Introduction and Overview

Private sector development is an essential component of economic growth and poverty reduction in developing countries, as it is a very important source of innovation and employment generation. A vibrant and competitive private sector can also empower poor people by providing them with better goods and services at more affordable prices. In recent years, policy makers in many developing countries, especially in Africa, have paid greater attention to fostering private sector development (PSD) as a key pillar of their national development strategies. Similarly, PSD has become part and parcel of the development assistance strategies of multilateral and regional development banks[1].

Fostering PSD has taken the centre stage in the recent international initiative for African development — known as the *Enhanced Private Sector Assistance* (EPSA) — that was launched on the occasion of the Group of Eight Summit Meetings at Gleneagles in July 2005. The EPSA is an international initiative designed to take a comprehensive approach to support PSD by channelling resources to five major areas of intervention: creating an enabling environment, strengthening financial systems, building competitive economic and social infrastructure, promoting the development of small and medium-sized enterprises (SMEs) and promoting trade and foreign direct investment, including intra-regional trade and investment whose potential has not been fully exploited. In addition to these areas of main concern, the private sector operations of the African Development Bank have assisted its member governments in developing national strategies to enhance corporate governance which is fundamental to attract and protect investors, both domestic and foreign (AfDB, 2006).

The discussion on fostering PSD inevitably places itself into a wider debate on the respective roles of markets and governments for achieving sustainable growth and poverty reduction. For markets to work efficiently and deliver desired outcomes, an effective government is also needed to create an enabling business environment, provide public goods, facilitate adjustment and mitigate negative externalities associated with private action, such as pollution and other harmful environmental effects. A further challenge for developing countries in Africa (and elsewhere) is to enhance transparency and accountability in the design and implementation of policies aimed at fostering PSD so as to ensure that private sector-led growth can benefit the society as a whole.

The 2007 flagship publication on *Business for Development* is dedicated to this theme and more specifically seeks to address the following two questions:

— What is the role of government in fostering private sector development both in theory and in practice?

— How can private enterprises in developing countries and especially in Africa better seize the business opportunities created by their increased participation in global and regional markets?

Before addressing these questions, it is important to explain why the OECD Development Centre has launched this new flagship publication.

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Why are we launching this new flagship publication?

Over the past years the Development Centre has made substantive contributions to the OECD's work on PSD in developing and transition economies and more recently in the African context. Three examples may suffice to illustrate this point.

The first is the OECD Regional Workshop on *Trade Capacity Building and Private Sector Development in Asia* which was jointly organised by the Development Co-operation Directorate and the Development Centre in December 2003 in Phnom Penh, in close collaboration with the Cambodian government. One of the key policy messages emerging from this workshop is that fostering PSD calls for a mix of interventions geared towards improving the domestic policy environment and firm-level capabilities: these two goals are mutually reinforcing and need to be tackled in a comprehensive manner (Bonaglia, 2006).

The second example is a series of studies conducted in the context of the *African Economic Outlook* whose annual focal themes over the past five years have included privatisation (2003), energy (2004), financing SME development (2005), transport infrastructure (2006) and access to drinking water (2007). Furthermore, such special studies have been extended to the MEDA region. Three short *Focus* articles based on the results of these studies are included in this volume.

The third example of the Development Centre's contribution to the work of OECD on PSD is two ongoing activities that were initiated as part of the Development Centre's 2005-06 Programme of Work, on the *Impact of the Economic Ascendancy of China and India on Other Developing Countries* and on *Aid for Trade and Agro-based Private Sector Development in Africa*. Regarding the former, Goldstein *et al.* (2006) have demonstrated that the rise of China and India is already affecting the business environment and growth patterns of African countries. They argue that resource-rich Africa will have to balance the need to match the promotion of job-creating sectors (agro-business, textiles, tradable services, etc) with the desire to capitalise on a windfall gain generated by higher commodity prices (*Ibid.*, p. 111)[2]. As for the latter, its aim is to explore the possibility of agro-based PSD at country level and discuss how governments and their development partners can support it effectively. Some preliminary results of this work are included in this volume.

These ongoing activities provide the Development Centre with the opportunity to launch *Business for Development,* a new series of publications dedicated to PSD. A novelty in this flagship publication is that the volume includes the contributions from other substantive directorates working in this area, including the Centre for Entrepreneurship, SMEs and Local Development (CFE), the Directorate for Financial and Enterprise Affairs (DAF) and the Development Co-operation Directorate (DCD). Their written contributions have broadened the scope of analysis and enriched policy discussions.

What do we know about the private sector in developing countries?

It may be useful at the outset to highlight some salient features of the private sector in developing countries. The private sector can be broadly defined as "a basic organising principle of economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk taking set activities

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in motion" (OECD, 2004). The term therefore covers all private actors — the poor and the rich, individuals and businesses — engaged in risk-taking activities to earn profits and income through market exchange. It applies to smallholder farmers as well as to very large multinational corporations (MNCs).

The diversity of the private sector across developing countries and regions and its fragility in many poor countries are already well documented in the literature. In the case of many low-income countries, notably in Africa, there is a paucity of reliable data on the size of the SME sector. But available evidence suggests that SMEs and informal enterprises account for over 60 per cent of GDP and 70 per cent of total employment in low-income countries and about 70 per cent of GDP and 95 per cent of total employment in middle-income countries (Ayyagari *et al.*, 2003). The majority of developing-country firms are not just small; they also disproportionately belong to the informal sector.

Taking the case of sub-Saharan Africa, OECD/AfDB (2005) highlights that a small number of large firms co-exists (even within the same sector) with a large number of micro and small enterprises. In this bi-modal distribution of enterprises, there is thus a so-called "missing middle". It has been argued that the predominance of micro and small enterprises stems from a combination of cumbersome regulations — it never pays to be just large enough to attract legal enforcement — and structural characteristics including low levels of skills and capabilities, underdeveloped product markets, unsophisticated demand and poor business environment.

The 2005 UNIDO Africa Foreign Investor Survey offers some interesting insights regarding the characteristics of the *formal* sector in 15 sub-Saharan countries. Ten per cent of the surveyed companies account for 70 per cent of all reported sales and 65 per cent of employment. Amongst the top 25 firms by sales revenue, 15 operate in the manufacturing sector (mainly in import-substituting sectors such as food and chemicals), nine in the service sectors (transport, storage and communication) and one in plantation agriculture. Of these 25 firms, which bar one are joint ventures, 14 were exclusively domestic-market oriented. The smallest economies in the survey have none of the largest investors who are concentrated in Nigeria, Cameroon and Côte d'Ivoire.

The high transaction costs and the poor business environment are the two major sources of constraints facing African firms. In fact, these factors reduce the competitiveness of all enterprises (regardless of firm size) engaged in transaction-intensive economic activities that require, for instance, supplier credit and other financial contracts often with overseas business partners. The World Bank *Doing Business* report shows that 16 out of the 20 countries characterised by the worst business environment are in sub-Saharan Africa. Lacking formal institutions or facing unsupportive ones, African entrepreneurs often resort to private networks, based on ethnic relationships. The reliance on such informal mechanisms to govern contracting and market exchange has inherent limits, as economic transactions become more complex (Biggs and Shah, 2006).

The low managerial and technical capacity of many African firms is another obstacle to private sector development. Improvements in the regulatory environment are not sufficient to spur entrepreneurial activity. Managerial skills, access to capital and technology, availability of reliable and affordable infrastructure services are among the most severe constraints facing African businesses, especially SMEs, and limiting their ability to serve domestic, regional and international markets.

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Access to finance is often considered as the most serious obstacle to SME development in developing countries, notably in Africa. However, the problem of SME access to finance cannot be separated from considerations on the overall business environment in which these firms operate. The institutional characteristics of the financial sector and various factors affecting the volatility of the business environment (information asymmetries, poorly defined property rights, lack of contract enforcement and protection of creditors' rights, high crime rates and so on) negatively affect the ability of firms to access credit. To be sure, these features tend to penalise SMEs disproportionately. An adequate strategy to promote SME development should then tackle both the internal weaknesses of the firms and the external factors that contribute to raising their perceived risk.

Private Sector Development: Theory and Practice

Chapter 1 of this volume presents a useful review of the very large body of literature on private sector development. It has two objectives: the first is to discuss the rationale for justifying public support to PSD following different theoretical approaches and for proposing an approach targeted at remedying so-called "co-ordination failures" that often lead to underinvestment in the economy. Since the actual policies and practices adopted at country level often deviate from what is justifiable on theoretical grounds, the second objective of this chapter is to review and discuss several concrete mechanisms currently used to foster PSD, with special focus on poor countries, notably in Africa.

This chapter concludes by drawing several policy lessons learned from recent experiences of PSD. These can be summarised as follows:

— The starting point for designing and implementing appropriate PSD policies is the firm-level. The analysis of firm-level weaknesses, notably in learning and innovation, should drive policy makers and donor agencies.

— The option to use indirect inducements, instead of direct interventions, should always be considered. This means building well-functioning institutions and appropriate incentive mechanisms supported by official development assistance.

— Open dialogue, transparency, accountability and regular evaluation are always necessary in designing and implementing PSD policies. These principles can help minimise corruption and avoid the risk of private firms capturing the whole benefits of policies.

— Governments need to adopt a dynamic approach to PSD as their policies evolve over time: this is because firms need to adapt to economic, technological and regulatory environments which are constantly changing.

As regards the role of donors, Focus 1 points to the importance of applying a pro-poor lens to PSD. This requires a rethinking of donor agendas and approaches, moving away from narrow direct interventions to broader, market-oriented approaches. In this context, public-private dialogue — the participation of civil society (e.g. consumers, employees, citizens and private sector associations) in the design and implementation of public policy — has been increasingly seen as a way forward to improving its effectiveness. Nonetheless, Focus 2 argues that donors' approach to public-private dialogue should be cautious and pragmatic in encouraging interactions between the government and the private sector in developing countries.

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Export Diversification and Global Value Chains

Although a broad range of policy goals are often attached to PSD, export promotion and diversification remain major development objectives associated with PSD in Africa today. This is because many low-income countries in the continent persistently depend on a very limited number of (largely unprocessed) primary commodities (Bonaglia and Fukasaku, 2003). Chapter 2 of this volume takes a close look at the question of export diversification in developing countries from the perspective of global value chains (GVCs). Among a variety of sectors that are considered to be affected by fragmentation of international production, the four sectors — namely household appliances, animation service, tourism and aircraft — were chosen to provide a varied picture of GVCs and draw some broader policy implications.

This chapter shows that the on-going fragmentation of international production has created considerable business opportunities for developing-country producers, not only in traditional labour-intensive manufacturing but also in a more technology-intensive industry and service sectors. Yet, realising such potential would require much more consistent efforts on the part of the private sector and governments. Value chain analysis can help identify the lead firms in the global supply chain with whom local SMEs could interact to promote domestic sourcing, linkage creation and upgrading. Governments can also support such firms' efforts to enhance production and design capabilities, as they seek to move into more profitable segments of value chains and adopt the strategies that allow them to turn their "latercomer status" into a source of competitive advantage.

Based on recent OECD experience on SME development and entrepreneurship, Focus 3 stresses that governments can play an important role in supporting the SME sector, particularly where there is market failure or where incomplete markets inhibit the provision of adequate financing to SMEs. Governments can also help improve awareness among entrepreneurs of the range of financial options available to them. Furthermore, Focus 4 provides a broader picture of SME development in Africa, notably from the point of view of financing. The key policy messages are drawn from the studies undertaken over the last few years in the context of the *African Economic Outlook*; these are still highly relevant for the current policy discussion on PSD in Africa.

Export diversification has been seen as a key strategic policy issue for many developing countries, since it is closely associated with their long-term development. On the basis of empirical work on the determinants of product variety in a country's export profile, Focus 5 presents a healthy reminder to readers that export diversification is closely linked to the stages of development (using per-capita income as a proxy) itself. Beyond that, the lack of human capital and deficiencies in infrastructure are found to be very significant among other factors driving product diversification.

Africa's Agriculture: Open for Business?

The policy issues discussed in Chapter 1 are highly relevant for Africa's agricultural sector. Chapter 3 reviews the current state of agriculture in the continent, discusses its export potential and suggests the ways forward as a critical component of PSD[3].

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Agriculture is by far the dominant sector in most African countries and plays an essential role in rural and overall economic development. More than 60 per cent of Africa's active labour force earns a livelihood in the agricultural sector. It also contributes 17 per cent of aggregate GDP and 40 per cent of total export earnings. Moreover, this sector is the primary source of employment for the poor, and is characterised by high female labour participation. Hence, an advancement of agriculture has the potential to contribute greatly to the achievement of the Millenium Development Goals (MDGs) by African countries. Stronger agricultural growth can also trigger development in the off-farm sector through production and expenditure linkages associated with higher agricultural income.

The global market for agro-food products is expanding and undergoing profound changes, which open up opportunities for African producers but also pose new challenges. The transformation of Africa's agriculture has been driven by technological advances, changes in food consumption patterns in OECD and more advanced developing countries, as well as stricter quality and health standards imposed by retailers and importing governments. This process is likely to continue at a faster pace, as regional and multilateral trade liberalisation gains (or regains) the momentum. Moreover, the likely increase in domestic demand associated with rapid urbanisation is another important driver of change for African producers. In many African countries, fresh fruits and vegetables are sold on the local market mainly through traditional retail channels. For instance, despite phenomenal growth since the late 1990s, exports remain a small fraction of Kenya's overall horticultural sector, with over 90 per cent of all fruit and vegetable production consumed domestically (Muendo and Tschirley, 2004).

Two country case studies reported in Chapter 3 show that both Tanzania and Zambia have given the highest priority to agricultural development and private sector-led growth through diversification and trade expansion. Development partners also emphasise the need to align their interventions with recipient-country policies and programmes. Nonetheless, more efforts should be devoted to better co-ordination of development co-operation efforts with the view to improving the supply-chain management and enhancing the capacity of local producers to link them up to processors and buyers.

In explaining the lack of dynamism in many segments of African agriculture in the past, Focus 6 argues that much of this problem can be traced back to the prevalence of institutional bottlenecks, such as weaknesses in property rights protection and in contract enforcement mechanism. This poses a huge challenge to policy makers and other stakeholders in pursuing agricultural policy reform which must be designed and implemented in a broader institutional setup. Similarly, insufficient provision of infrastructure services has long been considered a serious bottleneck to agricultural development, and more generally private sector development. Focus 7 gives a succinct review of transport infrastructure in Africa today and its importance to achieve the MDGs. It also points to the role the private sector has increasingly played in the operating segment of transport service provision.

Corporate Governance and Economic Development

The final chapter of this volume, Chapter 4, shifts attention to the question of whether corporate governance is important for developing countries to achieve long-term development. This is the area of research that has attracted greater attention since the East

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Asian crisis of 1997-98. This chapter argues that the role of corporate governance for development is likely to become even more important in the coming years, as virtually all developing countries are going through a difficult process of internal transformation, by moving towards more functionally rules-based systems of governance, away from those systems that are heavily relationship-based. This point may be better understood by seeing it from the angle of fostering PSD, because the purpose of corporate governance is to: *i)* facilitate and stimulate the performance of corporations by creating and maintaining proper incentives to motivate corporate insiders; *ii)* limit insiders' abuse of power over corporate resources; and *iii)* provide the means to monitor managers' behaviours to ensure corporate accountability and protect investors' and society's interests against corporate insiders.

The role of corporate governance for development is also better understood when one looks at the mixed results and lessons learned from past privatisation in many developing countries. Based on a new database developed by the Development Centre, Focus 8 provides a brief and insightful review of the privatisation process in the MEDA region. Its impact on PSD has been limited so far. More generally, it highlights the importance of governance — corporate and public — in managing the privatisation process and regulatory reform.

Concluding Remarks

Fostering PSD does not mean the disengagement of government in the development process; it means rethinking the ways it is engaged. Most importantly, it requires adopting a consistent set of policies and a "whole-of-government" approach to designing and implementing PSD programmes. Efforts to alleviate supply-side constraints would be useless if other policies perpetuated an anti-private sector bias and kept the incentives for engaging in new risk-taking activities low. A stable macroeconomic environment, adequate access to competitively priced inputs, protection of property rights and contract enforcement remain key priorities of any PSD strategy. Policies to ease certain supply-side constraints, for instance insufficient training for workers or low innovation activity, should be designed in conjunction with national efforts to identify a country's growth constraints. Concerning innovation, simply providing subsidised credit or incentives for re-investing profits in R&D might have little impact on a firm's actual R&D investment if the firm knows that, as a result of inadequate legal protection, it cannot fully internalise the benefits of its innovation. Again, a well-structured strategic collaboration between government, private sector and civil society can help identify possible areas of incoherence and legitimise government interventions.

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Notes

1. See, for example, AfDB (2006), AsDB (2000), IADB (2005) and World Bank (2002). See also UN (2004) and OECD (2006).
2. See also Blázquez *et al.* (2006) and Santiso (2007) for the impact of China on Latin America.
3. De Laiglesia (2006) provides a useful framework to analyse the institutional bottlenecks (ranging from cultural and social norms to legal and political systems) that may have affected agricultural development in sub-Saharan Africa. His analytical focus on fast-moving or slow-moving institutions seems very important to apply to the design and implementation of policies to foster agro-based PSD in Africa. See also Focus 6 in this volume.

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