

# Making Markets Work for the Poor





# Foreword

This report was prepared as a part of a policy process initiated by Sida in 2002 with the aim of preparing Policy Guidelines for a poverty focused Support to Private Sector Development (PSD). The principal author of the report is Claes Lindahl, Management Perspectives International (MPI). The report is the result of a dialogue and interaction between the author, the members of the PSD Project Group within Sida's Department for Infrastructure and Economic Cooperation (INEC) and the PSD Steering Group in which different Sida departments were represented.

The report has also to a large extent been shaped by a series of consultations that have taken place during the course of the PSD policy process, involving a great number of persons representing many different aspects of knowledge on PSD. The response from and engagement of all the people that have contributed during these consultations has been overwhelming. This clearly demonstrates that Private Sector Development is a matter of great interest and high relevance to Swedish development cooperation.

It should be underlined that this report is *not a Sida policy document*. Its purpose is to provide a basic descriptive framework and a source of knowledge on poverty focused PSD. We regard this as essential to the forth-coming introduction of PSD as a truly cross-cutting effort in Sida's organisation and work towards poverty eradication.

The report takes a broad, holistic approach to private sector development, encompassing basically all areas of development co-operation. In order for Sida to become truly effective in its support for a poverty eradicating PSD, Sida needs to continuously define its support and its means of assistance, taking into account not only the key constraints in private sector development, but also Sida's own competencies, comparative advantages and the resource base Sida can draw upon.

It is our hope that the report shall stimulate a discussion within Sida, with our partner organisations in Sweden, partners in cooperation countries and in international and bilateral organisations.

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# Abbreviations

AIG	Africa Infrastructure Fund
BDS	Business development services
BOT	Build-operate-transfer
BOO	Build-operate-own
BRAC	Bangladesh Rural Advancement Committee
CGAP	Consultative Group to Assist the Poorest
CGIAR	Consultative Group on International Agricultural Research
CRS	Corporate social responsibility
DAC	Development Assistance Committee
EKN	Exportkreditnämnden
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign direct investments
FIAS	Foreign Investment Advisory Service Programme
FIRST	Financial Sector reform and Strengthening initiative
GDP	Gross domestic product
GNP	Gross national product
GPG	Global public goods
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
HIPC	Highly indebted poor countries
HRD	Human resource development
HYV	High yielding varieties
IFC	International Finance Corporation
IFSC	International Financial Standards and Codes,
ILO	International Labour Organisation
IMF	International Monetary Fund
KWh	Kilowatt hours
LDC	Least developed countries
LFA	Logic Framework Analysis
LMD	Labour Market Dialogue
LO	Swedish Trade Union Confederation
LRF	Federation of Swedish Farmers
MDG	Millennium Development Goals
MFI	Micro finance institution
MSEK	Million Swedish crowns
NICs	Newly Industrialised Countries

NIR	International Council of Swedish Industry
NGO	Non-governmental organisation
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PRA.	Participatory Rapid Appraisal
PRSP	Poverty Reducing Strategy Papers
PSD	Private sector development
R&D	Research and development
RIPE	Reforming Infrastructure and Public Enterprises
SIYB	Start and Improve Your Business
SME	Small and medium sized enterprises
TCO	Swedish Confederation of Professional Employees
UNDP	United Nations Development Programme
USA	United States of America
USD	US Dollar
ZRL	Zambia Railways
WTO	World Trade Organisation

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# Executive Summary

The purpose of this document is to form a background to Sida's action for private sector development. The document:

- takes its stand in the overriding objectives and values underlying Swedish development assistance in terms of poverty reduction and human rights;
- explains how private sector development can be an effective instrument towards achieving these objectives and values; and
- operationalises this instrument in order to put private sector development to effective use in Sida's work, notably the country strategy process.

## **Why private sector development?**

The quest for effective models of private sector development within the donor community is driven by several factors:

- recognising the critical role economic growth plays as a means for eradicating poverty, and the role of markets and the private sector as the engines of such growth;
- the highly uneven dividends so far of market reforms and globalisation, requiring new models after the Washington Consensus;
- the global transition towards market economies since the collapse of the Soviet Union in 1991 and the growing importance of trade and the flows of commercial funds for investments in developing countries;
- the expansion of the private sector into traditional public sector domains such as infrastructure, utilities and social services such as health and education.

*The Millennium Goals* established by the international community in 2000, aiming at eradication of poverty, put the role of the private sector in a new light, namely as:

- an engine of improved economic growth;
- a means to generate the required domestic resources for investments in human resource development through health, infrastructure and education;

- a potential provider of some of these essential services;
- a direct partner in trade and technology transfers.

Sweden places strong emphasis on economic growth as a necessary condition for poverty eradication, linked to effective markets, open trade regimes, good governance, and democratic government. Sweden equally stresses that growth must be environmentally sustainable, based on human rights and gender equality and combined with distribution policies.

### **What is pro-poor private sector development?**

This framework document discusses PSD as an instrument in the context of effective *poverty reducing growth* based on:

- direct inclusion of the poor in economic activities, contributing to their employment, income and return to labour, and reduced vulnerability;
- economic growth as the means of generating resources in a society and enhancing productivity, employment and income;
- redistribution so that the resources generated from growth are invested meaningfully for the poor, especially in human resources development. Redistribution also includes assets. Countries with a skewed distribution of assets such as land, are generally much less effective in reducing poverty.

Strengthening the ability of all groups in society but in particular the poor to effectively participate in economic development is crucial for ensuring that growth becomes both equitable and sustainable, and thus an efficient vehicle for reducing material poverty.

Gender is an essential dimension of PSD as the roles of men and women tend to be different in economic activities, based on cultural, religious and other traditional institutions and power structures. Development, economic growth and private sector development have, as a result, different outcomes for men and women in basically all societies. A gender perspective should be an integral element of Sida's support for private sector development.

Poverty is closely linked to the quality of the environment and natural resources. Ill-defined and absent property rights often result in market failures in the governing of natural resources and eco systems of particular importance for poorest. To make private sector development and markets work for the poor, close attention has to be paid to the institutional framework and particularly its ability to secure informal property rights and the good management of common resources. An environmentally sustainable perspective will be integrated into all aspects of Sida's support to private sector development.

In this document, the fundamentals of a pro-poor private sector development, PSD, are defined as follows:

- *Competitive markets* are characterised by fair competition, free entry of new enterprises and efficient systems for exit of failing enterprises,

and low degrees of distortions. In these markets, the *market failures* should be minimised, implying that the private benefits are equal or near equal to societal benefits. The incentive structure of such markets should favour the inclusion of the poor.

- *Entrepreneurship* is human creative action in the commercial sphere which triggers innovation and structural change, and drives the creation of new enterprises, but also the development of the large ones. It is a critical ingredient to make markets dynamic, evolutionary and not just competitive.
- *Fair, non-discriminatory and effective property rights* is essential for entrepreneurs and other private sector operators to be willing to take commercial risks and invest. Non-existing, unclear and poorly formulated or implemented property and tenure rights are claimed by some researchers as the most significant factor explaining 'under-development'. Clear and fair property rights are essential for the assets of the poor.
- *Decent work conditions and sustainable use of the environment* are critical elements of pro-poor private sector development in order to achieve a fair share of the benefits of the market forces, and avoid exploitation of the environment which will impact negatively on current and future generations.

PSD is not limited to a sector in a conventional sense, but encompasses agriculture, manufacturing and services, including trade, and increasingly also infrastructure and social services. It also includes all types of market players, from the self-employed in the informal economy, small, medium and large enterprises, to transnational companies.

PSD is the interplay between the state as a formulator of the 'rules of the game', the 'players in the private sector', and civil society. These interact in dynamic processes. Understanding the dynamics of such a system is critical to be able to promote development from the outside.

Donors have a variety of means to assist countries to develop competitive markets which work for the poor. They can promote entrepreneurship, which make such markets dynamic. They can promote an institution of property rights effective for the private sector and for the poor, and assure decent working conditions and a sustainable use of the environment by the private sector. PSD requires broad-based development: human and skills development; establishment and improvement of policies, laws, regulations and other basic institutions of society; quality and efficiency in physical capital in the form of infrastructure, creating the environment for the private sector. It means, in particular, addressing these various elements from a systematic poverty, gender and ecological perspective.

Sida's effectiveness as an agent of change to contribute to such a pro-poor private sector development depends on the ability of the organisation to diagnose the constraints for PSD in different countries, to prioritise and sequence the interventions carefully based on such analysis, and fully use the strength and competencies of Sida in such work. It requires having the poor as the foremost partner, and seeing governments, public organisations, the private sector and civil society as intermediaries for such objectives.

## **Traditional markets for the poor**

The agricultural sector is generally the most important source of livelihood for the poor in developing countries. Agriculture, including fisheries, livestock and forestry, employs over half of the total labour force in developing countries, mostly as small-holders, tenants and agricultural labourers. In some of the poorest nations in Sub-Saharan Africa, the ratio is over 90%. Smallholder agriculture, must be considered an essential part of the private sector for the poor and, in particular, for poor women.

The informal economy, defined as non-registered self-employed or micro enterprises outside agriculture, is another major source of livelihood of the poor, employing 50–80% of the non-agriculture work force in developing countries. Women tend to be over-represented also in the informal economy. Poverty reducing private sector development with a gender focus must pay strong attention to these business ventures of the poor.

While small-holder agriculture and the non-agriculture informal economy are prime targets for a pro-poor private sector development, it must be realised that none of these economic activities will provide the long-term solution for poverty eradication on a global scale. The modernisation of developing country economies requires a movement of poor people out of low productive, small-holder agriculture and out of the informal economy to achieve such poverty eradication.

Both agriculture and the informal economy have in the past been discriminated against by government in many countries. In relative terms, they have also been given less attention by donors. Agriculture lends itself well to donor country support from efforts to change the highly distorted trade environment in OECD countries for agricultural products, to promoting technology development and the diffusion of technologies benefiting poor producers, to assisting countries to reform and finance supporting infrastructure, devise effective credit schemes, and develop property rights and land reforms. The informal economy, on the other hand, is more complex as a field for donor assistance in view of its 'informality'. Yet, efforts can be directed to assist countries to modernise the legal and policy framework for business in general as a means of reducing the dualism in the economy. Support of specialised programmes such as micro finance and entrepreneurship training have proven powerful.

## **Key determinants of private sector development**

Donor support aimed at addressing poverty and gender inequalities, is not a question of a narrow sector approach, with efforts limited to those sectors where the poor are engaged, or to various instruments to support the private sector operators directly. It has to do with the environment in which the private sector operates, and the incentive structures and qualities embedded in policies, institutions and resources. As donors are marginal players and external change agents, they need to make careful assessments, prioritising and sequencing their efforts in order to contribute to the overriding objectives. The key to donor effectiveness is assuming the role of change agent.

The functioning of the private sector depends on a number of broad conditions in society, which establish an 'enabling environment' in general. It is also the character of the environment which determines how effective the private sector is in its contribution to a poverty free and egalitarian world. For the purpose of analysing this environment, and the potential role of a donor, the following structure is applied:

- the meta system, or the international environment;
- the macro system, meaning 'institutions' or 'rules of the game' in a specific country;
- the meso system, here defined as resources required for business operators.

These systems impact on the micro level in a specific country, i.e. the market players in the form of commercial enterprises in the formal and informal economy, micro, small or large.

### **Meta level determinants**

The major determinants at the international level discussed in this document are:

- *Technology development and innovations* transmitted rapidly across the globe and impacting on business development everywhere, providing both opportunities for 'leap-frog' development and threats to many traditional markets and producers. They have allowed some countries to modernise and reduce poverty at an unprecedented rate in recent decades. The private sector is the key instrument in applying and adapting such technologies.
- *International trade*. These trade flows, critical for economic development, have increased dramatically in the past three decades. However, several countries have not taken part in this integration process. Indeed, the export share of the 49 least-developed countries has dropped from 3% in the 1950s to less than 1%. Integrating into and tapping the global trade environment, is critical for rapid economic growth, requiring a host of changes, from making the global trade environment fair and free from distortions to enhancing the competitiveness of poor countries.
- *Global capital movements*, today by far the most significant source of external capital for investment in developing countries. Not only is FDI a very significant source of capital: it also comes with essential development inputs such as technological transfer, modern management and organisational techniques, productivity, market know-how and market access. However, FDI discriminates. Only a limited number of countries have benefited substantially. Unattractiveness to FDI is often a good proxy of the problems of competitiveness in an economy.
- *Universal institutions*, expressed in international conventions and declarations ratified by a large number of countries, usually under the umbrella of the United Nations. These universal institutions, such as the ILO labour conventions, are of relevance for private sector development as they form value systems under which the private

sector operates. e.g. prevention of child labour, prevention of discrimination based on race and gender, sustainable use of the environment, etc. They contribute to steering private sector development in a socially positive direction. Civil society groups, Corporate Social Responsibility codes, the UN's Global Compact and other arrangements contribute to their influence.

- *Global public goods* refers to public goods with an international dimension such as the prevention of global warming, serious communicable diseases such as HIV/AIDS, and global financial instability. The international understanding and commitment to deal with such global public goods is increasing, with direct impact on the private sector, both as an element of their environment and their direct contribution as a supplier.

Donor countries can assist developing countries to address these 'meta' systems through a variety of means. They can impact on the systems as they are formulated at the international level, for example regarding the trade distortions in OECD countries. Donor agencies can assist developing countries by strengthening the capacity of the private sector to be able to benefit from global technology and innovations, international trade and FDI. Donor countries can strengthen the power of the universal institutions as they are impacting on the private sector.

## **Macro level**

The major determinants for the performance of the private sector embedded at the macro level in developing countries discussed in this document are basic institutions embedded in norms, rules, policies, and values governing a society. For example:

- *Peace and stability*. War, conflict and civil strife is the most serious negative factor for economic growth. Peace building, conflict resolution and private sector development are mutually reinforcing. Thus, peace and stability is a critical pre-condition for a healthy and effective private sector development, and the latter contributes to the former.
- *Sound macro economic policies*, manifested in low inflation, a realistic exchange rate, and low budget deficits are today well-established principles for both developed and developing market economies and a basis for an 'enabling environment', critical for effective PSD. They are also a pre-condition for pro-poor growth, as the major victims of poor macro economic policies tend not to be the rich, but the poor.
- *The legal and regulatory framework*, is critical for a healthy market and private sector development, as it determines the willingness by local and foreign investors to invest; what they are willing to invest in, and their behaviour, in general. A culture of rule-of-law is a critical ingredient in a conducive business environment. There are specific regulations governing the market and the private sector, the most important being commercial laws, property laws and contract laws, essential for the 'cost of doing business', and for the interplay between business, government and the civil society.

- *Good governance* is critical both as an element of the general environment for business. Of particular importance are the accountability, fairness, honesty and effectiveness of such government functions such as taxation, customs, business licensing authorities, bank inspections, but also authorities operating infrastructure such as harbours, determine transaction costs, predictability, and the overall business culture. Corruption is a major form of distortion of markets, leading generally to sub-optimal resource allocations based on cronyism and political connections, rather than efficiency of operation.

Creating a macro and institutional environment which is conducive for poverty reducing private sector development is a long and labour intensive process involving capacity building and dealing with vested interests in a society. The donor community, led by the World Bank and the IMF, is already very active, especially in macro economic policy reform, but the process needs complementary capacity building. One of the greatest challenges is how to accomplish such a process in conflict scenarios or in countries recently emerged from conflict. Using the private sector for a virtuous circle of peace and growth is a major challenge.

### **Meso level**

The determinants at the meso level are various forms of resources for PSD. It should be stressed that these are to a large and increasing extent, commercial markets themselves. Those discussed here are:

- *Financial capital*. Finance, including risk-capital, bank loans, bonds and insurance, provides much of the 'blood' of business development. The depth and diversity of the financial markets are closely related to economic performance. Of particular importance to the financial needs of the poor, are NGO innovated microfinance schemes.
- *Physical capital*. Transport systems, energy, water & sanitation, and telecommunication are all key determinants for an effective private sector and can also be effective pro-poor instruments. For example, physical access to markets is one of the greatest determining factors for the returns of smallholders and the informal economy.
- *Human capital*. While human resource development, HRD, is a social end in itself, there are strong interdependencies between HRD and PSD:
  - Human resources development is a critical, and perhaps the most significant determinant for an effective, dynamic and competitive private sector and for long-term growth.
  - The private sector in many developing countries is an increasingly important supplier of health services and education due to 'government failures' or by design.
  - The private sector is the prime engine generating resources for investments in human resources through health care and education, and thus critical for countries to be able to invest long-term in HRD.
- *Labour* – the poor depend to a large extent on employment, both in the informal and formal sector, and their way out of poverty will be



determined by the ability of formal businesses to absorb labourers; the wage levels and working conditions are paramount for the poor. The role of labour markets for PSD is determined both by supply and demand factors, and by the regulatory framework surrounding them. Social and occupational mobility and flexible labour markets are critical for well-functioning labour markets.

Development assistance for these resources are broad-based and, for some, obviously undertaken for higher social objectives than PSD. Nevertheless, the interdependencies should be made explicit, gearing support towards more effective interventions in a mutually reinforcing process.

### **Micro level**

Development assistance aimed directly at the market players is a common donor approach to increasing competence at the market level. This includes: competence building through the training of entrepreneurs, managers and technical staff; the development of market-based Business Development Services to enterprises in fields such as accounting, marketing, management and quality control; promotional activities and match-making through fairs and export promotional activities. While direct market assistance is a hands-on type of development assistance, often providing visible and practical results, such assistance runs the risk of causing various types of distortions of the market. To reduce the risk of such distortions, donors need to:

- avoid obvious market distortions in direct PSD support by focusing on industrial or business sectors, including regional clusters, rather than on individual enterprises;
- avoid subsidies of capital to commercial operators, unless there are very clear cases of positive externalities, and in such cases only for higher-risk, pioneering efforts. Donors must particularly avoid distorting capital markets, by providing subsidised credits to specific financial intermediaries;
- carefully review direct PSD support, which risks retarding and preventing the development of markets, for example of business services or micro finance. In such cases, donors should promote the development of such markets, rather than compete with them through subsidised schemes;
- be highly restrictive in direct forms of PSD support, by-passing domestic organisational structures. In finding such structures, preference should be given to private sector organisations, especially in fields where there are no compelling arguments for a government intervention.

In general, donors should aim for support which addresses constraints in the business environment, rather than supports the commercial players directly. The latter should be confined to interventions which indirectly address the constraints in the environment through a demonstration effect.



## **Integrating PSD into Sida's work**

While Sida has well elaborated principles of work based on country ownership and dialogue, three specific ways of making Sida an effective organisation for poverty reducing PSD are:

1. Making PSD a truly cross-sectoral theme within Sida. PSD is at the heart of Sida's work, touching upon basically all sectors of Sida's work. Explicit linkages between PSD and the various sectors can reinforce both. This can be achieved through:
  - on-going dialogue between the different sector divisions concerning the role of the private sector;
  - competence development within Sida in terms of what constitutes an enabling environment for effective private sector development and pro-poor growth.
2. Developing specific analytical instruments in order to integrate PSD into Sida's operations, especially the country strategy process, for identifying key constraints to be addressed by the donor. A set of such diagnostic instruments are elaborated.
3. Working with Swedish partner organisations specialising in different dimensions of market and private sector development, specifically:
  - the private sector, encompassing private enterprises and their organisations such as chambers of commerce;
  - labour market organisations;
  - public sector organisations with specific functions in assuring competitive and well- functioning markets.



# 1. Why Private Sector Development?

## 1.1 Background

### ***A new economic world order***

Since the fall of the Soviet Union in 1991, the market is the undisputed principle for the organisation of economic activities, applied by all nations of the world with a few exceptions such as North Korea. The end of the Cold War also meant a strong impetus for globalisation. Private capital increasingly began moving across borders, facilitated by various forms of financial liberalisation and communication technology changes. As import-substitution was replaced by export-orientation in many developing countries, inspired by the economic successes of the NICs such as South Korea, Singapore and Taiwan, the opportunity for trade and foreign investments further triggered the international flow of capital also to the developing world. Various trade agreements leading to the creation of the WTO in 1995 have reinforced the growth of a globalised world economy. The market and the private sector have expanded into new areas such as infrastructure, utilities and social services, traditionally the domain of the public sector also in most market-oriented countries. This process has been facilitated by technological innovations allowing competition in areas where natural monopolies existed such as in telecommunications and power.

### ***... but with uneven and some dysfunctional dividends***

While the market reform process and globalisation have paid dividends both in economic growth and the reduction of poverty globally, these benefits have been highly unevenly distributed. In many developing countries the private sector has failed to play a dynamic role. Foreign investments have not emerged as anticipated, and growth and poverty reduction have not taken place. Over 50 countries experienced economic decline during the 1990s, the majority of those in Africa<sup>1</sup>. Agriculture, one of the most controlled sectors in the past, has been liberalised, but the dividends have been uneven, especially between different groups of farmers. In some countries, e.g. in some parts of the former Soviet Union, the market reforms have had serious dysfunctional effects, resulting in Mafia-style economies. In sectors such as health and education,

<sup>1</sup> UNDP: Human Development Report 2003

governments strapped for financial resources and pursuing economic liberalisation have paved the way for the unregulated supply of services by private providers, which often has had detrimental effects on the health and educational standards of the populations. As a result, in many former planned economies earlier achievements in human development have deteriorated.

A search beyond the initial set of reforms has begun, indicating that the market-driven, private sector development agenda is more complex than initially anticipated. While the initial reforms propagated rolling back of the state to the most basic functions of law and order, the contemporary view stresses the importance of the state both as a nurturer and a regulator of the private sector and markets. A well-functioning private sector requires a well-functioning state, just as the state needs a well-functioning private sector. The learning by the donor community is

**Box 1. Beyond the Washington Consensus:**

The agenda of structural adjustment of the 1980s: Fiscal discipline, liberalisation, privatisation, openness to trade and foreign investments, market determined exchange and interest rates, protection of property rights, public expenditure focusing in health, education and infrastructure, tax reform...

The added agenda of the 1990s: Good governance, empowerment of the poor, democratic representation, country ownership.

Sources: Williamson 1993; Stern 2003

reflected in the current revisions of what is usually called the Washington Consensus, underlying the first phase of reforms. Concepts such as good governance and transparency have entered the development vocabulary (See Box 1). The concept of institutions, defined as norms, rules and laws, has emerged as an overriding explanation of long-term development, as is further discussed below.

A recent World Bank document uses the concept of a 'New Swedish Model' to indicate a desired model based on *combination of vigorous competition in the productive sectors with regulatory frameworks that safe-guard social and environmental standards.*<sup>2</sup> Added to this might be that in certain sectors, such as health and education, there are strong arguments in favour of public sector dominance and production.

The uneven dividends of reforms and globalisation for developing countries are not just a result of conditions in these countries. While developing countries have liberalised and opened their economies, the rich countries have maintained protection of important domestic markets, especially those where poor developing countries tend to have their strongest comparative advantage such as in agriculture and textiles. Agriculture in the OECD is subsidised by over USD 300 billion, or more than 6 times the total level of ODA<sup>3</sup>. As a result, rich markets are closed to developing countries, and farmers in the wealthy nations can sell their

<sup>2</sup> Klein, M. & Hadjimichael, B.: *The private sector in development. Entrepreneurship, regulation and competitive disciplines.* World Bank, 2003

<sup>3</sup> Hoekman et al (ed): *Development, trade and the WTO. A handbook.* World Bank 2002

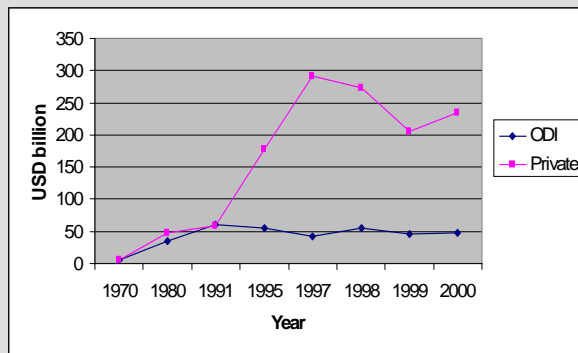
produce at highly subsidised prices in the poor, thus undermining local markets and producers. Donor countries are faced with the critical issue of double standards in terms of economic reforms and private sector development.

## 1.2 Consequences for development assistance

The globalisation and remodelling of the world economy have had radical implications on official development assistance.

- Commercial capital, especially foreign direct investments, has replaced ODA as a leading source of investments and capital transfers to developing countries. Only in the poorest nations is ODA still a main source. This trend is likely to continue. Donor agencies must increasingly interact with and take such flows into account.

### Box 2. The pattern of capital transfers to developing countries



Source: Mistry & Olesen, 2002

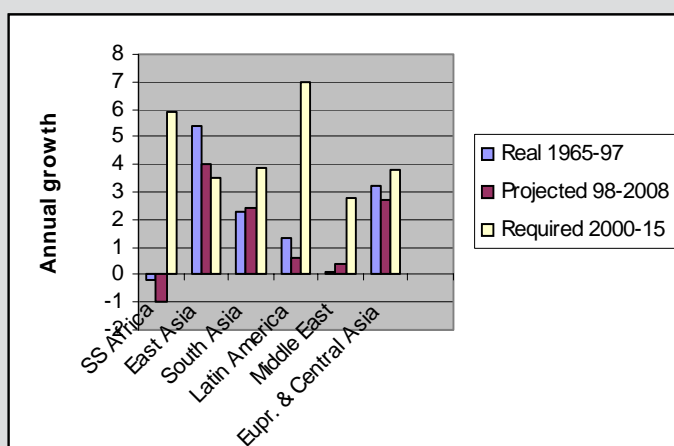
- The market reforms and globalisation of trade and investments have disclosed the constraints to economic development embedded in non-conducive macro-economic policies. While development assistance prior to the 1980s largely was micro oriented, there is today a much stronger focus on the macro issues.
- Support for industrial and enterprise development prior to the 1990s was often directed to selected state-owned enterprises. After the economic reform process, an indirect method is required, focusing on the conditions needed for enterprises to succeed. These are collectively called an 'enabling environment'. Support to individual commercial enterprises and even clusters of such enterprises has become problematic.
- Reforms towards a market-based, private sector operated model in traditional public sector domains such as infrastructure, utilities and social services are largely at an early stage of development including in industrialised countries. Thus, an often controversial dual process of learning and of trial-and-error continues.
- The globalisation and integrating into a fast changing and competitive market economy makes strategic choices and specialisation in the world economy increasingly important both for countries and enterprises. Donor agencies must develop a capacity to tailor-make assistance to fit different strategies, and to be highly situation-specific.

### 1.3 PSD and the key objectives of development assistance

#### **The Millennium Development Goals**

In 2000 the international community established the far-reaching and specific development objectives expressed in the Millennium Development Goals (MDGs) with the overriding objective of eventually eradicating poverty and hunger in the world. Specific targets were established for the year 2015 concerning income poverty, hunger, health, education, gender equality, a sustainable environment and global partnership. The MDGs are a bold, first joint effort by the international community to be specific about its targets, allowing monitoring of the progress made toward these goals<sup>4</sup>.

There is a strong linkage between private sector development and the MDGs. First, the attainment of the goal of halving income poverty by 2015 requires robust economic growth, and a dramatic change from the current growth pattern in many countries and regions of the world. With current patterns, only East Asia is likely to achieve the poverty reduction goal, mainly due to the fact that China – largely not a beneficiary of development assistance- has a record of very high growth rates combined with a fair income distribution. Especially Sub-Saharan Africa and Latin America require drastic changes. Sub-Saharan Africa is the most critical region being not only the poorest in the world, but also the one of least



Data from Hamner & Naschold, *Attaining the International Development Targets*, Development Policy Review 18, 1, 2000

promising growth. The challenge of breaking the 1990s trend of stagnant or declining economies in this region is formidable. In Latin America the issue is also better growth than present, but equally a matter of an economic development with a stronger inclusion of the poor than present, requiring distribution of income and assets. A dynamic private sector is the only well-established means to trigger long-term and sustained economic growth, while distribution is a political issue.

Second, achieving the MDGs depends on major investments in the social sectors. This includes: primary education; child and maternal

<sup>4</sup> Both the World Bank and UNDP annual development reporting reflected in UNDP Human Development Report and the World Bank World Development Indicators are now tailored to monitor such progress.

health; efforts to halt and reverse the prevalence of major diseases such as HIV/AIDS and malaria; safe water and improved conditions for urban slum dwellers. In many countries robust economic growth is a necessary condition to generating resources for tackling such issues. Donor countries can contribute, but never foot the full bill. Such local resources must be generated mainly from taxes levied on the private sector.

Third, while the public sector should and must play a pivotal role in the social and infrastructure programmes and investments mentioned above, the private sector can, besides enhancing the resource base, also contribute directly in several ways. Given the right policy frameworks, the private sector can do much to enhance the effectiveness and scope of the required social, human and infrastructure programmes as investors, operators and service providers. However, it must be stressed that privatisation of programmes in health and education is far from a panacea, as is further elaborated below.

Fourth, the last MDG includes several dimensions of private sector development. For example, changes in the global trade and finance systems, work standards, and transfer of technologies in certain key sectors such as communication. This indicates the role of the private sector in global public goods as further discussed below.

### **The Swedish development objectives**

In 1962 the Swedish parliament formulated the overriding objective for the newly initiated official development assistance as *'raising the living standards of poor people'*. While poverty over time increasingly has been given a broader definition, the poverty objective has remained. In 2003,

#### **Box 4. The view of Sida on growth:**

In Sida's key strategy document *Perspectives on Poverty*, the issue of qualitative growth is expressed as follows:

"The effectiveness of economic growth as a means to reduce material poverty varies between countries and over time. Hence, it is essential to focus not only on growth rates, but also on to what extent this growth is translated into reduced poverty. The latter depends both on the initial distribution of resources and on the nature of growth. The poverty reducing impact of economic development growth is higher in countries with an equitable distribution of resources (land, capital, enjoyment of human rights, education, etc.)."

Sida: *Perspectives on Poverty*, 2002

the Swedish government proposed a new, comprehensive policy called "Shared Responsibility: Sweden's Policy for Global Development". This policy deals not only with development assistance, but strives to form a coherent policy framework to include trade, agriculture, environment, security, migration and economic policy. Its overriding goal is *"to contribute to equitable and sustainable development . . . by contributing to an environment supportive of poor people's own efforts to improve their quality of life."*<sup>5</sup> See further [www.ud.se/propositioner mm](http://www.ud.se/propositioner mm).

<sup>5</sup> Swedish Government Bill 2002/03:122: *Shared Responsibility: Sweden's Policy for Global development*,

Like the donor community at large, Sweden has long recognised that economic growth is a necessary condition for poverty reduction. This is also re-confirmed in the 2003 policy, indicating that without growth people in poor countries will not be able to change their living conditions. According to the Swedish government, the elements of this are: functional market economies; stable macro economic framework; good governance; functional institutions; open and fair trade. There is a growing consensus in the donor community that growth is not sufficient, a notion long argued by Sweden. On the one hand, the concepts of 'ruthless' growth, a term coined by the UNDP, versus 'poverty reducing growth' or 'pro-poor growth' indicate a perception that economic growth can take many forms in respect of its impact on the poor and its ability to lift the poor out poverty. Thus, there is a strong current trend amongst donor agencies and multinational organisations to identify qualitative growth patterns.<sup>6</sup>

### ***The gender and human rights perspective***

Coherent with the UN declaration on human rights, Sweden places particular emphasis on the concepts of human rights and justice as the foundations for poverty eradication and global development. The human rights perspective places particular emphasis on democratic governance, and equal rights between men and women, and the rights of children, and other groups in society which tend to be disadvantaged. A prerequisite for such a policy is making discrimination and abuse visible, and to tailor-make policies to correct these inequalities<sup>7</sup>. Such a perspective is relevant for private sector development as it is within the private sector that the daily life of people, especially of the poor, is shaped. To a great extent, the economic return to labour is decided within private 'enterprises', whether self-employing or a large multi-national firm with many employees. Also decided are respect or disrespect for human rights, whether discrimination might take place, and whether the power of the individual is created or abused.

### **1.4. The objective of this document**

Sida is the main instrument for implementing Swedish official development assistance. Hence the overriding policies for such assistance laid down by the government steer Sida's actions. The purpose of this document is to form a background to Sida's action for private sector development which:

1. is based on the overriding objectives and values underlying Swedish development assistance in terms of poverty reduction and a human rights perspective.
2. explains how private sector development can be an effective instrument towards achieving these objectives and values; and
3. operationalises this instrument in order to put private sector development to effective use in Sida's work, notably the country strategy process and the project cycle.

<sup>6</sup> See, for example, World Bank: *The quality of growth*, 2000; UNDP: *Human development report*, 2003

<sup>7</sup> See further Government Bill 2002/03:122 op cit



### ***An holistic approach***

A basic premise is that donor assisted private sector development which is effective in poverty eradication, cannot look for a sector approach, or a 'magic bullet', nor work with the private sector alone or for that matter any other single entity in society. PSD is multi-sectoral, requiring broad based action, and the actions of private sector players as well as governments, civil society and public organisations. Given that donors can only act on the margins, PSD also requires well thought out sequencing and prioritising of efforts in order to act as an agent of change. This document shall not be seen as a 'blue-print' for PSD, but rather as a thinking model.

### ***Defining Sida's unique competencies***

A second premise of this document is that Sida, with its limited administrative and financial resources, must choose its interventions carefully for its efforts to have any impact at all, and not to drown in a sea of other factors of influence. Such support can partly be in co-operation with other donor agencies, adding resources and voice to larger efforts. While such joint efforts have many merits, the 'additionality' of the Swedish financial or technical resources might often be small. Both in joint donor efforts and bilateral, Sida must seek areas where the organisation has clear comparative (or competitive) advantages, i.e. fields where the support is a clear potential agent of change. This might be the result of past experience; embedded in the resource base Sida can draw upon; the way the organisation works; its way of diagnosing an issue, and even being representative of a 'Swedish model'. In this document an effort has been made to begin identifying such unique competencies in the different fields of PSD.

# 2. Defining the Role of Private Sector Development

## 2.1 What is private sector development?

### *It is more than private*

Private sector development, PSD, is a semantic misnomer. While the principle of private ownership of the productive means in society is one element, equally important is the principle of the market, i.e. that the production of goods and services is carried out through free and fair competition, determined by supply and demand in a decentralised fashion. An essential element of private sector development is entrepreneurship, risk-taking and profit seeking, the creative forces that create dynamism in an economy through innovation, transformation and change.

#### **Box 5. Definitions of PSD**

The OECD (DAC) defines private sector development as a basic organising principle for economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk-taking set activities in motion...

The World Bank defines PSD not as a sector, but as a cross-cutting issue. It is about 'a way of doing things', that can have relevance for any sector such as energy or agriculture. And the pursuit of private sector development is not a goal but a means of doing things better.

Sources: OECD-DAC Private sector development – A guide to donor support 1995; World Bank. Private sector development strategy 2002

The notion of private sector *development* means efforts to promote the private sector for the purpose of achieving certain societal objectives. The overriding objectives are eradicating poverty and promoting gender equality based on a human rights perspective. This implies poverty reducing private sector development which promotes markets, entrepreneurship and property rights that are effective for the poor and for gender equality, and based on a human rights perspective.

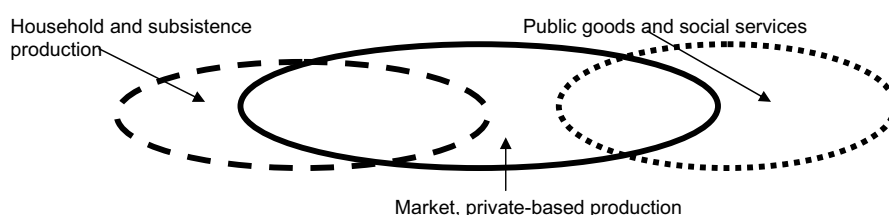
### **... and not a sector**

Private sector development concerns agriculture, manufacturing and services, including trade, and increasingly also infrastructure and social services. It also includes all types of market players, including the self-employed in the informal economy, small, medium and large enterprises, and transnational companies. All of these sectors, in different capacities, are essential for the poor, either directly or indirectly. Thus, private sector development is not a sector in a conventional sense. The term PSD is used here for the reason that it has become an established term in the contemporary donor vocabulary.

### **A relative concept**

Private sector development is a relative concept. The market principle can apply to a more or less wide segment of the total production of goods and services in a society. Outside the market are, for example, household production and the subsistence economy. Also the production of various public goods and social services is usually excluded from the market. The figure below demonstrate this:

**Figure 1**



With economic development, an increasing share of the production of services and products in a society becomes subject to market principles as subsistence and household production shift to production for markets<sup>8</sup>. This allows economies of scale and the division of labour in society, enhancing overall productivity and growth. A significant share of production taking place as subsistence or in the household, is the manifestation of a weak, undeveloped economy. Such systems are particularly discriminatory of the poor and of women. The traditional division of roles between men and women, with men primarily working in paid work, and women in unpaid work in the household, contributes to gender differences in income, power and human rights at national and household level. Bringing women out of subsistence into the market based economy is thus a powerful tool towards gender equality.

The current economic reform processes also tend to shift production of services and goods from public and non-market to private and/or market based. Such shifts are undertaken to create competition in production intended to lead to productivity increases and better value for money. It should be stressed, however, that while competition and decentralised decision making, which are the hall-marks of a functioning market system tend to produce better welfare, this shift is by no means easy as it often involves issues of equitable distribution, as is discussed below.

<sup>8</sup> The participants at the market place might not only be private for-profit operators, but also government-owned enterprises, and other non-governmental operators such as co-operatives, etc., operating on the condition of the market and in competition with other enterprises.

## **2.2 State, market and civil society**

### ***A dynamic interface between state and market***

Private sector development comprises the interplay between the 'rules of the game' and 'its players'. The 'rules' are institutions in the sense of policies, laws, regulations, norms etc. The state establishes organisations to enforce and further define such norms and regulations. Together, they create the environment in which the private sector operates. It is a dynamic system in the sense that neither the institutions, the public organisations, nor the private operators are fixed over time, but change as a result of interaction and interdependencies. Governments and policy makers establish most of the rules and create organisations to enforce these rules. However, the private sector players also greatly influence the rules. Institutions, including policy, are often created as a response to private sector behaviour. Understanding the dynamics of such a system is critical to being able to promote development from the outside.

### ***The role of civil society***

An important third element of the dynamic state-market system is the 'civil society'. The latter includes various types of non-profit, non-governmental organisations, including labour unions and consumer unions, issue-oriented NGOs such as human right groups, environmentalists, and various forms of democratic organisations, including political parties. Just as markets are being globalised, civil society too is in many ways becoming globalised. Civil society groups in industrialised countries are linking up with sister groups in developing countries, facilitated by the Internet. Political organisations form cross-national links. An increasingly powerful force providing checks and balances for multinational enterprises in developing countries are civil society groups engaged in 'fair trade', protection of the environment, human rights, child labour, etc. Such groups have stimulated the development of rules of conduct and other forms of ethical standards, now called Corporate Social Responsibility (CRS). This is discussed further below. In a global process to ensure development based on human rights, such a force is essential. Civil groups are important instruments which can be used by donor agencies to accomplish their objectives.

## **2.3 Gender, environment and the private sector**

### ***The private sector and gender***

The roles of men and women tend to be different in economic activities in society, based on cultural, religious and other traditional institutions and power structures. Development, economic growth and private sector development have as a result different outcomes for men and women in basically all societies. Some of the forces generating inequality are:

- the division of roles in the market economy versus the household economy, or the unpaid economy, as identified above;
- different traditional or legal rules concerning property rights and the right of using property;
- intra-household power structures;

- difference in wage structures;
- the time-poverty of women, i.e. time and physical limitations for women to seek outside employment due to customs and main responsibility for children and household activities;
- customs preventing women being involved in certain economic functions.

**Box 6. Difference between economic power and function amongst Vietnamese tribal women**

A poverty assessment in Vietnam described the economic activities of the Hmong women, spending most of the day and a large share of the night undertaking household tasks in combination with market-based activities such as feeding the animals, tending the fields, marketing products and making crafts such as basket weaving for sale. However, their decision-making power in the economy of the household and its investment decisions was almost nil.

Source: World Bank. Vietnam: Attacking poverty, 1999

Explicit gender analyses can identify who gains and who loses in different scenarios. Policies and strategies for private sector development can be more or less aware of these perspectives, and be made more or less directed to address inequalities. A gender perspective should be an integral element of Sida's support for private sector development.

***The private sector and the environment***

Comparing the environmental degradation which took place in the planned economies of the Soviet Union and Eastern Europe versus that of the Western market economies until the 1990s, gives a clear indication that market economies were far more effective in reducing the negative effects on the environment from economic development. However, private sector development is no panacea for a sustainable environment. Markets by themselves do not take 'negative externalities' such as pollution into account, whether this is local such as polluted rivers, or global such as omission of ozone destroying gases. Nor do markets pay attention to equity aspects of access to limited non-renewable natural resources. On the other hand, well functioning markets do have in-built mechanisms to deal with certain environmental issues, such as the use of scarce natural resources (scarcity triggers price escalation, which triggers the search for replacement and more efficient use). This mechanism only operates if there are clearly defined property rights.

Many of the negative effects on the environment requires harnessing of the market forces in an environmental friendly manner through legislation, price incentives or taxes, etc., which in its turn requires effective, and non-corrupt governments. As many of the negative effects on the environment go beyond borders, these control mechanisms require increasingly international agreements (see further the discussion on global public goods, below.)

Poor people tend to be directly dependent on renewable natural resources for their livelihoods to a greater extent than the well-to-do. For example, small scale farmers commonly use common forest resources,

such as fuel wood, meat and nuts, to complement their incomes derived from agricultural activities. Many resources of great importance for the poor, for example fisheries and non-timber forest resources, are characterised by ill defined and absent property rights. To make private sector development and markets work for the poor, close attention has to be paid to the institutional framework and particularly its ability to secure informal property rights and good management of common resources.

Stages of economic development determine to a large extent the type and scope of environmental degradation. Rich countries tend to be effective in controlling local negative environmental effects (both as a result of effective government regulations and as such effects increasingly are subject to market forces). On the other hand, they are the main culprits of global negative environmental effects such as the green-house effects, destruction of the ozone layer, the pollution and over-fishing of the seas, etc. Poor countries tend to have less impact on the global environment due to their much lower degree of industrialisation and use of non-renewable natural resources, but usually be destructive in the local environment through non-sustainable use of agricultural or forest land, over-fishing of coastal waters, rivers and lakes, lack of regulation of emissions and other negative externalities from extractive industries, etc. Much of the local degradation is a direct consequence of poverty at the household level: pressure on land make people cultivate increasingly fragile environments; etc. Poor people can often not afford to be concerned with long-term consequences on the environment as they have to survive in the short-term.

Donor countries concerned with environmental issues risk of being hypocritical. Should developing countries use the same per capita amount of non-renewable resources as rich countries do, including fresh water, and allow the same emission of pollution per capita, the world would not be ecologically sustainable. Hence, the greatest challenge in economic development is how everyone on earth can have decent standard of living without jeopardising the environment and leave the same opportunities to future generations. The only hope for this seems to be a combination of a constant thrust for more efficient technologies with increasingly effective international agreements. The private sector, whether as a small-scale farmer or a multinational company, is a critical instrument in this. However, it is an instrument which must be given the right incentives and the right directions through societal institutions<sup>9</sup>.

## 2.4 The role of PSD in poverty reduction

### ***Multidimensional poverty***

Poverty is defined by most development agencies in relation to several dimensions of human life such as poor health and lack of education, insecurity and lack of freedom, abuse of human rights, and no voice and power in decision-making. Sida's view on poverty is elaborated in Sida's *Perspectives on Poverty* (see box 7). The various dimensions and manifestations of poverty are interrelated at the individual level. For example, low

<sup>9</sup> Sida has published several studies on poverty, growth and the environment, see Segnestam and Sterner (2001), *The environment and poverty*, and Sterner (2000), *Growth and the environment*

income leads to vulnerability and often to poor health, and lack of education and illness reduce the ability of poor people to improve their living conditions.

#### **Box 7. Sida's view on poverty**

"Poverty deprives people of the freedom to decide over and shape their own lives. It robs them of the opportunity to choose on matters of fundamental importance to themselves. The essence of poverty is not only lack of material resources but also lack of power and choice... Poverty is manifested in different ways: hunger, ill health, denial of dignity, etc. It as its own dynamics, often lack of power or choice, lack of opportunities and security are key facets of vicious circles...."

Sida: Perspectives on Poverty, 2002

Individual and household poverty is determined by societal conditions. In the industrialised countries, most children of both sexes are born into a non-poor life. In the least developed countries, most children are born into multidimensional poverty, girls more than boys, and escaping poverty is often extremely difficult for an individual or a household.

UN statistics show a positive correlation on average between economic growth and most indicators of poverty. However, there is a large variance around the mean. Different development patterns and degrees of inequality result in quite different poverty reduction results even for similar growth rates. While long-term growth is usually considered as a necessary condition for poverty eradication, it is generally agreed that it is not sufficient. Middle-income developing countries may have significant prevalence in terms of poverty in most of its manifestations, while some countries at a much lower income per capita have done much better in reducing the poverty of its citizens, whether expressed in income terms or social conditions. Asian countries such as China, Vietnam and Sri Lanka, are used as cases in comparison to Latin American countries such as Brazil, El Salvador and Honduras, to indicate that a similar level of prevalence of poverty in its various manifestations can occur at very different level of per capita income. By the same token, similar levels of per capita income, and similar rates of economic growth, can and do have very different poverty reduction outcomes.

There are clearly pro-poor and non-poor growth trajectories to a considerable extent determined by history, traditions, customs, but also by policies and institutions. Furthermore, economic development is not taking place in isolation. The dimensions which reduces individual poverty, such as better health, better education, higher security, peace, dignity and democratic voice, are also essential for economic growth. In essence, there is usually a virtuous circle between economic growth and poverty reduction. Recent research seems to indicate that countries which only promote economic growth and neglect human development are bound to fail also in growth in a long-term perspective.<sup>10</sup> However, countries which neglect economic growth and focus only on human

<sup>10</sup> F. Stewart: *Evaluating evaluation in a world of multiple goals, interests and models*, OED, 2003



development might undermine their ability to continue such development, and thus be trapped in both economic and human poverty. In short, economic and human development should go hand-in-hand.

### **Poverty reducing growth**

Effective poverty reducing growth depends on three co-operating strategies. First and foremost, it is about the direct inclusion of the poor in economic activities, contributing to their employment, income and return to labour, and to reduced vulnerability. It is about transforming economies so that the poor are able to leave low productive, low return economic activities and be involved in high productive, better returning ventures as employees or entrepreneurs. Without the inclusion of the poor, poverty reduction will not be effective, nor will growth in the long term. Second, it is about economic growth in general as the means of generating resources in a society and enhancing productivity. The structure of the economic activities depend on the factor endowment of society, its comparative and competitive advantages. As noted above, without growth, poor countries cannot effectively address poverty for its citizens. Third, it is about means of redistribution so that resources generated in society are invested meaningfully for the poor, especially in human resource development. The market cannot and will not alone undertake human development. Such investments facilitate the transformation of primary product producing societies to industrialisation and eventually to knowledge based societies. Without human resource development poor countries will neither reduce poverty, nor sustain growth in the long term. Redistribution also includes material assets. Countries with skewed distribution of assets such as capital and land, are generally much less effective in reducing poverty.

#### **Box 8. Pro-poor growth**

Few concepts are so much discussed in contemporary development economics as 'pro-poor growth'. A good summary of the state of the literature is Klasen: *In Search of the Holy Grail: How to Achieve Pro-poor Growth?* A conclusion from this review is that, while there is no commonly agreed stringent definition of the term, a consensus is emerging on policy implications, for example that commonly accepted 'good macro economic policies and good governance' are especially critical for the poor; that reforms have to be phased carefully not to create volatility; human resource development is critical as is focus. Focus on economic activities in which the poor are directly engaged is critical, especially on effective agricultural policies and development., and rural non-farm employment. Equity in distribution of assets (such as land), as in income, and gender equality contribute considerably to pro-poor growth both from the point of view of trigger higher sustainable growth, and more effective distribution of the gains of growth.

Klasen: *In Search of the Holy Grail: How to Achieve Pro-poor Growth*, 2003



# 3. The Fundamentals of Pro-poor Private Sector Development

## 3.1 Pro-poor private sector development

Pro-poor private sector development is an instrument first and foremost to create economic growth and modernisation with direct inclusion of the poor women and men on equal terms. As such it is a tool, not an end in itself. (Nor is growth or modernisation an end in itself, but an instrument for higher societal objectives). Pro-poor PSD comprises four fundamentals:

1. competitive markets, encompassing the principle of free and fair competition, of no barriers for 'entry' of new players, and effective systems for 'exit' of failing enterprises, but also of means to address inherent market failures, and equity concerns.
2. entrepreneurship, embedded in risk-taking and profit-seeking as the driving forces of change, innovation and enhanced productivity through what sometimes is called 'creative destruction'.
3. private ownership manifested in clear property rights also for the poor and without discrimination in gender or ethnicity. This does not preclude public and co-operative forms of ownership as long as the principle of competition and free entry is upheld.
4. decent work conditions within the private sector based on respect for human rights and fair return to labour whether in self-employment or wage labour, without discrimination in terms of gender, religion or ethnicity. Also a concern for the environment based on the principle that the world should be a better place tomorrow than today.

These fundamentals are discussed more in detail below.

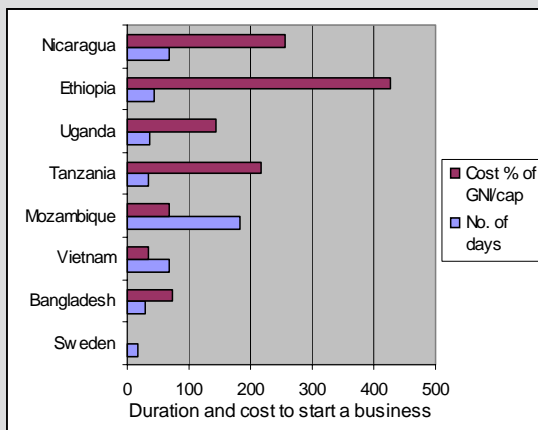
## 3.2 The creation of competitive markets

A lesson in economic reform processes is that competitive markets do not always emerge in spite of reforms and liberalisation. This has, for example, often been the case in agricultural markets in Africa, resulting in the poor supply of agricultural inputs such as fertilisers, seeds, implements, etc., limited demand and/or monopolised procurement of commodities. In other cases, markets do emerge, but they are plagued by various dysfunctional aspects such as corruption, monopolies, cartels, etc. In both cases, the poor tend to be particularly victimised.

Poorly performing markets can be the result of many factors:

- Barriers to entry. Overly cumbersome government regulations, for example, concerning registering of new enterprises, are a serious problem in many developing countries and transitional economies. A new enterprise might need hundreds of permits, which is a strong disincentive to 'entry', at least as a formal sector enterprise. This is often part of a political economy in which powerful groups in society gain from such a form of bureaucracy. Barriers to entry not only thwart enterprises from emerging, they also force entrepreneurs to operate in the informal economy. Box 9 gives an illustration of such 'costs of doing business' in selected countries.

### Box 9. The cost of doing business



Based on data from the World Bank Doing Business Database (<http://rru.worldbank.org/doingbusiness>)

- Barriers to 'exit'. Just as entry to a market by commercial players is essential for competition, so too are effective means of 'exit'. This means that non-competitive and failing enterprises that should be closed down, can do so, for instance, through a well-functioning bankruptcy procedure.
- Distorted markets. Some market players, such as public sector owned enterprises or enterprises belonging to a ruling elite or its cronies, might be provided with subsidies or other privileges, creating an inefficient allocation of resources in society, stimulating 'rent-seeking', and reducing the incentive for other enterprises to enter, i.e. a barrier to competition. Such enterprises tend to belong to the privileged, and are thus also a discrimination of the poor. Monopolies in utilities such as power and telecommunication are often good examples of such discriminatory distortions, which particularly affect the poor.
- Weak legal frameworks or poorly enforced frameworks – allowing various dysfunctional behaviours at the market place such as asset-stripping, monopolies and oligopolies – is a phenomenon that Adam Smith was well aware of. Poorly defined property rights, especially for assets belonging to and used by the poor, are a serious constraint for poor producers to fully participate in markets, and act as a strong discriminatory force against women.

### Box 10. Transaction costs

Transaction costs are defined by economists as costs associated with uncertainty and information imperfections in commercial operations taking place between producers and consumers. Transaction costs increase in situations of uncertainty, when rules and regulations are ineffective and arbitrary, breach of contracts are common and there are no effective institutions to make parties adhere to 'rules of the game' or trust in such rules. An explanation for the success of multinational enterprises and of cross border ethnic businesses is that such systems internally reduce transaction costs.

The creation of well-performing markets in general and for the poor in particular has, to a large extent, to do with reducing or eliminating 'government failures', i.e. governments which for one reason or another impose distortions which have little or no functional meaning of the kind indicated above, are unable to create and/or enforce the required legal framework, which apply discriminatory practices and frameworks, and/or allow non-productive 'rent-seeking' by officials and cronies.

However, there are other reasons for poorly functioning markets when none of the dysfunctional aspects above are in place. High transaction costs due to, for example, lack of information which creates higher risks, and infrastructure deficiencies making transports exceedingly expensive, hamper market development. The poor are especially hit by such constraints as they usually also are poor in information, including the ability to collect and analyse market and other types of economic information. They tend to be discriminated in access to infrastructure and services, also reducing their market activities, and adding to their transaction costs.

*Donor countries* can assist partner countries in making markets more effective as a means of poverty reduction in different ways. They can, for instance:

- Stimulate systematic analysis of constraints for market development in general, and for the poor and for women in particular. A number of instruments have been developed for the purpose of assessing investment and business climates in developing countries, such as the World Bank's system *Doing Business*. The World Economic Forum, Frazer Institute and others do regular business environment assessments for developing countries. These tools, however, are general and not geared for a poverty focused business environment.
- Highlight constraints to competition embedded in poor government policies, undue regulations, inept bureaucracies, red tape and rent-seeking through a variety of means such as disclosing 'bad practises' and transferring 'good practices', especially those with particular impact on the poor.
- In case there are potentially strong welfare gains in terms of poverty reduction and/or gender equality, contribute to the high risk 'research and development phase' of market development. This means bearing a higher risk than private operators are willing to do. Sometimes

donor supported NGO-led innovations, such as micro finance, can open up markets for the poor, previously shunned by the private sector due to risk and transaction cost issues.

- Support the setting up of institutions in the public or the private sector which counter tendencies toward monopolies, imperfect information, imbalance between producers and consumers, etc.

*Sida's role* in assisting countries in creating competitive markets must be strong if Sida is to be involved in PSD at all. As indicated above, this requires a broad-based approach, integrating many elements of development assistance. As a basis for such support, there is a need to develop effective diagnostic instruments to assess the constraints in PSD in general and for the poor in particular. An attempt to develop such diagnostic tools has been initiated in the current policy process as is discussed in section 9.4 of this document.

### **3.3 Dealing with market failures**

While the principle of the market is paramount in PSD, it is also important to identify when markets and the private sector are not performing from the point of view of the whole society. 'Market failures' refer to situations in which the market inherently is not the optimal way of organising production from a society point of view. There are several kinds of market failures:

- *Public goods and natural monopolies* refer to goods for which it is difficult or impossible to charge individual consumers, or for which it is difficult to create competition between suppliers. National defence, and law and order, are a common example of public goods. Also certain kinds of infrastructure, such as rural roads are public goods. These forms of market failures are generally corrected by public sector production or publicly regulated supply by private companies. Global public goods are a special case discussed further in section 5.4.
- *Positive externalities* means societal benefits which a private operator cannot capture to the full extent. This includes, for instance, basic education, research, primary health care (especially in preventing communicable diseases), leading to below optimal production by the market from the society point of view. Such market failures might be corrected by subsidies from private producers and/or consumers and/or public production.
- *Negative externalities* means the costs to society which a private producer does not pay for, such as pollution and public health hazards. Markets tend to over-produce such negative externalities, which require corrective action. Such actions might be bans, restrictive regulations, special taxes, etc.
- *Imperfect or asymmetric information* refers to markets in which the supplier or the consumer has inferior information versus the other party. Health care is an example: the patient often cannot assess properly his/her needs, and thus depends on a health care provider which might have an incentive to supply more than is required.

Market failures are neither constant, nor always requiring public intervention for correction. Technology development might allow competition for natural monopolies, and market mechanisms can be used to correct externalities. Overall, market failures probably affect the poor more than the rich as they rarely have options themselves to compensate for such failures through parallel market mechanisms.

### **...and equity and social concerns**

Another reason why the market does not create optimal social returns has to do with *equity or social considerations*. There are types of goods and services, often called 'merit goods', which can be considered human rights, such as primary health care, primary education and clean water. Markets generally provide sub-optimal allocations for these, in terms of addressing the needs of people with poor purchasing power. Such areas might be subject for various government interventions, from banning private operators and market principles for public production (such as primary health care in many countries), to subsidies. A hybrid form of private sector development in such areas is to allow private entrepreneurs to compete for the provision of government subsidised services. There might also be regional considerations in the sense that market forces tend to have a centralising effect, leaving peripheral areas behind and outside development.

### **...without creating government failures**

Successful private sector development is not a policy of *laissez-faire*, rather the reverse. However, just as there are market failures, there are also 'government failures', and it is rather the latter than the former which is the main cause of disappointing development in many developing countries. Governments have not been able to deliver public goods and services in a satisfactory way. They have often taken on tasks, which they have failed to perform due to lack of competence, shortage of funds, and other reasons. The political economy of development should also not be dismissed. Development is about resources. Pervasive 'Rent-

#### **Box 11. Institutions of the market**

Besides the *market creating institutions* of property rights and enforcement of contracts, which are essential for markets at all to emerge, the economists Rodrik and Subramanian have defined three other forms of institutions relevant for a healthy long-term market development, namely:

- *Market regulating* – institutions dealing with externalities and imperfect information;
- *Market stabilising* – institutions ensuring low inflation, averting financial crises and macro economic instability; and
- *Market legitimising* – institutions providing social protection and insurance, redistribution and managing conflict.

Rodrik & Subramanian: *The Primacy of Institutions*, Finance and Development, June 2003

seeking' in poorly functioning bureaucracies, is as much an issue in development as is the shortage of competence or funds. Development assistance agencies face a particular challenge since they provide resources mainly to governments, often far beyond what such governments can themselves afford, and inadvertently create an open invitation to rent-seeking.

The *role of donors* in dealing with market failures is complex. In the ideal world correcting market failures is a government responsibility. But in developing countries such government efforts might lead to greater government failures than those originally created by the market. The effectiveness, transparency and honesty of government is an essential issue in this context. Donors can provide capacity building to public organisations in dealing with market failures, e.g. trading of emission rights. A particular problem is natural monopolies or merit goods in which governments play a strong role as providers. In the past these have often failed to such an extent that private alternatives have emerged, and sometimes come to dominate the system, such as the example of the health sector in many countries.

*Sida* should be in a strong position to provide such assistance based on the value system underlying Swedish development assistance.

### **3.4 Stimulating entrepreneurship and innovation**

#### ***Creating dynamic markets***

A common problem in developing countries is that markets are competitive, yet they do not lead to growth and development. Many markets are characterised by an over-supply of similar traditional products or services, leading to cut-throat competition, low profit margins, and sometimes prices pressed below production costs. This is often the situation in markets in which poor producers engage, such as in peasant agriculture producing for local markets, in petty trading and other aspects of the informal economy. In general, these markets are characterised by low technology levels, a low degree of diversification, lack of innovation and easy replication. Generally, the markets are very local. Women, often being over-represented in agriculture, small scale production and local trading, tend to be particular victims of such cut-throat competition. Markets require continuous technical development, innovation, enhanced productivity, diversification, quality upgrading and expansion in order to contribute to economic growth and better returns to the producers and the employees.

Economic growth has been characterised '*as a process in which humans experiment by constantly recombining existing building blocks in innovative ways.*'<sup>11</sup> What drives this process is the subject of much theorising. The theories of Schumpeter have given rise to a school of thought which argues that human creativity is the most important production factor. The market is characterised by a process of 'creative destruction' in which new enterprises and innovations make the old ones obsolete through constant structural change, creating evolution and development. It is a chaotic system,

<sup>11</sup> Klein M. & Hadjimichael B.: *The private sector development. Entrepreneurship, regulations and competitive disciplines*, World Bank, 2003

very different from a 'planned model', and the outcome difficult or impossible to predict over time. The 'Swedish growth school' based on the theories of Erik Dahmén, is a modern exponent of the same thinking<sup>12</sup>.

The entrepreneur is the agent for change and modernisation. Many theories exist as to what creates such entrepreneurial spirit. One school of thought is that the culture and institutions of a society determine entrepreneurial activities. This is based on the classic Weber theory of the role of the Protestant ethics in the Western societies (later renewed to explain the rise of East Asia with the spirit of Confucianism). Other explanations are offered by the modern school of institutional economics. Another strand is more focused on the individual.

Entrepreneurship is not only about breaking new ground. It is also a matter of copying and adapting. While ground-breaking entrepreneurs tend to receive the greatest attention, research shows that those who copy and adapt tend to be more important for growth and employment.<sup>13</sup> Nor is entrepreneurship confined to new and small enterprises. The spirit of entrepreneurship is essential in all types of enterprises, not least amongst the largest, in order to create change, to break new grounds, to innovate and to be vital. The concept of *intrapreneurship* has been coined to indicate the importance of such change agents in large enterprises.

### ***The business environment and the entrepreneur***

Even those subscribing to the view of creativity as the driving force behind development, agree that entrepreneurship, to a large extent, is a reflection of the environment. Societal conditions determine whether entrepreneurs emerge, the role that they play in society, and whether this results in poverty reducing economic growth. First, educational levels are critical. In more advanced economies, entrepreneurial forces, innovation and new enterprises emerge around universities, and especially natural science and management based faculties. 'Silicon valley' and the IT industry in the USA is today a modern classic example, repeated and copied also in developing countries. In some developing countries, such as India, China and Vietnam, the level and the spread of higher education forms the basis of business development. Out of the cadres of the educated many entrepreneurs emerge. The same dynamic takes place at a more basic level in many poorer developing countries: for example, the spread and adoption of new technologies in agriculture takes place where farmers are literate. Education provides the entrepreneur with the ability to absorb technology and information, of widening horizons and seeing new opportunities, and also the freedom to break social traditions and taboos.

The openness of a society is a second factor. It determines the extent to which people are exposed to new ideas, markets, opportunities and new ways of doing things. Many successful enterprises in developing countries are started by returning citizens from abroad. Enterprises set up by foreign investments are copied by local entrepreneurs, often exploiting new market niches. These sometimes trigger large scale clusters of enterprises, which in their turn act as a breeding ground for new ideas and entrepreneurship.

<sup>12</sup> For a review, see Johansson, D. & Karlsson, N. (ed): *Den svenska tillväxtskolan. Om den ekonomiska utvecklingens kreativa förstörelse*. Ratio 2002

<sup>13</sup> Schmitz, J.: *Imitation, entrepreneurship and long-run growth*, Journal of political economy, vol. 97



Freedom of expression and organisation, and of economic pursuit is a third critical factor. It is in such environments that people are stimulated to experiment, pursue creative ideas and take economic risks. A free press and freedom of information contributes to such an environment.

Physical structures in society are a fourth factor. These can facilitate or hinder the exposure to ideas and the opportunities to experiment. Infrastructure such as roads, and the supply of utilities, such as power, are critical for local entrepreneurship, creating base conditions for enterprises to emerge, develop and survive. Exposure and ideas are stimulated by proximity and spontaneous interaction. Urbanisation is in many ways a manifestation of these processes: interaction between people stimulates ideas; openness is greater, local markets are larger and more diverse, infrastructure better developed, and transaction costs lower. Thus urbanisation is not only a result of economic development. It is also a triggering factor.

Fifth, the concept of clusters plays an important role in modern theories of entrepreneurship. Clusters consist of many enterprises often of a similar kind in a limited regional area which tend to have a high degree of spill-over effects, synergies and cross-fertilisation, or, in economic terms, positive externalities. Some countries with more aggressive policies for economic growth and private sector development, such as China, Vietnam, and Malaysia, try to stimulate such cluster formation by creating tailor-made infrastructure.

Government policies are a sixth factor which can do much to stimulate or thwart entrepreneurship. It is not only a matter of attitude, but also of readiness for change. This includes an ability of institutions governing markets to adapt to changed conditions, of using rather than refusing change, and providing the incentives for innovation and technology upgrading.

### ***The virtue of smallness***

Entrepreneurship is generally associated with small enterprises. Behind almost every successful very large industry there is an entrepreneur, an innovation tried out in small enterprises. Furthermore, employment is usually generated by the small, not by the large enterprises. While the latter tend to grow by merger and acquisition, the former grow organically. Governments in many countries often use policy language paying tribute to entrepreneurship and smaller enterprises, but policy action tends to be the reverse: the large enterprises are favoured as being more visible, having stronger bargaining power towards the state. Their leadership often belongs to the same social elite. The birth of small enterprises and their survival often takes place in spite of a hostile environment and policy frameworks. On the other hand, large enterprises tend to be protected and often rescued by the state if their survival is at stake.

*Donors can* assist countries to stimulate entrepreneurship development by focusing on creating conducive environments for entrepreneurs leading to creative business development which benefits the poor, whether direct or indirect. In view of what has been argued above, critical inputs are support of:



- education, from basic to advanced. In the latter case, a focus on fields which tend to spin off entrepreneurs such as natural science, engineering, agriculture and management.
- openness in societies, reflected in the free exchange of information, trade and foreign investments.
- institutional structures which allow experiments, for example company laws which simplify entry and exit for small enterprises.
- non-discrimination of smaller enterprises and female entrepreneurs.
- regulations which provide incentives to innovation, such as effective patent laws.
- infrastructure which stimulate physical and mental interaction, for example access to the Internet.
- support of development and diffusion of technologies with a high degree of relevance for the poor, in agriculture, small scale power systems, transports, etc.

There are many schemes in advanced economies set up specifically to foster entrepreneurship and innovations such as 'business incubators', and government run venture capital funds. Overall, donor agencies should be sceptical of trying such special arrangements in developing countries, until the more basic structures and institutions are in place. Donors should also avoid the temptation to an individualistic approach, i.e. trying 'to pick winners' through direct financing of 'promising entrepreneurs'.

*Sida can specifically explore ways of stimulating entrepreneurship based on the know-how in the 'Swedish growth school'.*

### **3.5 Securing fair and effective property rights**

The third fundament of private sector development is the institution of property rights. Such rights tend to develop in response to scarce resources. This is an evolutionary process through time where properties tend to move from free resources, commonly held resources based on traditions, to private holdings, with an increasing degree of legal protection. It is also a process of evolution from a limited number of properties (such as land and at one point of time, people) to knowledge-based and immaterial assets such as patents, copyrights, brand names and other forms of intellectual property rights. Property rights are seen as a basis for why entrepreneurs are willing to take risks and invest, making assets increasingly productive. The 'tragedy of the common' is a term describing the depletion of physical assets used by many without clear rights.

#### **Box 12. The assets of the poor**

"Developing and former communist countries' principal problem is clearly not the lack of entrepreneurship: the poor have accumulated trillions of dollars of real estate during the past forty years. What the poor lack is easy access to the property mechanisms that could legally fix the economic potential of their assets so that they could be used to produce, secure, or guarantee greater value in the expanded market..." (Hernando de Soto)

Non-existing, unclear and poorly formulated or implemented property and tenure rights are also claimed by some researchers, such as Hernando de Soto, to be the most significant factor explaining 'under-development' in general and for the poor in particular (see Box 12). A lack of clear property rights acts as a strong disincentive in private investments and makes it impossible to use assets as a basis for interaction with formal business systems (e.g. security for loans), which, in turn, reduces the ability to trade assets, or make assets give economic returns. Africa is a continent plagued with property rights issues due to traditional systems of rights to land complicated by superimposed colonial institutions and, after independence, various forms of Marxist inspired reforms. Privatisation processes and so called land reforms can easily be hi-jacked by the more influential in society, sometimes under the pretence of providing land for the poor. Zimbabwe is a current example. Unclear property rights is also a reason for the dominance of the informal sector and the growth of this sector in many developing countries. While the capitalist system increasingly dominates the economy of the world, the most fundamental principle of this system, private ownership and the right to the fruits of private ownership, is only partially implemented in developing countries and emerging markets.

Well developed institutions for property rights are not the same as a fair distribution of assets in society. Such rights can be extremely unfair from a morale or human rights point of view, and changes in property rights are often justified for distribution reasons. In situations of transition from one economic system to another, or from a traditional system to a modern, abuses of property rights are common, often creating highly skewed holdings.

*Donors can support the development of the institution of property rights by:*

- assisting countries in technical matters such as surveying, registration, titling, and the creation of land markets;
- assisting countries in reviewing specific constraints related to assets of particular relevance for the poor, such as land, and housing in urban areas;
- assisting countries in reviewing and changing property rights discriminating against women, for example, concerning the right to land titles, and use of assets as a security for loans;
- facilitating major reforms of property rights which are being initiated by some governments where which specialised organisations such as the *Instituto Libertad y Democracia* undertake work.

The distribution aspects tend to be a highly political subject and the opportunities to influence the fundamental principles in a country from the outside are limited. Nevertheless, donors can argue the merit of proper land reforms, and the importance of transparent and enforced rights concerning land for small-holders, for example in larger reform packages.

*Sida* has access to specific Swedish competence in technical aspects of property rights such as surveying, registration and titling.

### **3.6 Assuring decent work conditions and a sustainable environment**

A private sector which delivers growth and jobs at the expense of human health and dignity, at earnings and wages below what people can survive on, and which exploits the environment to the extent that the quality of life is jeopardised for current and future generations, is clearly a poor quality PSD. Development of competitive markets must go hand in hand with decent working conditions and fair remuneration, whether it is among the self-employed in agriculture and the informal economy, or as employees of transnational enterprises. It must also take ecological dimensions into account to promote a sustainable use of natural resources and the environment. Furthermore, a private sector which is discriminatory in terms of the working conditions applied to men and women, of different ethnic or religious groups is not a high quality PSD.

The quality of working conditions, level of earnings and the environmental impact in and by the private sector is determined by a number of factors: national policy frameworks and legislation, the collective action of unions and co-operatives, lobbying and surveillance by the civil society, the values and actions of the owners and managers of private (and public) enterprises, but also of global norms and standards. Working conditions and the return to labour cannot be treated in isolation of one another. The private sector in richer countries can afford and is obliged both by norms and the labour market supply to provide better pay and better working conditions than the private sector in a poor economy. Enforcing norms and standards through political means far above what an economy can afford usually results in non-competitive enterprises. Private sector development is a balancing and negotiating act between returns to capital and labour, and between exploitation of natural resources and assuring a sustainable use of the environment in which private enterprises, governments, labour unions and civil society groups take part. As such standards change over time, including universal norms. Working conditions, which were general at the beginning of industrialisation, are clearly unacceptable today even in countries which are in the early stages of their industrialisation.

*Donor agencies can assist countries in pursue 'high quality' PSD through a variety of means. These include: assistance in establishing effective and appropriate labour and environmental policies and related legislation; support in forming organisations (such as unions, co-operatives and civil society groups) which act as a balance to the market forces on behalf of the self-employed, employees and the environment. Donor countries can work on forwarding universal norms and values manifested in international agreements, and on pursuing ethical standards in terms of working conditions and environmental standards in dialogue with trans-national enterprises.*

*Sida, should have a strong comparative advantage in assisting partner countries in a high quality private sector development based on decent working conditions and environmental sustainability. Sweden has a strong historical tradition of competitive markets with a concern for equity, fairness and environmental sustainability.*

# 4. Traditional Markets of the Poor

## 4.1 Two key sectors: agriculture and the informal economy

Certain markets tend to be of particular importance to the poor, both as producers due to their direct involvement, and as consumers. Two key markets are agriculture, the dominant source of livelihood in many developing countries especially the poorest, and the informal economy, defined as the unregulated small scale business in trade and manufacturing outside agriculture. Private sector development aimed at reducing poverty in the short term cannot avoid to pay strong attention to these markets, since the poor largely depend on them. This does not mean that these markets will solve the poverty problem long-term. They will not. Development is a question of modernisation, transforming societies from primary producers to manufacturing and services. All historical evidence of development shows that agriculture is a diminishing share of an economy, both in terms of its share of GDP and of employment, as increased productivity in this sector produces the agricultural goods demanded. While some countries may specialise in agriculture for exports as a successful development strategy, on a global scale this will not work.

The informal economy, in its turn, is to some extent a reflection of a failed development. It is a depository of people who are not absorbed in gainful, productive formal sector employment, whether public or private. Due to its informality and as so many are dependent on this economy, it is highly dynamic, adaptable and resilient. But it is an economy generally characterised by low returns, low ability to enhance productivity, and poor, sometimes appalling, working conditions. It is outside the taxation system and does not contribute to government budgets. In many cases the informal economy actually undermines such budgets by diverting border trade to smuggling, for instance. It is also not always easy to draw a line between what is an 'acceptable' informal economy, and what is straight forward illegal. However, the dichotomy formal-informal has also a lot to do with rules applying to the formal sector. In many countries overly cumbersome regulations and laws, corrupt and/or inefficient regulators, and protective means have created the division. The problem is as much with the formal system as with the informal.

## **4.2 Agriculture as private sector development**

### ***The traditional business of the poor***

Agriculture, including fishery, livestock and forestry, employs over half of the total labour force in developing countries, mostly as small-holders, tenants and agricultural labourers. In low-income countries about 70% of the work force is engaged in agriculture, and in some of the poorest nations in Sub-Sahara Africa, the ratio is over 90%. Women are over-represented: in the low-income countries four out of five women are primarily engaged in agriculture. Poverty in the world is to a large extent still a rural phenomenon. Over 75% of the absolute poor are residing in rural areas, and most of them have agriculture as their main source of employment. Thus, poverty reducing private sector development cannot avoid but to pay strong attention to small-holder agriculture, both in the sense of making the sector more effective as a means of livelihood, and as a means of taking the poor out of low-return agriculture.

It is important to see smallholders, whether owners of land or tenants, as businesses and entrepreneurs. This means that they are forced to take commercial risks, to assess markets and production costs, to try new technologies. Sometimes they are able to expand, and sometimes they lose their businesses. While entrepreneurship in its conventional sense might not be associated with small-holder agriculture, it is there when farmers apply new technologies, explore new market opportunities, and learn from own experience which production strategies provide the best returns.

Smallholders tend to have more business and other economic activities parallel to agriculture as a means of making a living. This might be small scale agro-processing, trading, craft production, or temporary employment away from home. It is essential to have a perspective on the farmer household as an integrated 'business venture', where decisions are made based on all these economic activities, rather than a single one. Seemingly 'non-economic' behaviour by small-holders in the agricultural sector, such as preference for traditional varieties over High Yielding Varieties (HYV) can often be explained by a concern for other sources of income, requiring less time inputs into agriculture.

### ***The options to enhance agriculture***

The share of the labour force engaged in agriculture is generally a good proxy of the stage of economic development. Development over the last century has meant a dramatic shift of people from initially very low-productive agriculture to manufacturing and services. Parallel to this, the productivity per person engaged in agriculture has increased dramatically to the extent that the 5% of the population engaged in agriculture in the OECD area produces far beyond what the large majority of the population produced a century ago. The same process is taking place in many developing countries. For example, in countries such as South Korea, Malaysia, Mauritius and Botswana, the share of the labour force engaged in agriculture has dropped by half or more within the last 20 years, while the output from the sector has increased. The difference in productivity between a poor farmer in an LDC and his/her counterpart in an OECD country is partly due to a difference in yields per hectare,

but more importantly due to the land utilised per person, which in its turn is a factor of land available and the degree of mechanisation. As a result, the average return per year for a worker in agriculture in an OECD country is more than a hundred times that of the typical return of USD 250 – 300 per worker in a country such as India or Sri Lanka.

At a national level, the last twenty years has witnessed major economic reforms in agriculture, which overall have been beneficial by, for example, reducing urban biases, reducing 'rent-seeking' and other inefficiencies in state monopolies. Agriculture has grown in output better than the economy as a whole in many poor countries, notably also in Sub-Saharan Africa. But the reforms have had winners and losers. While market driven reforms have released productive forces and the creativity of masses of small-holders, they have also reinforced the process of marginalisation due to physical remoteness from urban areas or major roads, high costs due to transports, and other structural obstacles such as lack of market information. Ethnic minorities are particularly marginalised. Such groups, which tend to suffer a higher proportion of poverty, are often subject to discrimination in terms of the right to land, access to credit, and so forth. They are frequently relegated to the most remote areas.

While much can be done to enhance the agricultural sector in developing countries and thereby reduce poverty, there are also clear structural limitations. First, for many commodities such as cereals, coffee and rubber, income elasticity is low. Enhanced production of such commodities run the risk of leading to depressed world market prices, occasionally to a level below production costs. This requires a diversification of agriculture towards high-value products, itself often a high-risk venture due to volatile demand and quality issues. Second, poverty in rural areas is to a large extent due to 'functional landlessness', i.e. a large share of the rural population has no land or such small parcels of land, that land itself, however productive, cannot help people out of poverty. A dual strategy is required: a) getting higher returns for the enterprises and people in the sector; and b) reducing the pressure on the sector as a means of livelihood. A strategy focusing on agriculture alone will not work.

### ***The role of donors***

In spite of the fact that poverty largely is a rural phenomenon, and that the poor derive their livelihood to a large extent from agriculture, donor assistance for such endeavours tends to be in relative terms limited, and furthermore has shown a declining trend. The strong efforts to enhanced agricultural productivity through HYVs, extension systems, rural credit and investments in irrigation schemes of the 1960s and 70s, and the integrated area approaches of the 70s and 80s, have declined, and been replaced by structural reforms and liberalisation of agricultural markets in the 1990s.

The constraints in agriculture development in which the poor are directly involved are found at different levels. At the international level, a major constraint for developing country agriculture is that rich countries heavily distort global agricultural markets in their own favour. As noted above, subsidies of agriculture in OECD countries are of a magnitude of 5–6 times that of total ODA with the result that:



- Many OECD markets are de facto closed for developing country agricultural exports as these countries themselves produce more than there is demand for. As these countries tend to be the most important markets for exports, such distortions are serious for developing countries.
- OECD country over-production leads to the dumping of agricultural surplus in developing countries, thus undermining local producers and creating distortions.

This incoherence in policies is of a political nature and is nothing that donor agencies can do much about. However, as the beneficiaries of the distortions are in relative terms few (farmers in the OECD), and the losers not only millions of agricultural producers in developing countries, but also consumers in the OECD, making the effects of these policies explicit can impact on public opinion. This might in its turn eventually impact on OECD policy makers. International civil society groups are often effective instruments for such lobbying efforts.

Agriculture is one area where technical development and innovation can be diffused with dramatic change in productivity overall, as reflected in the HYV revolution in the 1960s and 70s. Although any such technological change has side effects, the potential to enhance productivity in traditional agriculture is still considerable in basically all sectors, including fisheries and animal husbandry. This is an area where donors have a comparative advantage in underwriting the often heavy financial costs of the research and development phase. The new technologies in agriculture, such as gene modification and tissue culture open up both opportunities and threats to agriculture in developing countries where donors can support the capacity of countries to deal with such technologies.

At national level, agriculture has been the victim in many developing countries, especially in Africa, in their efforts to industrialise quickly. Policies have been systematically skewed against agriculture to favour a few, over-protected manufacturing enterprises. Rural areas have been discriminated at the expense of the urban through a variety of policy instruments such as price controls, monopolised marketing, over valued exchange rates, and the urban bias of public investments. Such policies have to a large extent been weeded out, but there are still remnants in many countries. Donors can help countries in systematically analysing the policy framework to disguise such biases, and provide technical assistance in correcting them.

Property rights and the distribution of land is of critical importance. Land, and the right to land, is of primary concern for the poor who to such a large extent depend on land as the key resource for making a living. As land is scarce, and land values tend to increase, these rights are increasing in importance. Feudal, or quasi feudal systems in many developing countries resulting in extremely concentrated land ownership is a major impediment to poverty reducing agricultural development. Donors cannot directly interfere in such political issues, but at the international level, the argument for land reform and land distribution can stimulate political change, as can support for civil groups in countries involved in such issues. But also in countries with less of a feudal history, the institu-

tion of absentee landlords, often belonging to a political elite which have gained access to land with more or less legal means, reduces effective poverty PSD. Donors can act more strongly on such issues, being less lenient with governments which systematically undermine fair land rights. The models of the NICs should provide an important message: their industrialisation often went hand-in-hand with land reforms.

Small-holder agriculture is heavily dependent on supportive infrastructure such as irrigation, roads, energy and telecommunications. Such infrastructure often determines production costs and productivity, access to markets and the transaction costs in commercial exchange. Many of these are public investments, some of which is provided through donor funding and loans of varying softness from multinationals. The direction of such investments is frequently influenced by vested interests, where the poor always have the least say. Donors should, when involved in such financing, assess in which interests the investments are made, and through a poverty analysis determine the most effective allocation of such funds from a poverty perspective. Poverty assessment should be as essential as environmental assessment in infrastructure.

The agriculture sector needs constant diversification towards new products, different quality products and expanded geographical markets to allow a high growth in demand, without pressure on prices. Both government and donors have often failed to pay attention to the demand side, and have assisted small-holders to build up over-supply resulting in depressed prices. Donors can improve on this by: a) being more aware of the demand side in agriculture support and tailor production support to this; and b) assist countries in building more effective marketing and information systems. The latter does not mean supporting governments to take over marketing as in the past ill-fated marketing boards, but to develop facilitating marketing infrastructure for the private sector. The latter includes effective telecommunication systems for the purpose of transferring market information; effective harbours and airports for the handling of goods in exports; systems for quality control and grading in order to enhance quality and reduce waste; infrastructure supporting the growth of local agro-processing (e.g. power), and a policy and regulatory framework for this which provides incentives for trade. There are also examples when donors have been highly effective in supporting countries through technical assistance in defining new markets.

In a comparative donor country perspective, Sweden does not have a strong record in agriculture development in general. There are many reasons such as the fact that Sweden of its own has a small domestic agricultural base, and no experience in tropical agriculture. Swedish ODA historically had different foci. However, Sida has a good standing record in area based rural development with a long record going back to the 1960s and also in specific sub-sectors such as forestry.

Options in which Sweden has a strength due to past experience, and/or broader Swedish political positioning, are:

- At the international level, act for reducing trade barriers and for fairer markets for agricultural products relevant for developing countries.
- Support international research within CGIAR and similar organisa-



- tions towards improved varieties relevant for poor producers.
- Work with partner countries to strengthen property rights especially for small-holders, including technical matters such as surveying and land registration.
  - Improve market access of poor producers by investing in physical access, notably secondary and tertiary rural roads. Improve the system of maintenance of such infrastructure through decentralisation and through the involvement of service users.
  - Address structural issues in factor markets relevant for rural producers, such as in financial services, input supply, water and energy.

### ***The area approach***

Donor support for agriculture is often not sector, but area based, with a history from the 1950s and 60s of poverty focused integrated rural development. The justification is: a) a desire to address particular pockets of poverty; and b) the perception that constraints for poverty reduction are many and need to be addressed simultaneously. Such area based projects often had a combined thrust in enhancing agricultural production and provided various forms of social services. The results of these generally complex projects were often mixed, especially in their efforts to improve income in a sustainable fashion. The approach has nevertheless survived, perhaps as these projects lend themselves particularly well to a distinct poverty focused donor support. Sida has a long record of such poverty area based development.

One strength of the area based approach is that it allows experiments and as such can act as demonstration for broader, national programmes. It might be argued that donors should be restrictive with such area based efforts unless they have such potential demonstration effect.

In the effort to address poverty, donors, including Sida, have tended to focus increasingly on areas of 'hard core poverty', due often to a natural resource base with very limited capacity for farm production. Efforts to provide production development in such contexts, coupled with investments in infrastructure, can sometimes be counterproductive: farms are just too marginal to allow a decent living. The focus in such areas must be on people rather than on natural resources, i.e. build human capacities which facilitate moving out and shifting livelihood, including migration to higher potential areas.

## **4.3 The informal economy**

### ***What is the informal economy?***

The concept of a dual economy in the sense of a modern and a traditional sector existing side by side has been used as long as development has been a discipline. The perception was initially that this dualism reflected a transitional stage: with development the modern sector would absorb the traditional, and the latter would wither away. Hence, there was not much need to pay attention to this temporary residual of development. The dichotomy was the subject of renewed interest by pioneering research work undertaken by ILO in the 1970s, when the informal sector was 'discovered', and found to be both more significant as a source

of non-agriculture employment and more resilient, than previously believed. Furthermore, the sector was found to be of particular relevance as a source of livelihood of the poor.

The informal economy tends to be the clearly most important source of livelihood for people in general and the poor in particular, parallel to agriculture. The informal economy is estimated to employ about 60% of the non-agricultural labour force in developing countries, ranging from 50% in Latin America to 80% in Africa.<sup>14</sup> In many countries, the informal economy has a high share of female operators, sometimes as a result of a cultural-historic pattern (such as domestic trade in West Africa). Informal economy operations, for example run from the home and/or part-time, lend themselves to the traditional role of women as mothers of young children. Discriminatory property rights and formal regulations might also be reasons for a strong prevalence of women in the informal economy.

The informal economy is entirely private. The 'enterprises' operate, as per definition, largely or totally outside their countries' formal regulations and legal frameworks concerning business registration, licensing, taxation and labour legislation. The informality is either a result of the operators being too small to be covered by the formal system, or that they purposely avoid the system in order to reduce the costs of doing business, taxation and occasionally also legality. The informal economy comprises everything from the self-employed to micro enterprises with sometimes 5–10 employees. The term tends to be used for non-agriculture production, but covers otherwise basically all economic sectors, both urban and rural. The informal economy tends in most countries to be dominated by services, especially in trade, and also to be a predominantly urban phenomenon.

Informal economy operators are typically labour-intensive with no or limited capital invested. They often cater to the poor in terms of products and services with very local markets. Returns can be substantial, but as copying by other operators is easy and prevalent, profit margins and return to labour tend to be low. The informal economy might include criminal activities such as smuggling, prostitution, and drug-pushing, but the vast majority of informal enterprises are honest from a morale, albeit not taxation point of view.

The notion that the informal economy is a major potential recruitment ground for fast growing small-medium enterprises is, however, probably incorrect. The transition from informal to a more substantial formal enterprise is rare. The importance of the informal economy is rather its ability to provide a degree of income through a vast number of 'enterprises', its adaptability, easy entry and exit, and low transaction costs, and as an important source of livelihood for women.

### ***The role of donors***

Governments in developing countries tend to have an ambivalent view of the informal economy, because a recognition of this part of the economy would undermine the regulatory or legal frameworks for business. Often these operators are ignored, discriminated against or actively harassed in

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<sup>14</sup> Caar, 2002

order to close them down, for example in slum clearance programmes. Since the 1970s, donors and NGOs have, nevertheless, showed interest in the informal economy, devising various efforts of support. These include training programmes of entrepreneurs, technical assistance to informal enterprises and credit schemes. Increasingly such programmes are also accepted by governments. Perhaps the most significant and well-spread such scheme is micro finance, today covering 25–30 million clients, of which the vast majority belong to the informal economy (see further below). Another significant programme spread to many countries in which Swedish development assistance played a pioneering role, is the ILO operated 'Start and Improve Your Business' Programme (SIYB) providing business training to informal sector entrepreneurs and would-be entrepreneurs (see Box 13).

#### **Box 13. Improve your business**

Based on a training programme by the Swedish Employers' Association for small enterprises in Sweden, Sida funded an adaptation to developing countries during the 1970s through the ILO. The programme, first applied in Africa, was in the 1990s expanded under the name Start and Improve Your Business. It has been spread to 80 countries and a large number of entrepreneurs, mostly in the informal economy, have undergone training through various ILO projects, many funded by Sida.

Recently donor agencies, including Sida, have again placed the informal economy on the development agenda, triggered by the fact that the informal economy not only is resilient, but in fact in many parts of the developing world is increasing in importance. With the downsizing of governments and the public sector in many developing countries during the 1990s, the informal economy has become a survival strategy for many laid-off formal sector workers.

*Sida can*, in support of the informal economy as an element of a pro-poor PSD:

- Assist governments in streamlining the regulatory framework for business in order to reduce the costs for small enterprises to become formal. The regulatory burden is a major reason for informal enterprises to remain informal.
- Address property rights in the informal sector.
- Assist government to eliminate gender discrimination in business.
- Support efforts to spread micro-credit programmes, the only successful major model for non-collateral small-scale credits to informal economy operators.
- Support selected programmes for training and capacity building of entrepreneurs. Gender-specific training might be a strategy to tailor-make support to address gender inequalities.

# 5. Determinants for Enabling Environments

## 5.1 A dynamic systems approach

The discussion so far has made it obvious that the functioning of the private sector depends on a number of broad conditions in society, which establish an 'enabling environment' in general. It is also the character of the environment which determines how effective the private sector is in its contribution to a poverty free world. For the purpose of analysing this environment, and the potential role of a donor, the following structure is applied:

- The meta-system, or the international environment: global markets in trade and finance, international technology and innovations crossing borders, related international agreements. The setting in which countries and their commercial players operate. Donors are a part of this meta-system.
- The macro-system: 'institutions' in its meaning of 'rules of the game' in a specific country. Includes everything from overriding conditions in a society such as peace and stability, the rule of law, governance, to more specific institutions governing the economy, such as macro economic policies, property rights, and the many laws and regulations specific to the private sector.
- The meso-system: resources required for business operators such as infrastructure, human resources, financial systems, and business support structures.

These systems will impact on the micro level in a specific country, i.e. the market players in the form of commercial enterprises in the formal and informal economy, whether micro, small or large. Some of these conditions can only be changed over a long period of time, while others are more short term, an important aspect in governments' actions and in donors sequencing of support.

These systems interact. Conditions at the higher level of these systems tend to set the parameters at the lower level. Efforts to solve problems at a lower level might be fruitless if the higher system levels create hindrances. Higher system opportunities might trigger development at a lower level. But the process is also the reverse: by their actions, the operators at the micro level determine and shape the resources of a society, influence the macro policies, and also the international meta system.

## 5.2 The Meta system: the international environment

### ***Global technology and innovations***

It was the scientific and industrial revolution in the 18<sup>th</sup> century, which triggered a dramatic shift in development in Europe and North America, and which has paved the way for unprecedented wealth and reduction of poverty in a large part of the world today. The catching-up of many poor countries in recent decades at a faster speed than ever before, is based on the fact that these countries have leap frogged development through the application of largely imported technologies in agriculture, manufacturing, infrastructure and services. Poor countries have today access to the most recent technologies of the most advanced economies in the world. The ability to emulate, copy and utilise these technologies is the basis of growth and the creation of wealth at national and individual level. It is also the underlying reason why key human quality-of-life indicators such as longevity and child mortality rates have improved so much more dramatically in developing countries than they did at the time when the industrialised countries developed.

Many of these technologies affect the poor directly. The development and spread of HYV for grains – perhaps one of the most successful donor developments in the 50 year history of development assistance –

#### **Box 14. Difference in technology use**

In many industrialised countries the rate of use of personal computers per 1000 inhabitants is 300 or above, while in many of the least developed countries it is below 1. The number of mobile telephones per 1000 inhabitants is over 700 in many of the rich, and near zero in most of the poorest. The electricity consumption (Kwh) per capita is over 20,000 in some industrialised countries while below 100 in most poor nations.

Sources: UNDP Human development report 2003; and the World Guide 2001/2002

dramatically changed the conditions of the poor in countries such as India. A continent used to going through regular famines, became self-sufficient and a major exporter of grain in less than a decade.

Catching-up, however, is often not a simple process of copying. The ability of countries, enterprises and individuals to apply modern technologies depends on a number of pre-conditions: skills embedded in education, an appropriate infrastructure, the organisation of society, policies and attitudes, and not least that the technologies make sense in a local environment. For example, industrial technologies are often driven by a concern for factor costs, such as reducing costly labour, making them of little relevance in low income countries. Transfers of technologies from rich to poor countries contributes to the extreme dualism visible in all poor countries: a modern, urban based sector for the well-to-do, side by side with people using technologies not much different from those available a thousand years ago. Some countries have been able to absorb a rapidly increasing share of the population in the modern sector using up-to-date technologies. But in too many countries the dualism is becoming greater, with majorities largely left outside, frequently living on the scraps of the modern sector.

As the technology sophistication of the industrialised countries increases, the market reasons for them to address technology issues of the poor diminishes. The gap in use of modern technology between rich and poor nations is much wider than income differences would indicate (see Box 14). 'Second-hand' technologies can sometimes be a solution and are often applied. But there is stigma attached to this, and there are no well developed market mechanisms for broad-based second-hand technologies.

*Donors can assist partner countries and their private sector's ability to exploit international technologies and innovations, and stimulate technologies directly beneficial to the poor, in different ways:*

- In the long-term, the foundation for the capacity to participate in the global technology exchange is through education. Basic education is essential for a broad based assimilation, but also higher education, especially in subjects such as agriculture, engineering, natural science and technology, and management related sciences is important for more advanced local entrepreneurship and business development.

#### **Box 15. Breaking inefficient monopolies through new technologies**

In 1997, Bangladesh had one of the lowest telephone densities in the world with only 0.26 lines per 100 people. The waiting time for a fixed connection was more than 10 years, and the installation charge of US\$450 for a new fixed line was one of the highest in the world. The technological developments in the telecom sector have made it possible for Grameen Telecom and other newcomers using new technology to introduce mobile services in rural areas. A potential user can now simply walk into a Grameen Phone office and walk out in half an hour with a phone that functions. Grameen is also involved in making the technology available to the poor through collective use.

- Openness in societies in trade, foreign investments, information and exchange of ideas are the means by which technologies spread. To a high extent, they are embedded in government policies, but also in infrastructure.
- The modern technologies of information, such as the Internet and mobile telephone systems, are revolutionising access to information, including for the poorest nations. Reforms of monopoly systems for such communications can dramatically reduce costs and increase access, which can be applied by the poor in day-to-day life in their business activities (see Box 15)
- Support and promote the exchange of new technologies especially benefiting the poor. For example, donor support for the NGO-led development of micro finance since the 1970s has meant a dramatic change in the access of finance for the poor and for poor women in particular all over the world.
- Support research and development of technologies of particular importance for the poor. The example of HYV is one of the outstanding examples. Similar R&D efforts can be applied to numerous fields of relevance for private sector development of direct relevance for the poor.

- Stimulate global industries to develop and disseminate relevant technologies for the poor, for example in preventive and curative health (malaria control, HIV).

### **International trade**

International trade flows have increased dramatically in the past three decades. Developing countries have increased their share of exports, accompanied by a change in the composition in their exports from primary commodities to manufactured products. However, many countries have not taken part in this integration process and have experienced a decline in their share of world trade. Indeed, the export share of the 50 least-developed countries has dropped from 3% in the 1950s to less than 1% in the early 2000s.

There is a broad consensus that those countries that have integrated into the world economy through trade have enjoyed higher economic growth. The successful NICs all applied aggressive export development as a cornerstone of their development strategies in the 1960s and 70s, first in labour intensive manufacturing and later in increasingly sophisticated exports. On the other hand, countries such as Tanzania, which applied a strong import-substitution and self-reliance strategy in the 1970s and 80s, slid during this time to become one of the poorest in the world. A country's trade policy is an important instrument for channeling price signals from the world market to the national economy, thereby allowing resource allocations consistent with comparative advantage and increasing productivity.

Recent research is also putting the light on the importance of imports, versus the past focus on exports. Imports put pressure on the domestic sector to increase its efficiency, and weed out poorly performing operators. Imports provide an inflow of technologies as discussed above, besides providing welfare gains as price levels are being reduced (relative to protected domestic production).<sup>15</sup> However, dogmatic approaches to trade might not be the most effective approach: Countries successful in growth, such as the NICs have often applied asymmetric policies in terms of protection of certain parts of their economies. Also, today's industrialised countries had much more of protectionism at critical stages of their development than is commonly assumed<sup>16</sup>. Certain vulnerable segments of the society, such as small-holder producers for the domestic market, or operators in the informal economy, can be particularly hit by rapid liberalisation.

Many developing countries have been impeded in their efforts to take advantage of the global economy by inadequate policies, institutions, and infrastructure. Their efforts have also been frustrated by the protectionist measures of developed countries, including:

- high tariffs for products of special interest to developing countries (agriculture, textiles and clothing);
- a tariff system where the rate increases with the degree of processing (so-called tariff escalation), hindering the development of an industry in developing countries;

<sup>15</sup> See, for example, Stiglitz & Yusuf: *Rethinking the East Asian miracle*, Oxford Univ. press, 2001

<sup>16</sup> H.J Chang: *Kicking away the ladder. Development strategy in historical perspective.*, Anthem press, 2002



- import quotas applying to textiles and clothing;
- large amounts of subsidies (mainly agricultural) in industrialised countries;
- stringent technical, sanitary and phyto-sanitary measures which may hinder poor countries' export potential.

The poor are often directly involved in international trade as producers, and most of them are affected as consumers. Many export-oriented commodities such as coffee, cotton, spices, but also exported food crops such as rice, are predominantly small-holder crops, involving many tenants and agricultural labourers. The policy framework for such trade is critical. In too many countries, such trade has been discriminated against through export taxes, overvalued exchange rates, and monopolistic trading arrangements, undermining whole sectors. Trade is an important source of livelihood of people in border regions, which often belong to the poorest strata. Excessive tariffs, bureaucratic and corrupt customs officials, non-supportive infrastructure, cumbersome procedures and exchange mechanisms, either thwart such trade or send it underground.

Women dominate certain agro-based exports in many countries, both as farmers and farm workers. Therefore they depend on conducive environments for such trade. In countries pursuing openness to trade, labour intensive, export-oriented manufacturing dominates in the first stages of industrialisation. These provide formal sector employment, primarily for women, often triggering empowerment in oppressive family structures.

*Donor countries can support partner countries to become more competitive in international trade which directly and indirectly benefit the poor by:*

- improving market access through the multilateral trade talks taking place within the framework of the WTO (World Trade Organisation), ensuring that the new round of trade negotiations achieves a pro-development outcome;
- promoting the importance of trade as reflected in government policies and regulations, including analysing the constraints in the trade sector in specific countries;
- strengthening trade policy expertise and analytical capability in the partner countries, with a focus on the WTO rules;
- reinforcing partner countries' trade-related infrastructure to enable countries to live up to the requirements of export markets in respect of standard and quality (with links to the WTO agreements on technical barriers to trade, and sanitary and phyto-sanitary measures);
- supporting countries to develop skills and resources in trade promotion both in public sector organisations and private; and
- assisting countries in reviewing the effects of changes in trade regimes on different poor groups.

The specialised agencies in the donor community in terms of trade development are the WTO, UNCTAD, ITC, and the World Bank group. *Sweden and Sida has, nevertheless, certain comparative advantages in supporting partner countries in trade development for several reasons:*



- Sweden itself has traditionally pursued policies of free trade, and benefited from trade during Sweden's transformation from a poor country at the turn of the 19th century to a rich, industrialised society. Sida can assist partner countries in trade policy formulation.
- Sweden has a long tradition as an advocate for free trade and is advocating liberalisation both in the EU and in the WTO, acting as a strong voice for developing countries in such contexts.
- Sida has a record of support for technical development and capacity building in trade both directly and through organisations such as ITC.

### **Foreign investments**

Foreign Direct Investments (FDI) in developing countries, in the order of USD 150–200 billion per annum outstrips current official development assistance by a factor of 3–4. Not only is FDI a significant source of capital: it also tends to come with essential development inputs such as technological transfer, modern management and organisational techniques, productivity, and market know-how and access to developed economies. As a result, the earlier scepticism towards FDI in many developing countries has changed so that today most of these countries compete with various benefit packages to attract FDI. However, FDI is discriminatory. It flows to countries perceived to provide the best business opportunities, with low political risks. A handful of countries have so far received the bulk of FDI, of which China since the 1990s is the clearly the most important. Yet, LDCs get more or less a commensurate share of FDI, and some of them such as Cambodia, Vietnam and Tanzania have ranked high on the FDI per GNP. However, many poor countries especially in Africa tend to attract FDI for extraction for minerals, oil, etc., in what has been described as *'low development, low-quality FDI'*, i.e. investments in enclaves with few links and little impact on the rest of the economy.<sup>17</sup>

FDI is not only a flow from rich 'North' countries to the poor 'South', but increasingly a South-South pattern. Especially in Asia, the major source of FDI is regional. The concept of the 'flying geese' has been used to describe how a more advanced economy out-sources production to one nearby with lower production costs, which in its turn after growth and increasing production costs, out-sources to the one nearby with lower costs.

The relationship between FDI and poverty alleviation has been studied by, amongst others, the World Bank<sup>18</sup>. A review of the issue concluded that FDI is beneficial as a means for poverty alleviation under conditions of fair competition and a transparent and fair regulatory framework. FDI opens up sources of employment, often of a higher quality than in the domestic sector. FDI in agro-processing can have direct effects on the rural poor through systems of out-growers or by increasing the demand for agricultural labourers. Export-oriented FDI in garments, electronics, and shoes, have in some countries had a significant effect in providing mass-employment to mainly poor women.

<sup>17</sup> Mistry, P. & Oelsen, N.: *Increasing foreign direct investments in LDCs. The role of public private interaction in mitigating risk.*, 2002

<sup>18</sup> Klein, M.: et al: *Foreign direct investments and poverty reduction.* World Bank 2001

The ability of a country to attract FDI is a good indicator of its competitiveness in a global context. The direction of such FDI is also an indication of which sectors countries have comparative and competitive advantages: whether FDI dominates in export-oriented labour intensive manufacturing or services due to low labour costs and good labour productivity; or whether it is prevalent in natural resources exploitation in the form of mineral extraction, agriculture or tourism. The latter form of FDI is linked to 'ugly foreign businesses', and much abuse has and is still obviously taking place. It should be stressed, however, that such investments are not per se of 'low or inferior quality', with less potential to trigger development, or even less poverty reducing. It is rather the policy framework under which such investment takes place which matters: whether these frameworks provide incentives for the ruthless exploitation of humans, resources and the environment; or whether the frameworks are such that the economic benefits are ploughed back into the economy in a way which benefits development in general and the poor in particular, without detrimental consequences on the environment.

*Donors can assist developing countries to attract FDI which is beneficial for poverty reduction through different means:*

- As a long-term measure, attractiveness to FDI parallels the overall business and investment environment in a country. It depends on a host of development efforts such as regulatory frameworks, governance, political stability, productivity of labour, educational standards and infrastructure. As FDI is more sensitive to such factors, gauging attractiveness, or lack of attractiveness to foreign investors, is a good proxy of key constraints in these environments, which can influence the sequencing in the development agenda for PSD.
- Assist countries in reducing and eliminating constraints to FDI, for example embedded in policies concerning 'sensitive sectors' such as finance.
- Assist countries in strengthening their voice and role in the development of the WTO rules concerning FDI, the so called Trade-related Investment Measures (TRIM), so that legitimate developing country concerns are placed high on the agenda.
- Help countries in formulating effective policies, regulatory frameworks and the execution of such frameworks concerning FDI, especially in natural resources exploitation, including tourism, so that a) benefits accrue to the poor; and b) the environment is protected.

*Donors have various socialised instruments to assist developing countries in the promotion of foreign investments, for example through multilateral organisations such as IFC, and technical assistance provided through FIAS ([www.fias.org](http://www.fias.org)). In Sweden, Swedfund plays a similar role as IFC, and EKN provides export credit and investment insurance. The open or hidden subsidy element in direct investments in commercial enterprises is a subject of controversy. There are clearly risks for 'sub-standard' investments, and distortions by a public sector subsidy element in commercial FDI in developing countries. Thus, public sector organisations involved in direct investments or credits to foreign investors should apply market*

rates of return, so that clear externalities through such investments can be demonstrated (see further below).

*Sida's* competence in FDI promotion lies in the development of more conducive and competitive environments for business, rather than in the specific assistance.

### **Emerging universal institutions**

In a globalising world a number of values, norms, rules and policies fathomed by all or almost all nations are emerging. These might be called 'universal institutions'. Many of these are expressed in international conventions and declarations ratified by a large number of countries usually under the umbrella of the United Nations. These universal institutions are of relevance for private sector development as they form value systems under which the private sector operates, for example against child labour, discrimination based on race and gender, and sustainable use of the environment. Of special relevance for the private sector are various conventions on labour rights (see Box 16). In recent times, there is a tendency to seek a stronger partnership between the public sector and especially the multinational enterprises in order to apply and enforce these universal institutions. *Global Compact* is a UN initiative in which the Secretary General has challenged companies to embrace and enact nine principles concerning human rights, labour and the environment (see [www.unglobalcompact.org](http://www.unglobalcompact.org)). A similar initiative was taken in 2002 by the Swedish government, called the Swedish Partnership for Global Responsibility with the objective of making Swedish enterprises ambassadors for human rights, decent economic and social conditions and a good environment at home and abroad. (See [www.utrikes.regeringen.se/ga](http://www.utrikes.regeringen.se/ga)).

#### **Box 16. Labour rights conventions of:**

(In brackets number of countries which have ratified the convention by 2003)

Freedom of association and protection of the right to organise (141)

Rights to organise and collective bargaining (152)

Abolition of forced labour (157)

Equal remuneration (160)

Discrimination in employment and occupation (157)

Minimum age (121)

Worst form of child labour (131)

Source UNDP Human development report 2003

One element of the emerging universal institutions is what generally is called *Corporate Social Responsibility* (CSR), a term used to define widening behavioural norms or codes of conduct for business in terms of social responsibility for its workers, community or the environment beyond what is required by law. While morale or philanthropic motives among business leaders should not be dismissed as a driving force, corporate social responsibility is increasingly essential for business as it adds to image building, reduces risks of consumer actions at the market place, of strikes, and punitive actions by civil society groups. It may also create

added value amongst investors. International NGO activists have been in the forefront in pressuring social responsibility by transnational corporations in a number of fields such as labour rights, child labour, human rights, environmental standards, and fair trade. Civil rights group activists have also put pressure on these enterprises to check conditions for local suppliers and sub-contractors, hence triggering improved conditions in local industry.

While the enforcement of these institutions tends to be weak, as the universal community has no system of effective power of enforcement, their effectiveness depends on individual countries, governments and private operators' adherence to them. An important function of such institutions is that they promote values, i.e. over time countries and enterprises are likely to be less inclined to break such conventions to avoid being ostracised in the international community.

*Donors can* support the universal institutions relevant for business by various means:

- Applying them in action, for example making sure that enterprises participating in donor funded activities aimed at PSD fulfil the conventions. This should also include local or international contractors undertaking investments funded by donors.
- Support international efforts to develop such universal institutions (see Box 17).
- Assist countries to develop systems to monitor and enforce the adherence of conventions relevant for business.

#### **Box 17. Corporate Social Responsibility**

A system of CSR is embedded in the *OECD Guidelines for Multinational Enterprises*, see [www.oecd.org](http://www.oecd.org). An interesting international initiative in this context is the *Global Corporate Governance Forum* (see [www.gcgf.org](http://www.gcgf.org)), which is supported by Sida.

*Sweden* is at the forefront in the development of 'universal institutions of the kind discussed above. Sida should make this a strong aspect of its development assistance, both in support at the 'meta level', supporting NGOs in their work, and in more country specific work. A dilemma exists in Sida support aimed at small-scale operators, for example in the informal economy, which often abuse these institutions.

#### **Global public goods**

An increasingly important 'meta system' for the private sector is what is commonly labelled *global public goods*. GPG is defined as goods whose benefits reach across borders, impact on a large number of people and have impact on several generations. Examples of global public goods are:

- environmental protection, such as minimising climate change, reducing pollution, protecting biodiversity and defending global commons (such as the seas);
- prevention of communicable diseases which easily cross borders such as HIV/AIDS, malaria and tuberculosis;

- knowledge, for example scientific results which the global community benefit from, but also basic skills which tend to become global goods due to increased migration;
- peace and security, as wars and conflicts have implications far beyond the borders of the combatants; and
- global governance, for example financial and overall international economic stability.

**Box 18. An initiative on global public goods**

Sweden, France and the UNDP have established an international task force with a mandate to foster an enhanced provision of international public goods, which are of critical importance to achieving the Millennium Development Goals (MDGs), notably the objective of reducing poverty.

Markets tend to under-finance these public goods, and therefore they require public interventions which go beyond borders. Such international public interventions require binding international agreements concerning institutions and/or funding. From a private sector perspective, GPG both implies an emerging international regulatory framework and new incentive/disincentive systems. A source of information for the development of global public goods is the Global Network on Global Public Goods: [www.gpgnet.net](http://www.gpgnet.net).

Sweden is active in pursuing the development of global public goods, see Box 18.

# 6. Macro Level: Institutions of Society

## 6.1 Institutions as an overriding determinant

Under the influence of economists such as Douglass North, institutions defined as norms, rules and other structures of social behaviour, have emerged in development economics over the last decades as the overriding factor explaining long-term development processes, especially economic development (see Box 19).

### Box 19. The role of institutions

"Efficient economic organisation is the key to growth. The development of an efficient economic organisation in Western Europe accounts for the rise of the West. Efficient organisation entails the establishment of institutional arrangements and property rights that create an incentive to channel individual economic effort into activities that bring the private rate of return close to the social rate of return...If a society does not grow it is because no incentives are provided for economic activities..."

D. North & R. Thomas: *The rise of the Western World – a new economic history* 1973

Institutions of relevance for private sector development encompass many things, from the overall conditions of peace and stability, national policies, norms and laws promoting and regulating the market, down to specific institutions such as audit and accounting principles. Institutions are generally developed over the long-term, and are a result of historical processes. In many developing countries, colonialism strongly influenced the emergence of institutions, especially as 'modern' institutions were introduced to replace the 'traditional'. An important element of this is to determine what are 'good' institutions and what are 'bad'. Historical evidence seems to indicate that there are no strong reasons to believe that societies automatically gravitate toward 'good' institutions<sup>19</sup>. Vested interests of power groups, benefiting from a set of 'bad institutions' can prevent change and perpetuate the existence of such institutions.

<sup>19</sup> Acemoglu, D.: *Root causes: A historical approach to assessing the role of institutions in economic development*, Finance and Development June 2003

## 6.2 Peace and political stability

It is no coincidence that of the 20 poorest nations in the world, 15 are engaged in conflict. From an economic point of view conflict increases costs and uncertainty, thus detracting from investments both by locals and foreigners. War, conflict and civil strife also steer business activities to criminal and socially non-desirable areas such as weaponry, drugs, the criminal exploitation of natural resources such as oil and precious minerals. In many countries civil wars might be fuelled and maintained in order to carry on with such criminal business ventures. There are strong economic reasons of certain groups, sometimes including governments, for avoiding peace. The pattern of development in large parts of west and central Africa is a case in point.

### Box 20: Sida, humanitarian assistance and PSD

In line with the key principle of *Do no harm*, there is praxis within Sida's humanitarian assistance, that activities in the field during an emergency should not undermine the local market, e.g. by importing grain or using foreign transporting companies. Instead, Sida advocates the use of local service providers and institutions, as well as the purchasing of locally produced food staples while not distorting the market. The point is that a) local initiatives generally are quite capable of effectively respond to emergencies; and b) a long-term local coping capacity should be maintained and enhanced. These principles will be expressed in Sida's new policy for humanitarian assistance.

As conflict and stagnating or perverted economic activities tend to form vicious circles, ending conflict, and creating a state of peace, stability and order, have high dividends in terms of economic growth through reconstruction and private sector development. Growth creates improved conditions for peace and stability. The risk for resumed conflict is clearly higher in stagnant or declining economies, than in dynamic. Getting the economy going through reconstruction and effective PSD post-conflict is thus critical for peace-building. Business development might also be a way of building bridges to former enemies. There is less likelihood that countries which are engaged in mutual business and trade start violent conflict, an underlying hypothesis for the formation of the EU, and applicable elsewhere.

Conflict tends today to be a domestic problem rather than a conflict across borders. 95% of the victims of war are currently victims of civil strife. Not only is conflict predominant in the poorest nations: within countries, the poor tend also to be the prime victims of wars, conflict and civil strife, not only from a human perspective, but also economically. Small-holder agriculture and livestock are a major economic victim of war due to mine infestation, destruction of land, killing of animals, destruction of access to markets, supply chains of inputs, and the confiscation of productive resources by warring factions. The livelihood of the poor is hit hard. Women and children tend to be the most vulnerable.



*Donor countries can* do a number of things to promote a virtuous circle between peace, stability and business development, and to break the vicious. For example:

- be aware of the fact that poor or negative growth can be an early warning of civil strife and conflict in society;
- conflict might be initiated or fuelled by disputed or non-enforced property rights and economic discrimination, hence requiring institutional development and policy changes;
- ending conflict might require cutting off the revenues from illegal business activities, or the business of warring factions, which might require tracing the trading routes, and working for political action to close such trade;
- humanitarian assistance is easily siphoned off for business purposes in conflict scenarios, hence often requiring protection by force;
- in the reconstruction phase, rely on local entrepreneurship and businesses, rather than on imported materials, housing and food (See Box 20); and
- sequencing support in such a way that in a post-conflict scenario kick-starting local business and economic activities are given high priority in order to create employment and channelling energies into productive use.

Donors are increasingly working in countries which lack a functional government due to conflict or in a post-conflict situation. Working with the existing or emerging business community might be an effective method for peace-building or reconstruction in such cases, requiring development of new, unorthodox methods of development assistance.

*Sweden is* in a particularly good position to explore the linkages between peace, reconstruction and business. Sweden is a neutral country, with a record of peace brokerage. Sweden is neutral, with a good track record. Its private sector is not associated with neo-colonial adventures. Sida's often flexible and innovative approach to development assistance lends itself to higher risk efforts required in post-conflict scenarios.

### **6.3 Macro economic policies**

Sound macro economic policies, manifested in low inflation, a realistic exchange rate, and low budget deficits are today well-established principles for both developed and developing market economies and a basis for an 'enabling environment', critical for growth and effective PSD. It is also a pre-condition for pro-poor growth, as the major victims of poor macro economic policies tend not to be the rich, but the poor. Serious macro economic mismanagement of the past, especially in Africa, hit especially peasants and farmers by distorting both domestic and export-oriented agriculture in a negative way. What matters is to get the incentive structures in society right, providing signals to commercial entities which benefit society as a whole.

Donor countries have been active in macro economic reforms since the 1980s, led by the World Bank and the IMF. Much has been achieved in weeding out serious mismanagement. However, the structural adjust-



ment reforms have also shown short-comings. One explanation is that the reforms underplayed the importance of basic institutions. There is today evidence that reform processes require a much longer time for basic institutions to change, than what usually is implied in, for example, the donor supported IMF/World Bank loan conditions.<sup>20</sup>

Most donor countries, including Sweden, supported macro economic reform processes since the mid- 1980s, both by balance of payments and general budget support. Such financial support tends to be co-ordinated with efforts by the World Bank and the IMF, and is aimed at the poorest and most indebted countries, as under the Highly Indebted Poor Countries (HIPC) initiative.

*Sida* can support the required reform of underlying institutions for macro economic reform through technical assistance. For example, it can provide assistance to ensure partner countries are able to formulate and effectively maintain such policies through capacity building of key organisations such as ministries of finance and central banks. Given *Sida*'s experience and resource base, such support might focus on budgeting, taxation, accounting systems, and audit procedures.

#### **6.4 Laws and regulatory framework**

The legal and regulatory framework of a nation is critical for economic growth, a healthy market and private sector development from two basic points of view.

- 1) The conditions of 'rule of law' set the parameters for economic players, the willingness of local and foreign investors to invest and their investment choices, and their behaviour in general.
- 2) There are specific regulations governing the market and the private sector. The most important are commercial laws, property laws and contract laws, essential to the 'cost of doing business', and for the interplay between business, government and civil society.

Lawlessness in society is bad for business. Businesses in lawlessness environments tend often to be bad for society. A vicious circle is created. While establishing rule of law is a task with broader objectives than economics such as establishing conditions for human rights, good governance, and a democratic society, it also contributes to a conducive environment for economic activities and for growth. The poor tend to be the first victims of lawlessness, including in their economic activities, and are often the major beneficiaries when rule of law is established.

A prerequisite for a dynamic economy is a system of rules, which reduces transaction costs in the economy by making economic transactions predictable and allowing the enforcement of contracts. Many countries are in the process of shifting from traditional economic systems, including customary rules of ownership, often intermingled with colonial imposed systems, to modern systems in a short period of time. A common problem is that the new and old systems operate simultaneously, and the penetration by the modern is often shallow. It has been noted that as much as 80% of the legal issues of the poor are dealt with

<sup>20</sup> See, for example Rodrik & Subramaniam 2003 op cit

through customary law and/ or informal systems, for example concerning property rights. In most developing countries traditional laws are highly discriminatory against women, preventing women from owning productive assets, for instance.

**Box 21. Examples of laws directly relevant for the private sector and the functioning of markets**

- Property laws
- Contractual laws
- Commercial law
- Company law
- Accountancy law
- Banking law and financial market laws
- Stock exchange law
- Laws concerning property rights
- Intellectual property rights law
- Laws of association
- Credit legislation
- Insurance laws
- Bankruptcy law
- Laws concerning competition, including anti-trust laws
- Laws concerning compensation for damage
- Rental laws
- Laws concerning consumer safeguards
- Labour laws, minimum wage laws, working safety laws
- Laws concerning environmental protection
- Taxation laws

Lessons learned by donors in support of assisting developing countries to build appropriate and effective regulatory frameworks for the private sector and markets include:

- Genuine ownership and a local interest in the reform of the judiciary system is more critical than in most other forms of development assistance due to the proximity of politics and law.
- Better analysis is required of the specific circumstances in which development takes place, including customary systems, existing institutions which might facilitate or hinder a development process. 'Holistic analyses and approaches' are needed.
- Donor support for building legal frameworks in general and for economic transactions specifically, has tended towards ethnocentric features, i.e. a belief in transplanting systems from developed countries to developing, and a disregard for the existing customary systems.
- A long-term support process is necessary in order to build institutional and human capacity. 'Legal transplants' don't work.
- A legitimacy building process for the framework, requiring the involvement of the economic players, civil society, and others, is required.

*Donors can* play an essential role in assisting countries in making the legal and regulatory framework more enabling for business development, and for a pro-poor PSD. This might include assistance in:

- Modernising appropriate commercial laws, contract laws and property laws. Such support should be based on a systems approach, in which the ‘sector’ is first reviewed, rather than on ad hoc measures and ‘legal transplants’. Note should also be made of the fact that commercial law often is a good entry point for more politically sensitive judiciary reforms.
- Facilitating the harmonisation of the commercial regulatory system with international practices and legal frameworks. This concerns primarily foreign investments and trade. A special case is assistance to reforming the legal framework for economic activities for countries applying for EU membership.
- Paying proper attention to customary law and informal rules and laws governing economic activities involving the poor, for example in terms of property rights, land use, and the relationship between tenants and owners.
- Adjusting/reforming formal commercial regulatory frameworks to eliminate legal biases against economic activities essential for the poor. This includes, inter alia, legal frameworks concerning the informal economy; financial regulations preventing non-collateral based micro finance and others.

*Sida* is in a good position to assist countries with an appropriate regulatory framework for the private sector. Not only was Sweden early in establishing such systems itself (for example the oldest general company law concerning limited liability in the world was established in Sweden in 1844<sup>21</sup>), but Sweden has overall an appropriate legal system combining competitiveness with social and ecological concern.

## **6.5 Governance**

As the regulatory framework establishes the ‘rules of the game’ for the market and its operators, implementation determines transaction costs. Bureaucratic red tape, corrupt practices, slow performance of essential public institutions, add costs, slow down businesses and lead to various distortions. These factors might cause export-oriented enterprises to be non-competitive, stop others from growing, or lead them to prefer to operate in the informal, less controlled, but also less growth-oriented economy. They are an obstacle to foreign investors and for trade. They are particularly a problem for small enterprises, including small-scale agriculture, as their means to pay their way by-passing all the obstacles are less, and their political clout small. Good governance is often more important for the poor than for the rich, as the former are more affected by bad governance than the better-off. Good governance is not a ‘luxury product’ and an effect of growth as is sometimes argued, but very much a cause of growth.

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<sup>21</sup> Chang, op cit.

**A saying in Tanzania's public sector:**

"The government pretends it pays us, and we pretend we work..."

Recent research by the World Bank indicates that disappointingly little has been achieved in terms of 'good governance' during the last decade in most developing countries. It often requires changes in administrative cultures, major reforms of the public sector, simplification of procedures (often resisted by the bureaucrats as it reduces power, employment and 'rent-seeking' opportunities), and it requires a process of responsible corporate culture in the private sector. Many of the efforts to replicate models from developed countries have failed, and the donor community is currently searching for new models. The focus is on the role of civil society, on the media, and other groups that can act as correctives. It is to a large extent a matter of political will, of the quality of leadership, aspects that donors rarely can influence, but, on the other hand, can support when the political willingness already exists.

In terms of private sector development, good governance is critical both as an element of the general environment for business, and for the business specifically. In the latter aspect, the accountability, fairness, honesty and effectiveness of such government functions such as taxation, customs, business licensing authorities, bank inspections, but also authorities supervising infrastructure such as harbours, determine transaction costs, predictability, and the overall business culture. Corruption, is a major distortion of markets, leading generally to sub-optimal resource allocations based on cronyism and political connections, rather than efficiency of operation.

*Donors can* support countries in improving governance in general, and governance of specific relevance for business development, through many means. Capacity building in public organisations has a long tradition in bilateral assistance. It was initially believed that such capacity building was a mere transfer of know-how, and that the organisations would 'take off' after an initial dose of technical assistance. However, the political economy of governance is coming to the forefront, and issues of corruption and 'rent-seeking', words never used before, are now common-day language in ODA. Donors, including Sida, must be less lenient with 'rent-seeking' and inefficiencies than is often the case, but also be aware of the fact that poor pay in government in the aftermath of donor-driven public sector reforms, promotes neither honesty, nor efficiency. Effective taxation system is also often a pre-requisite for the emergence of an effective bureaucracy. The success story of the Asian NICs is partly explained by the fact these countries traditionally had reasonably efficient and non-corrupt public sector organisations.

Sweden places high priority on good governance, transparency and non-corrupt practices in development assistance. Sweden has also strong traditions in this. Analyses of the Swedish success story in development during 1870–1970 often point at the honesty and efficiency of the Swedish bureaucracy as one determining factor<sup>22</sup>. Sweden ranks high for

<sup>22</sup> De Vylder: *The rise and fall of the Swedish model*, UNDP Occasional paper 26, 1996

its non-corrupt, efficient public services. Furthermore, the principles of independent public authorities and of full transparency are essential factors. Given this, and Sida's experience and resource base, *Sida should have* a good comparative advantage for focusing on governance of particular relevance to effective business development, such as in customs, taxation and licensing agencies, all critical to the economic players in society.

# 7. The Meso Level: Resources for PSD

The 'meso level' is defined as the 'resources' or various forms of capital which are important for private sector development in general and poverty reducing PSD. These resources are essential both as determinants for the private sector, and increasingly as major markets for private operators. The following such resources or capitals are discussed below:

- financial
- physical (infrastructure, including transports, energy and telecommunication)
- human
- labour

## 7.1 Financial capital

There is a close relationship between economic growth and the development of financial markets. Financial market development triggers economic development and vice versa. Financial actors, such as banks, stock exchanges, risk-capital companies, credit institutes and insurance companies, are also a part of the private sector and, as such, essential service providers to businesses and elements of a market. Financial services are not just demanded by formal businesses, but also by the poor, both for personal use and in their economic activities. The formal financial markets have been notoriously bad in serving these markets, which have relied on informal suppliers. However, the world-wide growth of micro finance has paved the way for formal financial services to the poor and assetless.

Banking was a prime sector for nationalisation in the 1960s and 70s. In many countries it became a mistreated sector, utilised to underwrite unprofitable government enterprises. Also in economically successful countries the (largely private) financial system has been misused by cronyism. The lack of soundness in the banking system in many of the 'miracle economies' in South East Asia was disclosed with the financial crisis in 1997, triggering major banking reforms in countries such as South Korea and Indonesia. However, this crisis, and other financial crises in the 1980s and 90s – estimated to have cost the developing countries in the order of USD 1,000 billion and overnight resulted in massive poverty in countries such as Thailand and Indonesia – were not

all the wrong-doings of individual countries. These crises have partly been faults in the global financial system in the wake of the liberalisation of financial markets during the 1980s. As such, they are today subject for efforts to regulate the global financial system.

*Donor countries can* assist in the development of effective financial market(s) at different levels. Thus, at the international level, donors can support the establishment of International Financial Standards and Codes (IFSC) in order to reduce the risk and costs of global financial instability. These codes and standards include transparency of economic and financial policy, sound institutional and market infrastructure, and effective financial regulation and supervision. This framework is essential both from the point of view of establishing a more predictable and stable international financial environment and as standards for individual countries. An important initiative is the development of the IFSC and The Financial Sector Reform and Strengthening initiative (FIRST). For more information, see [www.firstinitiative.org](http://www.firstinitiative.org).

#### **Box 22. Sida support for financial sector development**

In recent years, Sida has stepped up its efforts to prevent financial crises in partner countries. For example, the Central Bank of Sweden, in co-operation with Sida, provides capacity building advice on monetary policy and capital market reform to the central banks of Uganda, Sri Lanka and Vietnam.

Donor agencies can at the macro level provide assistance in: the shaping of financial policy, in setting up legal frameworks for central banks, for the banking sector and the capital markets, and for the insurance sector; establishing and strengthening banking supervisory authorities, inspection units, national debt offices and other authorities governing the financial markets. At the micro level, donors have been active in promoting various financial services, either emerging from developing countries, such as micro finance, or by promoting models and systems from developed economies, such as stock exchanges, venture capital funds and leasing companies.

*Sida has* good know-how in financial sector reform and financial sector development based on past experience and Sida's resource base. Such assistance includes technical assistance, such as advice on policy and legislation, restructuring and privatisation of former state-owned banks,

#### **Box 23. Sector approach to financial markets**

Uganda has launched a Financial Systems Development Programme co-ordinated by the Bank of Uganda. The Programme is supported by Sida and the German GTZ and marks the start of a long-term co-operation in the financial sector with elements of the "sector wide approach". The Programme views the financial sector as a system of independent but interrelated segments and actors. It includes not only support to financial institutions but also to the institutional and structural framework, e.g. financial sector policy, prudential regulation and supervision.

training of staff in banks and other financial institutions including Central Banks, the development of new institutions such as stock exchanges and supervisory systems. An example of a new style, sector-wide approach in financial markets is shown in Box 23.

### **Micro finance**

Micro finance is of particular interest to donors with a pro-poor and gender equality perspective. It has become a global industry, today counting some 7,000 Micro Finance Institutions (MFIs) servicing some 25–30 million mostly poor clients world-wide<sup>23</sup>. Micro finance, including savings and credit, and to a smaller extent insurance, has proven to be a powerful instrument for addressing financial needs and reducing the financial vulnerability of the poor, and of poor women in particular. The innovation of ‘social collateral’, i.e. guarantees by groups of people for the credits, combined with social mobilisation has allowed a very high repayment ratio. It is a sector which has grown with active support by donors underwriting most of these MFIs, and actively promoting micro finance in new settings. Today the micro finance industry is well established and increasingly moving towards commercial viability. However, only an estimated 3% of the MFIs are self-sustaining, the balance being subsidised to a greater or lesser extent by donors. The low degree of MFI sustainability is often more a problem of donors providing soft loans or grants, thus undermining the process of sustainability, than lack of inherent sustainability in the industry. Poor people are prepared to pay commercial rates for credit and are able to mobilise considerable savings.

Donors’ role in the further development of a successful and sustainable micro finance sector world-wide should have several thrusts:

- Reduce and eliminate subsidies to MFIs which distort the sector in countries where micro finance is well-established. It is important that coherent donor policies are applied, as otherwise highly subsidised and ineffective MFIs can undermine non-subsidised and effective MFIs causing long-term detrimental impact on the industry.
- Efforts to mobilise commercial capital or semi-commercial capital such as philanthropic funds to replace donor funding based on grants.
- Capacity building of MFIs in countries and markets where such services are not yet established.
- Focus on the ‘social mobilisation’ elements of micro finance, which was the hall-mark of the earlier efforts in Bangladesh, and which Sida has made significant contributions to in many countries, is labour intensive and demanding. These efforts are particularly important for the empowerment of poor women.
- Work towards a better balance between supply and demand for donor funds to MFIs. Today, there is in many countries an over-supply, driving distorting practices.
- Widen the financial instruments from credit, towards savings, insurance, and others.

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<sup>23</sup> Data from CGAP



*Sida* has a strong position in micro finance. *Sida* was one of the pioneers in development assistance to micro finance by actively supporting Grameen, BRAC and other pioneers in Bangladesh in the 1970s. *Sida* continues to support the development of the industry, today increasingly in multi-donor initiatives such as the World Bank-led CGAP, but also as elements of bilateral urban and rural development projects. Guidelines for *Sida*'s support to micro finance are being elaborated.

### **Venture capital**

In the 1990s venture capital was seen by the donor community as a potentially effective way of addressing investment needs in emerging economies, replacing largely unsuccessful development bank initiatives. Venture capital is a specialised financial service emerging in industrialised countries on a large scale in the 1980s and 90s and to a large extent linked to the 'new economy'. Venture capitalists provide long-term high-risk capital to emerging enterprises, prepared for many failures, but a few very high returning investments. The model was emulated in developing countries by specialised organisations such as IFC in the 1980s. Sweden is involved in venture capital financing in developing countries through Swedfund, and, to a lesser extent, through *Sida*. In spite of high expectations, the experience of this type of support has overall been disappointing, as the opportunities for high returns are generally low due to fewer investment opportunities, a higher degree of uncertainty and higher costs for management<sup>24 25</sup>. While venture capital is likely to expand through commercial initiatives at least in some developing countries, the justification for donor support for such private sector initiatives must be clearly spelled out, and linked to the fact that there are clear positive externalities at hand, for example that a pioneering venture capital fund is likely to trigger broad changes in the financial market such as improvements in government policies and regulations.

*Sida*'s role in venture capital funding is limited, given the specialised agencies available.

## **7.2 Physical capital: Infrastructure**

### ***The importance of physical capital***

Physical infrastructure, such as roads, bridges, railways, harbours, lighthouses, airports, as well as systems for power transmission, water, telecommunication and other electronic media, are critical for business development, whether in basic agriculture or sophisticated manufacturing. Efficient and accessible infrastructure reduces production and transaction costs, enhances productivity and competitiveness internationally, nationally and regionally, and is often a pre-condition for business in the first place.

Infrastructure is not only physical facilities. It is also a matter of efficient operation and maintenance of such facilities. In many countries in Africa donors built roads and other infrastructure only to find these

<sup>24</sup> Lindahl, C.: *Risk capital and poverty. A desk study of Sida support for venture capital funds and risk-capital for micro finance as means of poverty reduction*, 2002

<sup>25</sup> IFC: *Investment funds in emerging markets*, 1996

deteriorating almost as fast as they were built. Roads that make transport slow or which are seasonally impassable, increase transport costs and time, and may prevent market access. Harbours with very low turn-over rates make shipping expensive and non-competitive. Frequent breaks in electricity hamper most types of industrial production and agro-processing, resulting in higher costs and lower productivity.

#### **Box 24. The impact of rural electrification in Mozambique**

A recent impact study of the electrification in the Nampula province shows that benefits are reaped by all strata of the population: local cotton industry expands, providing new job opportunities, directly and in the form of contract farming; small businesses flourish; security in electrified villages is improved thanks to street lights; electrified hospitals and health posts can operate around the clock, and medicines and vaccines can be kept refrigerated and instruments sterilised; schools start two-shift operations, and female enrolment and examination in both primary and secondary education is dramatically enhanced.

Åkesson G. et al.: *Study on the impact of rural electrification in the Ribáuè, Namigonha and Iapala areas, Ribáuè District, 2002*

Poorly managed infrastructure, in combination with unjustified under-pricing of utilities, might 'cost' developing countries in the order of USD 200 billion per annum, or four times the total value of ODA. Reforms of infrastructure are critical, and various types of privatisation have been introduced during the 1990s. A considerable amount of experience from infrastructure reforms in developing countries has been gained during the last two decades, resulting in emerging 'best practices' for infrastructure reforms.<sup>26</sup>

Infrastructure development can be an effective pro-poor business development strategy: rural roads or rural electrification tend to spur considerable local economic activities. Agriculture, fishery and livestock are particularly dependent on physical infrastructure such as extensive road networks from highways to rural roads, harbours and other marine infrastructure, warehouses, public markets, refrigeration facilities and irrigation systems. Physical access to markets is one of the greatest determining factors for the economic welfare of smallholders. Rural electrification can spur local agro-processing, and small-scale rural industries. Telecommunication which increases access in rural areas, contributes to reduced transaction costs in rural private sector endeavours, by improving market information and reducing the asymmetric relationship between poor producers and more resource rich buyers.

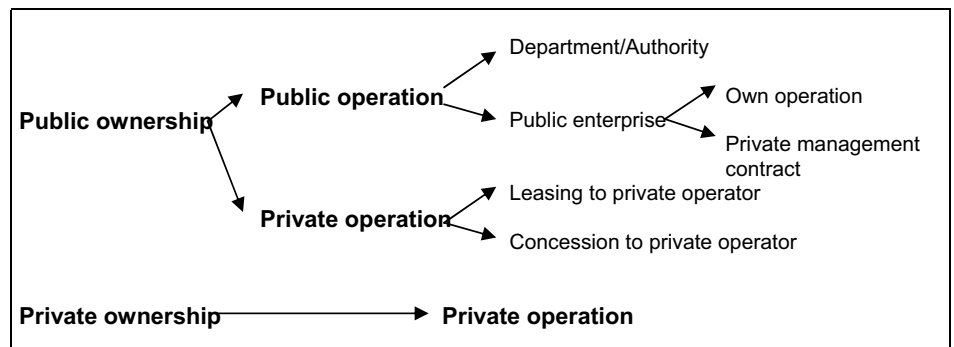
#### **Reforms of infrastructure operations**

Effective, poverty reducing private sector development is not only dependent on infrastructure. Infrastructure is also an important and increasing sphere for private sector operations. This involvement can take many forms, from a limited management contract of a publicly owned

<sup>26</sup> World Bank: "Private Participation in Infrastructure in Developing Countries Trends, Impacts, and Policy Lessons"; Clive Harris, 2003

and operated facility, to full fledged private ownership and the operation of an infrastructure facility. The figure below indicates various options in terms of ownership and operation:

**Figure 2**



The options depend on the type of infrastructure. Some types of infrastructure lend themselves poorly to private ownership or private operation due to their character as public goods or natural monopolies. Rural roads are a classic example. However, a seaport which also constitutes a natural monopoly, can be privatised with considerable gains in efficiency through a leasing or concession arrangement reached through a competitive bidding process, as shown in a country such as Mozambique. Also the privatisation of the operation of railways, a notoriously poorly managed facility by the public sector in many countries, has proven to be successful in terms of efficiency in operations and may even generate revenues to the government (See Box 25). In some types of infrastructure, such as telecommunications, technological innovations have allowed successful introduction of competition in areas previously subject to monopoly. Also in electricity generation competition is possible although such reforms are complex and may involve considerable risks to society.

Experience from telecommunication reforms shows that competition – even with only a few market actors – is a powerful tool for bringing about increased efficiency and dynamism in a market. In a country like Uganda which (like Sweden) started its telecommunications reform by allowing the entry of new actors, consumers saw rapid improvements. Even the state-owned telephone network improved considerably. In countries which, on the other hand, have chosen to maintain the previous monopoly while privatising the public telephone company, the outcomes have been much more problematic. Although the revenues from sales of protected monopolies may be larger, the losses to consumers and society are usually much greater<sup>27</sup>.

The investment needs in infrastructure in developing countries are enormous – according to one estimate USD 200 billion per annum. Public funding and local capital markets are clearly not capable of raising all the necessary capital. International flows of capital in the form of lending to build-operate-transfer (BOT), FDI or portfolio equity

<sup>27</sup> World Bank: Telecommunication Reform in Uganda; Mary M. Shirley et.al.; June 2002

### **Box 25. Sida and the privatisation of Zambia Railways**

No reform blue-print was in place in 1997 when Sida – after several years of discussions with the Zambian Government – decided to support the restructuring and reformation of the ailing parastatal Zambia Railways Ltd (ZRL). Sida assistance was provided to finance a management contract, to support the work of the ZRL Board and to support policy work by the Government in respect of the privatisation of the company. The project was regarded by Sida as a high risk venture. In March 2000, the Government of Zambia decided to privatise the railway through a concession. The World Bank agreed to provide a loan to facilitate the privatisation process. In February 2003, the Government of Zambia signed a 20-year-concession agreement with a private consortium. The concession is expected to yield some USD 253 million in revenues to the Zambian Government over the 20-year-period. Significant improvements in the financial and operational performance of the company has been achieved during the course of the Sida support.

investments increased rapidly during the 1990's. The Asia crisis as well as the economic downturn in Latin America halted this development and as of 1999 capital flows to infrastructure have contracted. The share of private capital in infrastructure is estimated to be in the order of 15% in the early 21<sup>st</sup> century. Several multi-donor initiatives have recently been taken to promote private investment in infrastructure.

Infrastructure privatisation has become increasingly controversial in many countries, especially in Latin America. Some water and energy privatisation schemes have failed due to strong opposition from groups affected by the abolition of subsidies in connection with privatisations. The building of an effective government regulating mechanism is critical. There is no guarantee, however, that a government will be more efficient in regulation than it was in supply. Therefore considerable work is required in establishing non-corrupt, transparent and efficient regulatory systems. Such regulatory systems, requiring laws and supervisory public bodies are complex and take considerable time to build.

In some cases reforms are not, and should not be, a matter of transfer ownership, for example in natural monopolies, but an issue of enhancing the efficiency of a public enterprise. The insight that privatisation does not offer simple solutions to problems generic to infrastructure, has led to a renewed interest in the public ownership and public operation options

### **Box 26. Promotion of private investment in infrastructure**

Sida supports several multi-donor initiatives for private infrastructure investments in Africa, for example *AIG Africa Infrastructure Fund for equity capital*; *Emerging Africa Infrastructure Fund* for long-term credits; Guarant Co for guarantees to domestic mobilisation of long-term capital, and *Private-Public Infrastructure Facility* providing technical assistance to governments that want to improve the legal and institutional investment climate for infrastructure investments.

for organising infrastructure. The previously common negative view of management contracts, may have to be reconsidered in the light of recent positive experience of such contracts<sup>28</sup>. The crucial factor is the quality of ownership and regulation exercised by government in its relation to publicly-owned companies. Experience shows that the developing countries which have demonstrated that they can be “good owners” are awarded by financial markets which may accept lending to publicly-owned companies without sovereign guarantees. The power company in Namibia, Nampower, is such a case.

*Sida can* support reform processes through many means. A learning initiative was set up in 1997, named Reforming Infrastructure and Public Enterprises (RIPE for change). Sida has been active in assisting partner countries in the reform of public enterprises in infrastructure. Reforms of infrastructure are critical for development in many of Sida's partner countries. The potential impact of reform support may be very high, but outcomes are often difficult to predict during project preparation. Infrastructure reform often can be politically controversial, requiring political sensitivity and a thorough analysis of the conditions under which reforms are being made. Failing to do so might result in serious political backlashes. Output based aid is a new, innovative form of assistance applicable in the provision of infrastructure services to the poor, which is relevant to Sida. See Box 28 below.

### **7.3 Human capital**

Human resource development (HRD), and private sector development are interdependent. First, the private sector depends on educated people, from the most basic forms of education such as learning to read and write, to advanced scientific education. One of the most important single factors behind the countries with the most rapid growth in the world over the period 1870–1970, Japan and Sweden, quite poor countries in the mid 19<sup>th</sup> century, was the reforms towards universal education for children. These gave rise to 100% literacy for both men and women quite early in the development process. The full capacity of humans could be used in modernisation of these economies.

Human capacity is more than skills formation. Health standards are essential. People that are malnourished, anaemic, sick from tuberculosis, malaria or AIDS, have a considerably lower capacity or no capacity at all to participate in the productive process in society. HIV/AIDS is expected to retard Africa's development and growth significantly, possibly in a similar fashion as the plague affected Europe in the 14<sup>th</sup> century. Investing in preventive and curative health, which improves the health conditions for large numbers of people (rather than the few which benefit from, say, advanced coronary medical support), is an essential investment not only for public health and human welfare, but also for private sector development. Health care aimed at poor women generally has a strong pro-poor PSD as poor women in many cultures have a disproportionate role as earners of the family livelihood, from agriculture, livestock, petty trading and crafts.

<sup>28</sup> Zambia Railways (see box) and the Tanzanian Power company, TANESCO, offer examples of apparently successful management contracts.

While education is an important determinant of growth, and a critical element of effective PSD, the balance between the supply of human skills and the demand in the labour market is critical. The history of development has proven that the educational system often has been out of tune with current labour market needs. School-leavers aspire to white-collar jobs in the public administration, shunning the labour markets in agriculture and the private sector. This has not only created a shortage of skilled workers in the latter sectors, it has also tempted many governments to bloat the public sector to absorb such potentially political verbal groups into unproductive public sector jobs created for no other reason than to pacify them. In many countries, the tendency to favour social science before natural science and engineering, often based in colonial traditions, is likely to have hampered the ability of such economies to absorb new technologies and innovations into productive development.

**Box 27. Schoolbooks in Tanzania: from state monopoly to market system**

During the 1980's it became increasingly evident that a monopoly system of textbook provision was not working properly. In 1991, the Government issued a new Textbook Policy, stating that the monopoly system was to be phased out. Textbooks should in the future be published by commercial publishers and distributed through commercial channels. Over a period of eight years, Sida supported competence development in local publishing and book-selling companies and the establishment of Government institutions for regulating the textbook market. These institutions included a national Education Materials Approval Committee and district Book Selection Committees. The new system was introduced gradually. The local publishers responded positively by investing in textbook development. A dynamic local textbook market emerged and today most textbooks are published by 7–8 competing publishing companies. The new system not only improved provision of textbooks in Tanzania, it also had positive side effects e.g. on other publishing.

Source: B. Lindahl, ÅF International

Second, human resource development is increasingly a private sector market. In many developing countries, the private sector has taken over a large share of the health care and education governments were supposed to deliver. For example, in the health care system private practitioners, private hospitals and private supply of pharmaceuticals make up as much as 70–80% of the total health care expenditures. This is mainly by default due to 'government failures', but sometimes also by design in planned privatisation schemes. Such systems often have various negative effects on public health. For example, they tend to lead to: 'supply induced demand', meaning an over-consumption of health services; a diversion of health workers from sectors of importance for public health, such as primary care, to highly specialised care for the well-to-do; and declining standards of basic health care.

For the private sector to be able to play a socially useful role as a provider, governments must put in place clear policy, a regulatory framework, and mechanisms to counter 'market failures', especially in terms of



distribution and equity aspects. All too often governments fail to do so, sometimes ignoring the fact that the non-public sector runs a large share of the health and educational system. Steering and co-ordinating the private sector in the provision of health care and education jointly with public sector efforts, utilising the private sector and civil society on a sub-contractual basis, and devising systems for the financing of basic services and making them available to all, require new skills and systems within governments.

Third, the private sector is the prime generator of resources for public HRD investments. Government failures in delivering universal basic social services such as education and health to an acceptable standard is to a large extent due to financial constraints, making the best intentions and bold policies of universal services to statements without content. Donor assistance can never replace these resources, and the fact that in some countries donors pay for a substantial share of the recurrent costs for public health and educational budgets, is more a sign of unsustainable systems, than a sound development practice or donor generosity. As a result, many developing countries 'under-invest' in human resources development from an economic growth/PSD point of view.

*Sida can* play an essential role in making the linkage between HRD and private sector development effective in the following ways:

- Make the linkage between HRD investments and overall economic development clear in the dialogue with partner countries. It should in this context be stressed that there is no inherent conflict between a human rights perspective in health and education and a pro-growth and pro-PSD perspective. Rather, a pro-poor growth perspective largely coincides with a human rights and basic needs approach.

#### **Box 28. Output based aid for the poor**

Output based aid is a concept launched by the World Bank in the context of private sector supplied social services or utilities. Private for-profit or non-profit providers are contracted to deliver such services, and their payment is based on the output delivered. Such output is measured in, for example, the number of children immunised, or children reaching a certain standard in terms of literacy. The concept can also apply to utilities, such as providing poor communities with water or electricity, etc. See <http://rru.worldbank.org/obabook.asp>

- Support countries to use the private sector more effectively in HRD by assistance in creating appropriate policy, regulatory frameworks, subsidy schemes and financial systems designed to utilise all types of providers and provide services to all. The concept of output-based aid is an innovation in this context, see Box 28.
- Work towards more effective HRD in countries which have liberalised the markets for health and education towards more fair systems. Counteract the dismantling of well-functioning public systems.
- Support countries to develop educational systems which are more in line with demand from local labour markets.



- Support the reform of higher education in order to make such education more private sector and growth oriented. For example, promote shifting from social science to natural science, agriculture and engineering.

## **7.4 Labour**

Labour markets, a subset of human capital and defined as the supply and demand of labour, are essential for private sector development from two perspectives: 1) labour is a key resource, if not the most important resource, for business. The availability, cost, productivity and creativity of labour determine the outcome of commercial operations; 2) the labour market determines economic returns to labour, working conditions, rights, and other outcomes. It determines the extent to which poverty objectives are fulfilled or not.

Poverty eradication takes place when labour markets develop and absorb more of the poor into employment with decent wages. Such changes take place when an economy is expanding. Then the supply and demand equation for labour changes, putting upward pressure on the price of labour, especially for labour in under-supply such as skilled workers. It is when labour is scarce that collective actions by labour unions can be powerful and labour legislation effective. Thus, the political and economic dimensions of labour markets tend to go hand-in-hand. The dilemma in most, if not all poor countries, is that the demand for labour is less than the supply, putting strong pressure on wages downwards and forcing the majority of the populations to seek self-employment or temporary low paid jobs in the informal economy. In contrast to industrialised countries, in developing countries unemployment is not a way of countering imbalances in supply and demand, as the poor cannot afford to be unemployed and must seek a livelihood at almost any level of pay. Labour legislation, collective actions through unions, and other measures, can be important for the improvement of conditions for employees, but these actions can not substitute for the market forces. With demographic conditions characterised by 40–50% of the population below the age of 15, and population growth rates of 2–3%, the ability of a developing country economy to generate gainful employment, and to absorb the new entrances into the work force, is extremely limited.

The labour markets in developing countries tend to be dualistic: on the one hand, there is a formal sector with certain regulations, basic workers' rights, minimum wage legislation, a labour union presence; on the other hand, there is an informal labour market, characterised by the absence of formal regulations, whether minimum wages or any other rights of workers, and no labour union actions. Working conditions and wages tend to be considerably better in the former than in the latter. In poor countries, the informal economy is by far the most important source of employment, if self-employment is included. This is not by choice of the poor, but due to the inability of the formal sector to generate employment to absorb more than a small share of the job-seekers and new entrances into the labour market. Contrary to the expectations of the 1970s and 80s, when the informal economy was 'discovered' by the donor community, it has not reduced in scale, but expanded in most

developing countries. In Africa, the informal economy accounts for 90% of the new jobs created during the last decade. In addition, there is a process of change in formal sector employment towards sub-contractual arrangements with non-formal work units and temporary jobs. The changing importance of the informal economy tends to be inversely related to the performance of the economy as a whole. The most rapid expansion takes place in poorly performing economies.

Labour is increasingly subject to globalisation trends. Multinational enterprises are outsourcing production and services to low-income countries, restructuring the division of labour between nations. This form of job creation is essential in changing local labour markets in some developing countries, not only for the direct employment created, but also indirectly for sub-contracting arrangements and services. It is often a force for modernising labour markets, providing working conditions more similar to developed economies than the developing in terms of working conditions, not in terms of wages, but in skills-upgrading, rights and services. The downside is that only few developing countries are attractive in this out-sourcing process.

Poor people in developing countries are an equally strong force for generating income outside their home countries through the process of temporary or permanent migration. In some countries such as the Philippines and Sri Lanka, remittances from workers abroad constitute one of the most significant in-flows of capital, equalling the major exports of these countries. On a global scale, remittances are a larger flow of capital to developing countries than ODA. However, this process is not evenly spread. Especially legal job-migration is attractive to limited countries, a process determined by the attractiveness of the labour market from the point of view of language. From one perspective, this globalisation of labour markets is one of the strongest and most dynamic forces for poverty reduction on a global scale. However, it is a force largely resisted by governments, enterprises and labour markets in the well-to-do countries due to the fear of losing jobs and privileges.

*Sida's role* in labour market development has so far been limited, with

#### **Box 29. FDI, Trade and Human rights**

Amnesty international has found that child labour to 95% is to be found in domestic enterprises, rather than in export-oriented enterprises. A reason might be that Corporate Social Responsibility and international consumer movements are putting strong pressure on multinational enterprises to weed out poor working conditions and child labour in own enterprises and suppliers in developing countries.

the exception of support through labour market organisations through the NGO window. This is to some extent a contradiction, given the considerable degree of development and organisation which is characteristic for the Swedish labour market. Sida could, through co-operation with Swedish labour unions, enhance support for effective labour markets through:

- advice on labour policies and legislation;
- advice and technical assistance to labour unions;
- harmonisation of regulations concerning formal and informal sectors;
- technical assistance in developing institutions for better performing labour markets.

# 8. Micro Level: Direct Private Sector Support

## 8.1 Many different forms of support

The forms of direct support to the private sector and market players which have evolved over the years are many. Several types of assistance can be distinguished in terms of donor support aimed directly at private sector operators:

- Financial assistance, either as grants, equities or loans with different degrees of 'softness'. Such support is either provided directly to an enterprise, or through a financial intermediary.
- Competence building through training of entrepreneurs, managers and technical staff, in a variety of fields. Such assistance is generally aimed at micro enterprises or SMEs.

### Box 30. PSD in Bolivia

The Bolivian Chambers of Industry and Commerce have received technical assistance from Sweden since 1993, which is aimed at improving the business environment and industrial competitiveness in Bolivia. The programme is based on a process-oriented approach whereby projects are gradually identified by the private sector itself and implemented by various co-operating organisations in Bolivia. Interesting examples of such projects are the certification of forestry production, the revision of the corporate law and the introduction of a Standardised Account Plan. To become successful such projects have to develop broad partnerships between all involved stakeholders (private as well as public).

- Promotional activities and match-making such as donors facilitating import to own country through fairs, export promotional activities and business-to-business contact promotional programmes for trade or joint ventures. Such support is aimed at mainly medium to larger enterprises. Sida has undertaken a number of such projects, especially trying to link Swedish enterprises with regional enterprises, such as in the Baltic states and Eastern Europe, or focusing on sector-specific promotion.
- Support of membership based private sector organisations for advocacy, such as Chambers of Commerce, Industrial Associations and

trade organisations. Sida has undertaken such assistance in a number of countries such as the Baltic States, Poland, Tanzania and Uganda. This support is often provided through twinning arrangements with Swedish private sector organisations.

- Technical services to enterprises in fields such as accounting, marketing, management, feasibility studies, costing and pricing and quality control. The assistance might include provision of consultants and experts. Such support is often called Business Development Services (BDS) and might be provided through public sector organisations. See below.

## **8.2 Business development services**

### ***Support to deal with market imperfections***

In industrialised countries many public or semi-public organisations have emerged for the purpose of nurturing the private sector, especially smaller enterprises. Many of these have been copied by developing countries often through assistance by the donor community. Examples of such organisations are exports and trade promotion; promotion of foreign investments and tourism; agencies for standardisation, quality control and certification; agencies for the development of small and medium industries; organisations for research and technology development. In agriculture almost every country has or has had public organisations for agricultural research, sometimes linked to a public seed-multiplication company and then linked to a government financed extension service system. Public organisations for the promotion of business in particular regions are common, such as various promotion agencies in municipalities and cities. Such regional or local business promotion and support systems have been copied to developing countries, often with the support of ODA.

The justification for these types of business support structures are a large extent related to market imperfections. Thus, some of these support organisations deal with positive externalities in the sense that the market tends to under-invest. This applies to F&U, agricultural research, and standardisation. Others are justified due to assumed information imperfections. For example, agencies to promote trade or FDI, agricultural extension, etc., are based on the assumption that the private sector at home and/or abroad does not have full access to information on markets, customers, etc., i.e. a public organisation can fill such gaps.

The effectiveness of these types of organisations as a means to stimulate business development varies. First, a key issue in development is to determine which organisations are critical in emerging markets. This means determining their importance at different stages of economic development, and the sequencing in developing such support systems. A lesson from development is that many such business support organisations were set up at the wrong time, leading to governments overextending themselves, both technically and financially with services that, at best, were marginally useful. There has been a tendency in donor support to replicate the systems of advanced economies in emerging ones, leading to the establishment of irrelevant organisations given the state of the emerging economy. These become a strain on financial and

managerial resources, and are finally unsustainable organisations, dependent on continuous financial aid in order to survive.

More important, however, is that many highly relevant support organisations were so poorly managed by the public sector that their assumed clients lost faith in them, making these organisations irrelevant. The most prominent example is agricultural extension. In many such cases the private sector has stepped in, such as in extension, but potential welfare gains have been lost in terms of reaching and assisting marginalised farmers.

### **Small business development services**

Government and/or donor sponsored projects and programmes providing (small) business development services in auditing, accounting, marketing and management through training, advisory services and information are common. In the past donors/governments tended to provide such services directly, often free of charge or at highly subsidised prices. These efforts were not only poor in achieving effective support services, but also undermined the emergence of commercial markets for such services. Donors have changed their approach in terms of BDS towards facilitating markets rather than replacing markets. Such facilitation should be based on how the BDS markets function in a specific country, and on an understanding of a possible lack of demand or poor supply. This new style of approach has been called a change in paradigm within the donor community<sup>29</sup>. The Committee of Donor Agencies for Small Enterprise Development has issued guidelines for donors in BDS support.<sup>30</sup> Commonly agreed principles for BDS are given in Box 31.

### **8.3 The case for direct interventions**

Direct interventions in markets and in the private sector by donors tend to be justified as efforts to overcome various structural constraints, such as undeveloped financial markets, financial gaps, lack of knowledge on behalf of the entrepreneurs, undeveloped markets for business services and lack of business organisations. Such interventions tend to be heavily subsidised or provided free of charge. The direct enterprise support is often modelled after industrialised countries, where subsidised interventions by governments to 'nurture' the private sector have been common. While there are many examples of meaningless and unjustified interventions both in developed and developing countries, there are also good arguments for some types of interventions:

- Externalities: If a government/donor intervention in a 'pioneering activity' can demonstrate the viability of a concept, and spur copying by other enterprises, thereby generating employment and spreading new technologies, the benefits to society are greater than to the single enterprise. The government/donor assumes the higher risk associated with the demonstration and the pioneering effort. The risk, of course, is that the pioneering effort is premature and ill adapted to the particular environment, leading to no spin-offs.

<sup>29</sup> ILO: *Business Development Services. Developing commercial markets for BDS. Can this give the scale and impact we need?* 2001

<sup>30</sup> *Business Development Services for small enterprises. Guiding principles for donor intervention*, 2001

- Information asymmetries: Especially small enterprises and the informal economy have clear obstacles in obtaining market information and information about recent technologies.
- Equity and distribution: Government/donor support to market players for the purpose of developing depressed regions, is a case in point. Support of business development for discriminated groups in society, e.g. ethnic minorities, is another example. Such equity considerations tend to be a trade off with the most efficient use of resources. Especially regional development might be a costly affair with limited long-term benefits.

#### **Box 31. Characteristics of BDS market development**

- Focus on markets
- View clients as customers
- Market transaction relationship
- Greater potential for sustainability – more limited use of subsidies
- Work towards goal of sustainable markets
- Work with many – preferably private – providers
- Roles: distinction between market facilitator and BDS providers
- Clear exit strategy
- Intervention focus on addressing market constraints

#### **... and the risk of distortions**

While there are arguments for certain types of direct market interventions by donors, there are also inherent risks with such support. These can be expressed as market distortions, and are of the following types:

- Distortion of the competition: This is almost inherent in direct support to individual enterprises, whether this is financial or technical. The assistance, if provided below cost, provides – at least in theory – an advantage to the recipient enterprise over other enterprises in the sector. Such distortions are negative in terms of efficiency – less efficient enterprises might be given an advantage, and there are also arguments of fairness and ‘level playing fields’.
- Sub-standard investments: Assistance provided below market price, especially loans, risk promoting sub-standard investments and enterprises, leading to an inappropriate allocation of resources in the economy. Similar arguments can be made for equity financing, when the expected return on such investments is below the market rate.
- Preventing markets from emerging: Subsidised or free business support prevents the development of a commercial market for such services, both by making enterprises expect subsidised services, and by crowding out commercial players.



#### **8.4 Principles for direct interventions in markets**

Direct private sector support is often hands-on and provides visible benefits to participants. It has a strong good-will value. Direct support to the private sector is also essential as a means of 'reality testing', to achieve direct feed back and maintain a dialogue with the prime movers in PSD. From this point of view, Sida can use opportunities in PSD to feed back information on structural constraints for PSD, which in its turn can be used in other forms of development assistance. Certain key principles which should govern direct support are:

- Assess each potential PSD intervention as to its leverage effect on the business environment. In general, to justify development assistance, the impact of the support must go beyond the enterprises targeted. Administratively costly support with marginal impact in a broader PSD perspective is poor resource utilisation.
- Avoid obvious market distortions in its direct PSD support by focusing on industrial or business sectors, including regional clusters, rather than on individual enterprises. PSD support should as a principle be open to any company in a sector. However, a system of selection might be required. Such selection might use the price mechanism as a means of allocating or could draw on quality assessment by professional bodies.
- Avoid subsidies of capital to commercial operators, unless there are very clear cases of externalities, and in such case only for higher-risk, pioneering efforts. Sida should particularly avoid distorting capital markets by providing subsidies to specific financial intermediaries.
- Carefully review direct PSD support risk of retarding and preventing development of markets, for example in business services or micro finance. In such cases, Sida should promote the development of such markets, rather than compete with them.
- Be restrictive in direct forms of PSD support, by-passing domestic organisational structures. In finding such structures, preference should be given to private sector organisations, especially in fields where there are no compelling arguments for a government intervention.
- Support PSD advocacy groups, especially for smaller enterprises, with the purpose of changing government policy, institutions and governance, as a means of creating change towards enabling environments.

# 9. Integrating PSD in Sida's Work

## 9.1 Sida's principles of work.

Sida's overall approach to development co-operation is well expressed in various documents, for example *Sida at work*, and requires no elaboration here. However, three aspects specific for PSD are discussed, namely:

- making PSD a truly cross-sectoral development effort within Sida;
- integrating PSD in Sweden's country strategy process and in PRSP;
- developing specific analytical instruments in order to integrate PSD in Sida's operations, especially the country strategy process; and
- working with the private sector in Sweden as a unique resource base in PSD.

## 9.2 Making PSD cross sectoral

PSD is at the heart of Sida's work and objectives. As discussed throughout the text, effective private sector development is dependent on peace and stability, human resources development, including health and education. Functional infrastructure and utility services is critical, as is good governance, democratic development and a vibrant civil society, i.e. the focus of Sida in a broad sense. But it is not a one-way stream: private sector development can also contribute to all these aspects of development. Thus, contrary to the title, PSD is not about a sector, but at the centre of Sida's development assistance, involving the whole organisation. Furthermore, PSD is largely an indirect form of development assistance, by which donors focus particularly on the environment.

Sida can reinforce this through several means:

- an on-going dialogue between the different sector divisions concerning the role of the private sector;
- an on-going competence development within Sida in terms of what constitutes an enabling environment for effective private sector development and pro-poor growth; and
- development of instruments for analysis and diagnosis of the private sector which can determine areas to prioritise for development assistance and assess various projects and programmes from a PSD perspective.

The latter is further elaborated below.

### 9.3 PSD in country strategies and PRSP

#### **The country strategy**

The country strategy process is Sweden's key instrument for development assistance co-operation, and should govern the direction of Swedish assistance over a 3–5 year period. The country strategy should be derived from a) Sweden's overall development assistance objectives; b) a country analysis and c) an assessment of past results of the co-operation. The critical element of PSD in this process is in the country analysis, and how the private sector dimension is incorporated into this analysis. A review of the country analyses for a number of countries indicated that the economic growth aspect and the private sector dimension tended to be poorly dealt with. A change in this requires certain re-orientation of the work for the country analysis, but more importantly, that Sida has appropriate tools to undertake such an analysis. See further below.

#### **PRSP**

The Poverty Reduction Strategy Papers (PRSP) is a World Bank initiative and today underpins much of the World Bank and IMF's support to specific countries, as it does assistance by many other donors. The PRSP describes a country's macro economic, structural and social policies and programs to promote growth and reduce poverty, as well as associated external financing needs. PRSPs should be prepared by governments through a participatory process involving civil society and development partners, including the World Bank and the IMF. See further Box 32. While growth is an essential element of the PRSP, a common experience is that many PRSPs are weak in outlining how growth can be achieved.

#### **Box 32. PRSP**

According to the World Bank, five core principles should be the basis for the development and implementation of poverty reduction strategies. The strategies should be:

1) country-driven — involving broad-based participation by civil society and the private sector in all operational steps; 2) results-oriented — focusing on outcomes that would benefit the poor; 3) comprehensive in recognising the multidimensional nature of poverty; 4) partnership-oriented — involving the co-ordinated participation of development partners (bilateral, multilateral, and non-governmental); 5) based on a long-term perspective for poverty reduction. See further [www.worldbank.org/poverty/strategies](http://www.worldbank.org/poverty/strategies)

Also, PRSPs largely focus on the role of government and sectors in which governments are key players, while the private sector dimension is less prominent. The donor community is active in improving the quality of the PRSP both as a general tool, and in specific countries, and over time the private sector dimension is likely to be given a more explicit role.

In conclusion, neither Sweden's present country analyses, nor the PRSPs tend to provide sufficient guidance for development assistance which is effective in promoting the private sector as an instrument for

poverty alleviation. Sida needs both in general and in specific countries to strengthen its capacity to identify constraints in the private sector and tailor-make interventions which are effective as change agents.

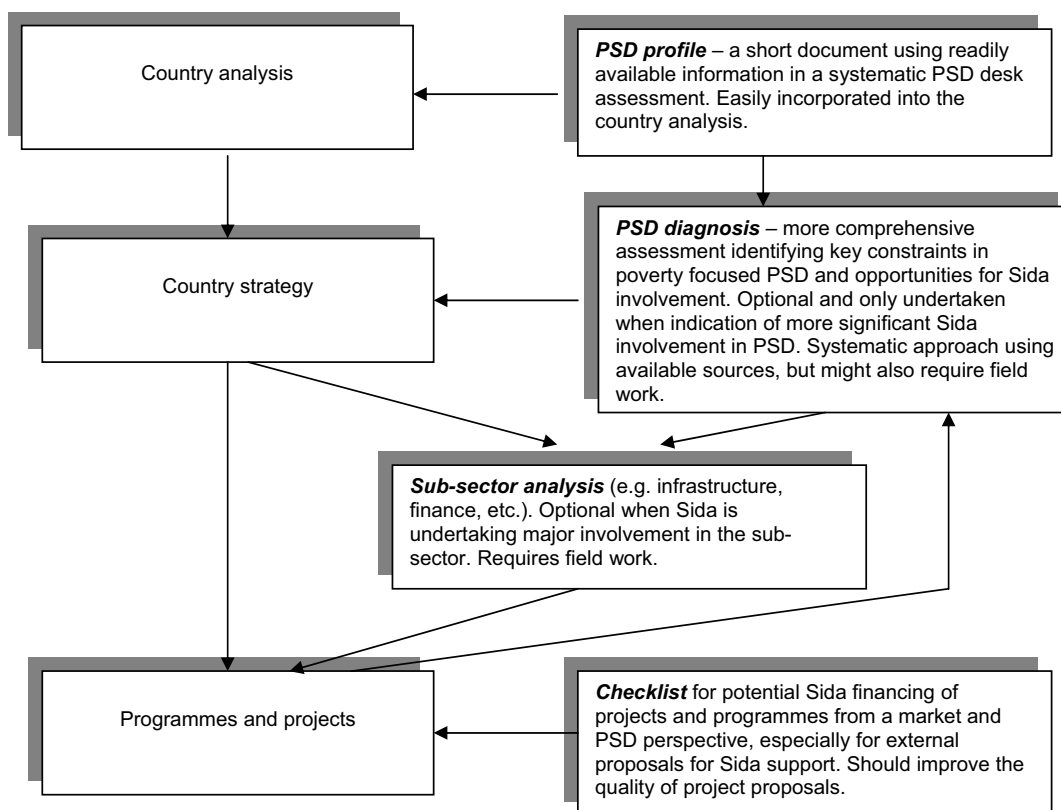
### 9.4 Diagnostic instruments for PSD

The following is a proposal for how private sector development can influence the operations of Sida, from the preparation of country analyses and formulation of country strategies, to assuring that specific Sida supported programmes and projects address key sector problems and take the market- and private sector dimensions into account. This is based on four specific tools:

- 1) a *PSD profile* or PSD ‘health check’ to be used as an integrated element of the country analysis;
- 2) an in-depth *PSD diagnosis* to be applied in the country strategy formulation process when Sida is likely to provide more than marginal resources for private sector related assistance;
- 3) *sub-sector analysis* for key elements of Sida’s PSD work; and
- 4) *PSD checklists* to assist in Sida’s assessment of specific programmes and projects proposed for Sida financing.

The roles of these tools and their relationships to Sida’s work are outlined below:

Figure 3



### ***A poverty focused PSD profile***

A short assessment undertaken in the preparation of a country strategy by Sida as a step in the country analysis. The profile, which should function as a 'health check' of the economy and the private sector, and its implications for poverty reduction, should be easily incorporated in the country analysis, either as an annex or in summary. It should be undertaken as a desk study by using pre-defined parameters, using readily available sources of information, and primarily relying on quantitative data for the analysis. This should be combined with a more qualitative assessment based on information from individuals within Sida, the Embassies, and other internal sources. It should also use readily available country documents such as the Country Poverty Reduction Strategy papers, the IMF country reports, EIU reports, and others. A guide for preparing such a profile will be given in a separate document.

### ***The poverty focused PSD diagnosis***

In cases where the Swedish government/Sida is considering more than marginal assistance in private sector development in a specific country, including key factors for PSD such as infrastructure, Sida might undertake a more comprehensive diagnosis of the economy, market performance and the private sector and consider their relevance to poverty reduction. Such a diagnosis would preferably be carried out in the context of formulating the country strategy. Such a diagnosis should be based on qualitative and quantitative information, both from readily available sources, and also through specific studies and the best judgement of staff in Sida and the Embassies. It should also use readily available country documents such as the Country Poverty Reduction Strategy Papers, the IMF country reports, EIU reports, and other sources. To a large extent, such a diagnosis should use pre-defined parameters to simplify the analysis and create consistency between different countries. An essential element of such a diagnosis would be to identify key constraints in PSD of particular relevance for poverty reduction, which might be subject for Swedish assistance. Such a diagnosis would also establish a framework for judging specific programmes and projects. The PSD diagnosis builds on the PSD profile, but goes further in terms of using data and in analysis. A guide for preparing a diagnosis will be given in a separate document.

### ***PSD sub-sector analysis***

Sector or sub-sector analyses are rarely undertaken by Sida, and can be a weak area of its work. The implementation of a Sida PSD policy would gain in effectiveness if sub-sector analyses were more common in subject matter fields such as finance, infrastructure, and others. Such analyses are also likely to improve the effectiveness of specific interventions by Sida. Some of the information for sector analyses are available from other sources, including work by multilateral organisations such as the World Bank. Certain elements of such a sub-sector analysis will be given in a separate document.

### ***PSD checklist***

The PSD checklist will be used in the assessment of specific projects and programmes suggested for Sida funding. It has two purposes: a) to make sure that the project/programme has sufficiently taken the market/private sector dimensions into account, and b) to have applied a clear poverty consequence analysis. An example of a checklist will be given in a separate document.

### ***The poverty and gender dimension of PSD diagnosis***

Information on development issues readily available in international statistics, data bases, country reports and so forth, is today overwhelming and furthermore, increasing by the day. This holds true for private sector related dimensions. Many international organisations have or are in the process of developing data bases open to the public and professional organisations in development, free of charge or against a fee. Other organisations rank countries' economic development, PSD, competitiveness, and other factors, based on a variety of parameters and criteria. In making the PSD policy effective, it is essential that Sida: a) uses such readily available information; b) avoid producing own information of the same kind; c) have a way of analytically processing such information. While the international data base on various aspects of PSD is overwhelming, there is, on the other hand, little in terms of data for assessing growth potential, PSD, competitiveness and other factors from a poverty or gender perspective, responding to questions such as:

- to what extent are the poor included directly in growth generating PSD?
- To what extent are women included directly in growth generating PSD?
- What are key constraints for poor/women for inclusion in PSD and growth?

While recognising the fact that effective growth and PSD also benefit the poor Sida needs to develop tools for the assessment of the poverty and gender dimensions of PSD.

## **9.5 Working with Swedish and other resources**

### ***Co-operating with the Swedish public sector resource base***

Sida works largely on the principle of acting as a broker between defined needs in partner countries and organisations, and individuals with relevant specialised competencies in Sweden or abroad. Over time, a considerable expertise has been developed through networking with specialised agencies and active involvement in certain areas of PSD, especially those essential for establishing enabling environments. Examples of such competencies are financial systems, from central bank capacity building to micro finance; infrastructure reform especially in the telecommunications and energy sub-sectors, institutional development in areas such as standardisation and certification and trade development. Some major public partner organisations to Sida for PSD are shown in Box 34.

### **Co-operation with the Swedish private sector**

Swedish, and other commercial enterprises and their organisations such as the Chambers of Commerce, the Confederation of Swedish Enterprises (Svenskt Näringsliv) and LRF (The Federation of Swedish Farmers), are essential partners to Sida in private sector development from several perspectives. First, these enterprises and organisations constitute

#### **Box 33. Examples of public partner organisations in Sweden for PSD**

- Central Bank of Sweden
- The Swedish Financial Supervisory Authority
- The National Land Survey of Sweden
- The Swedish Competition Authority
- Swedish Customs
- The Swedish National Debt Office
- The Swedish National Labour Market Administration
- The Swedish Patent and Registration Office
- The Swedish National Board of Trade
- The Swedish Central Securities Depository
- Statistics Sweden

expertise on what constitutes an 'enabling environment' for business development. They can assist Sida in improving its analysis and its instruments for private sector development on a general basis. Such formal and informal advice is taking place through board membership and in more ad hoc situations. Second, these enterprises and organisations can assist Sida in the diagnostic stage of defining constraints and opportunities in specific countries, either as they are already established in the partner country, or because they are utilised in as consultants. Third, commercial enterprises can be stimulated in developing direct commercial linkages through trade and/or investments with partner countries. This, in its turn, can result in the transfer of capital and technology. This has proven to be a significant force in the co-operation with Eastern Europe, especially in the Baltic states. Fourth, private sector organisations, such as the Swedish Chambers of Commerce, are essential twinning partners for the corresponding organisations in the partner country. Important in this context are also private sector organisations which play a role in providing specialised services to the private sector, such as the Arbitration Institute of The Stockholm Chamber of Commerce and the Stockholm Stock Exchange.

### **Co-operating with the Swedish labour market organisations**

Of importance as essential partners and resources to Sida in private sector development are also the Swedish labour market organisations. Organisations for the Swedish labour market such as the Swedish Trade Union Confederation (LO) and the Swedish Confederation of Professional Employees (TCO) have not only been instrumental in building a labour market in Sweden with high standards in terms of working conditions and non-discriminatory policies. They have also over many years been active in international co-operation through organisations



such as the ILO, and directly in institutional cooperation with trade union organisations in developing countries and transitional economies. An example of a recent joint initiative of Swedish labour market organisations is the Labour Market Dialogue, supported by Sida (see Box 33).

**Box 34. The Labour Market Dialogue (LMD)**

The central organisations in the Swedish labour market – the Confederation of Swedish Enterprise, the Swedish Trade Union Confederation, the Swedish Confederation of Professional Employees, together with their operating agencies, the International Council of Swedish Industry (NIR) and the LO-TCO Secretariat of International Trade Union Development Co-operation – have initiated a development co-operation programme focusing on the labour market and industrial relations, the pro-motion of trade unions and other human rights, economic growth and a fair distribution of resources in order to fight poverty in different countries in the world.

# Annex 1

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*Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.*



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