DAC ORIENTATIONS FOR DEVELOPMENT CO–OPERATION
IN SUPPORT OF PRIVATE SECTOR DEVELOPMENT

ORGANISATION FOR ECONOMIC CO–OPERATION AND DEVELOPMENT

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These orientations suggest broad policy outlines and practical donor strategies for promoting the private sector in developing countries. They take account of the evolution of thinking in this field and of current "best practice" in related assistance efforts. Many aspects of private sector development, however, are new to the development community and thus present special challenges. Accordingly, these orientations are considered by Members of the DAC to constitute a "work in progress". It is expected that as knowledge and experience deepens, they will be reviewed and revised as appropriate.

Executive Summary

A. Key Policy Orientations

The strategic importance of private sector development

1. Changing course: Economic development strategies adopted by the majority of developing countries following the Second World War focused on the central role of the state in planning and managing economic development, in allocating resources and in producing goods and services for public and private consumption. With time, however, it is increasingly evident that greater efficiency, productivity and economic dynamism can be achieved through market forces, competition and private initiative.

2. Since the mid-1980s, the widespread adoption of an economic development paradigm based on policies to strengthen market forces, increase competition and refocus the role of the state has heightened the importance of private sector development (PSD). Many developing countries are undertaking structural reforms aimed at encouraging private enterprise to take root and flourish.

3. These efforts are focused on:

   -- macroeconomic stability (fiscal and monetary reform) and creating incentives for efficient production (trade, exchange rate and price reform);

   -- promoting deregulation and competition; and

   -- improving the legal, judiciary and regulatory environment.

4. New efforts to improve the ability of the public sector to provide essential public goods, such as administrative and physical infrastructure and widespread access to health, education and training, are also part of the economic reform agenda which are of great importance to private sector development.
5. While these reform efforts have to "earn" their credibility in each developing country, it is important that their extent and significance be acknowledged and publicised by DAC Members so that positive images of the business opportunities in the reforming countries emerge as quickly as possible.

6. **The development impact of the private sector:** Private sector development promotes efficient economic growth and development and is a source of wealth, dynamism, competitiveness and knowledge. Beyond its economic merits, however, lie compelling social and political attributes that enhance the contribution private sector development can make more generally to sustainable development, the overriding goal of all development assistance efforts.

7. Jobs and incomes created by private enterprises lead to a more equitable diffusion of the benefits of growth to more people. In the case of microenterprises these factors are further enhanced by virtue of their particularly direct impact on poverty alleviation and on the integration of women and other marginalised segments of society into economic life.

8. PSD also engages people more actively in the productive and decision-making processes that affect their lives, furthering donor goals of participatory development and good governance. A growing private sector creates new stakeholders in the economy, advancing the development of a more pluralistic civil society that can lead to more accountable political systems and rising labour standards.

9. Finally, the combination of greater competition, market forces and profit motivations stimulates better use of both human and material resources (thus reducing resource depletion), and creates the tax base and potential for market-based policy instruments for tackling social and environmental challenges.

10. Taken in their entirety, the economic, social and political benefits of PSD suggest that it can be an important vehicle through which donors can help developing countries to establish socially-just and more environmentally-sound market-oriented economies based on democratic principles.

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**Definition and scope of PSD:** "Private sector" is conceived by the donor community as a basic organising principle for economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk-taking set activities in motion. The private sector principle can be applied in all economic activities -- agriculture, industry and services (including the delivery of public services). Donor motivations for supporting private sector development are based on promoting economic efficiency and social welfare. Donors agree that fundamentally private sector development is about people: releasing and harnessing their productive potential and satisfying their human needs and desires; and creating pluralistic societies which provide both human freedom and human security.
11. **The importance of an effective public sector**: The public sector provides for a secure and stable environment for business operations by formulating and implementing appropriate policies governing economic, social and political life. Government efforts to establish legal systems and enforce the rule of law are requisite for markets to function well and for business confidence. The state also has the important task of ensuring that markets work efficiently and correcting for market failure. The functioning of "safety nets" for those permanently or temporarily unsuccessful in the competitive system and, where necessary, the creation of safety net systems, is a public policy concern. Finally, the public sector can take strategic decisions regarding development in accordance with broader economic and political realities and a long-term horizon.

12. There is a wide consensus among donors that the more prominent role now accorded to the private sector does not detract from the central role played by the public sector: in fact, by releasing the state from the burden of producing goods and services that can be provided more efficiently by private enterprises, there is now greater scope for the emergence of a more responsive, more effective public sector. The ability of recipient governments to make progress in these directions is central to the success of efforts to develop the private sector.

**Recipient country tasks and responsibilities**

13. **Recipient country responsibilities**: Recipient government commitment to developing the private sector through sound, sustainable policies is essential. The fundamentals of good governance, including a responsible and responsive government committed to promoting transparency and accountability in administrative processes, institutional arrangements and economic management, should also be present. These conditions inspire business confidence, upon which future investment is based.

14. Recipient governments need to establish, therefore, through policies and administrative structures and procedures a "cultural" disposition that facilitates the growth of the private sector. This "reorientation" of policies, attitudes and expectations can be approached on three levels:

   -- **At the macro level**, it means adopting effective and sustainable policies that give credibility to government and to the economy. Fiscal stability, in parallel with the development of efficient financial markets supplying a variety of services, will foster more diverse and sustainable patterns of external finance and a greater volume of resource inflows. Rebalancing the roles of the public and the private sectors by reducing the considerable budgetary and administrative burdens imposed on the public sector through privatisation of parastatals is required in many countries if these macro conditions are to be met. This will also help to create the "fiscal space" needed for the expansion of key social investment expenditures in health, education, housing, etc.

   -- **At a meso level**, it means adopting policies that stimulate entrepreneurship, initiative and risk-taking. Governments have to focus special attention on measures to overcome resistance by elites,
labour, protected sectors and government bureaucracy to structural change and reform.

-- At a micro level, incentives and promotional measures should replace controls and prohibitions, and supportive attitudes and facilitation skills should be developed within the public sector.

The donor response to the challenges of private sector development

15. **The challenges of private sector development**: Private sector development creates new challenges and commitments for the donor community. Donor efforts to promote the private sector will necessitate changes to the way the aid effort is typically conceived and conducted. These changes are due, in particular, to two factors. First, PSD has to take place on a massive scale throughout the economy, and consequently donors have to organise themselves and their actions to leverage scarce aid resources to achieve this end. Second, aid efforts must work in harmony with market forces to create conditions that will trigger private initiative. New approaches to development assistance that address these factors will change the way donors organise themselves to carry out this work and the scope and method of designing and implementing related assistance efforts.

16. When planning aid programmes and projects in general, donors will need to assess systematically whether the effect and/or implementation of a given aid operation will help or hinder private sector development. Private sector development also calls for concerted efforts among donors to adopt closely co-ordinated approaches to public enterprise support, subsidies, investment incentives and end-user interest rates: this creates new imperatives for effective donor co-operation.

17. **Donor actions**: Donors have been strengthening their policies and programmes supporting private sector development:

-- on a macro level this entails encouraging, through policy dialogue, appropriate economic policies (such as low inflation, deregulation, fiscal and monetary stability, and rational factor prices) and structural change (through policy dialogue and technical co-operation in areas such as competition and trade policies and the creation of a well-functioning financial system);

-- on a meso level this involves donor efforts to assist in improving the institutional environment that frames business decisions: fostering predictability and stability in the business operating environment; promoting the rule of law and its enforcement; reducing the scope for corruption; and establishing institutions through which the public and the private sectors can engage in dialogue and feedback;

-- on a micro level it means donor support for such facilitative activities as business training and consulting services, micro- and small-scale enterprise development, privatisation, public enterprise reform, and foreign direct investment.
18. Donors acknowledge that PSD is not a panacea for all development problems. Developing countries present a wide variety of opportunities and challenges for development assistance in this area based on differing needs, strengths, capabilities, and relative levels of development. Progress is in large part dependent on changing attitudes and expectations, which should be encouraged to happen as quickly as possible. But progress also depends heavily on human and institutional development which must remain a basic, long-haul priority for development co-operation.

B. Operational Approaches to Policies and Programmes: A Donor Checklist

Building on "lessons learned"

19. The "foundations" of donor support: In a general way, donor private sector support should build upon basic approaches to development assistance as elaborated in the 1992 Manual of DAC Principles for Effective Aid. In particular, programmes and policies should incorporate basic development assistance objectives that stress strengthening indigenous capacities; engaging as many people as possible directly in development activities; fostering self-determination and self-reliance; building initiatives from the bottom up; mainstreaming women and marginalised segments of society in political and economic activities; reducing aid dependency; and structuring assistance in ways that ensure recipient "ownership" of the development process.

20. New ways of conducting the aid process: Private sector development involves diverse activities, ranging from supporting grassroots initiatives for microenterprise development to implementing technically demanding and highly complex projects furthering privatisation and financial sector reform. At the same time, the magnitude of the task of promoting private enterprise in the developing world calls for pro-active and co-ordinated donor efforts operating on a variety of fronts and at all stages of the aid cycle from preparation to evaluation, including feedback. Together, these factors call for new ways of designing development assistance programmes, delivering resources, and organising donor agencies in order to carry out this work. The following fundamental orientations guiding overall donor approaches to private sector development are distilled from the collective experience of the donor community. Donors agree:

-- to promote agency-wide awareness of how private sector development can be incorporated across the full range of aid agency activities;

-- to structure assistance efforts in ways that will build up indigenous systems that support entrepreneurs and facilitate resource flows throughout the economy;

-- to base country-level private sector development strategies on an accurate and timely diagnostic survey -- carried out either singly or jointly with other donors -- of private sector constraints and needs;
-- to identify key gaps or bottlenecks where donor interventions can have catalytic impact, setting in train similar forces spontaneously generated in situ;

-- while recognising the innovative function of pilot projects, to nevertheless focus increasingly on ways to scale up assistance efforts from a local to a national level by drawing on existing institutional networks and financial systems;

-- to channel assistance where feasible through self-help groups and, in that respect, help individuals organise themselves into groups through which they can collaborate with one another for mutual benefit, solicit public assistance, and influence public policies;

-- to rely on local financial systems for intermediating financial resources to enterprises where they are solvent and viable; to strengthen weaker local financial systems so that ultimately they can intermediate donor resources efficiently; to structure credit operations such that interest rates to end-users are positive in real terms and provide for cost recovery by efficient financial intermediaries; and to focus on extending effective systems for delivering credit to groups underserved by existing markets;

-- to bear in mind that much can be done with limited capital if funds are leveraged (i.e. revolving funds, guarantees) and are targeted at measures or initiatives that address the causes of market failure;

-- to ensure that direct lending to individual enterprises does not compromise the objective of developing indigenous domestic financial intermediation systems;

-- to foster the creation and strengthening of business linkages and enterprise networks -- for companies of all sizes -- within and among developing countries, including on a regional basis, and between industrialised and developing countries;

-- to explore opportunities created by open trade and investment policies to stimulate more diverse and competitive industries;

-- to provide assistance that is sustainable, meaning assistance that will neither contribute to degradation of the natural resource base nor result in donor dependency;

-- to design and carry out assistance programmes and projects in ways that blend with local customs, social mores and cultural dispositions;

-- to "think global, act local" by readying developing country enterprises for the challenges of globalisation and by creating networks for the exchange of experience and lateral learning at the regional and global levels between institutions and authorities;

-- to avoid direct private sector development assistance where a hostile policy environment renders such assistance ineffective;
and as regards microenterprise development:

-- to provide resources to end-users on a "wholesale" (i.e. through intermediaries) not a "retail" (i.e. directly) basis, and to adopt monitoring and control measures that maintain an acceptable balance between decentralisation and control;

-- to respond to local initiatives and provide resources to satisfy needs as articulated by beneficiaries and in amounts that can be readily and efficiently absorbed.

I. Basic Approaches to Private Sector Development

The crucial importance of private sector development strategies

21. Private sector development cuts across many sectors and involves a wide range of public policies and institutions. Achieving assistance goals is predicated on the careful elaboration of both country-specific and overall donor agency strategies in this area.

22. The elements of a country private sector development strategy are:

-- an on-going policy dialogue regarding measures and their phasing to liberalise and appropriately regulate the economy, downsize and upgrade the efficiency of the public sector and create a propitious enabling environment for private initiative and risk-taking;

-- project interventions supporting enterprise development, privatisation, export promotion, financial sector reform and foreign direct investment;

-- technical assistance for business and vocational training, specialised technical support and advisory services for governments vis-à-vis financial sector development and reform and privatisation, foreign direct investment promotional activities and the development of business-related professional services and standards; and

-- institutional development to strengthen public sector capacities for policy formulation and implementation, to deepen indigenous business management skills, and to promote the organisational development of private sector intermediaries.

23. Country strategies: Effective, coherent and mutually supportive policies and programmes for promoting private sector development are a logical outgrowth of an overall national strategy. While recipient country governments should take the lead in elaborating such strategies, donors have an important role to play in encouraging and assisting them to do so. Donors should work within country strategies, providing technical assistance and resources that fill gaps or complement ongoing support given by national authorities.
24. **The point of departure: private sector assessments.** Country strategies should be based on a clear understanding of the operating environment within which business is conducted. Private sector assessments, conducted in collaboration with other interested members of the development community and recipient country authorities where appropriate, are a useful starting point for donor work in this regard. Such assessments can also prepare the way for a national dialogue between government and the existing private sector that can foster greater mutual understanding of problems and concerns and stronger commitment to needed reforms. Donors recognise that the process involved in elaborating a private sector assessment -- and not the product itself -- is the greatest challenge to be met in this area: getting recipient country governments involved in conducting such surveys and ensuring that resulting policy prescriptions are implemented are crucial.

25. Private sector assessments are a useful tool for understanding how and where local policies and conditions hamper the sound growth and development of financial markets and the enterprise sector. When carried out with other members of the development community, they also create a collaborative framework within which the donor community can agree upon the selection and design of development assistance programmes and projects that will address such constraints. Assessments can as well determine whether market failures exist and how assistance efforts can most effectively attack their root causes.

**Fundamental donor approaches**

26. **Aid interventions in a market setting:** Donors agree that the overriding purpose of assistance in this area is to promote private sector development which is economically efficient and enhances economic welfare. Private enterprises which depend heavily and continuously on protection and official support are unlikely to be competitive or to contribute to sustainable economic welfare in the longer term. Aid should therefore be used to promote interventions geared to helping markets work more efficiently or to correct market failures. Donors should avoid interventions which create or deepen market distortions.

27. **Integrated approaches:** Donors need to forge an integrated approach to private sector development based on policy dialogue covering structural and institutional reform and on selective project interventions. Such approaches must be tailored to the economic and structural conditions, institutional capabilities and political realities of recipient countries.

28. **Catalytic, systems-building approaches:** Transforming countries long characterised by dirigiste policies and massive state intervention into market economies powered by dynamic and broad-based private sectors is a monumental task. Given the magnitude of effort required and the fact that development assistance is a scarce resource, donors must structure their private sector development strategies in ways that create synergies with basic economic and societal forces already in place in recipient countries. Thus, catalytic policy-based and system-building approaches should prevail over atomistic, project-by-project interventions with inherently limited reach.
29. **Differentiated approaches:** The elements, sequencing and priorities of a private sector development strategy differ among recipient countries given their relative stage in the development process and their basic approach over time to economic development. Middle-income countries in general have well-established private sectors and the basic institutions and markets required for producing and selling goods and services. The role here for donors will often be to support business-to-business linkages (i.e. transferring capital, technology, and management and marketing know-how) and the creation of business networks. Nevertheless, it will be important for donors to continue building local institutional and technical capacities and helping to create a more favourable environment for initiative and investment in these middle-income countries. Least developed countries, which have fewer and weaker institutions, markets and entrepreneurs and more destabilising factors, need assistance targeted at improving the enabling environment, strengthening institutions and establishing threshold conditions for business. Countries of the former Soviet bloc present altogether different needs and opportunities: while production skills and basic infrastructure exist, capital is scarce, marketing know-how is lacking and industry is often unable to penetrate and compete on international markets. Further, attitudes and habits more conducive to private enterprise (i.e. risk-taking, the concept of private property, the profit motive) are slow to develop.

30. **Diffusing private sector development throughout aid agency operations:** While private sector development is but one of several assistance priorities pursued by donor agencies, for many it is either a relatively new area of endeavour or one where, to date, activities have been limited: accordingly, its profile within donor agencies needs to be enhanced. Donors should ensure that policy approaches to private sector development are clearly articulated, widely disseminated throughout their agencies and incorporated into country programming. This horizontal approach helps insert a private sector dimension in assistance programmes previously reserved for and implemented by the public sector, including social services. Donors aim to ensure compatibility and coherence between PSD and aid programmes supporting other objectives, such as health, education, women in development (WID), urban development and the environment.

31. **Cultural context:** The development community is increasingly aware that the environment for production and exchange is strongly shaped by social values and cultural mores as well as by gender, generations and ethnicity. Attitudes towards saving, consumption, work, time, authority, the profit motive, and the community versus the individual may influence the receptiveness of local people to donor projects promoting the private sector. Donors must be sensitive to the social and cultural context of developing countries and, while remaining vigilant regarding harmful social behaviour such as nepotism and corruption, adapt their strategies accordingly.

**Donor private sector development partners**

32. **The leadership role of the existing private sector:** Established private sectors in the developing world have an important role to play in furthering PSD. Existing enterprises are a valuable source of information about the business operating environment and how it could be improved. They are also the
major catalyst for triggering a business response to policy reforms, yet they will not act if long-standing attitudes of mutual distrust and scepticism existing between government and the private sector are not changed. To overcome this, a process of constructive and collaborative consultations between the private and public sectors on the role of PSD and government control over that role is necessary. Donors can assist in this process, helping transform an adversarial relation into a more co-operative one based on better communication and compromise. Only where the existing private sector is organised on market and competitive principles should it assume such a leadership role. When corruption and protection are pervasive, the private sector will not make the broad contribution to economic and social development expected of it.

33. **Non-governmental organisations (NGOs), co-operatives and self-help groups**: Non-governmental organisations, co-operatives and self-help groups are key partners through which donors can implement PSD initiatives, especially those targeted at grassroots groups. Donors will be able to deploy resources more broadly by using such intermediaries as "retailers", but at the same time so as to maximise efficiency donors will have to strike a balance between delegation and control. Assistance focused on institutional development, in particular on organisational structure, operating procedures and financial controls, will permit progressive delegation of aid management to these organisations. In a larger sense, helping people organise themselves into groups to achieve economic, social and/or political goals is a crucial aspect of sustainable PSD. One of the greatest needs and challenges for donors in this regard is to learn how best they can help people to help themselves, often a fragile process requiring facilitation skills, patience and restraint.

34. **Donor development finance institutions (DFIs)**: Several OECD countries have established DFIs that invest in developing country enterprises through loans and/or equity, often with the participation of OECD private enterprises. Some also provide a range of financial services and products to promote capital market development and innovative financing arrangements in developing countries. These institutions have specialised knowledge about their home country industrial sectors and can be instrumental in helping donor agencies create business linkages and networks to help recipient country enterprises grow and become more competitive.

35. Many donor DFIs provide finance on non-concessional terms and, by mobilising other credit and equity sources, act as catalysts for new and more diversified patterns of private finance for development. Donors agree that these institutions should provide finance to end-users at terms that are positive in real terms and geared to recovering costs, and that lending should be focused on private enterprises, not parastatal enterprises. While mindful of portfolio diversification strategies, donor DFIs should refrain from concentrating unduly on client enterprises that could be served by existing local financial institutions.
II. Fostering an Efficient and Hospitable Enabling Environment

The framework for business transactions

36. The term "enabling environment" refers to the economic, physical, legal, regulatory and institutional framework within which business operates. It encompasses:

-- macroeconomic policies fostering growth and stability;

-- legislation and policy reform to facilitate the ability of local people to establish and protect property rights;

-- the creation of efficient markets in a competitive setting;

-- the provision of appropriate and efficient infrastructure;

-- rational legal and regulatory policies that balance legitimate controls and protection with concerns regarding efficiency, simplicity, impartiality, and legal redress;

-- appropriate fiscal policies and effective collection procedures;

-- a policy and institutional setting that facilitates empowerment, private initiative and risk-taking;

-- institutions and distribution systems for disseminating information about markets, enterprises and government policies; and

-- support services for business.

37. An efficient and hospitable enabling environment is a prerequisite for business investment, transactions and management. It reduces incentives for enterprises to operate informally. It is central to donor efforts to promote private sector development.

38. Fostering new attitudes: Donors recognise that changes leading to a supportive enabling environment must in the first instance be initiated and implemented by the recipient country, and that a constructive public/private sector partnership regarding policy reform is very important for progress in this regard.

39. Donors also consider that a hospitable enabling environment often calls for changes to the basic orientation of government authority (relying more on incentives rather than rules and sanctions) and to attitudes among public servants (engaging in promotion and facilitation rather than exclusively control and surveillance activities). Helping to rebuild and reorient institutions and individuals that interact with the private sector -- such as the courts, tax and customs departments and investment promotion and export development agencies -- can be an especially fruitful objective of development assistance.
40. **Linking PSD with good governance:** More generally, donor affirm that good government is central to establishing and maintaining a hospitable enabling environment and building public support for PSD. Donor efforts to strengthen accountability systems and civil society in recipient countries will promote effective and lasting change in this regard.

41. **Stressing legal and regulatory reform:** Policy dialogue is the major vehicle through which donors can pursue progress in this area. Economic policies have long been the centre-piece of donor/recipient country discussions. Donors now agree that greater emphasis should be placed on streamlining and rationalising legal and regulatory frameworks, much of which can be accomplished through active and ongoing technical co-operation. Consideration must be given to legitimate social and economic concerns underlying such policies. When advocating change, donors must be mindful of the feasibility of proposed reforms and the implications the reform will have on competitive conditions and access to resources and markets.

42. **Strengthening institutional certainty:** Reforms are also urgently needed to allay institutional uncertainty in recipient countries, the result of cumbersome bureaucratic procedures, discretionary and/or arbitrary decision-making and enforcement practices, repeated changes to the "rules of the game" and corruption. Greater transparency, objectivity, predictability and legitimacy in the institutional environment will lower transaction costs, increase contracting efficiencies and lengthen time horizons. It will also encourage open and formal business transactions and enhance the credibility of the state and its policies. Democratic institutions and processes protecting freedom of expression and promoting accountability in government have been most successful at creating conditions that ensure transparency and probity.

43. **The primacy of competition:** The most effective approach to creating a competitive setting in most developing countries is to pursue trade, price and investment reforms that liberalise and deregulate the economy, thus enabling the market mechanism to function efficiently. Continuing government financial support to inefficient and/or unviable parastatals precludes establishment of a "level playing field" for the enterprise sector and a competitive environment. Donors recognise the inherent difficulty of discouraging non-competitive behaviour in private operators and the appropriate role that regulation can play in improving the functioning of certain (i.e. financial, utilities) markets and in protecting consumers. Nevertheless, effective regulation is a function of government capacity which is compromised in some countries by the absence of a court system, discretionary decision-making by public officials and policies that favour certain sectors and public enterprises. Donors agree that the emphasis in the policy dialogue should, in the first instance, be on letting competitive markets work. However, anticompetitive and fraudulent business practices must be addressed. In assisting in this area, donors must weigh carefully local capabilities and the costs and benefits of establishing regulatory agencies.

44. **Human resources and labour markets:** In promoting private sector development, policies and programmes that can help labour to perform better and generate a skilled and educated labour force are critical. Permitting workers to associate and engage in collective bargaining on wages and labour standards is an important element of economic and social development, but at the same
time it is important that policies promote efficiency and adaptability in the labour market, both generally and at the enterprise level.

45. **Equitable and effective taxation:** It is axiomatic that a larger and more prosperous private sector will reduce fiscal pressures while simultaneously generating higher tax receipts. These developments (in addition to measures taken to reduce the size of the parastatal sector) will make it easier for governments to maintain macroeconomic stability and improve social conditions. Nevertheless, considerable scope exists for improving taxation policies (i.e. coverage, rates, incentives, structures and administration) in developing countries so as to improve the yield and enhance incentive effects. Collection procedures (including customs duties) need to be strengthened as well.

**Donor actions**

46. Creating a propitious business environment is the sum of a wide variety of policy initiatives and reforms and timely investment in physical and support infrastructure for business. Donors have a considerable array of options from which to choose their points of entry, such as:

-- providing technical assistance and expert services for implementing regulatory, legal and judicial reforms such as reducing barriers to firms’ entry and exit, streamlining tax administration and licensing requirements, creating and protecting property rights, ensuring contract enforcement, reducing labour market rigidities, eliminating discretionary decision-making and providing adequate oversight and control;

-- supporting the creation and modernisation of essential infrastructure such as transport, communications, utilities, energy, and port facilities, where possible by relying on private capital and management;

-- sharing experience and expertise with recipient countries regarding policies for creating competitive markets and industries;

-- strengthening company law to provide for adequate disclosure and auditing requirements;

-- promoting the rule of law; and

-- advancing the development of business services (information, export insurance, research, standards-setting, quality control, customs administration, etc.) and related professions (accounting, advertising, corporate lawyers, consulting, etc.).
III. Financial Sector Development and Reform

The impetus for change

47. The financial sector encompasses a nation’s network of financial institutions and markets as well as the instruments, norms and procedures that are employed in carrying out financial transactions. It serves three key functions: it mobilises and allocates savings, supplies the credit needs of investors and provides efficient payments mechanisms within national economies.

48. Access to long- and short-term finance made available on reasonable terms is indispensable for business operations. Donors recognise that the development of efficient financial markets and institutions capable of mobilising domestic savings and allocating scarce capital where returns are highest is a sine qua non for private sector development.

49. Widespread malaise: The financial sector in many developing countries is in a state of crisis. Much of the malaise in this sector is due to years of highly distortionary interest rate policies and arbitrary state intervention in credit allocation. For some countries over-indebtedness has jeopardised the solvency of banks, limiting their ability to source fresh external capital and increasing the cost of trade finance. Donors have contributed to restricting the role of financial sectors in developing countries by focusing on financial institutions rather than financial markets and systems. Financial institutions were considered to be merely conduits through which resources could reach the enterprise sector. Scant consideration was given to the crucial intermediation role of financial markets and the importance of minimising distortions in resource allocation which run counter to broadening access to finance and thus stimulating broad-based development.

50. Reorienting donor approaches: Investment finance provided by the development community supplies only a minute fraction of the capital used by enterprises in the developing world. It is important, therefore, for donor resources to be channelled in ways that contribute to the development of national financial systems in recipient countries. This implies working through and strengthening existing financial intermediaries where possible and setting interest rates at levels that are consistent with policies to mobilise savings and encourage the return of flight capital. A viable and efficient financial sector is instrumental in attracting a diversified, sustainable and expanding pattern of external capital flows.

51. Restoring the viability of financial institutions and building competitive and efficient financial markets is a priority concern of the donor community. Strategies must focus simultaneously on rehabilitating distressed banks (where advisable) through restructuring and recapitalisation operations and on policy reforms that liberalise credit and interest rate policies, reduce transaction costs, promote new financial instruments, establish appropriate regulatory and supervisory structures and provide for stable competitive conditions. Such strategies must be carefully designed and implemented in relation to macroeconomic and exchange rate policies. Given the crucial role that confidence and accountability plays in financial intermediation, it is important for financial markets and institutions to be characterised by sound
banking practices, adequate and timely government supervision, and the prompt enforcement of regulations and sanctions.

52. **Onlending terms:** Donors agree that subsidising the cost of credit to the final borrower compromises the efficient allocation of scarce financial resources, jeopardises domestic savings mobilisation, erodes the value of lending resources, undermines the financial viability of intermediaries and often gives rise to rent-seeking behaviour. It can also generate divisive competition among donors funding credit programmes in a given recipient country. Donors agree that, consistent with policies supporting the emergence of a competitive domestic capital market, interest rates to the final borrower should be positive in real terms and sufficient to sustain competitive and profitable financial institutions (i.e. market-related). Where private sector assessments have demonstrated that market failure exists, the appropriate response will be to target assistance at the cause of the market failure. Often this will lead donors to focus assistance on credit systems that reach enterprises currently underserved in recipient countries and on identifying and providing training and other technical assistance services.

**Fundamental donor approaches**

53. Donors have reviewed their experience with financial sector development and reform and have determined the following approaches and objectives as key for future development assistance in this area:

--- **Strengthening domestic capital formation:** The volume of development finance required by the developing world far exceeds the supply of capital that can be provided by donors and international capital markets. Experience shows that the savings accumulation potential in developing countries can be very high and is often disguised or undermined by a poor policy environment. Accordingly, developing countries must promote and enhance domestic savings and capital formation and the return of flight capital. Donors should, in the first instance, stress the need for policies to augment and preserve public savings and to stimulate private savings through rational interest rate policies and appropriate fiscal and regulatory measures. Similarly, donor-funded credit programmes should actively promote savings among participants.

--- **Building up existing systems and networks:** Financial sector assistance should be structured such that existing systems and networks in recipient countries are used and strengthened. For example, credit provided by donors for domestic enterprises should -- where feasible -- be channelled through the existing financial system. While most public-sector DFIs in recipient countries have fallen far short of achieving financial viability and efficiently allocating resources to worthy investment projects, many have recently undergone considerable reform. DFIs that are financially sound and managed in accordance with private sector principles (i.e. profitability, managerial accountability, performance incentives) should be utilised by donors as financial intermediaries.
-- **Financial market deepening:** Donors should support financial market deepening by encouraging policies that create a wide diversity of financial institutions and services (e.g. venture capital, leasing) and the development of financial instruments (e.g. bonds, equities, warrants) that can mobilise term finance. Policies and regulatory systems that build public confidence in stock exchanges are also important. Donors might also consider the use of guarantee funds, which have proven to be a cost-effective mechanism for catalysing investment finance, potentially on a regional basis among a group of countries. Guarantee funds must be organised such that risks are appropriately spread among all parties to the transaction (thus ensuring that each will work to reduce risks) and that beneficiaries pay fees to defray the costs of the guarantee.

-- **Improving payments channels:** Considerable scope also exists throughout the developing world for improving existing payments and clearance systems, thus facilitating business transactions and international trade.

-- **Supervision and regulations:** Adequate supervision of financial institutions and appropriate, enforced regulatory policies are the corner-stone of a sound financial system. Donors can assist recipient countries in this regard by sharing their knowledge and experience.

-- **The importance of well-conceived, comprehensive and carefully phased financial sector strategies:** Donor financial sector development strategies at the country level must be carefully designed. Interventions must harmonise, both in scope and timing, with a given recipient country’s overall strategy to move towards a more market-based financial system. As well, donor strategies should be comprehensive: a piecemeal approach to building and strengthening financial systems has proven inadequate and, at times, counterproductive.

-- **The role of DAC DFIs:** Donor DFIs have an important role to play in providing market-based finance to developing country enterprises and contributing to capital market development.

-- **Aid to reform banking institutions:** Donor assistance in the restructuring, rehabilitation and privatisation of financial sector institutions can be a powerful impetus to improving the performance of the existing financial sector.

-- **Transferring management skills:** Technical assistance for financial sector development, which constitutes the bulk of donor assistance in this area, is crucial for establishing efficient, competitive financial institutions. Financial sector technical assistance must be carefully planned and executed. The aim should be to transfer management and know-how to the staff of local institutions: over time the financial sector should be capable of operating without excessive reliance on expatriate personnel.
Donor co-ordination: Improved co-ordination and co-operation within the development community is decisive in the area of financial sector reform. Donors should discuss, at a high level, financial sector strategies with recipients at an early stage, they should plan interventions and exchange information with other donors, and they should inform other donors as appropriate about any dialogue that has taken place.

IV. Privatisation and Public Enterprise Reform

Rebalancing the public and the private sectors

54. Privatisation programmes are an important element of private sector development. They encompass actions to transfer the ownership of state-owned enterprises (SOEs) to private interests, to liquidate unviable SOEs, and to improve the performance of SOEs that will remain in the public domain. They also include policies to promote the private provision of public services. Privatisation programmes undertaken in conjunction with broader economic reforms to increase competition and correct factor prices are central to improving the allocative and productive efficiency of market economies.

55. Privatisation creates new stakeholders: For several decades most developing countries pursued economic development strategies based on massive state intervention in determining relative prices, protecting "infant" industries, and producing goods and services for public and private consumption. This gave rise to a large number of unviable and inefficient SOEs that created an unsustainable burden on state budgets and crowded out the private enterprise sector. Many countries are now seeking to "rebalance" their public and private sectors by facilitating the development of a larger, more dynamic private sector coexisting with a smaller, more effective public sector. Privatisation is an essential part of this rebalancing process. It is also critical to the long-term development of the private sector, drawing on and contributing to efforts to strengthen market forces and competitive conditions, to develop local capital markets and financial institutions, and to create new opportunities for potential private entrepreneurs, thus increasing the number of people with a commitment to and a stake in the reform programme.

56. Divestiture: Experience has shown that the full benefits of divestiture can only be achieved where the transaction results in the effective transfer of ownership, management and control to the private sector in a competitive setting. A change in ownership must, of course, be associated with changes in management attitudes and practices if the benefits of privatisation are to be realised.

57. Public enterprise reform: Not all public enterprises can or will be privatised. Inherently unprofitable enterprises need to be closed: although decisions in this regard are difficult due to concomitant job losses, liquidation will have an immediate and beneficial effect on public finances. The remaining SOEs can be managed much more efficiently. Soft budget constraints, interference in management and recruitment, and restrictions on
competition need to be eliminated. Social burdens should be removed from public enterprises, financed directly out of the budget and targeted to the poorest and most vulnerable sectors of society. Even if privatisation is not possible in the near future, improvements in SOE operations should help to open up divestiture opportunities at a later date.

58. **The vital importance of competition:** Efforts to improve economic efficiency and productivity through privatisation programmes will founder if policies fostering competition are not in place. Divestment should be sequenced with steps to liberalise and deregulate the economy and to strengthen market forces and competitive conditions so as to ensure that managers of restructured and reorganised SOEs -- whether private or public -- will respond to market signals based on true opportunity costs. Those SOEs which remain in the public sector will only prosper if government subjects them to competitive pressures and, in the case of utilities and natural monopolies, prudent regulation.

59. **Coping with unemployment:** Privatisation programmes will often result in labour redundancies and dislocation. Governments need to anticipate unemployment by devising plans and allocating necessary funds for severance payments, employment retraining programmes, placement and counselling services, and microenterprise development schemes. In many cases, SOEs provided considerable social services (i.e. schools and clinics) to employees and their families. Alternative ways of meeting genuine social needs must be elaborated. In this respect, privatisation programmes can help governments define social goals more explicitly and make their costs and relation to the budget more transparent, thus aiding the development of more sustainable and effective ways of achieving them.

**Fundamental donor approaches**

60. Donors agree to support actively the privatisation programmes of recipient countries and to approach such assistance as follows:

--- **Promoting structural adjustment:** Donors consider rebalancing the private and public sectors to be a crucial element of development strategies for the future, and hence a key ingredient of structural adjustment programmes. They recognise that the driving force must come from within the developing country itself. The orientation of donor support should therefore be encouraging and responsive to the policy reform process in general and to privatisation in particular.

--- **Donor efforts:** There are three broad areas where donor interventions can be of strategic importance: the design of a privatisation strategy; education and training for policy-makers and implementing officials regarding the ways and means of effectively carrying out privatisation programmes; and broad support in conjunction with multilateral agencies to improve the enabling environment. Donors are also uniquely placed to help divesting governments find foreign investors with the mix of technology, markets, skills and resources that will ensure a mutually beneficial privatisation outcome. Donor DFIs could play a substantive role in this regard.
**Competition:** Competitive conditions must prevail where privatisation is undertaken, and a level playing field as between the private and the public sectors must be established.

**The privatisation process:** Privatisation is a gradual process, best pursued in tandem with reform or improvement of the institutional setting in deliberate, sequenced steps (i.e. establishing a coherent and realistic government strategy, an efficient and independent executing agency, financial and physical audits, economic liberalisation and deregulation, transparency and public information, follow-on safety net programmes, etc.). Helping governments to build up public sector competences for managing the privatisation process will improve future prospects for advancing the rebalancing process further.

**Coherent aid actions:** Aid programmes should be consistent with privatisation goals. Donor assistance should not introduce distortions into the allocation of capital or crowd out local intermediaries. Donors need to be particularly careful that their grants or loans to public sector entities will neither hinder the possible future divestiture of these enterprises nor discriminate against private companies.

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**V. Enterprise Development**

**Basic needs for business**

61. Facilitating the creation and growth of business entities is the very heart of a private sector strategy. A diverse and broad-based enterprise sector efficiently producing goods and services for domestic and foreign consumption is a source of economic dynamism, wealth, entrepreneurship, and innovation. A hospitable enabling environment and ready access to resources create threshold conditions for enterprise development. In many countries, policies enabling local people (especially the economically and politically weak) to establish formal title over property for collateral purposes are also needed.

62. Donors can stimulate enterprise creation and growth by supporting training and technical services, by encouraging technology transfer and foreign direct investment, and by fostering appropriate financial services and resources. The private sector in donor countries can play a central role in helping to develop competitive and growing enterprises in recipient countries. This role, however, should be placed in perspective. Historically donors have tended to provide assistance in ways benefiting both donor and recipient country enterprises in this area: greater emphasis should be placed on appropriately responding to recipient country enterprise needs.

63. Human resource development is fundamentally important for the enterprise sector and is a key aspect of development assistance in this area. Unfortunately technical assistance to enterprises has been problematical for
the donor community: difficulties related to sustainability, relevance and appropriateness, successful skill retention and accessibility have proved enduring. Although many donors are concerned about performance to date, there appears to be an ongoing deficit within the development community vis-à-vis information and consensus concerning this very important area. Donors are committed to working together to discover the causes of technical assistance problems and failures and to devise pragmatic solutions.

Foreign direct investment

64. Foreign direct investment (FDI) is an important source of capital, technology and know-how for developing countries. It also facilitates access to international markets and stimulates trade and competition. For many developing countries FDI flows will be crucial to economic growth and efficiency and investment finance in the decades to come. Foreign capital will flow to countries that have strong and growing private sectors and where market opportunities exist. Although primary responsibility for improving investment conditions rests with the host country, donors can help by encouraging improvements to the enabling environment, especially those affecting foreign investors more directly. Reforms regarding the right of establishment, profit repatriation, taxation, land ownership, currency convertibility, intellectual property rights and existing judicial and accounting systems are often in order.

65. **Projecting a better image:** Over the past decade many developing countries have reversed previous policies by adopting legislation facilitating direct investment. Still others are now more aggressively seeking out foreign investors by offering tax, investment and/or trade benefits and creating a more favourable business environment. New competitors for FDI have been created in the former Soviet Union and China as these countries shift from command to market economies. As a result of these developments, competition for direct investment is intense and growing. Donors are well placed to help developing country investment promotion agencies more effectively target and organise their activities and, more generally, to engender a more hospitable and promotional attitude among public servants towards potential investors. Perhaps most importantly, donors could more actively assist recipient countries to improve their image abroad when merited by demonstrated commitment to reform and by improved economic performance. Information about business opportunities, incentives and current operating conditions in the developing world is urgently needed to counter the legacy of inhospitable government policies and poor business environments that until recently characterised many developing countries.

66. **Improving the outcomes of business linkages:** The donor community has actively promoted foreign direct investment and other forms of enterprise linkages between donor and recipient countries for many years. Nevertheless, most donors have had only marginal success in achieving lasting and mutually beneficial business partnerships with developing country enterprises. Business-to-business linkages will figure more importantly in private sector strategies in the future as global resource and production patterns are reconfigured and consolidated, particularly for middle-income and very large, economically dynamic low-income developing countries. Donors should make concerted efforts to share their experiences and lessons learned in this area.
Technology development and assessment

67. Technology is a key factor driving efficient production and international competition. Developing countries need to absorb, adapt and create technologies in order to fuel rapid economic development and to compete in international markets. Donors can help by encouraging foreign direct investment and industrial partnerships and by strengthening local capacities to absorb and develop technology and management practices. More fundamentally, donors should aim to facilitate the capacity of local peoples to solve technical problems themselves: this requires access to networks of knowledge and experience.

Fundamental donor approaches

68. Donors agree that the following orientations should guide their strategies for enterprise development:

-- **Sustainable assistance:** The focus of assistance must be on developing indigenous systems through which resources, advice and services can become quickly, efficiently and broadly available to the enterprise sector, ultimately on a self-sustaining basis.

-- **Forging linkages:** Helping developing country enterprises to compete successfully in global markets should be a key aspect of donor assistance to enterprise development in the future. Donors should look more systematically for opportunities to create local and international dynamic enterprise linkages through subcontracting, licensing, franchise arrangements and public sector and donor procurement policies. When enterprise linkages between donor and recipient countries are being promoted, the recipient country enterprise should be the pro-active partner.

-- **Linking technical assistance with credit extended to small-scale and microenterprises:** Donors have historically been active supporters of small-scale enterprise development in view of its economic dynamism and contributions to employment and income distribution. More recently many donors have begun to support microenterprise development for similar reasons. Donors affirm their commitment to assisting smaller enterprises and agree to focus greater efforts on providing useful and effective technical assistance programmes in conjunction with credit.

-- **Sharing lessons learned:** Concerted efforts must be made within the donor community to share lessons learned and accrued experience vis-à-vis industrial twinning arrangements, joint ventures, and other forms of donor/recipient country business partnerships sponsored through development assistance.

-- **The "quid pro quo" principle:** Donors should ensure that aid is not used to offset commercial risks in a way that undermines necessary discipline on management. Measures ensuring cost recovery in private sector development projects (i.e. requiring enterprises to pay all or
a share of technical assistance costs) increase overall aid effectiveness and sustainability by promoting ownership and involvement by recipient enterprises.

-- **Strengthening competitiveness through technology transfer:** Given the escalating competitiveness of global markets, donors must be attentive to ways of strengthening the competitiveness of developing country enterprises by integrating business-to-business linkages, research and development, technological and organisational innovation and regional integration within private sector development assistance programmes. Donors should ensure that technology transferred via such arrangements is appropriate to the needs of recipient countries and not motivated by commercial interests.

-- **New technical assistance needs:** Technical assistance to recipient country enterprises should be provided in response to locally defined needs, it should draw where possible on local expertise and it should be delivered through local intermediaries. Greater needs are now evident in the areas of marketing, management, product development, quality control and environmental management.

-- **Regional initiatives:** More innovative mechanisms for promoting regional enterprise development through networks for mutual learning and technological capacity building could be researched and collectively supported by the donor community: such an approach could be an effective way of building regional capabilities to satisfy regional and world markets.

-- **Subsidies for training and institutional development:** There are sound reasons for regarding business training as an "adult education" programme which could be partially subsidised by donor funds. Subsidisation may also be an appropriate means of defraying the costs of institutional development -- especially in the start-up phase. In the interests of promoting sustainable assistance programmes and local institutions, however, such subsidies should be progressively phased out.

VI. **Microenterprise Development**

69. Microenterprises are a large, growing and very dynamic element of the economies of developing countries. In many countries these very small, generally family-based enterprises or sole proprietorships comprise an important part of the informal economy. A thriving microenterprise sector generates output, employment and incomes and strengthens intersectoral linkages leading to more integrated, resilient economies and balanced growth. It also promotes more broad-based participation -- particularly by the poor and by women -- in productive activities, leading to more equitable income distribution. The goal of donor support to microenterprises should be to address impediments to their operation and to establish sustainable local
systems and institutions facilitating their creation and development and their eventual integration into the formal enterprise sector.

A new priority: co-ordinated donor support for national strategies

70. Donor assistance to microenterprises has typically taken the form of project-centred interventions involving the provision of credit and technical assistance. Donors acknowledge that the focus of assistance now needs to shift to improving and strengthening the policy framework and developing indigenous institutional systems which promote and facilitate microenterprise development, ultimately on a self-sustaining basis. This requires co-ordination among donors vis-à-vis coherent donor policies in this area and strengthened national strategies for microenterprise development by developing country governments. Donors need to help recipient countries understand the potential and problems of the microenterprise sector and set out national strategies for addressing their needs.

The primary role of self-help groups

71. Donor assistance to microenterprises must be geared to local, grassroots participatory processes of communication, decision-making and planning in order to let projects evolve from below. Self-help groups organised by local microentrepreneurs are an important vehicle through which development assistance can be channelled to microenterprises. They are indispensable to the process of promoting communication, planning and implementation between microenterprises on the one hand and government, non-governmental organisations and donors on the other. While their potential is enormous, self-help groups are rarely adequately prepared -- organisationally, financially or politically -- to function efficiently and on a sustainable basis. Their performance could be greatly improved through appropriate donor institution-building assistance.

Appropriate secondary intermediaries

72. Central to a systems-building approach to microenterprise development is the evolution of appropriate local secondary intermediaries which can reach large numbers of microenterprises and/or their self-help organisations with effective, low-cost facilities for collecting savings and providing credit, technology and training services. The public sector has not generally been an appropriate source of such institutions, although services it has provided such as training have been beneficial. NGOs have proven to be especially effective in working with grassroots development schemes. In order to provide the financial and other business development services which microenterprise need, NGOs and other secondary intermediaries require a critical mass of institutional capabilities and skills. Business-oriented NGOs have proven to be most successful in this regard.

73. Donors are relying increasingly on NGOs as partners in implementing aid projects and programmes, but this greater involvement has not always been beneficial. In the case of microenterprise credit programmes, donor funding pressures have often resulted in an extremely rapid expansion in the scope and
size of programmes handled by secondary intermediaries, overburdening existing management and financial systems, compromising the organisations’ ability to provide services to their clients and sometimes weakening the focus of their original purpose, where the intermediary finds their strength.

Lending modalities and financial systems

74. Experience has shown that there is no single "correct" model for providing financial resources and technical assistance to microenterprises. The most successful and effective microenterprise lending projects are often those that "design themselves" in the field in response to locally determined needs and the unique social, cultural and economic setting of a given recipient country. Successful lending programmes have "learned" from the experience of other lending programmes and applied these lessons in different ways: they have modified their approaches, their objectives and their delivery technologies over time to adapt to changing circumstances. Finding the right mix of credit and technical assistance, the appropriate technologies for delivering them and the best ways of organising microentrepreneurs and support institutions that work with them is often achieved only through trial and error and over lengthy periods of time.

75. Domestic resource mobilisation must be a key aspect of microenterprise support programmes that have a credit component. External resources cannot provide more than a fraction of the total needed to finance microenterprise growth. Building financial systems which reach small savers and microenterprises and promote greater financial intermediation on a local, regional and national basis is critical in this regard. Linking formal with informal financial markets and coupling lending activities with savings programmes will help ensure the financial viability of credit projects and promote better economic and social integration.

The crucial role of female entrepreneurs

76. Microenterprise development is especially important for women, who often find themselves without access to jobs in the formal sector due to either a lack of training and/or the competing demands of household maintenance and childcare, and yet who increasingly shoulder family financial burdens. Donors note that women are very good credit risks and that the benefits of assistance in this area are very considerable since a predominant share of income earned by women is ploughed back into human resource development (i.e., food, health and education for children). Nevertheless, women face considerable handicaps when competing for scarce resources and services due to cultural constraints, lack of access to legal rights or recourse to legal remedies and low educational and literacy levels.

Fundamental donor approaches

77. Donors agree that microenterprise development should become a more central part of the private sector development agenda. Approaches to development assistance in this area should fall in line with those for private
sector development more generally: donors should focus on developing systems and networks, designing strategic interventions that act as catalysts, working within national strategies, upscaling assistance from the local to the national level, providing resources on a "wholesale" rather than a direct "retail" basis by working through intermediaries, and promoting lateral learning between institutions and authorities. Beyond these general orientations they also agree to:

-- **Help recipient countries better understand the potential and needs of microenterprises:** Donors resolve to encourage and assist governments to recognise the important developmental role of microenterprises, to develop overall, coherent national strategies to promote microenterprise development and to understand better how macro and microeconomic policies and legal and regulatory frameworks affect microenterprises.

-- **Adopt common approaches regarding credit operations:** Donor agreement on certain principles governing credit operations is central to achieving sustainable, mutually supportive assistance efforts. Donors broadly agree on the following points:

  . credit programmes that require large amounts of grant funding to meet high operating costs and large loan losses are not sustainable and have relatively limited reach;
  
  . utilising lending and savings technologies that imitate the efficient and flexible practices and procedures of informal financial markets substantially improves the efficiency, financial viability and effective reach of microenterprise credit programmes; thus microenterprise credit programmes should rely on character, group dynamics and the prospect of repeat loans to motivate repayments rather than on detailed appraisals and collateral;
  
  . microenterprise programmes should pursue credit and savings activities in a business-like manner and they should incorporate mechanisms that encourage a collective stake among participants in the success of the project (i.e. group collateral or liability lending, participation on the governing board, etc.);
  
  . donor assistance should strive to establish links between existing formal financial institutions and microenterprises, either directly or by forging links between banks and NGOs working with microenterprises in order to increase the access of microentrepreneurs to credit facilities.

-- **Focus concerted efforts on providing resources and services to women:** Donors resolve to help eradicate legal and administrative constraints on entrepreneurial activity by women; to promote women’s participation in project implementation and evaluation activities and in decision-making bodies; to help women acquire technologies for decreasing domestic work loads so as to free up time for entrepreneurial activities, and to provide training and extension services on-site and at convenient hours.
**Rely on local intermediaries:** Donors should work through local intermediaries, aiming to generate enduring local capacities, rather than interfacing directly with local enterprises. Adequate institutional support should be provided to these intermediaries to strengthen management and control functions and improve their ability to participate actively in all phases of the aid project cycle. Donors should exercise restraint when building up the volume of resources to be channelled through these institutions, providing resources in the measure that they can be absorbed and/or distributed based on existing administrative and financial management capacities and phased expansion possibilities.

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**VII. Environmentally Sustainable Business Development**

78. The productive sector -- both public and private -- in developing countries is a major source of environmental pollution and waste. Poorly defined property rights and obligations and indiscriminate access to resources have made it possible for enterprises of all sizes to produce goods without sufficient regard for the environmental impact that production processes and products themselves may have on resource depletion and environmental degradation. While some countries have enacted legislation, administrative procedures and enforcement mechanisms to address the environmentally harmful effects of industrial production, the majority are still in the incipient stages in this process. Furthermore, where legal and administrative frameworks have been developed to protect the environment, effective implementation and enforcement leave much to be desired. Donors are cognizant of the urgent and imperative need to ensure that development co-operation supporting industrial development proceeds in an environmentally sustainable manner.

**Environmental policies**

79. Recipient countries need to take an active, more forceful role in promoting incentives for the productive sector to operate in an environmentally-friendly way. Donors can help partner countries establish or become better informed about strong and enforceable policies, regulations and standards for environmental quality. Market-based incentives are often the most effective and efficient in terms of both financial and administrative resources.

**Technology transfer**

80. Technology choice and use is a key aspect of sustainable industrial development. Enterprises should be encouraged to utilise cleaner technologies so as to optimise resource use, to dispose of wastes more effectively and to mitigate more broadly negative environmental impacts. Reconditioning or replacing existing plant and equipment is an effective way of implanting cleaner technologies, but because few enterprises in developing countries have the means to learn about and/or acquire most environmentally sound new process
technologies, more scope exists to promote environmentally sustainable
development through the acquisition of end-of-pipe treatment technologies.
Effective technology transfer and transmission calls for a considerable
increase in the technological capacities of productive enterprises and in
supporting infrastructure in developing countries.

Challenges created by small- and medium-scale enterprises

81. Perhaps one of the most intractable environmental problems remains the
control of emissions and effluents from small- and medium-scale enterprises.
Large numbers of small, spacially dispersed companies may appear
environmentally insignificant but, in the aggregate, they significantly
contribute to water pollution (e.g. waste water contaminated by heavy metals
and other hazardous effluents) and toxic waste (industrial solvents and salts
in the water table). "Command and control" regulatory policies to deal with
this problem have proven especially difficult to monitor and enforce.

Fundamental donor approaches

82. Donors are concerned that production processes and products in the
developing world are a source of pollution and waste and are resolved to help
governments and enterprises join forces to promote environmentally sustainable
industrial development. In this regard they agree to:

-- Initiate a policy dialogue regarding environmental issues covering
environmental action plans or structural adjustment programmes
covering sectoral policies that address regulations impeding
environmental protection activities (i.e. subsidies, degressive
tariffs, uncertain or imprecise property rights, etc.).

-- Assist enterprises to acquire cleaner technologies or purchase
end-of-pipe technologies to reduce or eliminate industrial pollution.
This can take the form of grant financing for feasibility studies and
expert technical services. As regards subsidies for financing plant
and equipment, care must be taken to ensure that official development
assistance (ODA) does not substitute for finance that the market can
provide on commercial terms under reasonable assumptions concerning
pricing and competition, in accordance with agreed-upon DAC
principles and wider OECD disciplines (such as the Polluter Pays
Principle).

-- Fund training and technical assistance supporting the effective
transfer of technology, including operation, maintenance, adaptation
and creation.

-- Study and support creative measures to deal with the environmental
problems created by small- and medium-sized enterprises.
VIII. Institutional Development

83. **Linkages and advocates:** Private sector development can be an important vehicle for strengthening local institutional capabilities. Every donor intervention should support such work. The aim should be to build up indigenous capacities for planning and implementing reforms, maintaining a propitious enabling environment, establishing supervisory and control capabilities, managing business operations and supplying credit and business services. Donors have found that creating and supporting interchanges between networks of experienced practitioners who are skilled at solving problems and managing crises is the most effective way of supporting institutional development.

84. Many developing countries have undertaken sweeping reform programmes over the past decade to strengthen market forces and competition and to reduce and refocus public sector activities. In the initial phases of the adjustment process these reforms exact social costs in the form of unemployment and reduced living standards that impact most heavily on the poorer segments of the population. Widespread reform "fatigue" in the public at large currently imperils not only continued economic adjustment but political stability as well. Effective public information programmes to counter this tendency are of crucial importance at this juncture. The donor community can assist recipient countries "market" the reform process and strengthen the political will to complete adjustment by helping private sector institutions show the public why reforms are needed and the benefits that have already accrued. Donors can also support research and policy analysis that can inform the public debate.

85. **Helping entrepreneurs help themselves:** It is also important for donors to help indigenous private sectors organise themselves so as to advance their interests vis-à-vis government authorities and the public at large. Donors should support efforts to establish (or improve where necessary) institutional interfaces (such as chambers of commerce, producer associations, self-help groups) through which an interactive dialogue on policy issues and related concerns can take place. Private/public sector consultative processes inform government of the legitimate concerns of the business community while simultaneously building up the private sectors’ sense of ownership and commitment to the government’s agenda for private sector development. The involvement of the private sector in identifying needed reforms in regulatory systems and trade regimes is one example.

86. **Private sector "public relations":** Private sector development often calls for attitude changes within the public sector and civil society. For example, public servants interacting with the private sector often need to develop facilitation and promotional attitudes and skills. In countries with a strong dirigiste heritage donors can help governments promote entrepreneurship by restructuring school curricula and sponsoring special training facilities. Education, exchange of information and experiences, and the publication of country and case studies are ways in which donors can influence broad political attitudes and improve a government’s ability to manage.
IX. Improving Donor Co-operation and Coherence

87. *New imperatives:* The pursuit of private sector development creates new imperatives for effective and sustained donor co-operation. The complexity and political sensitivity of such activities as privatisation, public enterprise reform and financial sector reform require co-ordinated approaches by the donor community. Moving from project approaches to systems-building approaches will require donors to work within national strategies on a collaborative basis. Without improved co-ordination there is a high risk of conflicting and/or incomplete approaches that may hinder the development of a viable, efficient enterprise sector and waste scarce aid resources.

88. *Donor competition:* At times donors have operated as though they were competing with each other for both project ideas and capable institutions to help carry them out. DAC Members recognise that the lack of transparency and exchange of information among the donor community about past and ongoing assistance projects has often proven to be exceedingly costly.

89. *Basic orientations for donor co-operation:* Effective co-ordination processes should not be onerous and time-consuming. They should focus on harmonising broad objectives and strategies and organising information exchanges that will improve the effectiveness and reach of individual donor interventions. Greater continuity and complementarity are important objectives for the donor community to work towards in this regard. Striving for greater co-ordination will be important in such areas as interest rates, subsidies and investment incentives so as to ensure that donor actions will be effective, coherent and mutually supportive. Over time donors may find it useful to allocate high-level human resources, time and funds to the challenging task of co-ordinating aid efforts and collating donor experience. Such investments can be expected to result in substantial gains in the effectiveness and sustainability of the development processes thereby sent in motion. Donors recognise that co-operation is especially important at the country level, in particular as regards local absorptive capacity and the terms at which resources are provided.

90. *Sharing "lessons learned":* Concerted efforts should be expended to share lessons learned and experience regarding donor programmes and projects supporting private sector development. This will ensure more effective and efficient aid efforts in this area and the husbanding of scarce development assistance resources.

91. *Joint diagnostic surveys:* Where appropriate, donors should collaborate with each other and the development community at large in carrying out private sector assessments prior to planning the design of their country aid programmes.

92. *Policy coherence within OECD Member country governments:* Donors also recognise the need to improve policy coherence within their own governments. OECD Member countries’ policies, particularly in the sphere of trade, investment and financial flows, must be coherent with policies espoused by donor agencies vis-à-vis private sector development in the developing world, such as the need for recipient countries to facilitate foreign direct
investment, liberalise capital movements and financial markets and promote export-led development. In the area of international trade, of particular importance to developing countries, donor country public policies fostering non-discriminatory market access and reducing non-tariff barriers, tariffs on value-added goods and managed trade are essential to improving policy coherence in this regard. Recent initiatives to liberalise trade through bilateral and multilateral trade arrangements that lower barriers among participants without raising barriers to third countries are a major step in the right direction.

X. Application of the Orientations and Follow-up

93. DAC Members agree to:

-- review their private sector development policies and procedures taking into account the above orientations;

-- review private sector development policies and projects as part of individual DAC country aid reviews and other relevant DAC work;

-- exchange lessons learned and best practices regarding private sector development programmes, policies and instruments on a continuing basis in DAC fora;

-- revise and update these orientations, as necessary, in the light of indications emerging from these reviews and exchanges of information.
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