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CHAPTER 3

UNLEASHING THE POTENTIAL OF THE PRIVATE SECTOR

The Commission acknowledges that the constraints on developing a sustainable private sector are widely known—and generally accepted. So are the key elements of policies for addressing them. The big challenge is moving from an understanding of the broad constraints to putting together specific, country packages. Now the focus must shift from determining “what” the constraints are to “how” they are to be lifted and “who” is to lift them. Here we examine the policies and administrative steps that can alleviate these constraints and help create the capacity needed to govern transactions, capacity that is vital to the development of the private sector and to the efficient functioning of a market economy.

The Commission has emphasized that the private sector is important to the poor in many ways. If the benefits of reform are clearly articulated and the results of reform are quickly evident, constructive approaches to private sector development can translate into greater political support. And the momentum and consensus for change that this creates can provide the springboard for a comprehensive programme of reform and change.

FIGURE 3.1 STRENGTHENING THE EFFECTIVENESS OF TRADITIONAL PRIVATE SECTOR DEVELOPMENT ACTIVITIES

| | Targeted at public sector players | Targeted at private sector players |
|---|---|--|
| Driven by private sector players <ul style="list-style-type: none"> ■ Companies ■ Civil society organizations ■ Foundations | <ul style="list-style-type: none"> ■ Setting broader standards (industry norms, sustainability, corporate governance) ■ Lobbying for policy changes ■ Promoting participatory processes through social dialogue | <ul style="list-style-type: none"> ■ Business linkages and partnerships ■ Investment, including foreign direct investment ■ Mentorship for entrepreneurs |
| Driven by public sector players <ul style="list-style-type: none"> ■ Local governments ■ Donor governments ■ Development agencies | <ul style="list-style-type: none"> ■ Policy reform ■ Policy advice ■ Funding and delivering technical assistance for public sector reforms ■ Financial transfers (aid, loans) | <ul style="list-style-type: none"> ■ Public-private partnerships, for example, for basic service delivery ■ Public-private consultative bodies ■ Privatization or contracting ■ Investment promotion ■ Direct business development services ■ Direct financing |

Some broad lessons of experience:

- Successful policy reforms have generally been those in which concerned governments and policymakers have made strong and voluntary commitments to change.
- Reforms linked to conditionality rarely succeed when implementing governments are not committed to them.
- Significant changes often occur when countries are faced with major economic crisis (India in 1991, East Asia in the late 1990s), and the response to these changes can be rapid. Of course, it is better not to wait for a crisis to reform.
- Changes can also follow major shifts in basic economic philosophy (China, Vietnam and Eastern Europe).
- New governments that replace previous regimes with a history

of poor governance (Kenya, Nigeria in the past few years) can often use the impetus of change to implement reforms.

- Changes almost always include new roles for the local private sector and civil society organizations, including employer and worker organizations.
- Technology is the agent for much of the needed change, and new technology enables change to be implemented much faster than might generally be expected.

Support to private sector development—both global and national—can involve economic research, macro and sector policy advice, technical assistance and direct financial support to specific private sector projects. Barring the latter, the bulk of these interventions involve governments and public institutions directing their support to governments and public institutions in developing countries (figure 3.1).

The main public players in this field are the World Bank Group (including the International Finance Corporation and the Multilateral Investment Guarantee Agency) and the International Monetary Fund. The regional development banks, including the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development and the Inter-American Development Bank, are also focused on helping to create the enabling environment for entrepreneurial development in their respective regions. Important roles are also being played by the Organisation for Economic Co-operation and Development in research and policy, and by the major UN specialized organizations such as the United Nations Industrial Development Organization, the United Nations Conference on Trade and Development, the International Labour Organization and the United Nations Development Programme. Bilateral agencies and institutions (such as the United States Agency for International Development, the U.K. Department for International Development, the Canadian International Development Agency and the Netherlands Development Finance Company) are also focused on important elements of the task, including enhancing access to capital and supporting the development of micro entrepreneurs and small and medium enterprises.

The Commission believes that any approach to private sector development—and the policy and action recommendations that accompany it—needs to be grounded in the realization that the savings, investment and innovation that

lead to development are undertaken primarily by private individuals, corporations and communities. Governments should thus act as facilitators of private sector development and avoid actions that impede it. Governments and intergovernmental agencies can facilitate private sector development only by fostering properly functioning competitive markets.

- Providing conducive operating and investment environments in which all private enterprise (domestic, foreign, politically connected or otherwise) can flourish without fear or favour. This involves an overall social context that is politically stable and predictable, with appropriate procompetition rules and effective enforcement and sound macroeconomic fundamentals, including a fiscal policy conducive to the development of the formal private sector and adequate to the financing of the required human and physical infrastructure.
- Establishing properly functioning legal and judicial systems for protecting property rights and resolving contractual disputes—systems seen to operate credibly and efficiently when judged by international (not national) standards.
- Facilitating the movement of private capital of all kinds, not just foreign direct investment, through the progressive development of national capital markets and their links to regional and global capital markets. Liberalization of financial capital flows requires great prudence, however. A sound financial system with good regulations and

enforcement is required before proceeding to full liberalization.

- Influencing national, regional and global risk perceptions favourably through better information dissemination in real time (rather than simply through promotional marketing of investment opportunities) and encouraging government behaviour that excites and supports rather than turns off investors, whether domestic or foreign.
- Targeting subsidies and tax incentives where clearly needed to address market imperfections, and moving away from broader reliance on measures that may be politically attractive in the short run but are generally counterproductive for sound private sector development in the long run.
- Providing or enabling the private provision of essential infrastructure (power, water, communications, transport) through public-private partnerships, innovative regulatory models and other means to ensure that private enterprises are not put at a competitive disadvantage.

BUILDING THE FOUNDATIONS

Chapter 2 discussed the global and domestic macro environment and the availability of physical and social infrastructure. We focus here on more specific actions relating to fostering the rule of law and creating a level playing field for entrepreneurs. We also address the broad principles that need to be applied to improve access to financing and the availability of skills and knowledge. Effective

implementation of these policies can help private entrepreneurs enter into transactions with confidence that the contractual underpinnings of these transactions can be enforced. In any economy, a strong capacity to govern transactions is needed to unleash domestic entrepreneurial energy.

Strengthening the rule of law

For private enterprises the rule of law provides the foundation for a predictable regulatory framework and capacity to govern transactions between private parties. Ensuring the rule of law is not only about having or introducing the appropriate set of laws—it is about ensuring that laws can be enforced, fairly.

The overriding need is to ensure integrity in public service, which requires governments to:

- Establish and use transparent, public, open, nonexclusionary and objective procedures in public procurement contracts.
- Establish open, transparent, efficient and fair employment systems for public officials to ensure efficiency and good service and avoid patronage, nepotism and favouritism.
- Provide education, training, supervision, incentive structures and codes of conduct that breed and reward integrity and professionalism.
- Establish a system to avoid conflicts of interest and improper influence on officials and to provide mechanisms for officials to report such misconduct without endangering their safety and professional status.

Related to ensuring integrity in public service is ensuring accountability and transparency in the actions of public officials. This requires governments to:

- Build a broad base of support by running well publicized, participatory anticorruption campaigns addressing the public and private sectors.
- Establish appropriate auditing procedures for public administration and the public sector, and measures and systems to provide timely public reporting on performance and decisionmaking.
- Ensure transparent procedures for public procurement, privatization, state projects, state licenses, state commissions, national bank loans, other government guaranteed loans, budget allocations and tax breaks. These procedures should promote fair competition and deter corrupt activity. They should also establish adequate simplified regulatory environments by abolishing overlapping, ambiguous or excessive regulations that burden business.
- Promote systems for access to information about public expenditure.
- Strengthen antibribery actions and promote integrity in business operations.

Enforcing property rights

There is also evidence that governments do too little to protect property rights. The best-practice countries build efficient courts and support laws and institutions that define the rights of citizens and businesses to their property. Yet, the institutions that define and enforce property rights in many developing

countries—the court system, property registries and law enforcement agencies—are often the least modern and least funded of all public institutions.

Business property rights can often be protected by providing alternative channels for resolving disputes with other businesses, customers, suppliers and government officials.

- Alternative dispute resolution systems provide a substitute for slow and expensive formal courts in their ability to provide predictable legal protection for the contracts and property of small entrepreneurs. Argentina piloted such a system, with 66% of 32,000 commercial cases resolved in an average of 2 months (not the typical 3–4 years).
- Automated assignment of cases, involving random computerized assignment of individual cases to judges, increases a judiciary's efficiency and reduces corruption. In a Slovakian pilot case the time between the filing and the first hearing fell from 73 days to 28, with the number of steps in case processing reduced from 23 to 6.
- Specialized debt collection courts resolve claims faster because those who preside over them have more command over the law and have responsibility for the entire debt collection system, from seizure to auctioning of property, if necessary. In Colombia a specialized debt collection court increased the number of cases filed from 4,000 a year to 11,000 (1996–2000), with 75% of cases resolved in a year and the number of pending cases falling by 5,000.

ERECTING THE PILLARS

Chapter 2 also described the three pillars that are indispensable for entrepreneurship and the private sector to flourish: a level playing field, access to finance, and knowledge and skills.

Creating a level playing field

Creating and defending a level playing field for companies requires a system of rules and enforcement that inspires trust and reasonably limits the cost and burden on enterprises. In recent years this area has received more attention from private and public players in development. One focus has been on improving legislation and regulation. In Vietnam a new enterprise law helped create a million new jobs. A level playing field also requires strengthening the institutions that implement and enforce regulations. The content of the solution seems clear—overcoming the entrenched behaviour that led to poor regulation in the first place. Someone benefits from every rule, and finding out how to overcome resistance by those who benefit is the first step in effective reform.

Simplifying regulations. An important element for a level playing field is simplifying regulations affecting the entry, operation and exit of private enterprises. The approach to resolving these issues is simple, and the experience is well demonstrated—needed is the will to implement change. The basic steps involve adopting best practices for business registration, for changes of ownership and closures and for the governance of transactions. Illustrative action programmes include:

- Kiosks and one-stop shops that simplify business and title registration make registration more efficient, and the greater transparency minimizes corruption at all levels. In Tanzania the Business Registration and Licensing Agency reduced the time to register a business from 90 days to about 3. In India electronic title registration in the state of Andhra Pradesh reduced the process from 7–15 days to a few hours.
- Single business permits enable governments to consolidate registering businesses so that entrepreneurs need secure only one permit to own and operate a business, rather than different ones at each level of government. In Kenya the single business permit reduced the costs to small enterprises and increased government revenues by 30–40%.
- Unified tax authorities are responsible for tax collection (including customs duties) and inspections for all levels of government. In Zambia such a system eliminated duplicate inspections and investigations while improving overall customer service and compliance.

Many of these changes could greatly reduce informality in most economies, particularly if accompanied by country efforts to fully understand the characteristics of informal firms. But informality is so pervasive that a special approach is needed.

Finding ways to increase the benefits of formalization is one such approach. It can be accomplished in part by opening public contracts to informal players willing to formalize if they win the contract, and improving market access through organizing

trade fairs and creating links with international buyers. Affordable business development services for boosting management skills, productivity and quality are a demonstrated way of supporting formal small and medium enterprises.

Much of this rests on increasing awareness of the costs of informality—and on shifting mindsets. Public dialogue can be fostered through public awareness campaigns. And lobbying groups that represent small businesses can be strengthened.

Creating competitive markets.

Creating a competitive market and reducing the influence of incumbents are critical ways to level the playing field. Where incumbents have already taken hold, three levers can open markets—technological innovation, financial development and freer trade and capital flows. Technological change fosters competition and relaxes the pressure for entry restrictions. By bringing in competitive pressure from outside, technology helps erode barriers to entry and creates a constituency for the further freeing of market entry restrictions. A well developed financial market promotes competition by making debt capital and equity financing available to firms without connections or access to subsidies. Trade and capital flows also reduce the ability of incumbents to influence governance by creating competition between domestic and foreign firms.

Competition creates winners and losers, a source of great tension between markets and democracy. Some of those employed in inefficient firms might bear the downside of change, particularly

when social safety nets are not in place. So, opening markets to competition may best happen in phases, with full openness occurring after a strong set of market institutions is in place. A safety net focused on people, not firms, is needed to provide socio-economic security for those left behind.

To keep this process going despite these tensions, the costs of uncompetitive markets should be made transparent. The public should be able to understand when it benefits from rules that keep politicians and incumbents in check. A simple way to accomplish this might be to demonstrate quality and price differences between goods in protected economies and that of goods in roughly comparable open economies. Another might be to show the amounts of subsidies that go to protected firms.

Reforming taxes—simplicity, clarity, stability. Creating a positive and enabling business environment for small and medium business requires a tax policy that responds to business needs, encourages new businesses to start and helps existing businesses to expand. Governments need to develop tax policies in partnership with small and medium businesses, simplifying the rules applied to these businesses, reducing the burden of compliance and promoting transparency and stability.

Governments also need formal mechanisms for regular briefings and consultations to ensure that small business representatives are kept up to date on changes in tax codes and can give their views

on proposals. To help small and medium businesses comply with the rules and ensure common interpretations across the country, tax officials need to be trained on the substance of tax rules and procedures.

Reforming finance and access to capital

Creating efficient domestic financial markets and increasing the access of domestic businesses to credit have been major goals of the multilateral development banks and bilateral development agencies. Their activities are mainly geared towards fixing the business environment and strengthening financial institutions.

The big issue with today's interventions, working through many intermediaries of varying effectiveness, is that they are not always demand driven. Successful models have taken a multiple-stakeholder approach to developing functioning markets. Consider the IFC's efforts to develop the leasing sector across countries—a model also applicable to micro-finance and housing finance. The model involves a coalition of market players including governments and regulators, international leasing companies, local financial institutions and experts in the legal, regulatory and tax aspects of leasing.

Governments should play a key role in creating and building long-term and sustainable financial institutions and infrastructure, strengthening the banking system to make it competitive. In the process, governments must ensure that public financial

assistance programmes complement rather than compete with private financing that could be available on commercial terms.

Policymakers should concentrate on reducing barriers to access to finance, recognizing that access is generally more important than the cost of financing. They should recognize that subsidized credit programmes are unsustainable and unnecessary and that reducing transaction costs and increasing innovation and productivity among financial service providers are more important. They should also reform financial market rules and build enforcement capabilities, introducing new legal structures and removing obstructive caps and ceilings. Legal conditions and well-functioning implementation systems need to be established to address bankruptcy, registration and collateral and the regulations for leasing. Such measures can have benefits far more important than targeted credit programmes.

Strengthening the range and operational capabilities of financial institutions will better serve the needs of smaller businesses. Subject to appropriate regulation, nonbank financial institutions should become more prevalent. New financial products and liquidity vehicles would allow them to better serve small and medium enterprises with tailored insurance, lending and savings products.

In some cases public finance might bridge the gaps in financing. But governments must ensure that public programmes complement rather than compete with private financing that could be available on commercial terms. Efforts should

focus on using the existing banking and financial system to direct resources rather than creating dedicated state agencies, which have demonstrated for too long their inability to channel funds themselves. A Small Business Administration type of approach has been successful in the United States and may be useful as a model. The goal is to bring about a financial system that can catalyze growth for small and medium enterprises and allay the nonbusiness risk that entrepreneurs can do without.

Entrepreneurs should have the risk management tools that large private firms do. These tools include a range of savings and insurance products as well as more sophisticated products that minimize foreign exchange or inflation risks, for example. But networks and partnerships may matter even more. Funds may come from diasporas, nascent venture capitalists, equity funds or other types of firms or groups of individuals, commonly referred as “angels” who have made progress in the system and are willing to help others. Access to these funds can embed the entrepreneur in professional networks that use common standards for evaluating new firms. To the extent that access to these networks is formalized through institutions, even entrepreneurs who are poor can receive financing and manage risk.

The long-term goal should be to have private financial institutions supporting small and medium enterprises—and to encourage well-functioning capital markets. This will require putting into place and developing credit bureaus and other mechanisms to provide credit references—an effective way of strengthening financial systems.

Developing human skills and knowledge

More investment is needed in local business-related skills, including foreign languages, information technology skills and basic finance, economics and project management. Public-private partnerships that combine more practical training on the job with basic education could be the basis for viable apprenticeship models. Also effective are recent efforts to conduct more leadership training by pre-eminent educational and leadership institutions for top decision makers from developing countries. Of particular importance is building local training capacity by “teaching the teachers”, the only way to meet the large demand for local (and developing country to developing country) training.

There are also opportunities to accelerate skill-building and foster entrepreneurship by using social ties to the developing country’s private sector. A country’s diaspora in advanced economies is well suited to mentoring local entrepreneurs—or becoming investors or entrepreneurs. Expatriates in developing countries may also have skills that could be tapped for coaching and motivating local entrepreneurs.

Additional steps for governments:

- Build entrepreneurial networks and associations for peer-to-peer learning. Networks can create an entrepreneurial climate for coaching, mentoring and learning and strengthen links between companies. Networks support indigenous and private systems of learning, so that entrepreneurs can be encouraged to learn from their peers.

BOX 3.1 COSTA RICA’S PRIVATE SECTOR—UNLEASHED

Costa Rica has attracted some leading information technology companies. Intel’s \$0.5 billion chip assembly and manufacturing plant now produces 25% of Intel’s global output and 40% of Costa Rica’s exports. This has made the country one of the top 30 software exporters worldwide and the highest per capita information technology exporter in Latin America. Between 1985 and 2002 Costa Rica’s exports grew fivefold, from \$1.1 billion to \$5.1 billion. Foreign direct investment inflows grew more than tenfold, from \$59 million in 1989 to \$661 million in 2002.

Costa Rica has a 95.5% literacy rate, and 18.5% of the active labour force has completed university, technical or parauniversity studies. Government policy has upgraded the educational system by incorporating technical education and training in electronics, informatics and engineering. Costa Rica has 85 vocational high schools (educating more than 85,000 students a year), 4 state universities and 46 private universities, including one of Latin America’s best known business schools, INCAE. The government also set up a National Learning Institute, which offers technical training free of charge and has trained more than 127,000 people.

The private sector took the lead in attracting investment and creating a pro-business environment through an apolitical nonprofit organization, the Costa Rica Investment and Development Organization (CINDE) in 1983, with funding from international donors and strong support at the highest levels from the government. In the mid-1990s CINDE began to woo multinational corporations, and it played a key role in influencing Intel’s decision to locate its first Latin American chip plant in Costa Rica, which was not originally on Intel’s short list of countries. Intel was swayed by the open, business-friendly environment, with a stable political system, respect for the rule of law, low corruption and good infrastructure.

More than 30 multinational companies have relocated to Costa Rica, employing more than 10,000 people in the electronics industry. Multinational corporations like Intel have also directly contributed to the development of a skilled workforce through on-the-job training and support for formal education institutions. And Intel’s presence has increased awareness of career opportunities in engineering and other technical fields.

Source: UNDP (2001)

- Tap the private sector’s potential to deliver on-the-job training and apprenticeships as a vital part of human capital development.
- Build an effective national system for training and skills development involving employer and worker organizations as key stakeholders.
- Develop institutions of management learning, including business schools, to develop a pool of local managerial talent.
- Conduct additional research on entrepreneurship in developing countries to better understand the interplay of entrepreneurial

characteristics and the business environment.

- Develop government policies to encourage skilled emigrants to return home.

True involvement of relevant stakeholders in the process of change is useful only if accompanied by commitment from the top and confirmation of the belief that change is taking place. Particularly in the beginning of such a process, early evidence of victories and real change is vital to dispel the mood of scepticism and disbelief that

often accompanies government announcements of change. And particularly where the changes involve administrative rules, the authorities generally already have the authority to implement newer approaches and to do so rapidly.

Building explicitly on successful models of change in other developing or neighbouring countries is likely to be particularly useful in ensuring support because it is more likely to be seen as applicable to local conditions. Thus, tapping the intellectual and implementation capacity of the domestic private sector will be particularly important where it is available,

to be supplemented by international or developing country to developing country learning.

Poor people have repeatedly demonstrated the ability to use technology—so it should be a central element of any change programme, allowing the leap-frogging that is essential if progress is to be rapid. And working with civil society organizations to audit and monitor impact and extract lessons will continue the process of coalition building and lay the groundwork for future stages of reform.