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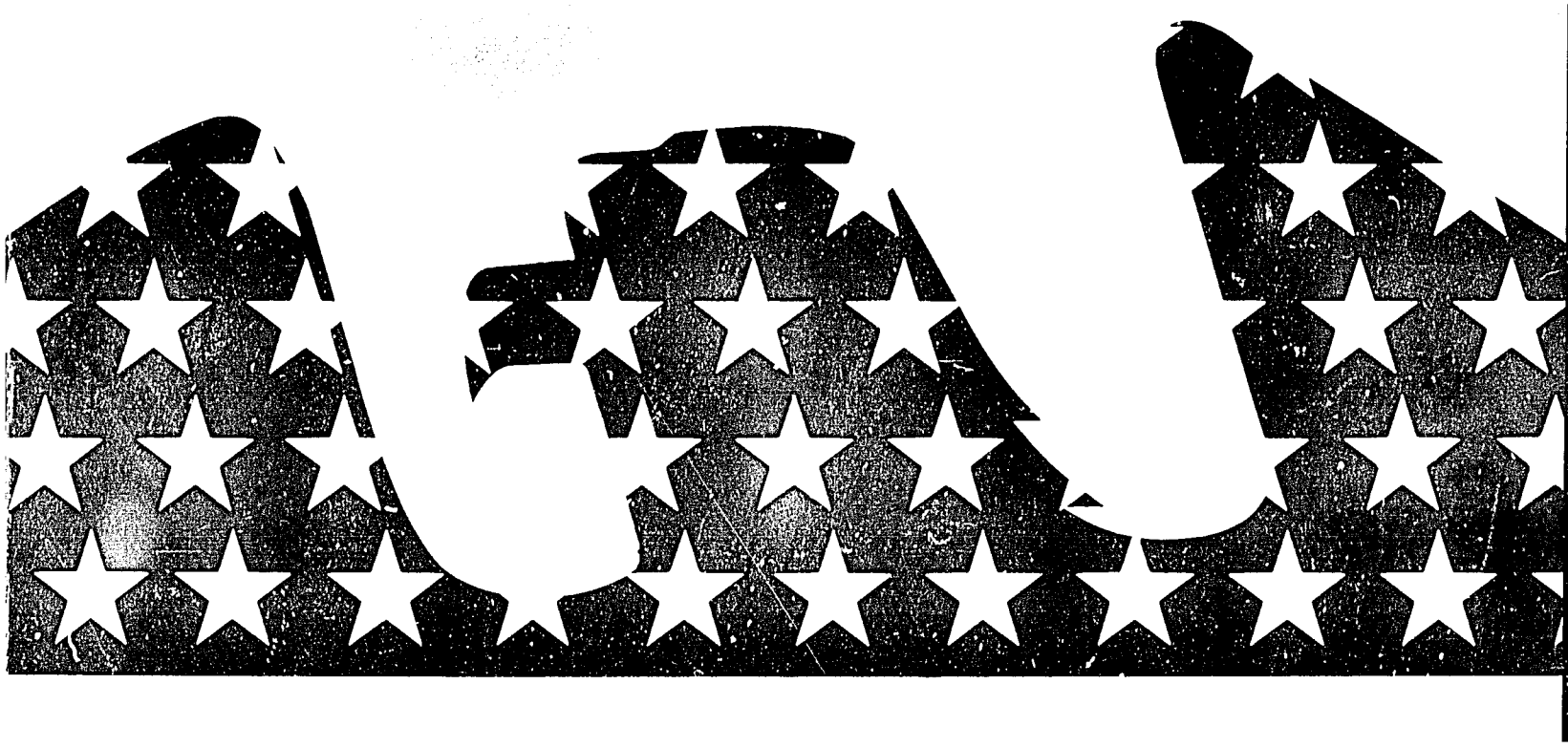
A.I.D. Policy Paper

PRIVATE ENTERPRISE DEVELOPMENT



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A.I.D. Policy Paper

Private Enterprise Development

Bureau for Program and Policy Coordination
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I. Introduction

This policy paper is based on the premise that greater reliance on private enterprise in third world development is essential to the effective and efficient achievement of A.I.D.'s central objective. A.I.D.'s central objective is to assist recipient countries meet the basic human needs of their poor majorities through sustained, broadly-based economic growth.[1]

We at A.I.D. are committed to enhancing the role and strength of free and competitive markets in third world countries. We have made this commitment because we are convinced: (1) that economic growth is central to the alleviation of poverty in the third world; (2) that private enterprise is the engine that makes growth occur most quickly; and (3) that a free and competitive market environment stimulates private enterprise. We also are convinced that allocations of resources through competitive markets are almost invariably fairer and more equitable, over time, than allocations made by governments. In fact, much of the poor performance of many low-income countries can be attributed to policies that have inhibited incentives to use markets (e.g., through price distortions, restrictive controls on private enterprise, unsound fiscal and monetary policies, and ineffective provision of public services). Many of these measures have had severe adverse effects both on economic growth and on the conditions of the poor in developing countries.[2]

President Reagan made these points explicitly in his speech last fall to the Board of Governors of the IBRD and the IMF:

> We who live in free market societies believe that growth, prosperity and ultimately human fulfillment, are created from the bottom up; not the government down.
>
> Only when the human spirit is allowed to invent and create, only when individuals are given a personal stake in deciding economic policies and benefiting from their success—only then can societies remain economically alive, dynamic, prosperous, progressive, and free.
>
> The societies which have achieved the most spectacular, broad-based economic progress in the shortest period of time are not the tightly controlled, nor necessarily the biggest in size, or the wealthiest in natural resources. No, what unites them all is their willingness to believe in the magic of the market place.

We should note at the outset that the achievement of broadly-based economic growth includes a legitimate role for the public sector in the economies of the developing countries. Primarily this role includes (1) the provision of public goods (goods and services which are not feasibly provided by private enterprise since it is impossible to exclude non-payers from receiving the benefits involved, as in the case of national defense), (2) the provision of goods and services involving externalities in either production or consumption (e.g., public health measures such as vaccinations that benefit those who do not receive them), or (3) the undertaking of high risk, large scale investments with long gestation periods which, although of substantial benefit to the economy, are not undertaken by private investors, particularly in low income countries (e.g., major physical infrastructure facilities).

Frequently, however, governments have preempted or discouraged private enterprise growth. They have involved themselves in the direct production of goods which could be produced more efficiently by private enterprise; they have administered prices in ways which discourage production and lead to misallocations and underemployment of resources; they have appropriated capital and scarce management skills that are better utilized in private production; and they have subjected the economy to political and centralized rather than economic and decentralized forces. The result often has been mismanagement and stagnation.

Governments also frequently have adopted negative or vacillating policies on investments by foreign private enterprises. Foreign private investments can play important roles in providing additional capital and new technology, management and marketing know-how.

The development history of the past two decades confirms the importance of private enterprise and individual initiative. One needs only to look at the recent growth experience of some of the more successful developing countries to appreciate the importance of market-oriented,

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[1] Section 101(a) of the Foreign Assistance Act (FAA) of 1961, as amended, delineates the following goals for U.S. development cooperation policy: (1) the alleviation of the worst physical manifestations of poverty among the world's poor majority; (2) the promotion of conditions enabling developing countries to achieve self-sustaining growth with equitable distribution of benefits; (3) the encouragement of development processes in which individual civil and economic rights are respected and enhanced; and (4) the integration of the developing countries into an open and equitable international economic system.

[2] There is growing evidence that rapid growth typically has been associated with reductions in absolute poverty. See Crosswell, M., "Growth, Poverty Alleviation and Foreign Assistance," A.I.D. Discussion Paper No. 39, 1981.

private enterprise-centered approaches to development that are complemented by a supportive public sector that provides infrastructure, invests in human resources, and creates a policy environment which encourages private enterprise investment.

The Foreign Assistance Act makes it plain beyond dispute that the private sector is critical in our development assistance strategy. The Congress, in Section 102 of the FAA, provides that "United States cooperation in development should be carried out to the maximum extent possible through the private sector. . . ." In Section 601 of the FAA the Congress also explicitly recognizes "the vital role of free enterprise in achieving rising levels of production [and] standards of living essential to economic progress and development." Section 601 further declares that it is the policy of the United States:

. . .to encourage the efforts of other countries to increase the flow of international trade, to foster private initiative and competition, to encourage the development and use of cooperatives, credit unions, and savings and loan associations, to discourage monopolistic practices, to improve the technical efficiency of their industry, agriculture, and commerce, and to strengthen free labor unions. . . .

Finally, Congress also declares in the same section that it is United States policy:

. . .to encourage the contribution of United States enterprise toward [increasing the] economic strength of less developed friendly countries, through private trade and investment abroad, private participation in programs carried out under this Act (including the use of private trade channels to the maximum extent practicable in carrying out such programs), and exchange of ideas and technical information on the matters covered by this subsection.

A.I.D. has *not* adequately pursued implementation of this portion of the legislative mandate. The Agency has not sufficiently explored and encouraged private enterprise options and alternatives in its policy discussions with host countries and in its formulation with them of assisted projects and programs. Accordingly, this policy paper directs a refocusing on the importance of free enterprise and the market mechanism in the development process.

We do so for several reasons. First, experience has shown that increased reliance on private ownership of the means of production, coupled with free and competitive markets, leads to accelerated economic growth. Second, the growth of private enterprise will bring less developed countries (LDCs) more completely into the international market system, and bind the developed and less developed worlds more closely together. Third, the growing interdependence of developed and less developed countries, together with the attitudes engendered by an open and free market system, will increase the political stability of the third world, and help spread a belief in democratic political systems.

A.I.D. intends to encourage this process across all of its development activities. We agree with Professor P.T. Bauer of the London School of Economics when he argues that donor nations "should favor governments which, within their human and financial resources, try to perform the indispensable tasks of government, but who refrain from closely detailed control of the economy—briefly, governments who govern rather than plan. This emphasis would promote liberal economic systems, minimize coercion, reduce political tensions and favor material progress."[3]

A renewed emphasis on private enterprise for development, as directed by the President, is directly responsive to A.I.D.'s four new strategic emphases: (1) economic policy reform; (2) institutional and human resource development; (3) private sector initiatives; and (4) technology development and transfer. For private enterprise to flourish there needs to be:

- A policy environment that is encouraging rather than inhibiting;
- Institutions and skills that strengthen the working of markets;
- A flow of capital resources for new investments; and
- A constant stream of new technologies that leads to both increased productivity and increased employment.

For the purpose of this paper, "private enterprises" consist of profit-oriented economic units producing goods and services for the market in which the means of production are privately owned. Included in this definition are agricultural, service and industrial enterprises—either incorporated or unincorporated, small or large, employers of large numbers of workers or of the owner solely. This paper also is concerned with business associations (e.g., chambers of commerce) that promote private enterprise, and profit-oriented, privately-owned cooperatives. Excluded from the definition of private enterprise are private and voluntary organizations (PVOs) that produce marketed products, non-profit oriented or publicly-owned cooperatives, and parastatals. These organizations, while they may conduct commercial operations, tend to respond to motives in addition to, or in place of, the profit motive, and thus

[3] Bauer, P.T., *Equality, the Third World and Economic Delusion* (Cambridge, MA: Harvard University Press) 1981.

are less influenced by the operation of free and competitive markets.[4] A.I.D. policy regarding assistance to public enterprise or parastatals involves complex issues and will be addressed in a separate paper.

While farms make up the vast majority of private enterprises in most less developed countries, A.I.D. policy in this area is covered extensively in the Food and Agricultural Development policy paper of May, 1982. That paper is completely consistent with this one.

In encouraging private enterprise initiatives, many instruments are available. Our approach must be balanced and tailored to meet the particular development needs of the countries in which we are working. Missions are urged to be creative and to look for innovative, private enterprise solutions to development problems. Risk taking is encouraged.

In the following sections, we focus on the two key issues in a private enterprise strategy: first, identifying and evaluating constraints to the growth of free enterprise and market-oriented development; and, second, developing policies to eliminate or at least reduce those constraints. The final section discusses implementation issues raised by the paper.

II. Identifying and Addressing Constraints to Enhancing the Role of Private Enterprise in Development

In carrying out the statutory mandate to expand the role of private enterprise in development, we must, of course, be aware of factors that might constrain accomplishing that objective. This section discusses several possible constraints, and suggests ways to evaluate their seriousness. Section II also points out the specific requirements of the Foreign Assistance Act which direct A.I.D. to provide assistance that alleviates these constraints. Section III discusses a number of actions to alleviate constraints and to promote private enterprise in developing countries.

A. Government Policies

Perhaps the most severe constraints to private enterprise are host government policies. Constraining policies include: (1) supporting government production in key fields such as marketing, finance, heavy industry, and utilities; (2) administering prices rather than allowing the market to determine them, especially for food and agricultural products; (3) mobilizing savings for public investment, while keeping interest rates too low, thus starving the private sector of credit; and (4) using trade, investment, and fiscal policies to direct the pattern of private investment in ways different than competitive markets would allocate such investments. These policies more often than not lead to widespread inefficiency and inhibit the investment of private resources.

Relying heavily on existing studies where appropriate, missions should place heavy emphasis on identifying host country macro- and micro-policies which impede an expanded role for private enterprise in development. Missions should have the elimination or modification of such deleterious policies at the top of their list of priorities in ongoing policy discussions with host governments. The Foreign Assistance Act requires this approach, since it states in Section 102(b)(1) that "development is primarily the responsibility of the people of the developing countries themselves."

B. Well-Functioning Markets

Inextricably related to the issue of government policies is the need to encourage the development of competitive well-functioning markets. For example, markets function imperfectly when monopolistic power, typically conferred on favored enterprises by government policy, is exercised. Where market performance is inadequate, missions should undertake institutional development projects that encourage better functioning of the market. In particular, consideration should be given to creating or strengthening financial intermediaries that rely on equity or debt instruments to provide funds for productive investments. FAA Section 601(a) explicitly refers to credit unions and cooperatives.

C. Physical Infrastructure

As Adam Smith pointed out two centuries ago, the wealth of nations derives from the specialization of labor, and the specialization of labor is dependent on the extent of the market. The extent of the market and, hence, the growth of private enterprise, depends on, among other things, an efficient transport network able to move goods and people cheaply. In addition, most agribusiness or manufacturing firms require an assured source of energy, a working communications system, and adequate supply of water and sewerage facilities, and other infrastructure systems. The less reliable these infrastructure systems are, the greater will be the costs of production, and the greater the disincentive to the growth of private enterprise.

[4] It is already established A.I.D. policy to support the strengthening of indigenous, development-oriented PVOs and cooperatives. These organizations, together with private enterprises and private universities, constitute the "private sector." Some PVOs and private sector production cooperatives respond to market forces in virtually the same manner as private enterprises as defined here. A new A.I.D. policy paper on PVOs is forthcoming and a Policy Determination on Cooperatives was issued in 1980 (PD 73).

A.I.D. is encouraged under Section 103(b)(1) of the FAA to expand "rural infrastructure and utilities." Similarly, FAA Secton 106(d)(5) authorizes A.I.D. to focus on "programs of urban development," including "marketing systems for small producers." In order to ensure its effective use, A.I.D. will consider capital assistance for infrastructure and other development purposes complementary to private enterprise only when such assistance is linked to proposed changes or effective performance in the areas of institutional development, technology transfer or development, or economic policy. Country performance will be closely monitored and evaluated to determine whether such assistance should be continued.

Although large-scale capital transfers are now largely beyond the A.I.D. development assistance budget, substantial infrastructure projects still are undertaken in, for example, Economic Support Fund countries. Moreover, close cooperation with other donor countries and multilateral institutions, as required by FAA Section 102(b)(11), frequently provides a means of obtaining necessary funding for infrastructure projects. Rural infrastructure projects can be important means of encouraging private enterprises to serve the needs of the poor.

D. **Supply of Investable Funds**

The lack of a developed financial market system which can provide local private enterprises with the investment funds necessary for expansion can be an important constraint to private enterprise growth. A rudimentary financial system inhibits the growth of savings and raises the costs of channeling savings to those investors with the most profitable investment opportunities. Existing credit markets tend to discriminate against small borrowers, owing to the excessive administrative costs and complex and lengthy procedures. Finally, interest rate ceilings established by governments often discourage savings, and result in a misallocation of scarce credit.[5] Further, although subsidized credit may be intended for small borrowers, they often are denied that credit because they lack the political power required to obtain it. Private financial institutions should be fostered so that they can play a more important role in providing credit and other services to small and medium-size entrepreneurs.

[5]For example, if interest rates were fixed at 10%, when the market-clearing rate might be 20%, all investors with projects returning above 10% would enter credit markets. Credit would be rationed among them with no assurance that a 25% return project would be favored over a 12% one. In these circumstances, political influence is all too likely to become the rationing criterion.

E. **Managerial and Entrepreneurial Skills**

One should not underestimate the degree of entrepreneurial ability present in LDCs. In low-income countries, however, entrepreneurs are experienced primarily in providing services, particularly in trade and transport. The co-existence of entrepreneurial ability with the know-how necessary to expand and operate manufacturing and other industries is relatively rare. Moreover, the development of larger-scale enterprises requires specialized management skills which in turn are based on more sophisticated training. A lack of skills in the areas of accounting, marketing, and financial management inhibits indigenous entrepreneurs from expanding their activities as quickly as opportunities present themselves.

Section 105(b) of the Foreign Assistance Act specifically provides that assistance shall ". . .be provided for advanced education and training of people in developing countries in such disciplines as are required for planning and implementation of public *and private* development activities" (emphasis added). Accordingly, it is entirely appropriate to address the possible constraint of insufficient managerial and entrepreneurial skills through projects funded under the Section 105 account of the FAA.

F. **Quality of the Labor Force**

In most LDCs, laborers often are inadequately trained, and lacking in sufficiently disciplined work habits. Lack of job skills means that many workers are unproductive relative to their potential, and consequently, the development of human resources is an important factor in making private enterprises more productive. Skills training programs are vitally important in efforts to improve the quality of the labor force. Section 105(b) of the FAA also directly addresses this issue, requiring that assistance shall be provided "especially" for those projects "designed to improve productive skills of rural families and the urban poor."

G. **Technology**

Private enterprise is by far the largest source and repository of new technology, particularly for industry. However, virtually all new technology is produced by and for the already industrialized countries. Many of these technological innovations are appropriate to business conditions in developing countries, but many more are not. Firms in developing countries often lack the capacity to enable them to choose or adapt the best technology from a range of available options or lack the ability to generate a continuing stream of innovations on their own. Section 601 of the FAA states that it is the policy of the United States to encourage the efforts of other

countries ". . .to improve the technical efficiency of their industry, agriculture, and commerce. . . ." Section III below offers some recommendations for expanding the role of private enterprise in the transfer and application of new technology.

H. Foreign Private Investment

In addition to the policies and resources of third world countries themselves, there are constraints which reduce the flow of foreign private investments below optimal levels. Free and open international markets will stimulate an increased flow of private resources into the third world from developed countries in general, including the U.S. There are several constraints that inhibit the operation of free and open international capital markets, including:

(1) **Insufficient Information.** There is a clear need for more and better information flowing from developing countries to private business in the U.S. that will help to identify undertakings of mutual benefit to U.S. business firms and LDC economies. Creating or strengthening institutions (e.g., the U.S. Chamber of Commerce branches in developing countries) to serve as information conduits can be an important and cost-effective task.

(2) **Excessive Risk and Start-Up Costs.** For many U.S. enterprises, the risks of investing in developing countries are perceived to be much greater than those of investing at home. Some of these risks exist because the requisite information is less readily available. U.S. firms understandably know less about tax laws, legal systems, unions, markets, and so on in a Latin American or Asian country than they do about the same practices in the U.S. Moreover, investments *per se* tend to be riskier in LDCs since governments are less stable, infrastructure and labor force less reliable, and economies more fragile than in the developed world. In addition, start-up costs may be higher; time is required to learn how to penetrate markets, develop management techniques that can work in a new environment, and adapt technologies to local conditions.

The Overseas Private Investment Corporation (OPIC) is, of course, available to provide political risk insurance and guaranties to U.S. firms. Missions may support feasibility studies in order to stimulate investments from U.S. firms that are interested in sound development oriented activities in host countries.

(3) **Biased and Unstable Government Policies.** By far the greatest constraining factors on foreign private investment are LDC policies themselves which tend to increase the risk and lower the profitability for such investment. Equally important, policies which vacillate (with or without changes in government) increase risk and provide no firm basis for positive long-range investment decisions.

III. Promoting Developing Country Private Enterprise

This section discusses several ways in which A.I.D. can alleviate the constraints identified in Section II. The primary emphasis of A.I.D.'s efforts to promote private enterprise development will be to encourage policy reform and to improve the way markets function. If successful, these efforts will have "ripple" or "multiplier" effects throughout the economy. For example, by helping a country reform policies (e.g., exchange rates, tariffs, taxes, and subsidies) that discriminate against exports, and by providing related technical assistance in the form of information and training on the world trade, A.I.D. would be helping that country develop its exports and create more competitive conditions. Other useful interventions should be made to upgrade human resource skills, stimulate technological change, and develop financial markets. The following discussion is intended not to be exhaustive, but to be illustrative of possible interventions by A.I.D.

A. Priority Sectors

A.I.D. will focus its private enterprise development activities in four priority sectors. These key sectors are (1) agriculture, (2) agribusiness, (3) small and medium scale industry, and (4) privately operated service enterprises. Activities need not, however, be limited exclusively to these four priority sectors. Economic Support Funds (ESF) in particular may be used to provide broad support in such areas as urban development, infrastructure, export or domestic industry, or other areas which directly support or are complementary to the Agency's private enterprise initiatives. A.I.D. will evaluate these priority sectors over time to determine whether they should be modified:

(1) **Agriculture.** In most developing countries, small scale farmers form the largest group of productive individuals within the private sector. As a group, these farmers and their employees comprise the bulk of the poor (including the self-employed). Agriculture offers a haven, no matter how temporary or bleak, for the otherwise unemployed. Small scale farmers respond to market signals, even if sometimes weakly (e.g., on subsistence farms) or cautiously (due to understandable risk aversion). A.I.D.'s emphasis on a farming systems approach to providing assistance for small farmers strengthens the small-holder, private sector base of many LDC economies. In most LDCs, progress toward

meeting agricultural production objectives implies that large numbers of small scale farmers should become economically viable, and produce growing marketable surpluses, over the next decade or so. A.I.D.'s private enterprise activities should reinforce its long standing concern for small scale farmers.[6]

(2) **Agribusiness Firms.** Support for agribusiness activities is especially useful in areas in which, owing to the application of new farm technologies, farm incomes are rising. Agribusiness firms frequently use efficient, labor intensive technologies. Most have strong forward (e.g., marketing services) or backward (e.g., agricultural production) linkages directly to the agricultural sector. As a result, in the vast majority of cases, agribusiness firms help create (directly and indirectly) a great many productive job opportunities. The Alimentos Congelados Monte Bello, S.A. (ALCOSA) project, supported by the Latin American Agribusiness Development Corporation (LAAD), which is in turn supported by A.I.D., provides an instructive example. In this project, small scale vegetable farmers were offered assured markets by an agribusiness vegetable processing plant. There were strong linkage effects on farmers' production and income. The evaluation of the project noted, however, that the ability of the management of the processing plant to honor its contracts with the small farmers was critical to the success of the project.

Many agribusiness activities (e.g., marketing, transport, storage, processing, credit provision, and production of inputs such as seeds and fertilizers) have been performed by public bodies in a number of LDCs. Encouraging private agribusiness firms to perform these functions should improve efficiency; the resulting expansion of the size of the markets involved also should create new productive job opportunities.

(3) **Small and Medium Scale Industry.** A.I.D. has not, in recent years, focussed on the industrial sector (with the exception of some large ESF programs, such as in Egypt). Support for small and medium scale enterprises is fully consistent with A.I.D.'s legislation. Small firms in market towns in rapidly growing agricultural regions offer particular promise. In general, profitable small scale enterprises use capital efficiently and account for a disproportionately large number of industrial sector jobs in LDCs (this is due in part to their quick response to market signals); in general they allocate both capital and labor according to their respective opportunity costs. A.I.D. also may support medium scale industry in those cases where enterprises are relatively labor-intensive or linked to labor-intensive industries.

A.I.D. also could promote mechanisms that link labor intensive enterprises to larger firms through subcontracting or other less formal arrangements. It is often in the mutual interest of all parties for a large firm to provide technical assistance to its small enterprise suppliers. An emphasis on linkages also may lead to activities designed to help overcome critical constraints in marketing, a crucial area in which small industries traditionally are very weak.

The extensive and very successful subcontracting experience of Japan (and to a lesser extent South Korea and Taiwan) suggests that these kinds of industrial linkages can be a potent source of growth in output, productivity, incomes, and employment. For example, A.I.D. may offer technical assistance to firms to help them establish financially viable subcontracting relationships with smaller, labor-intensive firms. A.I.D. also may provide support directly to prospective subcontracting firms in areas such as management, technology, purchasing, marketing, and credit.

(4) **Privately Operated Service Enterprises.** A number of services which could be provided by private firms are, in many developing countries, provided by public entities. For example, various components of health care systems (e.g., publically funded outreach clinics) are provided through governmental institutions. It may be appropriate to develop efficient, private alternatives to public health care systems in certain settings. The range of service enterprises is very broad, including transport, retail and wholesale marketing, financial services, training, health care, family planning, and education. A.I.D. will promote private enterprise options across this array of activities, where appropriate.

B. Improving the Functioning of LDC Markets

The primary focus for A.I.D.'s assistance to local private enterprise must be to improve the functioning of LDC markets, primarily through encouraging policy reform as well as by strengthening institutions which serve the private sector (e.g., financial intermediaries) and developing the human resources needed in key skill areas.

(1) **Host Country Policy Climate.** The importance of the host country policy climate cannot be overestimated. A.I.D. should not devote its scarce resources to developing private enterprise projects in LDCs whose policies discourage free markets and private investments by their own citizens. The chief characteristics of a favorable policy climate include: (1) consistent

[6] Further discussion of A.I.D. policy with respect to private farms will be found in the "A.I.D. Food and Agricultural Development" policy paper, May 1982.

market-oriented pricing policies in product, factor, and financial markets; (2) a legal and regulatory framework which protects private property, rewards risk taking, promotes competitive market structures, and enforces valid commercial transactions; (3) political and administrative stability; and (4) reliable public services.

A.I.D.'s efforts to influence the attitude toward private enterprise in specific host countries should proceed on informal as well as formal levels. Time-worn arguments suggest that A.I.D.'s ability to influence general policies in LDCs is limited. However, fruitful policy discussions require thorough understanding of the individual country situations as well as the requisite technical and professional competence on A.I.D.'s part. When these ingredients are present, the likelihood of positive results from ongoing policy discussions between any A.I.D. mission and its host government should not be underestimated; nor should the benefits of changes in general policies (e.g., a change in exchange rates) on activities in specific sectors (e.g., in agriculture) be underestimated. Effective coordination with other U.S. agencies, with other donors and with potential U.S. investors is essential to successful sectoral and general policy dialogue. Technical assistance and policy-oriented research projects often offer suitable means of helping create a policy analysis capacity within the government and of improving the likelihood for policy reform.

Examples of policy-reform related activities include assistance:

- To organizations to help establish new or expand existing financial and credit institutions;
- To governments in establishing a legal and institutional framework for their capital markets and commodities markets;
- To governments and potentially concerned private businesses, profit oriented cooperatives, or investors on ways to "privatize" or denationalize existing public sector activities and on ways to increase competition in existing markets.

While technical assistance of this type can be very useful, it is important to remember that the key constraint to effective policy typically is political not technical. Policies are in place because they are of benefit to some group. Policy reform always creates political tensions, and we need to understand the political forces that will resist reform as well as those forces which will encourage it.

(2) **Institutional Development.** The development of viable institutions, private and public, informal and formal, (e.g., markets, land tenure systems, banks, government agencies) is essential to the success of any development effort.[7] A.I.D. typically supports the creation or strengthening of formal institutions in the form of organizations.

Hypothetical examples of informal as well as formal institutional development projects that would promote private enterprise activities in LDCs include:

- Assistance to help strengthen existing informal apprenticeship (training) systems. Apprenticeship systems can be very important mechanisms for training skilled labor.
- Technical and other assistance to upgrade the efficiency of formal and informal financial systems, especially in rural areas (e.g., rural banks, traders, and traditional money lenders).
- Technical and other assistance to support activities in standardization, measurement and quality control. Supporting these kinds of formal government and private institutions will help stimulate greater domestic commerce and will help strengthen linkages between small LDC businesses and both larger domestic and U.S. firms.
- Assistance to help strengthen existing local business associations (e.g., trade associations and chambers of commerce) by providing technical assistance in the areas of general management, wholesaling, technology assessment, accounting systems and the like. Helping to identify and establish links among different business associations in related fields would strengthen the voice of the domestic business community regarding economic policies in a given developing country.

(3) **Training and Management Development.** A.I.D. should develop the capacity to provide management training where appropriate. Partnerships between host-country institutions and U.S. business schools and training institutions to provide long- and short-term technical assistance and participant training is an appropriate area for A.I.D. involvement. There is a need for training at almost every level, from the need to improve clerical and artisan skills to the need for more people trained in accounting, finance, and marketing.

Technological change is, or can be, transmitted through entrepreneurship and other training programs. Business schools, appropriate PVOs, and other private training institutions are vehicles for transferring useful technologies, as are informal training mechanisms involving, for example, apprenticeship systems. In general, management training must be tailored to LDC conditions.

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[7] For further discussions see the draft policy paper on "Institutional Development" now circulating in A.I.D.

A.I.D. should emphasize basic accounting and management training useful in small and medium businesses, although the application of sophisticated techniques taught in most U.S. graduate schools of business may well be appropriate in some circumstances.

Skills training programs are especially important. They provide useful skills to individuals who otherwise swell the ranks of the unskilled and often unemployed labor force. The critical training needs will be specific to each country. Missions need to assess the most important human resource constraints to promoting the growth of private enterprise, and develop programs to address these constraints.

C. Increasing the Flow of Technical and Financial Resources

A.I.D. can assist in increasing the flow of technical and financial resources to the third world. There are several ways to involve United States private enterprise in such efforts. As noted previously, utilizing the knowledge and resources of United States business is mandated by the FAA. We also note, however, that our principal goal is economic development in the third world and that the establishment of a climate conducive to the expansion of host country private enterprise is a principle means to achieving that goal.

(1) **Technology Creation, Transfer, Adaptation, Dissemination, and Use.** Clearly, the transfer of modern, productive, and appropriate technology to LDCs is vitally important. The U.S. is the major producer of new technologies; most of these new technologies are developed by U.S. private enterprises. The topic of technology transfer is a subject for a separate policy paper. What follows is a partial listing of the ways in which A.I.D. can facilitate the creation, transfer, adaptation, dissemination, and use of technologies that will raise the productivities of LDC workers, reduce costs to consumers, and make investments more profitable.

A number of activities involving both private and public institutions appears promising:

- Businesses, consumers and other users of technology need to be able to assess correctly the value of technologies that are available; missions may consider support for the establishment or strengthening of institutional capacity for technology assessment. Private sector approaches are preferred and to be encouraged in this area. Some effective public institutions, such as the Korean Institute of Science and Technology (KIST), have had strong ties to private enterprise, and have been run largely on a fee or contract basis.
- New technologies must be developed, technologies that can be adapted to the conditions in which they are used; missions may consider supporting research and development institutions in selected fields. Again, private institutions should be encouraged.
- Demonstration programs which stimulate the dissemination of technologies by identifying market demand may warrant support.
- Increased subcontracting and cottage industry approaches can expand productive employment, increase efficiency, and encourage technology transfer; missions may wish to support projects that incorporate these approaches.
- U.S. business firms increasingly are involved in selling unbundled technologies through licensing arrangements, royalty fees, or management contracts. Many older technologies have a market value in the LDCs. New marketing channels are emerging. In the U.S., rapidly growing numbers of "technology middlemen" are establishing businesses which bring together potential buyers and sellers of technology, particularly involving small and medium scale firms. Even relatively large firms may cooperate with each other to form their own technology sales business. An example is the non-profit British Technology Transfer Group, established by 10 British companies. This non-profit group was able to establish useful contacts in developing countries; the individual companies, not readily recognized outside Great Britain, had not been able to do so.[8] A.I.D. could stimulate the establishment of similar private technology transactions organizations for U.S. corporations.
- A.I.D. also could stimulate increased collaborative arrangements between U.S. and local professional (e.g., chemical engineers), industrial (e.g., plastics), commercial (e.g., retail sales), and general business (e.g., chambers of commerce) organizations through visits, conferences and the like. Commercial appropriate technology trade fairs bring together U.S. suppliers of technology with prospective buyers from developing countries. Consultants such as the retired executives from the International Executive Service Corps transfer much needed U.S. management technologies.

(2) **Financial Transfers.** Where appropriate market environments exist, financial transfers to local private enterprises could help to remove bottlenecks to expansion. There are several criteria which should be used to determine whether such transfers of A.I.D. funds are consonant with our objectives:

- Most financing should be made through intermediaries rather than directly to individual

[8] See Ford, D., and C. Ryan, "Taking Technology to Market," *Harvard Business Review*, March-April, 1981.

firms. There are two major reasons for emphasizing the indirect approach. First, using intermediaries economizes on staff time which will be in increasingly short supply in the future. Second, using intermediaries helps develop the financial and management expertise and experience of host-country citizens.

- All investments should be economically and developmentally sound, and be justified by an economic rate of return which is greater than or equal to the scarcity cost of capital.
- All investments should, where possible, avoid the use of subsidies except where economically justified; that is, they should reflect prevailing market interest rates, particularly to end users, so as to ensure efficient and non-discriminatory allocation of resources and to encourage saving. Loans to private intermediaries should be at interest rates above A.I.D.'s normal concessional terms; in any case, provision should be made for using the profits engendered by concessional lending to expand the credit base of those intermediaries and on-lending or leasing to final borrowers should be at market terms to require these borrowers to be commercially viable.
- Investments should, in general, be confined to the priority sectors listed above.
- All capital transfers should be in the context of an overall country plan which, taken as a whole, strives to obtain the development objectives set out in the FAA.

(3) Information and Packaging Services.
A.I.D.'s information services to U.S. firms will draw on the knowledge of its field mission staff, host country business contacts, and local sources of key services. Missions, assisted where possible by PRE Bureau staff, will identify opportunities for investment created by, or uncovered by, A.I.D.'s development projects. In any given A.I.D. project there may be unidentified linkages to productive activities that represent forgone investment opportunities. For example, an A.I.D. project designed to increase farm production may flounder if parallel investments in marketing and processing are not made. A private firm may be interested in making these investments. Of course, the project taken as a whole is more likely to be successful if these "spin-off" investments are made. Another mode of "spin-off" investment involves parallel financing for projects related to, for example, an A.I.D. rural road project or a river basin development project. Private enterprise activities stimulated by almost any infrastructure project may be considerable; informing U.S. firms of these opportunities could encourage rapid development and would help A.I.D. projects meet their objectives. Finally, packaging a set of seemingly discrete activities such as an A.I.D. access road project, a small farmer technical assistance program, a local commercial fertilizer distribution scheme and a U.S. or joint venture commercial vegetable processing plant may be a very effective use of A.I.D.'s resources.

The PRE Bureau will experiment with alternative models to further the Agency's private enterprise development program. For example, the PRE Bureau will assemble, in a single package, feasibility study credits, OPIC guarantees, A.I.D. concessional funds, and other resources as warranted to support investments in indigenous development-oriented private enterprises. In some instances a complete package might include the participation of U.S. commercial banks, the IFC, or other financial interests in a co-financing or parallel financing arrangement. Firms other than the primary investor may provide technical or other services. Some government-to-government mechanisms may be involved as well. Financing pre-feasibility, feasibility and technical studies, and providing non-commercial risk insurance, should stimulate additional U.S. private enterprise and financial institution involvement in LDCs in collaboration with indigenous private enterprise. The main focus of PRE's pilot efforts will be, however, on the development of entrepreneurial activity *within* LDCs and particularly on strengthening the capability of indigenous financial institutions to provide medium and long term credit to small business and to improve the legal and policy environment for private investment (see Bureau for Private Enterprise Policy Paper for further discussion).

IV. Implementation

This section makes a number of specific recommendations to further the implementation of A.I.D.'s private enterprise policy. A.I.D.'s approach to promoting private enterprise emphasizes the growth of and reliance on competitive, free markets. Consistent implementation of A.I.D.'s policy, conducted in a sensitive and collaborative manner with host country counterparts, should result in an expansion of the role of private enterprise which, in turn, promotes broadly based economic development.

A. Staffing

In order to implement its private enterprise policies, A.I.D. must be able to place suitably trained staff in the field and in Washington. In earlier decades, A.I.D. was more closely involved with host country and U.S. private enterprise. While many of those activities were similar to some current A.I.D. projects, the Agency recently has been working more heavily through governmental institutions. Few A.I.D. staff members have lengthy experience working

directly with U.S. and developing country private enterprise.[9] Missions should identify personnel who have both an interest in, and knowledge of, the roles of private enterprise and free markets in development as well as a good understanding of the development problems facing specific host countries. A.I.D. will provide training to U.S. and foreign professional staff in order to develop the necessary "in-house" capacity to deal with crucial areas such as establishing a meaningful policy dialogue on the role of private enterprise in development, dealing directly with host country businesses, and identifying spin-off projects of potential commercial viability from more traditional A.I.D. projects. Through various contractual arrangements (e.g., Indefinite Quantity Contracts [IQCs]), A.I.D. can tap private enterprise expertise both to help develop country level private enterprise program strategies and to help formulate supporting projects. Project Development and Support (PD&S) funds should be utilized for obtaining appropriate outside expertise in the development of field programs and projects.

B. Project Approval Procedures

The types of interventions discussed in Section III can be designed and implemented using existing Agency procedures. However, some interventions will have to be designed to respond to fleeting opportunities normally seized by private enterprises on the spot. Business firms cannot afford to become enmeshed in a bureaucracy which takes years to conceive, design and implement projects. More expeditious procedures are being devised for PRE funded projects. As Agency experience with these streamlined procedures grows, they may be applied to other private enterprise projects.

C. **Procurement Procedures**

A revision in current procurement procedures could encourage the growth of indigenous private enterprise activities. Increased local procurement of raw materials and off-the-shelf equipment will stimulate local businesses; they also would help keep down the costs of A.I.D. projects and promote a stronger host country business environment. Increased procurement bids from the private sectors of "941" developing countries would leverage A.I.D.'s assistance to those countries. "Unbundling" larger contract packages would encourage local subcontracting bids. In general, and in a manner consistent with existing procurement regulations, procurement contracts should be handled on a competitive basis in which "941" countries and host countries are considered part of the market.

D. **Project Appraisal Criteria (Economic and Financial)**

All A.I.D. projects are subject to systematic economic and financial appraisal criteria. In general, a project warrants support if it achieves a suitably high internal economic rate of return using appropriate shadow prices that would, for example, take account of labor availability. (Ideally, that internal economic rate of return would be at least as high as all alternative uses of A.I.D. resources, whether those uses be in the public or the private sector.)[10]

A financial analysis at market costs and prices faced by the firm is called for as well. A.I.D. support for private enterprise projects for which the financial rate of return is less than the opportunity cost of capital would require explicit justification. A subsidy may be warranted, for example, if it can be demonstrated that the economic rate of return is very high and the business firm is unable to capture the returns on its investment.

[9] A recent study by PPC/E, "Promoting Private Sector Development Initiatives," January 1982 (draft), suggested that staffing problems may be the most serious constraint the Agency faces in developing its private enterprise program. It may be noted that the current emphasis on stimulating private enterprises by promoting market solutions to development problems calls for background and expertise on the role of free markets in development as well as direct experience with private enterprise. A.I.D. continues to employ staff members with considerable expertise on the effective functioning of markets.

[10] There are relatively standard procedures for estimating shadow prices (also referred to as "scarcity" or "economic prices" or "opportunity costs"). A.I.D. Handbook III provides guidelines on these procedures. PPC plans to distribute by summer 1982 more detailed material to missions on economic analysis, including the estimation of shadow prices.