

Chapter 3

Promoting the Supply-side Response: Technical and Financial Assistance for Pro-poor Growth

Why is the supply-side response important for pro-poor growth?

The economic reform programmes introduced in many developing countries during the 1980's stressed the need for a propitious enabling environment for the private sector. Initially there were high expectations that a package of macroeconomic reforms ("getting the prices right") would give quick dividends in terms of economic growth. There has been growing disappointment with the growth record in many developing countries. During the 1990's only 18 out of 117 countries with populations of more than half a million people were able to sustain growth rates exceeding those of industrialised countries.¹ Today, there is widespread awareness that much more comprehensive investment climate reforms are required and that such reforms are time consuming and challenging exercises.

Economic research has shown that as well as the level of economic growth, the pattern of growth is crucial for achieving pro-poor growth and reducing poverty in accordance with the Millennium Development Goals (MDGs).² There is a concern that the pattern of growth is not sufficiently pro-poor in a number of developing countries, which means that growth does not contribute as fully as it could to poverty reduction. An important reason is that the results of economic reforms have been weak, especially in markets and economic sectors in which a majority of poor people are active. This calls for greater focus on those markets that are important for the poor in their roles as entrepreneurs, employees or consumers.

Traditionally, donors have attempted to strengthen the enabling environment for the private sector by providing support to economic institutions and infrastructure. In parallel, considerable support has been provided directly to individual firms or groups of firms. Such support has included technical support *e.g.* business development services (BDS), often provided through public organisations or through donor projects. This support has frequently been supply-side oriented and has often included subsidies provided directly to individual firms. Financial support has also been provided for banks in the form of credit lines earmarked for specific types of company, in many cases with subsidies to reduce the cost of borrowing.

The rationale for direct support at the firm level has been described as follows:³

- 1 Direct support may be necessary to overcome **market imperfections and/or market failures**.
- 1 Such support may help **improve the response to reforms** in the policy environment.
- 1 Support to business champions and leaders may **create demonstration effects** for other firms and thereby stimulate the supply-side response.

Over the last decade, the shortcomings of subsidised and targeted support to individual firms or groups of firms have been widely recognised.⁴ Important lessons have been learnt and many donors are now reviewing their practices in order to make their support for private sector development more strategic.

The market-based approach that is now emerging can be seen as a reaction not only to the shortcomings of direct support to the private sector, but also as a realisation that efforts to improve the general investment climate are not sufficient. This approach puts the focus on the supply response, especially in markets of importance for poor men and women. It aims to identify obstacles to the development of specific sub-markets and to improve the institutional environment of those markets that benefit poor people – directly and indirectly – with special attention to small and medium-sized enterprises.

Lack of access to various kinds of services has been shown to be a critical constraint on the development of enterprises. Improving firms' access to business development services is one of the core instruments for promoting income and employment generation for poor people. The same applies to financial services where a deepening of markets for such services is an important element in many programmes aimed at stimulating pro-poor growth. Access to other productive resources, such as land and technical knowledge, can also be critical constraints.

What do we know so far and/or still need to know?

Commenting on selective interventions at the firm level as a complement to broad-based investment climate reforms, the “World Development Report 2005” states that “in theory, selective interventions can yield positive social outcomes. In practice, cases of unambiguous success are rare, and there are many examples of costly failures, even in developed countries with abundant technical expertise and well-established checks on rent-seeking”.

A general problem with interventions at the firm level is that they do not address the fundamental causes of market failure, but instead provide support to reduce the symptoms *e.g.* lack of access to credit. They can even deepen market distortions by preventing services from becoming available at cost price. Another main criticism is that by providing assistance only to selected firms (“picking winners”) donors distort the competitive environment and retard market development in specific industrial sectors. Firms benefiting from such support schemes often resist their removal.

Today, there is a well established consensus among donors that whenever assistance is provided at the firm level, the leverage effect of such interventions on the business environment, and on relevant markets, must be carefully considered.

BDS was one of the first areas in which the new market-based approach to private sector development was broadly applied. In 2000, the donor community agreed on guiding principles for BDS interventions⁵ which may be summarised as follows:

- i) Look at the target groups (entrepreneurs, farmers, etc.) as clients and not as beneficiaries (**demand orientation**).
- ii) Develop transactional relations with clients instead of a charity relation (**cost recovery**).
- iii) Supply BDS via **providers** that are themselves **business-oriented and market-led**; they may be individuals, private enterprises, non-governmental organisations (NGOs), chambers of commerce, business associations, parastatal bodies or government agencies.
- iv) Strengthen the **capacity and competence of service providers** to compete successfully in a market for BDS (no continued subsidies and clear points of exit for donor-funded interventions).

- v) **Stimulate the market** for BDS, *e.g.* through initial subsidies to clients (*e.g.* vouchers, matching grants or cost-sharing) for purchasing BDS on the market.
- vi) **Donors should act either as facilitators or supporters** of national/local BDS-facilitators, rather than providing services directly by themselves to the target groups.

There is today a growing amount of experience from implementing this market-based BDS approach, some of which can be summarised as follows:

- i) A high proportion of BDS donor programmes claim to address (explicitly) the poor, but empirical evidence is lacking; in general, market-based BDS for micro-enterprises, small farmers etc. still seems to be poorly developed.
- ii) BDS market development for poorer target groups has increasingly been based on market-led approaches; furthermore, there is a growing awareness of the importance of separating or “unbundling” business and welfare-oriented services (including from NGOs and public service providers).
- iii) Donor interventions aimed at BDS market development are increasingly directed towards agricultural sub-sectors and transformation of agricultural products in rural areas, where BDS markets are particularly weak.
- iv) BDS market development is increasingly part of broader programme approaches, *e.g.* development of value chains and local and regional economic development (LRED) or cluster promotion. However, empirical evidence on the pro-poor impact of such integrated approaches is still lacking.

What are the controversial issues?

While there is now a consensus among donors on the need to move towards more market-oriented approaches, opinions differ regarding how this should be dealt with in practice. For example, although there is common recognition that market-based approaches have limitations, there are different views regarding the appropriate criteria for diagnosing such situations and the steps that should be taken when markets fail.

Against the background of contributing to the MDGs, donors may be tempted to strive for short-term achievements and, as a consequence, neglect the principles of the market-based approach. Considerable resources may be spent on highly subsidised or even free services and goods (*e.g.* fertilisers, tools or infrastructure) in order to achieve some measurable results in direct poverty alleviation. This type of intervention may threaten attempts by other donors to promote systemic and structural change including broad market outreach, sustainability and efficiency, which can only be achieved in the medium or long term.

For the extreme poor and particularly for vulnerable groups, *e.g.* persons living with HIV/AIDS and handicapped people, the livelihood services approach has proved to provide a successful mix of group delivery mechanisms, subsidies, income generation activities and social mobilisation. Key challenges for donors in this context are developing appropriate exit or graduation strategies and striking the right balance between providing “charity” and supporting more business-like and sustainable approaches.

A core element in the market-based approach is that the providers of financial as well as technical support to enterprises should themselves be business-oriented and market-led. Although there is common agreement that any support to such providers should be

market-oriented, opinions vary regarding the design of such support. The debate on the use of intermediaries for provision of financial services is one example.

Policy implications for donors

The emerging approach for support to private sector development is based on the concept of systemic change; altering the incentives within markets to deliver pro-poor outcomes rather than providing direct support to enterprises.

The following key criteria and guiding questions may be applied by donors in connection with assessment of proposals that involve support to individual or groups of firms:

- i) Define the **rationale** for intervention: The focus should be on the sources of problems, not on the symptoms. What is the market failure that justifies a direct type of intervention? Is the proposed intervention the most appropriate response to the problem? Are there any risks that the intervention in itself may cause market distortions or retard the development of markets?
- ii) **Level playing field:** All firms should have an equal opportunity to access support instruments. This promotes competition and creates better chances for cost efficiency in the use of such support.
- iii) **Avoid or minimise subsidies to firms and intermediaries:** The subsidy component of credit and technical assistance provision should be as close to market terms as possible. This will ensure that the assistance reaches the firms that see a real value addition from the assistance provided. Instruments that minimise the required financial inputs, *e.g.* guarantee schemes that share risks with commercial banks and provide them with incentives to lend to small and medium enterprises, may be useful in the appropriate context.
- iv) **Provide subsidies to end users:** In situations where there is clear rationale for the public sector to provide subsidies, *e.g.* for social or infrastructure services, subsidies should preferably be provided in a transparent way to end users, rather than being channelled through providers of goods and services. Applied in this way, subsidies strengthen the demand for services and stimulate competition and market development.
- v) **Apply principles of “output-based aid”:** To support the delivery of basic services, explicit performance-based subsidies may be justified to complement or replace user-fees. Affordability issues for particular groups of users, positive externalities or the infeasibility of imposing direct user fees are examples of the types of concerns that could motivate the use of public funds to support the delivery of basic services. The principles for output-based aid have been defined by “the Global Partnership on Output-Based Aid” (www.gpoba.org).
- vi) **Clear exit strategies:** A predefined exit strategy should always be prepared in connection with support to firms.

There may be situations when market development approaches are not applicable. Particularly in post-conflict situations or after natural or man-made disasters, in the short term, direct firm-level assistance seems to be the most appropriate way to re-establish affected enterprises. The fundamental challenge is on the one hand to identify the right point of exit and, on the other, to find the right starting point for a gradual shift to a

market-based approach that aims to rebuild the supporting institutional environment for the private sector. There is often a need to differentiate and sequence donor support depending upon the type of firm and the stage of development.

Direct assistance at the firm level may provide valuable learning and insights into actual business problems and policy obstacles that can play an important role in advocacy for reform by donors and private business associations.

In the provision of technical and financial support at firm level, donors have often co-operated with a number of different stakeholders. For this and other reasons, donor support has often been scattered and duplication is common. The market approach requires concerted efforts to align donor support with national strategies and to strengthen aid co-ordination mechanisms.

Donors should review the way they internally organise themselves to support private sector development. There may be possibilities to promote synergies and cross-breed experience between different types of instruments. For example, the “transaction experience” among people who are involved in support at firm level may be very useful for colleagues specialised in the development of the enabling environment. Likewise, experience of analysing market institutions may provide valuable inputs for preparation of firm-level support. At the country level, it is often important to combine and co-ordinate interventions at different system levels; *e.g.* support to macroeconomic reforms with support at the meso (market) and/or micro (firm) level.

Impact monitoring should be an integral part of donor programmes aimed at market-based development of technical and financial assistance. Relevant information should be gathered regularly. Emphasis should be placed on learning rather than on proving. Amongst other measures, monitoring information should be used to keep the programme “on track”, and if necessary for adjustments. The monitoring system should include indicators which allow for measuring the impact of market development on the productivity of firms and on income and employment generation, with special focus on poor women and men.

Recommended best practices

It is not possible in a brief paper to provide more detailed recommendations on best practice within a large knowledge area. However, there is a wealth of sources that provide guidance and best practice on various aspects of firm-level assistance. Recommendations on some titles for further reading are given at the end of the chapter.

The following are some concrete examples of practices to be encouraged in the field of BDS:

- i) **BDS market assessments** should take into account the livelihood systems and the views of the targeted poor, including socio-economic, cultural, gender and other relevant aspects, by making use of participatory instruments.
- ii) This also applies to **value-chain analysis**, which should look into the links in the value chain and sub-sectors with a potential for value addition, thereby resulting in higher incomes and employment for marginalised populations.
- iii) Special attention should be given to services of particular relevance to the poor such as:
 - i) commercially oriented **input suppliers** to small-scale farmers; ii) **market access distribution systems**; iii) **embedded services** for rural micro-entrepreneurs and small

- farmers; and iv) **buyer or supplier credit schemes** linking producers to alternative financing mechanisms.
- iv) **BDS in rural areas:** Poverty is particularly widespread in rural areas. At the same time, there are clear constraints regarding the absorptive capacity of urban agglomerations. Therefore, it is extremely important to make BDS markets work for the poor in rural areas. The various approaches such as the sector approach in agro-business and food-processing, value-chain development or the promotion of local and rural economic development offer ample scope for creating improved income and employment opportunities. Interventions in favour of these inter-firm relations are usually geared to the development of a competitive edge for the whole cluster, sector, industry or region, and less to individual enterprises. This may bring about the systemic change that is so greatly required.
- v) **Possibilities of public-private partnership (PPP):** In developing value chains as well as in local and regional development, public and private partners could join forces to provide commercial and sustainable business services in the scope of business linkages. Depending on the partners, these can also result in the provision of cost-effective, high-quality, embedded services, such as market access or extension services.

Notes

1. World Bank (2005), *Economic Growth in the 1990s: Learning from a Decade of Reform*, Washington DC, www1.worldbank.org/prem/lessons1990s/index.htm.
2. Operationalising Pro-Poor Growth Research Program (2005), *Pro-Poor Growth in the 1990s – Lessons and Insights from 14 Countries*, Washington DC.
3. See Snoddgrass, D. and J. P. Winkler, (2004).
4. For a review of international experience with selective interventions at the firm level, see Chapter 8 of World Bank (2004), *World Development Report 2005: A Better Investment Climate for Everyone*, Washington DC.
5. The Committee of Donor Agencies for Small Enterprise Development (2000), *BDS for small enterprises. Guidelines for Donor Intervention*, often referred to as the “blue book”.

Further reading

- Brook, P.J. and M. Petrie, “Output-based aid: precedents, promises, and challenge”, paper prepared for the Global Partnership on Output-Based Aid (GPOBA).
- CGAP (The Consultative Group to Assist the Poor); *Building financial systems for the poor – Key principles of microfinance*, Washington DC.
- DFID (UK Department for International Development) (2005), “Making Market Systems Work Better for the Poor (M4P): An introduction to the concept”, discussion paper prepared for the ADB-DFID “learning event” ADB Headquarters, Manila.
- Lindahl, C. (2005), “Wealth of the Poor – Eliminating poverty through market and private sector development”, *Sida Studies* No. 14, Sida, Stockholm.
- Porteous, D. (2004), “Making Financial Markets Work for the Poor”, paper commissioned by FinMark Trust, South Africa.
- Snoddgrass, D. and J.P. Winkler (2004), “Enterprise Growth Initiatives: Strategic Directions and Options”, prepared for the US Agency for International Development, Bureau of Economic Growth, Agriculture, and Trade.
- The Committee of Donor Agencies for Small Enterprise Development (2001), *Business development services for small enterprises: Guiding principles for donor intervention*, Washington DC.

Tomecko, J. (2000), *The Application of Market Led Tools in the Design of BDS Interventions*, German Agency for Technical Co-operation (Deutsche Gesellschaft für Technische Zusammenarbeit – GTZ).

White, S. (2004), *Donor Approaches to Improving the Business Environment for Small Enterprises*, The Committee of Donor Agencies for Small Enterprise Development, Washington DC.

World Bank (2004), *World Development Report 2005: A Better Investment Climate for Everyone*; World Bank and Oxford University Press.