Lessons and Practices No. 17

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PRIVATE SECTOR DEVELOPMENT (PSD): FINDINGS AND LESSONS FROM SELECTED STUDIES

This paper presents findings and lessons of the Bank's Private Sector Development (PSD) activities in the 1990s. It offers project and country-level evaluation results and provides a synthesis of studies which examined the effectiveness of Bank activities in Private Sector Development. The studies reviewed for this exercise included: i) *Support for Smaller Enterprises* (1998); ii) *The World Bank and Micro-enterprise Finance: From Concept to Practice* (1999); iii) *Financial Sector Reform* (1998); iv) *Making Privatization Work* (1995); v) *An Evaluation of the Foreign Investment Advisory Service (FIAS)* (1998); vi) *Information Infrastructure: The World Bank's Experience* (2001); and vii) *Review of Private Sector Development in IDA 10-12* (2001).

Project-Level Findings

- PSD project performance was slightly better than that of all projects as a whole.
- PSD performance on sustainability and institutional development was weaker in International Development Association (IDA) countries than in International Bank for Reconstruction and Development (IBRD) countries.

Country-Level Findings

- Country-level PSD strategies are generally weak; Country Assistance Evaluations (CAEs) find considerable unsatisfactory PSD performance.
- Weak governance and public sector management are major constraints to fostering improvements in the investment climate of borrowing countries.

Other Findings

- Economic and Sector Work (ESW) and related advisory services in PSD have generally been effective.
- The record on privatization has been mixed.

Lessons

- The PSD strategy and poverty strategy linkages need clarification.
- Institutional issues, local capacity building, and the distributional impact of PSD warrant more attention.
- Better risk management and contingency planning at the project, sector, and country levels are needed.
- Better performance and vulnerability indicators are needed.
- More consistent application of the Operational Policy on Financial Intermediary Lending (OP 8.30) is needed.

PSD Project Performance in the 1990s

An analysis of evaluations from 1996 to 2000 (Figure 1) indicates that while the outcome ratings for projects with at least modest PSD components were similar for IBRD and IDA borrowers, sustainability and institutional development (ID) impact were significantly lower for IDA.

Projects with PSD components outperformed projects without PSD components on all three dimensions, with especially large gaps in sustainability and Institutional Development (ID) impact (Figure 2). However, although the ID impact ratings for the PSD projects were above those for non-PSD projects, ID impact remains low. This is worrisome, because *Annual Reviews of Development Effectiveness* have stressed the importance of well-functioning institutions. Box 1 presents evaluation findings for International Finance Corporation (IFC) projects.

Figure 1: Ratings for PSD Projects, by IBRD and IDA, 1996-2000

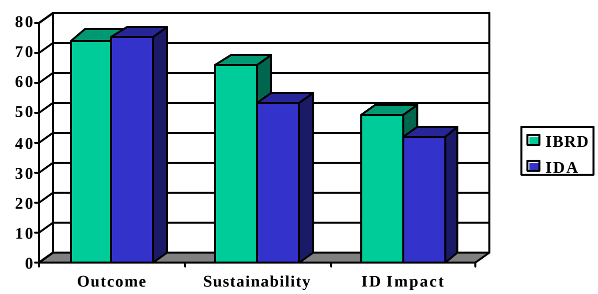
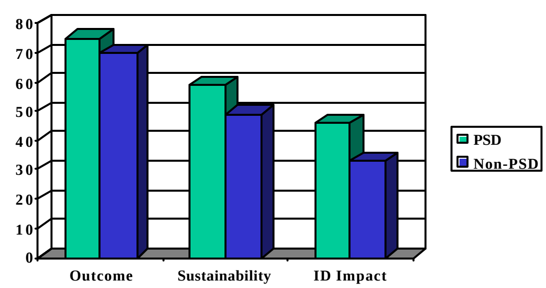


Figure 2: Ratings for All Projects, by PSD and Non-PSD, 1996-2000



Box 1: Performance of IFC Projects

Of the 101 IFC projects evaluated by the Operations Evaluation Group (OEG) since 1996, 62 percent had economic rates of return of at least 10 percent. The majority of the benefits of IFC-financed projects go not to owners and financiers but to other members of society: governments (taxpayers), customers, suppliers, and employees. The owners and financiers risked $9.6 billion in capital. IFC invested $1.8 billion and mobilized another $1.3 billion in syndicated loans. The net value of the returns to all investors, at a 10 percent discount rate, was approximately $0.4 billion. However, the returns to others in society, who had no capital at risk, were three times as large, at $1.3 billion.

Despite the relatively high project outcome ratings, a selection of 15 CAEs gave low ratings to the effectiveness of PSD work by IDA and IBRD. Given the small sample, the results are only indicative but they display revealing patterns. For example, the "disconnect" between high project-level outcomes and lower country-level outcomes was often a result of project ratings being based more on *output* indicators (such as numbers of firms privatized for privatization projects) than on *outcome* indicators. Similarly, some projects rated as satisfactory for having supported changes in policies, laws, and regulations eventually displayed poor implementation and enforcement, resulting in disappointing results on the ground. Thus, in many cases, the "disconnect" is attributable to the choice of performance indicators and/or the timing of the evaluation.

Performance at the Country-Level

At the country level, many CAEs point to a need for better choices of interventions, approaches, and instruments, as well as more attention to the distributional impact of PSD activities; stronger linkages among financial sector reform, privatization, and judicial reforms; and improved corporate governance. The CAEs also expressed concern about weak institutions and lack of comprehensive, country-specific private sector development strategies. Similarly, the *IDA Review* found that, on the whole, PSD activities have not, on the whole, been well integrated into IDA country assistance programs. (See box 2.)

Box 2: PSD Strategy Recommendations from OED's Review of IDA 10-12

OED's 2001 review of IDA found that to date, there is no overall strategy, as required in the IDA 12 replenishment, for support of private sector development linked to IDA's mission of poverty reduction and based on World Bank Group areas of comparative advantage. PSD is a complex, multifaceted endeavor and there is a need for selectivity based on country commitment and performance, IDA performance and comparative advantage, partnership with other key actors, and greater focus on governance, environmental, and social issues.

The review concluded that the forthcoming PSD strategy should propose selectivity criteria reflecting the distinctive roles of IDA, IBRD, IFC, and MIGA (Multilateral Investment Guarantee Agency). It also should help identify ways to improve IDA's support for the policy and regulatory environment for private investment, proper institutional foundations for privatization, expansion of the private provisioning of infrastructure and social services, and a positive distributional impact from increased private sector–led growth. IDA should make capacity building a core dimension of every aspect of its work.

Selected Studies

Support for Smaller Enterprises

The *Support for Smaller Enterprises* evaluation conducted case studies of small and medium enterprise projects in the Philippines, Sri Lanka, and Ecuador and the evaluation identified three lessons. *First,* it is essential to have a coherent strategy for removing distortions in the economy—for getting the prices right—before undertaking SME and other financial sector lending. This was illustrated especially in the Ecuador case, where highly negative real interest rates, regulated wages, and a heavily protected industrial sector meant that the loans continue to provide deeply subsidized credits to borrowers, rather than access to credit. *Second*, banks need more flexible financial products to reduce high transaction costs and to deal with the special risks of SMEs. *Third,* under the right circumstances SMEs can be effective in creating jobs but are not likely on their own to have much effect on directly reducing poverty, increasing exports, or shifting the location of industry.

The World Bank and Micro-enterprise Finance: From Concept to Practice

The Bank was a relative "late comer" to micro-enterprise finance, but during the past decade its micro-finance portfolio has grown rapidly, especially since the establishment of the Consultative Group to Assist the Poorest (CGAP) in 1995. The *World Bank and Micro-enterprise Finance: From Concept to Practice* review found that the traditional financial services (or CAMELs[1]) approach to quality assurance was appropriate and well illustrated by good practice outside the Bank, but that it had not been applied systematically to Bank-financed operations. Thus, mainstreaming of CGAP principles within the Bank remained a challenge, and micro-enterprise finance was still performing less effectively and was less sustainable than Bank projects in general. The report concluded that the World Bank Group had not given sufficient attention to commercial viability and argued that it is better to deliver subsidies as targeted incentives to participating institutions (for example, to deliver complementary services and the necessary infrastructure to reach targeted populations).

The report presented three lessons in the form of recommendations:

- Bank support for micro-finance institutions should make greater use of advisory services and of new products, such as Learning and Innovation Loans (LILs) and Adaptable Program Loans (APLs).
- Further improvements in design were required, such as use of a subsidy dependence index and of performance indicators included in the CGAP Practical Guide.
- Bank management should pay more attention to maintaining consistent applications of OP 8.30 and the Donor's Guiding Principles.

[1] CAMELs stands for Capital, Assets, Management, Earnings, and Liquidity, with the "s" signifying efficiency of outreach to the poor.

Financial Sector Reform

A 1998 OED report on financial sector reform covering 23 countries found a high relevance of Bank support to the financial sector. Lending operations strongly targeted sectoral reforms, especially policies to reform distortions and strengthen financial institutions, in keeping with the intent of OP 8.30. But the efficacy of these operations was mixed. Reforms to develop banking laws and regulations and to remove distortions were more successful than reforms to strengthen individual institutions or increase competition. The study found that the outcomes of financial sector policy and/or institutional reform could be deemed satisfactory in only 12 of the 23 countries. In terms of institutional development, Financial Sector Adjustment Loans (FSLs) performed far better than Financial Intermediary Loans (FILs).

Among the lessons cited in the report were the need for:

(a) Good preparatory economic work as a foundation for lending operations.
(b) Stronger monitoring and evaluation systems using performance indicators such as the financial fragility index (FFI) relating to risk exposure and governance of financial sectors.
(c) Better analysis of sequencing, for example, between interest rate deregulation and development of the regulatory framework, or between bank recapitalization and modifying the incentives that banks have to maintain their capital.
(d) Better matching of the pace of changes in financial policy reforms to the capacities of institutions to implement the reforms effectively.
(e) Improved coordination among the Bank, IFC, and IMF.

Making Privatization Work

The 1995 OED review of Bank/IDA assistance to privatization found a very mixed record of performance across countries and sectors. Performance tended to be worse in low-income countries where preconditions for successful privatization were not met. These preconditions were stable macroeconomic conditions, broad ownership among stakeholders (not just the government), policies conducive to competition, an existing robust private sector, and administrative capacities to implement the program. For the lower-income countries, intermediate solutions—such as management contracts, leases, or partial privatization—were seen as attractive alternatives for large enterprises such as public utilities. Reforms that introduce hard budget constraints, options for bankruptcy, increased competition, and improved governance lay the ground for successful privatization at a later time.

Since this report was prepared, OED assessments of privatization projects show that although most IDA-supported privatization efforts have improved results at the firm level, macroeconomic and distributional results have been mixed. Problems with the methods and sequencing of privatization and weak institutions are partly to blame. As the 1995 report had warned, where legal and regulatory institutions are weak, privatization has not improved (and has sometimes worsened) equity and has done little for short-run productivity. Trying to reform state enterprises rather than divest them has not been any more successful. Privatization in transition countries where corporate and overall governance are poor has been especially problematic. Box 3 discusses the effectiveness of the Foreign Investment Advisory Service (FIAS), a joint Bank/IFC program facility aimed at assisting clients to promote direct foreign investment.

Box 3: Findings of a Joint OED/OEG Evaluation of the Foreign Investment Advisory Service (FIAS)

The Foreign Investment Advisory Service, a joint agency of the World Bank and IFC, has the central objective of helping client countries to promote direct foreign investment.

A 1998 joint OED/OEG review of FIAS found the relevance and efficacy of FIAS's work to be high (and on a par with World Bank policy advice). The consensus from client surveys was that FIAS provided detached, authoritative, sensible, and action-oriented advice. FIAS staff were found to be responsive to client needs. Some criticized FIAS for inflexibility, lack of timeliness, uneven quality, and high staff salary levels. But on the whole, clients were well satisfied with FIAS's services.

The survey found that clients largely adopted FIAS's advice or used it as a blueprint for local action.

Key lessons emerging from the FIAS experience are that achieving better results will require more intensive, country-specific diagnosis; a longer-term view; proper institutional foundations; and concentration on key firms and sectors. Since privatization is highly sensitive from a political perspective, it must be managed with due account to political economy considerations, involve a wide set of stakeholders, and give attention to prospective social/distributional impacts. Successful privatization also calls for managerial oversight focused on profit generation. The main test of successful privatization is meaningful and effective pre- or post-privatization restructuring.

Information Infrastructure: The World Bank's Experience

The *Information Infrastructure: The World Bank's Experience* study found that significant progress was made in the 1990s with (a) the adoption of a "new" private sector–led agenda (emphasizing privatization, competition, and independent regulation) under Operational Policy (OP) 4.50 (1995); and (b) the incorporation of the new agenda in most recent Bank lending and non-lending interventions. These measures led to an increased IFC share of total Bank Group funding commitments for telecommunications (from 8 percent in 1986–92 to 32 percent in 1993–99). Both the Bank and the IFC telecommunications portfolios have continued to perform better than average. However, existing measures do not capture the bulk of Bank Group information infrastructure (II) activity—including many components of multi-sector projects and wide-ranging analytical and advisory services and partnerships—which, for the most part, is not subject to systematic performance monitoring.

The Bank Group's ability to play a global policy leadership role in helping developing countries cope with the information revolution has been hampered by its benign neglect of the sector at both the strategic and country management levels. As a result, the number of countries where it has had a real impact is limited. In a majority of developing countries, the sector reform agenda remains unfinished, private investment in most lower-income countries has been lagging, and connectivity gaps have been growing within countries. The study recommends that:

(a) The Bank Group's strategy transcend its traditional focus on telecommunications to encompass the broader information infrastructure sector, and optimize the use of its instruments (lending and non-lending) and expert skills.

(b) Gaps in the existing monitoring and evaluation systems be filled, at both the project and global level, to provide the framework necessary to assess the future effectiveness of the new strategy.

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