. Suspicion and non-co-operation leads to inefficiency and waste, which inhibits growth, investment and poverty reduction (Herzberg and Wright, 2005). This needs to be overcome effectively before any sustainable reform can take place (Jutting, 2003). Key challenges for PPD are therefore promoting sub-sector and horizontal dialogue processes and improving vertical linkages and communications to ensure that issues that have to be addressed at a higher policy level are indeed taken up.

202. **Dealing with the diversity of the private sector.** The private sector includes a multitude of different actors varying from international companies, (privatised) state-owned enterprises, business of different size, active in different sub-sectors and locations. Their goals are not necessarily the same: there is self-interest, mutual suspicion and some are severe competitors. Others are prepared to co-operate to defend their interest via a business organisation. (Former) state-owned enterprises, some international companies and larger firms might find it easier to maintain informal dialogue with government officials, while looking for one-to-one deals. The interests of (former) state-owned companies may dominate decision-making on private sector development, which can run contrary to the interest of privately owned enterprises, faced with a different set of constraints than (former) state-owned companies.

203. **Organisational set up of the public sector.** The public sector also consists of many different actors, and it may be difficult for an outsider to know to what department or agency a certain private sector development-related question should be addressed. The position of government officials differs with respect to the level of operation, authority and resources at their disposal. Moreover, elected officials such as mayors, councillors, parliamentarians and other politicians play an important role in policy making and implementation. The difference between private and public sector is not clear cut, as government officials and politicians may have business interests of their own or may have previously worked for private enterprises.

204. **PPD structured in time.** Four stages of policy reform can be distinguished in which PPD is essential: i) assessing and agreeing on problems; ii) designing and legislating solutions; iii) implementing reforms; and iv) monitoring and evaluating the impact of reform. Even when PPD is taken into account in the first two phases, neglect of private sector participation during implementation can still derail promising initiatives (Bannock, 2005), whereas the monitoring and evaluation phase must guarantee continuity.

205. **Public-private dialogue framework.** Figure 1 proposes a PPD framework-tool that can be used for identifying and analysing the different levels of dialogue and decision making on private sector development, both vertically within the private and public sectors respectively, as well as horizontally between these different sectors (van der Poel et al, 2005). It is inspired by the institutional setting in Tanzania, and may require adaptations when used in other countries.

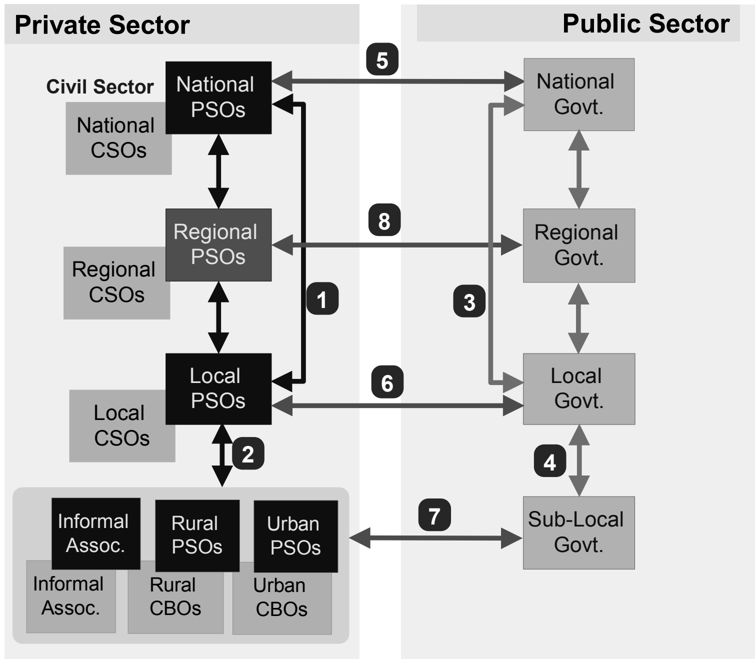
206. The PPD framework-tool consists of two vertical columns, each showing the different levels of the public (grey) and the private (black) institutional structure. The private sector column also pictures civil society organisations (CSOs) involved in private sector development for each level. The framework shows eight numbered key dialogue or communication interactions.[38] These four vertical and four horizontal lines each depict a particular intra or inter-sector dialogue process. Of course, many diagonal communication lines may exist as well, e.g. between a particular local level private sector organisation (PSO) and a sector ministry at the national level, but this type of interaction tends to be incidental and informal.

207. The public sector column shows the administrative set up of a country: from central government via sub-national or provincial level to local level, such as district or municipal councils, and further down to sub-local level, e.g. divisions, wards or individual villages. The presence and status of these various entities, and the degree to which the vertical relations are hierarchical, varies from country to country. Bureaucratic procedures and social norms can seriously affect the ability to communicate with superiors at higher levels.

208. The private sector column presents formal and informal linkages between private sector organisations such as the national chamber of commerce), sub-national level business organisations (district branches of the chamber of commerce), and sub-sector or product organisations (e.g. local organisations of coffee producers or livestock owners). In both rural and urban areas, many formal and informal associations exist at the grassroots level that are often organised around a certain trade in a particular location, e.g. informal associations of local fruit vendors, farmer organisations, savings and credit groups or a local association of shop owners. At this level, the distinction between PSOs and CSOs is often blurred as objectives may overlap.

209. The lack of horizontal dialogue processes between public and private institutions at different levels (lines 5-8 in Figure 1), in combination with limited capacity for analysis and weak bottom-up communication, all contribute to a limited understanding of the real constraints to pro-poor private sector development and economic growth, which may lead to inadequate policies and programmes that sometimes even aggravate the climate within which the private sector operates. In addition, policy makers can only learn from local experiences when functional, bottom-up vertical communication processes are in place (lines 1-4 in fig. 1).

**Figure 1. Public-Private dialogue framework**




## 3. Pro-poor public-private dialogue: good practice and challenges

### *a) The aims*

210. A structured and inclusive public-private dialogue is needed to identify bottlenecks, opportunities and possible interventions for private sector development. The way in which such a dialogue is organised, facilitated and institutionalised and the quality of participation and commitment to the process largely determine the outcome and thus its potential contribution in guiding reforms. The PPD process has three aims, which can be seen as outcomes of and preconditions for different stages in the process:

i) Awareness of those representing PSOs and the public sector of the root causes underlying the identified constraints on pro-poor private sector development and economic growth at various levels.

ii) Ability to transfer these issues to the appropriate decision making levels in both private and public sector organisations (horizontal as well as vertical, bottom-up dialogue and communication).

iii) Translation of these issues into appropriate policies, strategies and plans (design of reform) to resolve them effectively.

211. However, PPD remains important during the stages of implementation and monitoring and evaluation of reform and should be institutionalised accordingly.

### *b) Good practice*

212. **Essential steps in preparing a specific PPD.** Obviously, the way a PPD is designed has to be context specific and adjusted to prevailing institutional arrangements, as shown in Figure 1. Issues that need to be considered carefully are: what will be the first issue for discussion, with which participants, level and structure, focus, communication strategy and also the role of donors (Herzberg and Wright, 2005 and Bannock, 2005). Good planning is vital, such as the preparation of clear and concise agendas in advance, timeframes that show milestones for each specific outcome, good chairing of meetings and ensuring that all present can participate, agreement on minutes and accountability of the secretariat to the participants (Bannock, 2005). A number of experiences with PPD have been documented recently and analysed for good practices and pitfalls. Most cases refer to PPDs set at the central level, but sub-sector PPDs and processes at district or municipal level have also taken place (Bannock, 2005 and Herzberg and Wright, 2005). The next few paragraphs focus on issues that need to be considered in particular for making PPD pro-poor.

213. **Focus of PPD.** For a PPD to be effective, it has to focus on problems that include those of MSMEs, that are not too sensitive or politicised, and have the prospect of attainable results in the short term. Business registration may be more neutral than land registration; improving tax administration is less controversial than revising tax rates. PPD is most effective at the lowest level at which entrepreneurs and government services interact (van der Poel et al, 2005). Sectoral dialogue has been the most effective in producing results, but central-level PPDs are rarely conducive to MSME participation (Bannock, 2005). Most of the constraints that MSMEs and informal firms and workers face are likely to concern local-level situations that have to be solved there and not at the central level (fig. 1). Generally, for MSMEs, the level of urban or rural local government, or the lowest interface with line ministries for certain sub-sector issues, are the most relevant. Still, some of the constraints they face may need policy changes at higher levels.

214. The weak enabling environment for MSMEs - in terms of overly complex legal and regulatory frameworks, registration, licensing and tax regimes, corruption and limited provision of support - are an obvious area for dialogue. At the same time, this situation is the reason why these entrepreneurs are reluctant to trust the government in the first place. For many, their only contact with government is through the police over regulations and with tax collectors. Before a PPD can be fruitful, local government authorities first need to understand that by collaborating with the private sector they stand more chance of achieving their development objectives and improving their revenue base, while the private sector should understand its obligations but also its right to demand accountability and better services, such as good infrastructure.

### *c) Challenges*

215. **Importance of strong private sector organisations**. The presence of well-organised, accountable and capable private sector organisations organised at various levels makes PPDs more relevant. A lack of such organisations is one of the biggest challenges to be addressed. National-level umbrella or apex organisations would be the best way for the private sector to express its voice, but few such organisations exist that truly defend mutual interests. Most chambers of commerce and business organisations bring together only a small part of the private sector. Membership fees can be high in comparison to the perceived immediate value of services delivered, especially for MSMEs. Few poorer entrepreneurs are members of business organisations and, when they do join, their specific interests may carry limited weight. In all-inclusive organisations, even if most of the membership comes from MSMEs, the small group of larger companies tends to run the show. However, some opportunities for collaboration may exist, in particular when larger firms have many backward and forward linkages with MSMEs in a certain sub-sector.

216. A shortage of associations that represent the diverse issues of specific sub-sectors or product groups is apparent at all levels. When such organisations do exist, they often lack capacity and resources to effectively voice the opinions and concerns of their constituency and become a serious dialogue partner. Moreover, many grassroots-level private sector organisations are not linked to apex organisations such as chambers of commerce at the regional or central level, which potentially could have taken care of their interests in national-level dialogue processes. This situation hampers dialogue at all levels, vertical as well as horizontal.

217. **A level playing field.** An inclusive PPD process requires a level playing field. Even when MSME organisations are invited to a PPD, the effectiveness of their participation may be limited. Small businesses' voices can be drowned out, even in well-established PPD systems with formal structures. Larger firms will always have better informal links to policy makers, so MSMEs need to be well-organised and focussed to make a difference. The design and quality of the PPD can prevent the process and the issues covered being dominated by larger, more powerful businesses. Moreover, convenors cannot limit their work to just inviting the associations and organisations that claim to represent MSMEs. Before starting the PPD, they may have to organise a broader consultation process with MSMEs and assist them in selecting representatives for the PPD, provide training and coaching to these individuals so that they can make their case effectively and assist them with the design of mechanisms for consultation and feedback.

**218. Representation and champions.** The composition of a PPD and the quality of the dialogue determines whether the process can make a meaningful contribution to private sector development. The number of participants in a PPD is limited in order to make dialogue possible and the issue of whom to invite and who decides is crucial, particularly when starting up the process. Commitment to the process of respected PSO representatives with a broad support base as well as influential representatives of the public sector are an important condition for arriving at a successful dialogue. Individuals may play an important role in driving such a process (or blocking it). Finding the right 'champions' for a PPD is an important factor for a successful PPD. Some successful PPDs have been driven by handpicked individuals (the 'champions') but who were not necessarily perceived as accountable to a constituency. The PPD will have to demonstrate legitimacy in order to contribute effectively to reforms, and therefore it can be useful to arrange public awareness and education campaigns related to PPD activities.

**Box 1. Value added taxes in Tanzania: An example of a PPD that failed to take account of implications of a new policy for poor entrepreneurs:**

Tanzania adopted a VAT system in 1998 under strong pressure from the international development community, and in consultation with private sector representatives. This consultation took place at the national level and mainly involved larger firms. The new VAT system is acceptable for medium and large firms but causes problems for MSMEs and agricultural producers for two reasons. First, many small enterprises are not VAT registered and can therefore not claim back taxes paid on purchases. To alleviate the VAT burden for farmers, agricultural inputs such as fertilizer and seeds are VAT exempt but other production factors such as transport are not. This has led to an increase in production costs of 10% – 20%. Second, Tanzania adopted a VAT system based on monthly instead of yearly summaries, which is a major constraint for seasonal businesses (van der Poel et al, 2005). It has been claimed that introduction of the VAT system is one of the main reasons why the realised economic growth has not benefited the poor (Tanzanian Vice President Office, 2005). However, most development partners, government officials and business organisations at the national level were unaware of the costs of the VAT for poor entrepreneurs, suggesting inadequate bottom-up communication processes in both the private and the public sector column in Figure 1.

219. **Quality and effectiveness of participation.** There is a trade-off between 'representativeness' and 'capacity for dialogue'. General business associations tend to have many members (in some cases membership is compulsory) and should have a broader perspective of the business environment. However, they have less in-depth knowledge of key sectoral issues and very limited grasp of MSMEs concerns. Sectoral organisations and specialised organisations have a deeper understanding of their areas of work, but this may lead to tunnel vision. They may be effective in informal dialogue, but their narrow mandate is a drawback in formal dialogue.

220. The quality of the PPD, including at the local level, may suffer from the inability of participants to contribute effectively to the analysis of root causes and to developing evidence to support requests for policy reform. Such PPDs tend to produce laundry lists of symptoms. Approaches and tools that facilitate participatory analysis of problems and identify opportunities by local actors exist and can be adapted to local level PPDs.

221. **Facilitation by third parties, providing a neutral space and tools.** Third parties who are perceived as impartial and able to provide a neutral space and to facilitate processes play an important role in PPDs. Their contribution is particularly important where there is a history of lack of co-operation and distrust. They may also initially host PPDs by setting up independent secretariats. Ultimately, a public sector organisation should become the convener, to ensure that the outcomes of PPDs will indeed influence public policy, planning and implementation (Bannock, 2005). Apart from providing a neutral space, specialised organisations may also be better equipped to help apply participatory tools for analysis and planning, such as tools for identifying opportunities and risks, and indicators determining the quality of the business environment as perceived by local entrepreneurs and potential entrepreneurs.

222. **Costs and benefits of participation, and danger of allowances.** Since structured dialogue processes and mechanisms have a greater financial and time burden, these tend to disproportionately penalise smaller firms and their organisations. Larger enterprises can more easily afford to invest in processes as they are better resourced and often have more capacity at their disposal. Simply providing *per diems* and fuel allowances to individual participants can undermine a PPD as this has often led to attendance but not to commitment. A more structural approach is, on the one hand, providing support to PSOs and, on the other hand, ensuring that the participants in a PPD experience the benefits. Government officials, however, may prefer a series of formal dialogue events simply to secure the *per diems* and fuel allowances on offer and many of them may be less inclined to participate in more informal gatherings. This attitude may also extend to private sector participants if they too start receiving such allowances. A danger of paying allowances is the potential emergence of private sector organisations (or other types of membership organisation) growing rich on donor funding whilst losing touch with their membership base.

## 4. Policy implications

### *a) Facilitating pro-poor PPD processes*

223. PPD can provide an important contribution to the PRSP process as well as to more specific reforms aimed at promoting private sector development. Flexible structures (respected convenors, facilitators, resources) need to be in place to accompany PPD processes. A PPD will not automatically promote the specific interests of poorer entrepreneurs unless special efforts are made by convenors and facilitators. It is vital that poorer entrepreneurs are invited and represented, but also equipped to present their interests in a coherent and analytical manner. They may even need research support to gather the evidence that gives credibility to their case (Bannock, 2005). A policy towards pro-poor PPDs therefore needs to include support for facilitators that encourage more effective participation of MSMEs. Approaches and tools need to be made available to MSMEs that enable these actors to see the wider picture, make a diagnosis of their situation and formulate proposals for reform.

### *b) Building and supporting organisations representing poorer entrepreneurs' interests*

224. Strong business associations that genuinely speak for MSMEs can be extremely helpful in making sure that the concerns of MSMEs are heard. Two policy approaches are needed: i) encouraging self-organisation by MSMEs and co-operation with apex organisations; and ii) stimulating general business organisations to become more representative (MSME membership) and enhancing awareness and understanding of MSME issues. Policies in relation to existing organisations need to focus on organisational strengthening and promoting mechanisms that enhance accountability and transparency, as well as capacity building on issues such as sub-sector analysis, lobbying and advocacy in order for them to participate effectively in local PPDs.

### *c) Strengthening responsiveness of the public sector to private sector development*

225. Before a PPD can have an impact, policies may be needed that change the mindset of civil servants, especially at district/municipal government level, as well as to ensure that the role of government changes from a controlling to a facilitating and service-oriented influence. Accountability and the establishment of mechanisms to resolve complaints and malpractice need to be addressed too. This policy can only be successful when implemented in top-down processes that require continuous, strong leadership and drive over a considerable period of time, and if it is also accompanied by incentives for local government officials to change behaviour (van der Poel et al, 2005).

### *d) Decentralisation*

226. Participatory planning and budgeting processes from the village level upwards are being institutionalised in more and more developing countries with the spread of devolution. These bottom-up processes provide an opportunity to promote pro-poor private sector development. Policy support to PPD processes can provide the foundation for such co-operation. Effective local policy making and implementation further requires that the strengthening of local government authority is accompanied by the allocation of sufficient resources by the central government, so that these entities can adequately perform their role and take care of their responsibilities. Fiscal redistribution and equalisation mechanisms may be needed to support poorer parts of the country.

### *e) Institutionalising mechanisms that promote bottom-up communication*

227. In many developing countries, vertical communication and dialogue processes (as shown in Figure 1) are mostly top-down, while mechanisms for meaningful bottom-up communication processes are weak or absent. The policy measures needed to respond to this situation include the creation of effective and efficient communication lines between different sector ministries and their local counterparts. This will also involve better information provision and capacity building at the local level. Many local government officials lack awareness, information and knowledge on private sector development programmes, strategies and policies.

## 5. Implications for donors

228. Overall, donors need to adopt a more daring attitude towards PPD: treat it as a high risk, but highly essential investment, with a healthy tolerance for failure and the flexibility for innovative and experimental ideas, including an exit strategy that allows ownership of the process by the public and private sector entities themselves (Bannock, 2005). It can be accompanied by support for knowledgeable business journalism or international benchmarking of the business climate. Donors can give more weight to PPDs and support their work by referring to these processes in discussions with policy makers, in publications etc.

229. However, donors should stay clear of imposing their own agendas on the PPD process or creating a situation that in the end makes public and private sector entities respond more to donor priorities than to those of their constituencies. Donor support has to be in balance with allocations of time and resources by participants in PPDs. 'Buy-in' by both the public and private sectors to PPDs is essential for their success.

230. Donors can contribute to making PPDs more pro-poor by encouraging PPD organisers to take MSME participation seriously, supporting independent facilitators who have the knowledge and skills to get MSME representatives prepared for a PPD and ensuring a level playing field during the PPD process. MSMEs and representatives of informal firms and workers can be supported with capacity building, guidelines and tools for policy analysis, lobbying and advocacy.

231. Supporting the emergence and strengthening of private sector organisations representing the interests of MSMEs and informal firms and workers is another important issue that donors may decide to support. However, too much cash can undermine these organisations, by making them lose touch with their membership base. It is therefore recommended that donors concentrate on developing capacity, while using their influence to ensure that PSOs are included in the policy dialogue.

232. Development partners can assist with the design of support mechanisms that ensure that PPD processes will be sustained over longer periods of time instead of depending on large one-off financial contributions. In addition, sudden opportunities for constructive dialogue with the public sector may present themselves. It is therefore important that mechanisms are in place that can seize such opportunities for PPD. Experience exists with establishing independent and flexible trust and challenge funds, which are made available to PPD processes. These funds have offered critical flexibility and responsiveness to PPD processes that cannot be provided through donor aid processes (Bannock, 2005). Moreover, donor experience has shown that it is more effective to build capacity for setting up inclusive PPDs at central, sub-sectoral and local level in response to needs and opportunities, rather than to focus on a specific PPD process.

233. Better co-ordination of reforms for private sector development, and PPDs in particular, is required to prevent overlap, omissions and conflicting programmes. Lessons learnt and best practices generated in the many different interventions should be more widely shared and disseminated to ensure incorporation of these into national-level strategies, policies and follow-up programmes. The PRSP process, providing a comprehensive framework for donor support, is one of several on-going reform processes aimed at improving private sector development that is accompanied by a series of PPD-type endeavours. Co-ordination of different private sector development programmes is needed and PPDs may contribute to this.

***Further reading***

Bannock Consulting Ltd. (2005), *Reforming the Business Enabling Environment, Mechanisms and Processes for Private-Public Sector Dialogue*.

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van der Poel, N., F. van Gerwen, D. Olomi (2005), *Reforming Institutions aimed at Improving the Enabling Environment for Pro-Poor Private Sector Development*, Tanzania case study.

Tran Thanh Binh (2005), *Reforming Institutions aimed at improving the Enabling Environment for Pro-Poor Private Sector Development*, Vietnam case study, Hanoi.

Tran Tahnh Binh (2005), *National Level Initiatives in Vietnam: the CPRGS Experience*, Hanoi.

United Republic of Tanzania, Vice President's Office (2005), *National Strategy for Growth and Reduction of Poverty: Republic of Tanzania*.

**NOTES**

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37. See World Bank (2002) World Development Report 2003: Sustainable Development in a Dynamic World: Transforming Institutions, Growth, and Quality of Life, The World Bank/Oxford University Press, New York.

38. No specific distinction is made in the framework between informal or formal dialogue, although the focus of this paper is more on formal – and therefore transparent - forms of PPD. Informal dialogue constitutes an important and powerful mechanism too, and may consist of horizontal, vertical and diagonal interactions.