
Private Sector Development Strategy
- Issues and Options -

A DISCUSSION DOCUMENT

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PRIVATE SECTOR DEVELOPMENT STRATEGY

- Issues and Options -

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I. INTRODUCTION

This discussion paper is meant to elicit feedback on a select set of issues and options that may form part of the future Private Sector Development (PSD) strategy of the World Bank Group (WBG). The paper is the outcome of a discussion process within the WBG dating back to mid-2000 culminating in a discussion with the Executive Directors of the World Bank Group on May 23, 2001. The options presented in the paper do not constitute recommendations either of Management or the Executive Directors of the World Bank Group. However, the topics are seen as meriting serious attention and debate.

The paper is focused on six major themes:

- The creation of an investment climate that promotes growth and provides opportunity for the poor;
- The role of the private sector in enhancing access to social services for the poor;
- The role of private solutions in providing access to infrastructure services in environments with weak governance;
- Ways to deploy WBG instruments so as to shift performance risk from taxpayers in developing countries to private providers and to target subsidies better to the poor;
- Ways to impose disciplines on the provision of finance and advice to private parties by the World Bank Group so as to allow explicit targeting of subsidies on activities where such subsidies are required to support the poor or to deal with externalities such as environmental ones; and
- Transparent ways of measuring subsidies embedded in World Bank Group products and evaluating their impact.

A full-fledged draft PSD strategy is planned to be presented to the Executive Directors of the World Bank Group by December of 2001. That eventual strategy would broadly be structured around the following questions:

- How can the private sector best complement the public sector in achieving the overarching goal of poverty reduction?
- What is the role of development institutions in furthering and developing an appropriate role for the private sector?
- What is the comparative advantage of the World Bank Group in this respect?

- How can the different parts of the World Bank Group best complement each other in their PSD activities so as to contribute effectively to poverty reduction?
- How can the objectives of the World Bank Group's PSD work best be defined and measured?

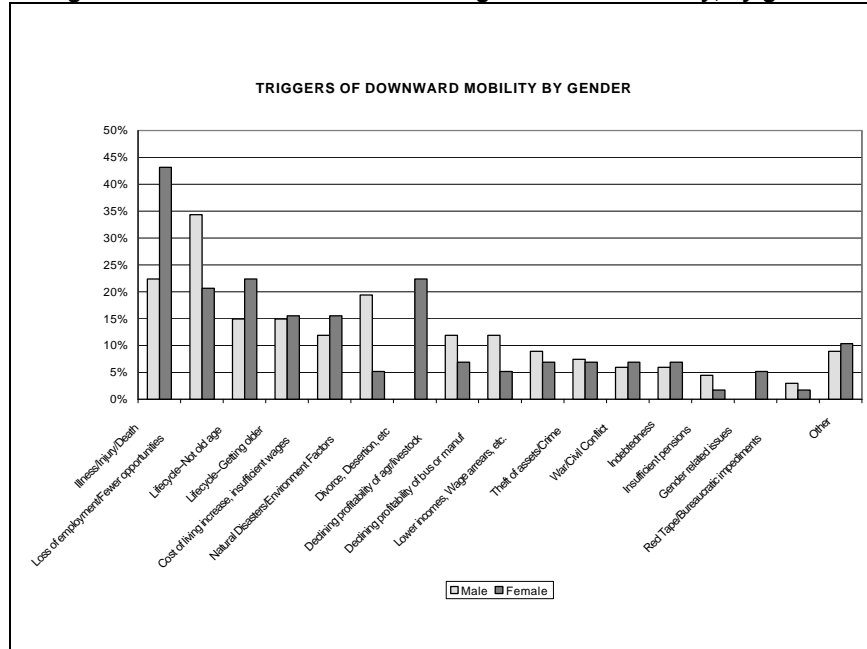
Answers to these questions are intimately linked, because any PSD strategy is not about a traditional sector like transport or education, but about a way of doing things. The ways of doing things that the Bank recommends to clients can also apply to itself. For example, if certain activities are better carried out by the private sector in a country, that might also apply to activities of the WBG itself, which should then leave such activities to private parties. Hence a PSD strategy has potentially broad implications for overall WBG strategy.

The six themes, on which this paper focuses, form only part of the issues to be addressed in a PSD strategy. They are intended to represent a set of particularly thought-provoking options that may yield new innovative ways of placing private initiative at the service of the poverty reduction effort.

II. PSD STRATEGY AND POVERTY REDUCTION

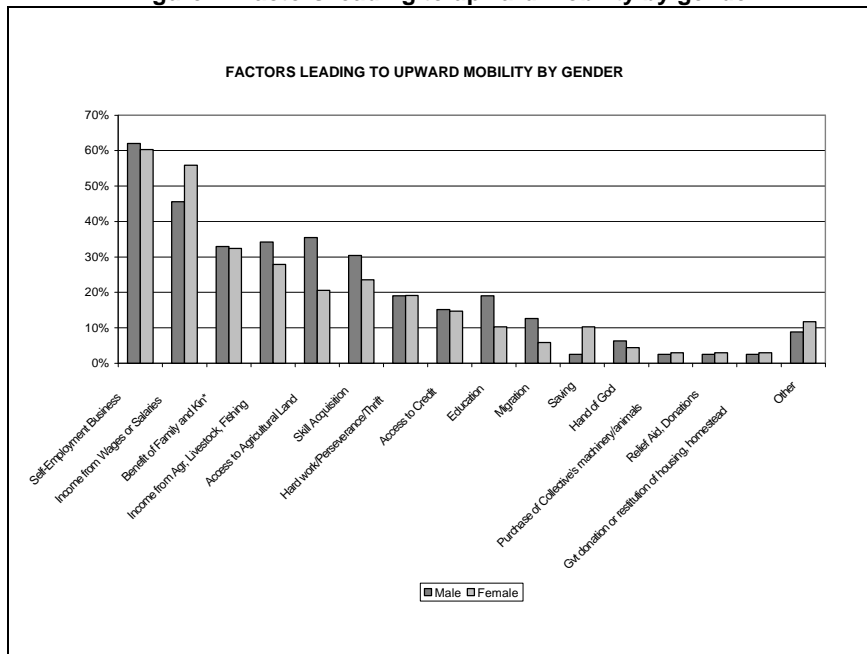
A. Opportunity for the poor. De facto, the private sector is one of the central features in the life of poor people across the world. Almost all of the poor pursue some form of private activity to earn their living. They may work as farmers, as small entrepreneurs or as laborers for others. Roughly two-thirds of the poor work in rural areas on farms or on non-farm activities. The Bank's study "Voices of the Poor" documents that next to illness and injury, the scope for entrepreneurial activity and the availability of jobs is the most important factor determining the fate of poor people – for better or for worse (Figures 1 and 2). Overall, opportunities for jobs and entrepreneurial activity in the private sector are critical for the poor. Hence the pervasive importance of small and medium enterprises, of small informal activity and of micro-finance services (Audretsch, 2000; Aw, Forthcoming; Hallberg, 2000; Morduch, 1999; Nugent and Yhee, Forthcoming; OECD, 1997; Snodgrass and Biggs, 1996). In many cases improved security of property rights for the urban and rural poor are means to improve their access to credit (de Soto, 2000; Dollar and Kraay, 2000). Access to credit enhances opportunity and security for the poor.

Figure 1: Shocks and stresses causing downward mobility, by gender



Source: Narayan et. al. (2000b).

Figure 2: Factors leading to upward mobility by gender



Source: Narayan et. al. (2000b).

B. Basic services for the poor. The poor also receive most basic services from private providers or through their own effort. Women in particular often suffer from poor service offerings and have to spend considerable time to obtain water and fuel for their family. Energy, water and communication services are typically privately provided in the

poor areas of the world, where national public sector networks typically do not reach. Basic health and education are also in large part provided by private parties to poor citizens (Table 1). Even where public services can in principle reach the poor have often voted with their feet and chosen private offerings due to better quality and service orientation (Narayan et. al., 2000a).

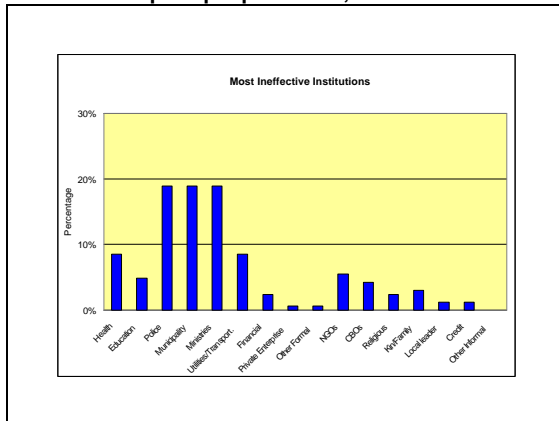
TABLE 1: PERCENT OF TOTAL HEALTH EXPENDITURES THAT ARE PRIVATE

	SHARE OF PRIVATE HEALTH EXPENDITURES	NUMBER OF COUNTRIES
All countries	53.6	115
Low income	63.1	32
Low-middle income	42.8	36
High-middle income	54	15
High income, non-OECD	62	10
High income, OECD	32.6	22
East Asia and Pacific	53.2	14
Latin American and Caribbean	58.1	32
Middle East and North Africa	47.4	11
South Asia	74.8	5
Sub-Saharan Africa	59.6	19
Rest of the world	29.3	34

Source: Filmer et. al. (1997).

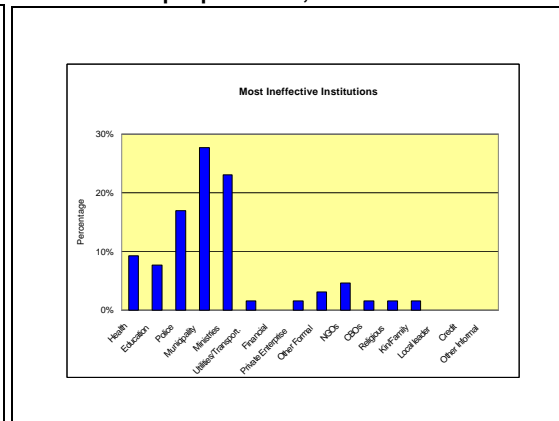
The people interviewed in “Voices of the Poor” consider private sector institutions to be much less ineffective than many other institutions. They like community-based organizations and family support better, but they have little doubt that the private sector is among the least ineffective institutions (Figures 3 and 4).

Figure 3: Most ineffective institutions in poor people’s lives, urban areas



Source: Narayan et. al. (2000b).

Figure 4: Most ineffective institutions in people’s lives, rural areas



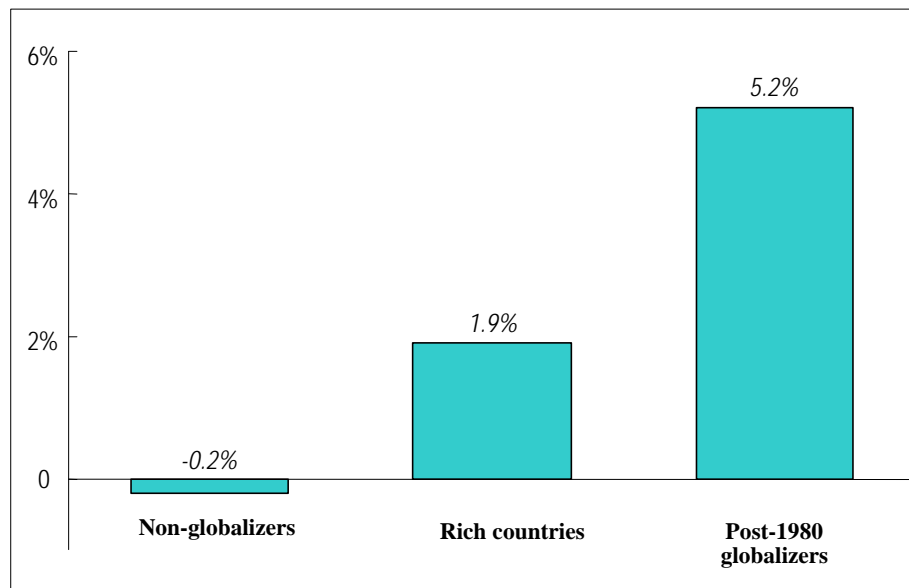
Source: Narayan et. al. (2000b).

C. The engine of growth and poverty reduction. The role of the private sector is not only relevant, because poor people happen to be employed in it or because they are de facto served by it. More importantly entrepreneurship and markets are critical tools to raise productivity and thus allow the poor not just to have a job or business, but a

progressively better paying one. Furthermore, the hope of better basic service delivery for poor people in many cases lies in shifting performance risk to private parties, while focusing the public sector's effort on improving the regulatory framework and building institutional capacity (West and Martin, 2001).

During the second half of the 20th century, for the first time in history, it has become possible for poor people everywhere to escape from poverty within a human life span. Prior to the industrial revolution, income and living conditions in the world had remained little changed for thousands of years. Today, a wide variety of countries have been able to double average per capita income in about 10 years (e.g. Botswana, Chile, China, Ireland, Japan, Korea, Thailand) – by adopting and adapting technical and organizational advances already invented elsewhere (Figure 5).

**Figure 5: Convergence and divergence in the 1990s
GDP per capita growth rates**



Source: Dollar (2001).

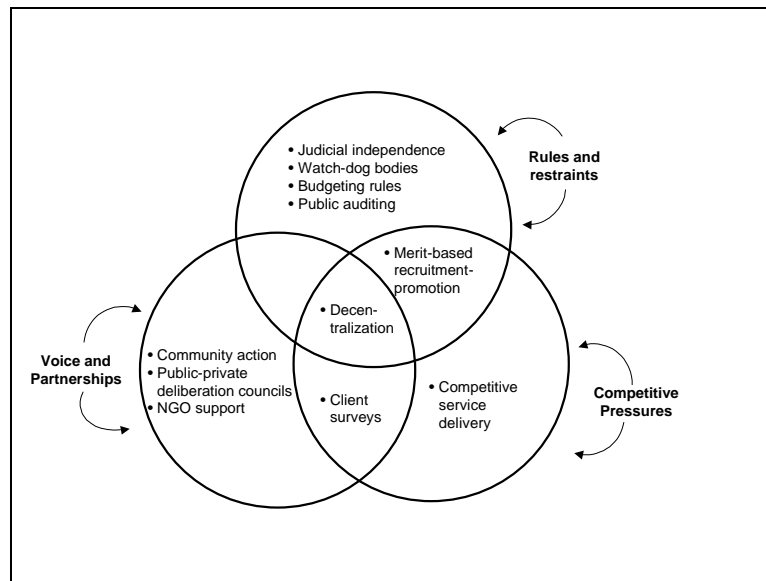
This growth in productivity is the very reason why we can even think about international development targets like halving poverty by 2015. By the same token we can today be upset about the lack of progress in poverty reduction in many countries, particularly Africa – precisely because growth and, therefore, rapid poverty reduction is now possible, but not automatic and growth does not always translate into effective poverty reduction – across countries or within them (Collier and Gunning, 1997; Stiglitz, 1998).

Enabling the poor to benefit from productivity advances and better service options is at the core of the development challenge. Effective poverty reduction requires a balance between the state and the private sector such that the private sector's initiative and efficiency is exploited in the interest of citizens and with respect for the environment. More broadly development requires functioning communities and a level of co-operation

and trust in society (“social capital”) (Collier, 1998; Fukuyama, 2000; Guisco et. al., 2000; Knack, 1999; Ostrom, 1997). At the same time competition is required that provides choice for citizens and that creates new opportunity for entrepreneurs and workers as well as incentives to improve productivity.

Getting the balance between competition and co-operation right is hard. We may characterize the critical task of institution-building as resting on three pillars (Figure 6) - voice and partnership, rules and restraints and competitive disciplines. The PSD strategy is particularly concerned with the introduction of competitive disciplines that help channel private initiative in socially useful directions. From this perspective PSD is a way of helping focus the state and other institutions on critical public functions and rendering them more effective.

Figure 6: Mechanisms to enhance state capability – three drivers of public sector reform



Source: World Bank (2000a).

The core of the contribution that the PSD agenda can make to development is the creation of a sound investment climate. A good investment climate promotes markets that provide opportunity for entrepreneurs and create jobs supported by adequate institutions (World Bank, Forthcoming). For example, in a number of cases a key role for the government is to open up entry for entrepreneurs and to provide citizens with choice. Such policy approaches and concomitant reduction in “red tape” also tend to reduce opportunities for corruption (Brunetti et. al., 1998; de Soto, 1989; Pfefferman and Kisundo, 1999; World Bank, 2000b)

Openness to “best practice”, entrepreneurs and markets embedded in decent governance systems are a key reason, why we can have hope for poverty reduction. The effective and rapid adoption of best practice requires openness to new ideas and technology. Competition provides incentives to adopt them (Geroski, 1990; Nickell, 1996; Scherer,

1992; World Bank, Forthcoming). Competition means free entry for new entrepreneurs. This creates opportunities for all sorts of firms, be they small, medium or large. New entrants try new ways of doing things and are crucial to the process of diffusing best practice. Competition also means choice for customers. This empowers consumers and makes firms responsive to them. Overall open and competitive markets, supported by facilitating public policies, have proven to be the best mechanism both to stimulate innovation and to spread best practice within countries and across borders. Growth, driven by such markets, is a powerful pre-requisite for poverty reduction.

For example, openness to technology imports and product market competition, particularly in demanding export markets but also among domestic firms, underpinned much of the growth of East Asian economies (Stiglitz, 1998). At the same time the experience of the Asian crisis has driven home the importance of governance mechanisms, particularly for financial markets (Caprio and Honohan, 2001). The most comprehensive survey (over 50 studies) of the experience with trade liberalization suggests that the costs of trade liberalization are small compared to the benefits (Matusz and Tarr, 1999). Liberalization and deregulation has tended to favor labor-intensive and rural occupations. This has produced a boost to growth and led to only relatively short episodes of increase in unemployment for a relatively small part of the affected population. This is not to downplay the hardship that may be imposed on losers in the process. However, without the introduction of market forces it has proved hard to raise living standards (Edwards, 1997; Frankel and Romer, 1999; Sachs and Warner, 1995; Srinivasan and Bhagwati, 1999; Winters, 1999; see Rodriguez and Rodrik, 2000 for a critique of the above).

In a similar vein, the experience with privatization, which is as controversial or more so than that of trade liberalization shows success - when done right. Studies of several thousand of privatization cases in countries across the globe suggest that privatization into a competitive or well-regulated market environment is typically better than state-ownership. Even when the environment was not prepared perfectly, privatization has fared relatively well compared to realistic alternatives (Barnett, 2000; Bernal and Leslie, 1999; Boubakri and Cosset, 1998; Boubakri and Cosset, 1999; Djankov and Murrell, 2000; D'Souza and Megginson, 1999; Earle and Estrin, 1998; Ehrlich et. al., 1994; Frydman et. al., 1999; Galal et. al., 1994; Harvylyshyn and McGettigan, 1999; Jones et. al., 1999; La Porta and Lopez-de-Silanes, 1997; Megginson et. al., 1994; Megginson and Netter, 2001; Newbery and Pollitt, 1997; Petrazzini and Clark, 1996; Pohl et. al., 1997; Shirley and Walsh, 2000).

The effective shift to private markets is normally critically dependent on opening up entry for new firms that are not controlled by incumbents – not just on privatization of existing assets. New entrants create new jobs and provide essential competition that disciplines state-owned firms as well as privatized ones provided they operate under hard budget constraints. This has proven particularly important in transition economies (Pinto et. al., 1993; see Frydman et. al., 1998 for limitations of budget constraints). Sometimes privatization has distributed wealth to well-connected parties. To prevent such effects privatization design needs to take into account the corporate governance environment and

ways to target benefits to citizens more broadly. Full privatization is not always the best approach. Where private participation is considered for natural monopolies, concession-type arrangements may play a useful role (Klein, 1998).

Connecting the poor to markets by giving them choice, by providing entrepreneurial opportunity, by building roads and communication systems – all such measures support the most powerful mechanism for escaping poverty, namely the ability to adopt and adapt improved practices. People also need some minimum of health and education to respond to new opportunities and increase income. As is well-known improved education, particularly of girls, is probably the most powerful tool to help correct inequality in income distribution.

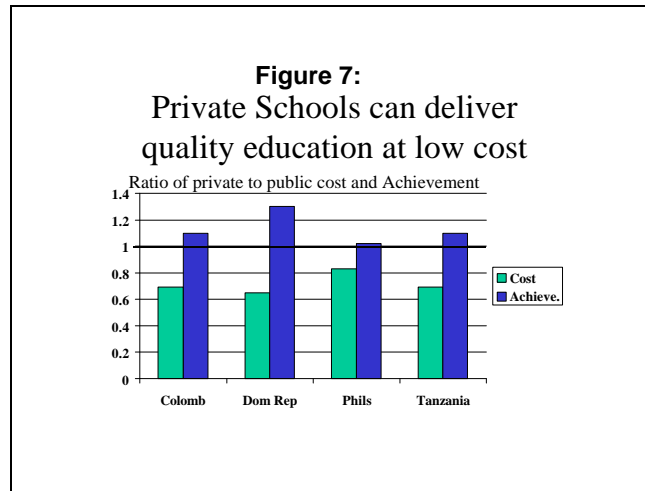
The interplay between better governance systems and the development of entrepreneurs and markets is crucial. This does not mean that countries need to wait for governance systems to be perfect before creating markets. Competition is part of the system of checks and balances that helps create good governance. The weaker the governance climate in a country, the stronger in many cases the argument for free entry and choice for citizens. In designing policy and project interventions government failure has to be weighed, case-by-case, against market failure.

D. Basic service delivery and the role of markets. The amount of potential resources available from donors is now relatively large compared to known poverty dimensions and the grant element in aid is now about 75 to 80 per cent of total transfers (World Bank, 2001). For example, in Africa's low-income countries the average aid level amounted to about 9 per cent of GDP during the 1990s. At the same time the poorest 20 per cent of people had incomes equivalent to just 4 per cent of GDP (World Bank, 2000c).

The world has become so rich that poverty elimination is within practical reach (UNDP, 2000). The critical elements are adequate resources and delivery systems with improved incentives such that intended beneficiaries are reached. A number of traditional delivery systems have failed to provide effective service, particularly to poor citizens and subsidies have often not been well targeted and reached richer parts of the population (Castro-Leal et. al., 1999).

The last decade has seen a number of experiments to tap the potential of private initiative to improve basic service delivery. Both in infrastructure and in the social services effective models have been tested (for infrastructure, see Bacon, 1994; Baker and Tremelot, 2000; Bartone et. al., 1991; Brook and Tynan, 1999; Brook, 2000; Collignon and Vezia, 2000; Ehrhardt, 2000; Estache et. al., 2000; Izaguirre and Rao, 2000; Klein and Roger, 1994; Komives and Brook, 1998; Komives et. al., 2000; Lawson and Meyenn, 2000; Mariño et. al., 1998; Maas, 2001; Roger, 1999; Saghir et. al., 1998; Wellenius, 2000; for social services, see Hoxby, 2000; James, 1990; James, 1991; Jimenez and Sawada, 1998; OECD, 1994; Filmer et. al., 1997; Shobhana, 2000; West, 1997). Despite abuses of privatization processes and despite remaining problems a number of private ventures have led to improved service delivery than alternative public providers for

example in water concessions in Abidjan, Buenos Aires and Santiago (Clarke et. al., 2000; Noll et. al., 2000) or in some education systems (Figure 7). Also, a number of developing countries have demonstrated that it is possible to improve electricity systems by way of operating wholesale market competition, most notably Chile and Argentina (Chisari et. al., 1999; Jadresic, 2000; Lalor and Garcia, 1996; Wellenius, 1997).



Source: Jimenez et. al. (1991).

More and more private and market-based schemes have not only shifted performance risk to competent private parties. In addition, in several cases public resources have been focused more directly on targeted subsidy schemes to reach the poor, for example in water and telecommunications (Bosch, 2000; Foster et. al., 2000; Gomez-Lobo et. al., 2000; Yepes, 1999).

III. THE ROLE OF THE WORLD BANK GROUP IN PROMOTING PRIVATE SECTOR DEVELOPMENT

A. Interventions of the WBG in support of PSD. Much of what the WBG does can help promote private sector development. At the broadest level the creation of a sound investment climate is the critical pre-requisite for private sector development. A sound investment climate requires macro-economic stability, good governance (e.g. rule of law, absence of corruption, functioning financial sector, a regulatory framework that safeguards social and environmental concerns), sound infrastructure and educated, healthy individuals. Various parts of the World Bank Group contribute to this. In this sense private sector development is being promoted across the Group. The contribution from the PSD operations of IBRD/IDA and from IFC and MIGA to the creation of a good investment climate lies in three broad areas:

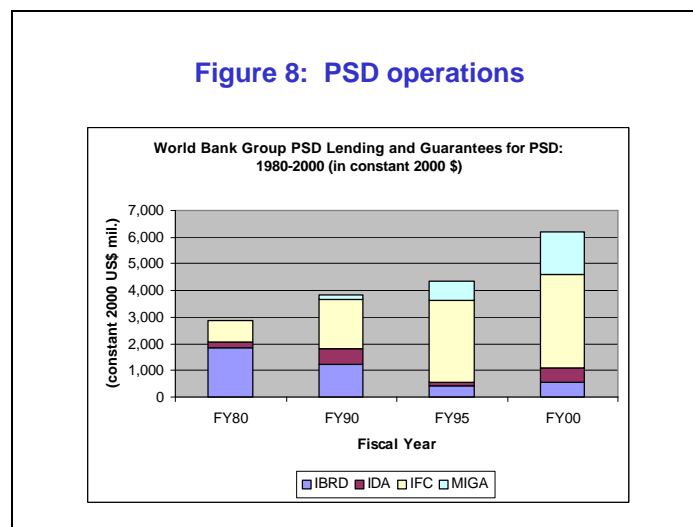
- Policy work and policy-based lending to promote open, competitive private markets (sound property rights systems, company tax systems, removal of entry and exit barriers, deregulation of pricing, etc.).

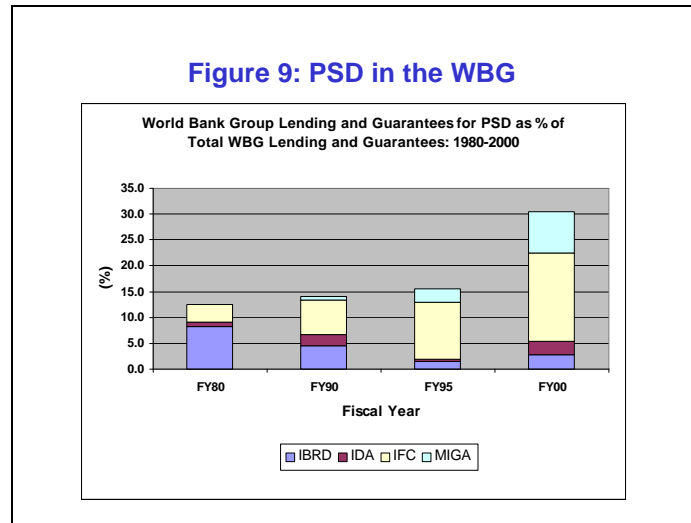
- Demonstration projects, direct financial or advisory assistance to SMEs and micro-enterprises (creation of support institutions for SMEs, micro-finance schemes, entrepreneur training schemes etc.).
- Support of privatization, concession and contracting-out options for the delivery of goods and services (choice of market structure, market design, regulatory regime, privatization process design and management, financial support).

Measured by lending and guarantee volume the WBG as a whole has increased PSD operations by about 60 per cent during the 1990s in real terms. In relative terms the share of PSD operations has increased from about 14 percent in 1990 to about 30 per cent in 2000 (Figures 8 and 9). This rapid increase in relative terms is due to the combination of the real increase in PSD operations combined with an overall absolute decline in IBRD operations.

The increase in PSD operations is mainly due to an increase in operations of IFC and MIGA. The Bank (IBRD/IDA) itself still lends in the order of US\$1 billion to private firms via on-lending operations. However, the Bank has withdrawn from lending to public enterprises in many sectors where competition and private participation works. IFC and MIGA have taken over here.

Taxpayers in client countries are responsible for paying back Bank loans even if projects or recipient enterprises do not perform. This is not the case for IFC and MIGA operations, both of whom assume the risk of project or enterprise performance. The shift in operations from the Bank to IFC and MIGA thus implies that performance risks have been shifted from taxpayers in developing countries to private investors. This not only promises to support growth but will also help reduce the exposure of taxpayers in poor countries to public sector debt and thus help reduce the dependency of poor countries on government debt.





Source: Bank Group staff estimates.

B. Core issues for discussion. Looking forward more and more sector strategies of the WBG have embraced the potential of PSD approaches as have, as a matter of course, IFC and MIGA. Competition and transparency are recognized as the tools that allow governments to become more effective and citizens to be better served by adopting PSD approaches. The recent public institution and governance strategy paper is written in a fashion complementary to the proposed PSD strategy, highlighting the scope for competitive disciplines to improve government performance (World Bank, 2000a).

While many sector strategies have embraced private sector development and while implementation is moving in the same direction a number of key areas remain, where some re-orientation of strategies might make sense. In some cases such re-orientation would affect the broad thrust of strategy, in others it would be more about disciplined implementation. The following three main themes may warrant further thought and re-orientation:

i. The investment climate

The WBG has undertaken much work in support of an improved investment climate in client countries. This ranges from work on the governance environment and institution-building including strengthening the rule of law via support for efficient financial sector development to the provision of infrastructure and social services that allow people to respond to economic opportunity. One particular feature of a good investment climate is the space it creates for entrepreneurs and markets to develop and exploit new opportunities for growth and job creation across the economy (Dollar, 2001; World Bank, Forthcoming). This is, of course, of particular importance for the development of small and medium enterprises. Furthermore, the Bank Group is pursuing the development of policies and practices that render private activity compatible with social and environmental sustainability. This includes efforts to foster corporate responsibility. The general direction for work on the investment climate is widely agreed. At the same time many detailed issues remain to be addressed and the WBG is grappling with these. The

PSD strategy will aim at providing goals and mechanisms to enhance the quality of work, two of which are highlighted here.

First it may be desirable to conduct more systematic work across countries and over time to improve the design and implementation of policy reform for a better investment climate. In addition, most direct financial or non-financial assistance to private firms appears ineffective when the basic policy and institutional framework is deficient – just like for aid effectiveness overall. To operationalize this basic approach there would also be a need for better systematic assessment of the quality of the investment climate across countries and over time. This would be needed to underpin better policy-based lending. In addition, decisions on World Bank Group interventions in support of firms could also be made on the basis of such assessments to prevent ineffective firm-level support. IFC's experience and interventions, which also help promote a good investment climate would need to be further integrated with the Bank's work.

Second, most PSD work has focused on supporting growth and thus hoped to support poverty reduction indirectly. More work may be required to assess the scope for more direct, effective pro-poor interventions. This would include (but not be limited to):

- Effective support to the development of small scale entrepreneurs;
- Ways to scale up micro-finance schemes;
- Improvements in property rights assignment and distribution;
- More aggressive incorporation of service obligations for the poor in private infrastructure schemes;
- More focus on complementing deregulation with the provision of basic infrastructure e.g. rural roads; and
- Targeted subsidy design.

None of this is entirely new, but it may require more focused attention.

Questions for discussion:

- **Is there agreement that the work on investment climate is critical and that the issues revolve around implementation issues?**
- **Are the highlighted implementation issues the critical ones and how should they be addressed?**
- **What role should the World Bank Group play vis a vis other actors including other multilateral or bilateral aid agencies or private actors?**

ii. Improving access to basic infrastructure services in weak governance environments

Free entry into monopoly segments in infrastructure. It is sometimes argued that public provision is preferred when governments have weak implementation capability for contracting-out or regulation. It is not clear that this follows, because weakness in exercising necessary regulatory functions is not necessarily improved by public provision. The alternative is to allow free entry even into natural monopoly segments of businesses, e.g. the wires of electricity systems or water pipelines. When that is allowed (Yemen and Cambodia - electricity, Somalia-telecom, Paraguay-water) consumers have more choice and service than when it is legally prohibited (as is the case in many low income countries). Allowing such small-scale entry of infrastructure service providers opens up options both for non-profit and for-profit providers and tends to rely on local rather than foreign providers (Baker and Tremolet, 2000; Brook and Tynan, 1999; Brook, 2000; Collignon and Vezia, 2000; Ehrhardt, 2000; Estache et. al., 2000; Komives et. al., 2000). Financing is also easier to arrange for such options than for large-scale private projects. Domestic taxpayers are typically not exposed to credit risk that typically arises from explicit or implicit guarantees under large-scale projects.

Critics of such approaches fear “anarchy” among small-scale providers, inefficient system development and pockets of private monopoly power. The counter-argument is that problematic service that people choose to buy is still better than no service at all. After all the poor pay typically a lot more for service than the better-off. Light-handed regulation of service standards can help mitigate some of the problems associated with free entry into infrastructure. In the longer-term the transition to more efficient integrated infrastructure systems needs to be supported through gradual creation of an adequate regulatory environment (Smith, 1997a; Smith, 1997b; Smith, 2000).

Questions for discussion:

- **Should entry into natural monopoly areas of infrastructure systems be allowed, for whom and under what conditions?**
- **How should issues of quality and price regulation be tackled in weak governance environments? Can they be better handled when the public sector also provides the service or can regulation be better improved by delegating the responsibility for provision to non-governmental providers?**

iii. Improving access for the poor to social services

PSD and the social sectors. Another controversial issue is the role that market-type mechanisms can sensibly play in health and education. On the one hand, it is feared that markets and private participation could hurt the poor, because fees might go up or because service might be directed at the rich or because essential social goals might be neglected by private providers. On the other hand, the experience with public provision

in many low-income countries is disappointing and the poor have often chosen private providers, where they have the choice (Filmer et. al., 1997; Narayan, 2000a)

Potential solutions lie in allowing private (for-profit and not-for-profit) providers to enter the market where that is currently not the case to give the poor greater choice. If it is felt that such providers are not serving the poor adequately or that user fees would push the poor to stay away from essential services such as primary education, then subsidy schemes could be put in place to enhance the purchasing power of the poor (Cave, 2001; Greene, 2000; Kim et. al., 1998; King et. al., 1997; Patrinos and Ariasingam, 1997; Sawhill and Smith, 1998; Shokraii Rees, 2000; Vawda, 1997; see Carnoy, 1997 for a critique of education vouchers). Community participation could help set service standards (Benchemsi, 2000; Gugerty and Kremer, 2000; Jimenez and Sawada, 1998). Light-handed regulation of service standards (including mandatory disclosure requirements) combined with accreditation, certification and monitoring systems would often be required to help present the poor with better choices. More broadly, the delegation of service provision to non-governmental providers does not imply that government responsibility to ensure service provision is diminished.

Questions for discussion:

- **Should the WBG consider the options for private sector provision and customer choice in the social sectors?**
- **What role could communities have in setting service standards, monitoring service or providing service? How should the regulatory framework be developed for social service provision in weak governance environments?**

IV. THE COMPARATIVE ADVANTAGE OF THE WORLD BANK GROUP VIS-À-VIS THE PRIVATE SECTOR

A. PSD in the Country Assistance Process. The overall approach to PSD is part and parcel of the Comprehensive Development Framework (CDF) and complements other sector strategies. Based on consultative processes country assistance strategies need to be derived. As in the case of many other development issues there is no simple cook-book model for applying PSD approaches to particular types of countries. Case by case discretion is required to design the appropriate PSD component of a country strategy (Figure 10).

Figure 10: PSD in the Country Assistance Process

- | | |
|---|---|
| • Framework and approach | • CDF, sector strategies, PSD strategy |
| • Country-specific application | • PRSP, CAS |
| • Market-type disciplines on the exercise of discretion | • Rate-of-return target
• Output-based contract
• Unbundled subsidies |

To help provide focus and selectivity the particular question for a PSD strategy is what the respective roles of the WBG and the private sector should be and hence how they should relate to each other. Because PSD is essentially about a way of doing things, it has to be left to other sector strategies to provide guidance and focus on the content of the WBG's work, for example whether to work on certain sectors or certain topics.

B. New ways of complementing the private sector. There are two fundamental points. First, the private sector may often be better at assuming performance and market risks than public agencies. Shifting those responsibilities and risks to the private sector may thus be desirable. As part of this shift in risk allocation the exposure of domestic taxpayers in poor countries to the burden of public debt can be reduced.

Second, when shifting risks it is often desirable to unbundle some of the products of the WBG. For example, by unbundling the policy risk function from the traditional Bank loan freestanding policy risk guarantees have been created in the Bank and MIGA that shift commercial risk to private parties. There may now be further options available to shift performance risk to private parties so as to improve the investment climate and service for the poor. Unbundling the subsidy component embedded in some WBG financial products would allow targeting it better at its intended purposes or beneficiaries.

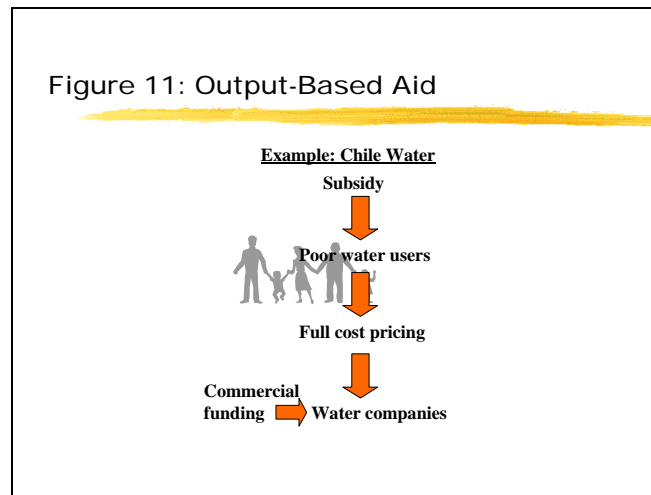
Three major themes are proposed for discussion:

i. Output-based aid

Traditional aid in some sectors and in some low-income countries has at times been associated with disappointing performance by the state-owned providers that were funded (Burnside and Dollar, 1997; Collier and Dollar, 2000; Easterly, 1998; Easterly and Levine, 2000; Pritchett, 1996; World Bank, 1998). In addition, subsidies embedded in aid funds may not have reached the poor but benefited the better-off. There are thus two

main issues: How to improve service to the poor and how to ensure that any subsidy judged necessary actually benefits the poor.

The key to better service delivery is to shift performance risk more effectively to service providers and away from taxpayers. This can be achieved wherever it is possible to disburse aid when service is delivered and not when inputs are constructed. Such schemes are, in principle, feasible in most parts of infrastructure and some areas of health and education (Figure 11; Brook et. al., 2000; Vinson, 1999). Service standards should be responsive to beneficiaries by empowering them to choose. This includes community participation to set goals for collective goods and services. Providers (for-profit and/or not-for-profit) can then compete for the right to provide service on the best possible terms. Funding can be obtained in the market when the provider is competent and cash flow is expected to be adequate, which is facilitated when aid is disbursed upon achievement of contractual service obligations. IFC could help develop the financial markets for this. Policy risk guarantees by MIGA or the Bank can help deal with the special risks in difficult environments.¹ In many complicated policy environments small scale solutions that are within the managerial and financial reach of domestic providers may provide appropriate solutions. (Note that output-based funding could be achieved with grants or with loans. In the case of loans ultimately the local taxpayer pays, with grants foreign taxpayers pay – both in the case of concessional loans such as IDA).



Normal competitive markets are output-based schemes. Consumers pay when the product or service is finished, not when the firm builds a factory. Typically improved

¹ The Bank has provided policy advice on output-based schemes during the 1990s. The private infrastructure schemes supported by the Bank have typically contained output-based remuneration for private providers, although the Bank has not itself disbursed funds as a function of output. The closest scheme to a true output-based project was the Guinea water concession in 1987, where the Bank de facto funded a water price subsidy that declined over a ten-year period. Currently an output-based financing scheme is under consideration for small-scale water supply in Paraguay.

service delivery systems by themselves will help the poor most, because access to service rather than subsidies are crucial for them. For example, poor water users typically pay 10 to 40 times as much as those connected to pipelines.

Where it is judged that some form of subsidy is needed to help the poor this can be combined with market-type mechanisms. Output-based aid allows in particular to shift performance risk to private parties while retaining the option of subsidizing user fees partially or completely, for example in education. Where consumers do not have choice one can use targeted subsidy schemes to deserving customers or one can auction the right for service provision to the bidders of the lowest subsidy. Output-based subsidies can also help reach sub-sovereign projects efficiently without complications of counter-guarantees.

It may be argued that such output-based schemes and targeted subsidy schemes are hard to implement in countries with weak governance systems. They are, indeed, harder to implement there than in other places. However, it is not obvious why, therefore, potentially less effective alternative approaches should be favored. The question is: if feasible output-based schemes with competent sponsors, policy-risk guarantees and adequate expected cash flow (possibly supported by aid) do not work, then what chances are there that traditional approaches will actually help the poor?

There may also be worries about adequate capacity building when resorting to private provision of service. Staff typically learn most when working for the most competent provider. Staff trained in such companies are also most likely to set up local SMEs as sub-contractors or competitors. Capacity-building to government would remain important and focused on the core functions of government, namely the contracting process and the regulatory or monitoring functions that remain in public hands.

In a number of cases private schemes may be most effectively managed by domestic firms, for example output-based small-scale infrastructure schemes that are currently under consideration in Cambodia (water and electricity) and in Paraguay (water). However, in other cases foreign companies may be more efficient. This may worry some governments. However, under private provision employees of the provider are mostly local staff, even when the provider is owned by a foreign company. Otherwise the foreign company would not be competitive. Typically the move towards private provision also stimulates the emergence of domestic private providers where they do not yet exist.

None of this is to say that output-based schemes are miracle solutions. They can help shift performance risk and allow more explicit targeting of subsidies. However, the ability to measure relevant output in an unbiased fashion is critical. Capacity in government to contract out and to regulate is required, in particular to prevent private providers from shifting risk back to domestic taxpayers. Governments would typically also be involved in allocating the funds to be disbursed against output. Arranging financing may also be hard in the case of large projects. However, many small-scale solutions are typically within reach of local investors.

Questions for discussion:

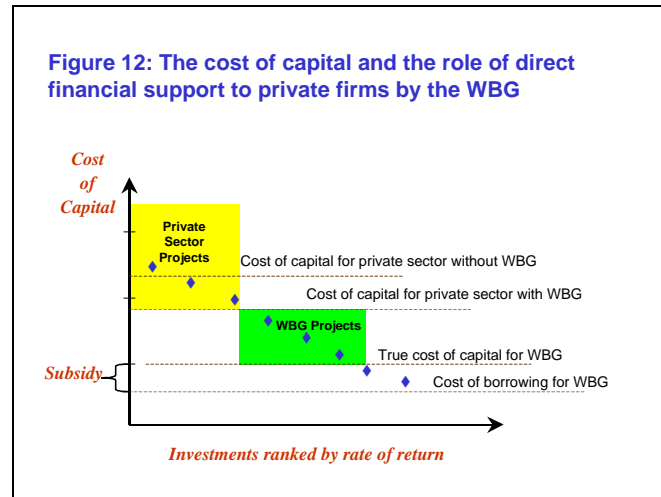
- **Under which conditions should output-based aid schemes be tried out?**
- **Should they be grant or loan-based or both?**
- **Which sectors or projects would seem to qualify (e.g. certain infrastructure or social sectors)?**
- **What type of providers would typically be eligible to compete (e.g. for-profit, not-for-profit)?**
- **What role should governments, communities and private providers play in output-based aid schemes?**

ii. Commercial disciplines for commercial services

In those areas, where limited supply response, i.e. failure by the private sector to pursue all good deals is the rationale for activity by the WBG one needs to determine whether the World Bank Group truly tackles market failures or whether it misallocates the subsidy embedded in its products.

A number of arguments are typically made for the role of the WBG. WBG presence may help reduce political risks and may provide valuable demonstration effects. The special relationship with governments and the long experience in developing economies may allow the WBG (IFC, MIGA, Bank on-lending operations) to identify and invest in good projects that the private sector is not willing to pursue. Its commercial acumen and financial capability may also allow it to improve on fragmented and inefficient domestic financial markets.

Developmental interventions by the WBG should benefit other private parties by improving investment opportunities. Such benefits are not captured by the WBG itself. Nevertheless all these justifications assume that the WBG would pick up “good deals left on the table” by the private sector in the following sense. Due to its special standing the Bank Group arguably has a lower risk-adjusted cost of capital than private firms. It can thus undertake some projects that are not attractive to private firms. There will be such projects until the investment climate has improved to such a degree that there are no more projects left for the World Bank that the private sector would not want to fund itself (Figure 12).



But there is no argument that substandard deals supporting private parties be financed that require subsidies in the sense that the affected parts of the WBG should be content with average returns of less than its own risk-adjusted cost of capital. There is also ample evidence that subsidized credit does not lead to efficient investment.

Under the existing system WBG management already copes with the issue as follows. Discretionary decisions by the Bank, IFC or MIGA establish

- whether financial assistance to private firms has sound development impact by supporting projects in developing client countries that promote growth (adequate economic rate of return) and are environmentally and socially sound.
- whether an activity is deemed to complement private activity rather than substituting for it. This includes application of the pricing guidelines for IFC or Bank on-lending operations that require market-based pricing for financing private firms (e.g. OP 8.30).

The key remaining strategic issue is whether an institution that helps fund good deals that are left on the table by the private sector should also be required to earn a target rate of return, that is set so as not to provide incentives to waste subsidies and not to hand out “corporate welfare”.

Unbundling the subsidy contained in some of the WBG products (Bank on-lending operations, IFC and MIGA) would allow “profits” so earned to be used explicitly to subsidize those activities that are deemed to require subsidies under disciplines discussed below.

Questions for discussion:

- **Is the imposition of return targets to meet the full cost of capital for development agencies that invest in private projects compatible with development goals?**
- **Should such targets be imposed and, if so, how?**

iii. Targeted subsidy allocation

Unbundling subsidies would leave the total amount of resources at the disposal of the WBG constant. What was possible before can still be achieved, for example by re-bundling subsidies with loans. However, the unbundling process can provide more transparency and allow deployment of instruments in new ways, for example under output-based aid schemes that shift performance risk and target subsidies.

The issue remains what disciplines to place on the allocation of unbundled subsidies (including those for output-based projects). In principle the incentive system would be as today. The allocation of the subsidies would need to reflect the strategic thrust of the WBG overall. As is the case now, country considerations and thus the Country Assistance Strategy would drive the allocation.

Transparency and measurement are key for discipline on such allocation processes. Hence, unbundling and clear measurement of the size of subsidies could be helpful. This may build on the practice of some member countries that prepare special subsidy reports. There are a few policies of the Bank Group that require the calculation of subsidy dependence of projects or the subsidy equivalents embedded in them, for example for agricultural credit. However, broader application and more systematic and transparent implementation might be useful. Such systematic evaluation of the level of subsidies and improved measurement of the outcome of activities funded by them are in any case desirable. The eventual PSD strategy would contain proposals for concrete measurement approaches.

Questions for discussion:

- **Should subsidies be unbundled or is there a danger of losing synergies?**
- **What kind of measurement approaches would be desirable?**

C. Shifting performance risk to the private sector and targeting subsidies - selected implications for work in low and middle income countries and for highly indebted countries

i. Balancing work in low and middle income countries

Middle-income countries are still in need of assistance, particularly at the sub-sovereign level (firms, municipalities). At the same time the shareholder and donor community would like to focus assistance on low income or frontier countries.

Unbundling of subsidies makes it easier to focus subsidies on low-income countries. At the same time, this may allow, for example IFC and MIGA to expand activity in Middle Income Countries without diluting the terms of assistance to low-income countries.

ii. PSD strategy and highly indebted countries

If one shifts performance risk to the private sector this could potentially help improve interventions to low income countries and reduce the risk that taxpayers in those countries would be faced with future repayment obligations. Of course, debt relief itself shifts risk away from these taxpayers, but after the fact, not as part of original project design.

For example, assume that all infrastructure projects in IDA countries are done under output-based contractual disciplines. In this case IDA funds would be disbursed upon achievement of service goals rather than for construction. Assuming that this new way of doing things were not to affect lending volumes, this could annually shift performance risk for about US\$ 1.5 billion away from domestic taxpayers. Similarly, the subsidy element in on-lending operations under IDA could be unbundled and used for targeted poverty reduction. The commercial component of on-lending operations could be assumed by IFC. In this case, again, performance risk would be shifted from domestic taxpayers to private investors and foreign taxpayers (via IFC). On-lending operations under IDA currently amount to about US\$ 0.2 to 0.3 billion per annum. Altogether the shift in performance risk from domestic taxpayers to private investors and foreign taxpayers could amount to about a third of IDA resources, assuming no change in the volume of operations. While highly indebted countries are only part of IDA countries this could still contribute to reducing the likelihood of future rounds of debt relief.

Of course, the shift of performance risk to the private sector may affect the total sums involved. Direct lending to the private sector under on-lending operations might be affected because IFC might take a different view on whether on-lending was justified from the Bank. Output-based schemes may reveal policy problems more clearly than traditional loans to public sector projects and lead to a reduction in volume in some cases. However, where successful, output-based schemes may stimulate greater activity overall and stimulate willingness of donors to provide funds. None of these schemes would reduce the need for IDA funds, but risks would be re-allocated to those parties better able to manage and bear them (Figure 13).

Figure 13: PSD Strategy and Potential Impact on IDA Operations

- **Actions**
 - On-lending operations carried out by IFC
 - Infrastructure and some social sector operations become output-based
 - **Shift in existing activities**
 - About US\$ 0.2–0.3 billion per year
 - About US\$ 1.5 billion per year
 - **Results**
 - Exposure reduction of poor taxpayers/performance risk to private sector
-
- About 30-40 per cent of total IDA lending

D. Next steps

Following dialogue and debate on the basic approaches set out in this discussion paper, a consultation report will be prepared for management of the World Bank Group that would summarize the feedback obtained. Taking into account the thrust of the debate more detailed reviews of the implementation challenges would be carried out. In particular organizational and operational implications would be considered in greater detail. As mentioned in the beginning all this would feed into the PSD strategy to be presented to the Executive Directors of the World Bank Group for decision by December 2001.

ANNEX I: ISSUES IN THE UNBUNDLING OF WBG PRODUCTS

Traditionally, the WBG has provided products in bundled form. Most importantly the traditional Bank loan bundles funding, guarantee (to investors), subsidy (e.g. IDA) and advice (as part of project preparation and supervision). With the rise of private alternatives, more and more products have been unbundled. This is simply a reflection of the same forces that unfold when market-type mechanisms are introduced in client countries. The introduction of market forces drives, in particular, towards an unbundling of subsidies to allow for fair competition on the one hand, while preserving means to help the poor and remedy market failures on the other hand.

The analytical and/or operational unbundling of products has the potential to establish more clearly the comparative advantage of the WBG. First, unbundling allows the activities of the WBG to be focused on matters that it can tackle relatively better than others, e.g. political risk guarantees vs. funding. Second, unbundling may be necessary to deal with potential conflicts of interests, hence, for example, the independence of ICSID. Unbundling also creates greater transparency and thus potentially enables better judgments as to the effectiveness of an intervention.

Unbundling of a product can be implemented such that it still allows integrated, simultaneous or parallel provision of the component parts to a client, if there are synergies between the components or if one wants to safeguard the average terms on which a country receives financial and non-financial support. For example, the average resource flow to countries and the average terms of such flows need not be affected by unbundling. What would be affected is the discipline on the achievement of the ostensible goals of the support provided.

The table below shows that already today the World Bank Group has some level of unbundled provision of products for each function it seeks to fulfill and there are competitors/partners in all areas. This means in particular that there is no area of absolute advantage for the WBG.

FUNCTION	EXAMPLE OF UNBUNDLED PROVISION IN WBG	COMPETITORS/PARTNERS
Guarantees	Credit and political risk guarantees by IBRD/IDA, MIGA and IFC	Private insurance companies, other MFIs, ECAs
Subsidies	Fiscal subsidies under OP 8.30; grants under social funds, GEF, DGF, trust funds	Public and private donors, including foundations
Advice	Fee-based (FIAS, IFC advisory services, IBRD reimbursable T.A.)	Investment banks, consultants, academics, think tanks
Capacity building	Free and fee-based programs e.g. by WBI	Training institutes, universities...
Global standard-setting	Dams, mining, forests,	UN organization, OECD,

FUNCTION	EXAMPLE OF UNBUNDLED PROVISION IN WBG	COMPETITORS/PARTNERS
	environment, re-settlement, insolvency...	Council on Economic Priorities, Basle Committee, IOSCO...
Certification	ROSC, procurement assessments...	Rating agencies, ISO...
Arbitration	ICSID	New York Convention...

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