DAC Network on Poverty Reduction

PROMOTING THE SUPPLY - SIDE RESPONSE: TECHNICAL AND FINANCIAL ASSISTANCE FOR PRO-POOR GROWTH

Hot Topic paper prepared by the Task Team on Private Sector Development

This Hot Topic paper is one of a series being prepared by the POVNET's Task Team on Private Sector Development, to provide guidance to donors on using aid more effectively to promote the contribution of private sector development to pro-poor growth.

Once this and the Task Team's other Hot Topic papers have been finalised, they will be brought together in a compendium as the Task Team's contribution to the POVNET's work on promoting pro-poor growth.

Comments on this paper are welcome and should be addressed to the Secretariat (to: michael.laird@oecd.org).

Contact Person: Michael Laird - Tel: +33 (0) 1 45 24 90 33 - Email: michael.laird@oecd.org
FOREWORD

1. This Hot Topic paper is one of a series being prepared by the DAC Network on Poverty Reduction’s (POVNET’s) Task Team on Private Sector Development to help donors promote the contribution of private sector development to pro-poor growth. The series covers the following themes:
   - Removing barriers to formalisation.
   - Enhancing women’s market access.
   - Implementing competition policy in developing countries.
   - The financial sector’s contribution to pro-poor growth.
   - Promoting the supply-side response: Technical and financial assistance for pro-poor growth.
   - Institutions and public-private dialogue.

2. The Hot Topic papers are anchored in and build on “Accelerating Pro-poor Growth through Support for Private Sector Development”1, the analytical framework paper previously produced by the Task Team, and have been developed using the following set of guiding questions:
   - Why is the topic important for pro-poor growth?
   - What do we know so far and/or still need to know?
   - What are the big controversies (if any)?
   - What sort of policy implications and suggestions can be given?
   - Recommended best practices (more of a prescriptive value).

3. The Task Team proposes that its Hot Topic papers be published as a compendium in the DAC Guidelines and Reference Series. The compendium will also include a synthetic and policy-focussed overview that brings out the main messages for donors from the analytical framework, links the Hot Topic papers to the analytical framework and explains why these topics merit the attention of donors in their efforts to promote pro-poor growth.

4. The compendium of Hot Topic papers constitutes the Private Sector Development Task Team’s contribution to fulfilling the POVNET’s mandate to develop policy guidance for donors on using aid more effectively to promote economic growth and poverty reduction (pro-poor growth).

5. The Hot Topic papers will be presented to the POVNET at its meeting on 27-28 October 2005 and will subsequently be submitted to the DAC for approval.

---

1. This report is available on the Internet at: http://www.oecd.org/dataoecd/53/21/340555384.pdf
PROMOTING THE SUPPLY-SIDE RESPONSE: 
TECHNICAL AND FINANCIAL ASSISTANCE FOR PRO-POOR GROWTH

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

6. 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 macro-economic 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 wide-spread awareness that much more comprehensive investment climate reforms are required and that such reforms are time consuming and challenging exercises.

7. 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 has been weak, especially in markets and economic sectors in which a majority of poor people are active. This calls for putting an increased focus on those markets which are important for the poor in their roles as entrepreneurs, employees or consumers.

8. Traditionally, donors have provided support to strengthen the enabling environment for the private sector in the form of support to economic institutions and for economic infrastructure. In parallel, considerable amounts of support has been provided as direct support to individual or groups of firms. Such support included technical support e.g. business development services (BDS) often provided through public organisations or through donor projects, frequently supply-side oriented and with subsidies provided directly to individual firms. Financial support has often been provided for banks in the form of credit lines earmarked for specific types of companies, in many cases with subsidies to reduce the cost of borrowing. Chapter 4 of the conceptual framework “Accelerating Pro-Poor Growth Through Support for Private Sector Development”\(^3\) provides a discussion of these different types of donor interventions.

9. The rationale for direct support at the firm level has been described as follows\(^4\):

i) Direct support may be necessary to elude market imperfections and/or market failures.

ii) Such support may contribute to accelerating the response to reforms in the policy environment.

iii) Support to business champions and leaders may create demonstration effects for other firms and thereby stimulate the supply-side response.

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

11. The market-based approach which is now emerging can be seen as a reaction not only to the shortcomings of practices of providing 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 to the economic activities of poor women and men. 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-size enterprises.

12. Lack of access to various kinds of services has been shown to be a critical constraint on the development of enterprises. Improving firm’s 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 technological knowledge, can also be critical constraints.

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

13. 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 practise, 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".

14. A general problem with interventions at the firm level is that they do not address the fundamental causes of market failure due to a weak enabling environment for the private sector, but instead provide support to reduce the symptoms of market failure; e.g. lack of access to credit, or even risk of deepening market distortions by preventing services 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.

15. 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.

16. BDS was one of the first areas in which the new market-based approach to private sector development was broadly applied. Already in 2000, the donor community agreed on guiding principles for BDS interventions which may 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 by providers which are themselves business-oriented and market-led; they may be individuals, private enterprises, non-governmental organisations (NGOs), chambers of commerce, business associations, parastatals 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, marketing of BDS, getting the environment for a BDS-market right.

vi) With donors acting either through their programmes as facilitators or supporters of national/local BDS-facilitators, rather than providing services directly by themselves to the target groups.

17. 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 great deal 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 seem 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 for BDS market development for the poor 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.

III. What are the controversial issues?

18. While there is today a consensus among donors on the need to move from direct assistance at the firm level towards more market-oriented approaches, opinions differ regarding how this is dealt with in practice. For example, although there is common recognition that market-based approaches have limitations, there are different assessments regarding the appropriate criteria for diagnosing such situations and the measures that are suited when markets fail.

19. 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. A considerable amount of 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.

20. 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.
21. 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.

IV. Policy implications for donors

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

23. The following key criteria and guiding questions may be applied by donors in connection with assessment of proposals which 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 the 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 which share risks with commercial banks and provides them incentives to lend to small and medium enterprises, may be useful in the appropriate context.

iv) Apply principles of "output-based aid": In situations when 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. Voucher systems are an example of this approach. Applied in this way, subsidies strengthen the demand for services and stimulate competition and market development. The principles for output-based aid have been defined by "the Global Partnership on Output-Based Aid" (see www.gpoba.org).

v) Clear exit strategies: A predefined exit strategy should always be prepared in connection with support to firms.

24. 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.

25. 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.
26. 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.

27. 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 macro-economic reforms with support at the meso (market) and/or micro (firm) level.

28. 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.

V. Recommended best practice

29. 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 which provide guidance and best practice on various aspects of firm-level assistance. Recommendations on some titles for further reading are given below.

30. 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 for value-chain analysis, which should look into the links of the value chain and sub-sectors with a potential for value addition 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 prospering of and 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 which is so greatly required.

v) **Possibilities of public private-sector 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.

### Further reading:

Brook, P.J. and Petrie M. *Output-based aid: precedents, promises, and challenge.* Paper prepared for The Global Partnership on Output-Based Aid (GPOBA)


An introduction to the concept Discussion paper prepared for the ADB-DFID ‘learning event’ ADB Headquarters, Manila


The Consultative Group to assist the Poor (CGAP); *Building financial systems for the poor - Key principles of microfinance*; Washington


NOTES


2 Pro-Poor Growth in the 1990s - Lessons and Insights from 14 Countries. Operationalising Pro-Poor Growth Research Program; 2005

3 "Accelerating Pro-Poor Growth through Support for Private Sector Development - An Analytical Framework"; OECD 2004


5 A Better Investment Climate for Everyone; World Development Report 2005; World Bank, Washington DC; 2004

6 BDS for small enterprises. Guidelines for Donor Intervention, Donor Committee for SED, 2000, often referred to as the ‘blue book’.

7 See also the Hot Topic Paper on "Enhancing Women's Market Access"