PN ABJ-436

AGENCY FOR INTERNATIONAL DEVELOPMENT

PRIVATE SECTOR WORKSHOP

Abidjan, Ivory Coast
September 24-26, 1986
and
Nairobi, Kenya
September 28-30, 1986

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20523

12 September 1986

TO: Private Sector Workshop Participants

FROM: AAA/AFR/PRI - H.I. Munson

SUBJECT: Workshop Notebook

Enclosed herewith are the agenda and readings for the Private Sector Workshop.

All reading materials are highly relevant to workshop sessions and have been cut back to the irreducible minimum for informed discussion. We would like you to read them all. If that is not possible, please, at the very least read the following:

Private Sector Strategy

- o Africa Private Sector Development Policy Strategy AFR/PRE-DP-PD.

Developing and Implementing A Country Private Sector Strategy

- o USAID/Kenya Private Enterprise Strategy Statement, USAID/Kenya.

Financial Markets Development

- o Excerpts from Draft Policy Paper on Financial Markets Development, AFR/PRE.
- o Kenya Private Enterprise Development Project, AFR/PRE.

Privatization

- o Policy Guidance on Implementing AID Privatization Objectives, AID/PRE-AID/PRE.
- o Privatization in the Agricultural and Agribusiness Sectors, Dr. Ian Marceau.

Promoting Foreign Investment

- Termination of the Booker T. Washington Project, AFR/PRE, H.I. Munson Memorandum.
- IFC's African Project Development Facility, IFC.
- Assessment of Investment Promotion Activities, SRI International.

Promoting Small Scale Indigenous Business

- Small Scale Industry in Sub-Saharan Africa: Emperical Evidence and Strategic Implications, C. Liedholm and D. Mead.
- Policy and Program Planning Issues in the Private Informal Sector, Harold Lubell, USAID/Senegal.

I look forward to seeing you at the Workshop.

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INTRODUCTION

AFRICA BUREAU
PRIVATE SECTOR WORKSHOP
ABIDJAN, IVORY COAST
September 24 - 26

INTRODUCTION TO THE WORKSHOP

The primary objectives of the Workshop are to:

- Review, discuss and promote understanding of A.I.D.'s and the Africa Bureau's private sector policy and strategy.

- Present, discuss and critically examine the objectives, processes and many components (policy reform, financial markets, privatization, investment promotion, etc.) of private sector development.

- Exchange and assess views, experiences and recommendations concerning private sector development, and report them back to AID/W.

This Workshop is action oriented. We will critically and candidly examine private sector policies, strategies, programs and projects; take a best shot at determining what is good and not so good about them, what has worked and not worked; what has been or has not been worth the time, cost and effort invested; and what recommendations you want to make to AID/W and field Missions to improve our private sector development performance.

Workshop findings and recommendations will be reported back in writing and commentary to AID/W, the Africa Bureau's Mission Director's Conference in November and to all Missions.

We request and need maximum participation by Mission representatives in all Workshop sessions and have designed the agenda to accomplish that purpose. Consider all presentations, panel discussions and case studies as an open invitation to solicit your questions, ideas, comments ard recommendations.

We look forward to working with you. Have a good Workshop.

AFRICA BUREAU
PRIVATE SECTOR WORKSHOP
ABIDJAN, IVORY COAST
September 24 - 26

WEDNESDAY, September 24

2:00 - 2:30

Welcoming Remarks — Charge' Carl C. Cundiff
REDSO/CWA Director, Laurance Bond
AAA/AFR/PRE, H. I. (Bud) Munson

PRIVATE SECTOR STRATEGY

2:30 - 3:30

Agency and Africa Bureau private sector policy and strategy

Overview: Development and implementation of Africa Bureau private sector strategy. Speakers will solicit Missions' views and suggestions.

Speakers: AFR/DP, Jerome Wolgin; AFR/PRE, H. Munson

3:30 - 3:45 Coffee Break

Readings: AA/AFR Mark Edelman Statement before the House Appropriations Committee Subcommittee on Foreign Operations, March 18, 1986.

Africa Private Sector Development Policy and Strategy AFR/PRE - DP - PD.

A.I.D.'s Experience with the FY 1985 African Economic Policy Reform Program (AEPRP) AFR/DP

DEVELOPING AND IMPLEMENTING A COUNTRY PRIVATE SECTOR STRATEGY

3:45 - 5:30

Presentation: Kenya private sector strategy development

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Speaker: DAA/PRE Bureau, Charles Gladson
Moderator: Deputy Director, AFR/PRE, Charles Buchanan

Readings:

USAID/Kenya Private Enterprise Strategy Statement USAID/Kenya

Developing a Private Sector - Mauritania Case Study AFR/PRE

Evening

REDSO/CWA Director Bond reception

THURSDAY, SEPTEMBER 25

FINANCIAL MARKETS DEVELOPMENT

8:30 - 8:40

Introduction: Common components of financial markets, the criticality of appropriate policies

Speaker: J. Wolgin

8:40 - 9:15

Presentation: Kenya private enterprise development project - venture capital, export credit, investment promotion, technical assistance for management

Speaker: C. Gladson

9:15 - 10:45

Case Discussion: Kenya rural private enterprise project - consideration in establishing a credit fund through local banks

Participants will be divided into three sub-groups which will analyze the case separately (9:15-10:00) and report findings and recommendations back to the plenary session (10:00 - 10:45)

Coffee available during subgroup sessions

Discussion Leaders: C. Gladson
H. Munson

Project Resources: Richard Loth, PRE/I
Elizabeth Rhyne, AID/Kenya

10:45 - 11:15

Presentation:	Factors in developing a stock market in Togo and a regional stock market based in Abidjan. Comments on the background paper "Considerations in the Establishment of a Stock Exchange".
	Speaker: John Moore - U. S. entrepreneur and steel plant owner/operator in Togo
	Moderator: J. Wolgin

11:15 - 11:50

Panel Discussion:	Financial market development potential in West African countries
Panel Members:	3 Mission participants to be selected in Abidjan
	John Moore
	R. Loth
	Ivory Coast bank representative selected by REDSO
	Moderator: H. Munson

11:50 - 12:00

Summary:	Major factors, problems and opportunities in financial market development
	Speaker: J. Wolgin

12:00 - 1:30	Lunch
Readings:	Excerpts from Draft Policy Paper on Financial Markets Development AFR/PRE
	Financial Constraints in African Private Enterprise Development World Bank
	Kenya Private Enterprise Development Project AFR/PRE
	Kenya Credit Facilities AFR/PRE
	Considerations in the Establishment of a Stock Exchange AFR/PRE

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PRIVATIZATION

1:30 - 2:00

Review: A.I.D. Privatization Policy. Solicitation of Missions' views and suggestions

Speaker: PRE/PD, Paul Haire

2:00 - 4:30

Privatization Activities in West Africa - a series of 20 minute presentations.

Factors and issues that have emerged in promoting privatization including A.I.D. policy; scope of work, time and effort required; political considerations and risks; and financial demands

- Overview of Privatization divestiture in Africa:
  Adrian Ford: Director, Development Finance consultants, Ltd.

- Nigeria Family Planning Project: Utilization of Private Sector
  L. Eicher: A.I.D. Nigeria Health Officer

- Privatization in Guinea
  Mark Wentling: AID/AAO Guinea
  Adrian Ford

- Privatization in Gambia

  T. Herlehy, Program Analysist: A.ID. Gambia

3:20 - 3:35 Coffee Break

- Privatization in Senegal
  H. Lubell: A.I.D. Senegal Program Officer

- Privatizing steel mills - Togo, Cameroon and Ivory Coast

  John Moore

- Privatization in Mali

  W. Thomas - A.I.D. Deputy Director, Mali

4:30 - 5:30

Panel Discussion: Review of privatization issues and lessons learned to date

Panel Members: 3 Mission representatives - to be determined in Abidjan

Paul Haire

Moderator: Adrian Ford

5:30 - 7:00 Break

Readings:

Policy guidance on Implementing A.I.D. Privatization Objectives A.I.D./PPC - A.I.D./PRE

Privatization in the agricultural and agribusiness sectors - Dr. Ian Marceau

Zimbabwe: Agriculture and the Private Sector Eric Witt, USAID/Zimbabwe

Agricultural Input Privatization - Country X Case AFR/PRE

Agricultural Development and Marketing Corp. (ADMARC) AFR/PRE

INVESTMENT AND BUSINESS DEVELOPMENT IN AFRICA

7:00 - 7:30

Cash Bar

7:30 - 9:00

Panel Discussion: Opportunities and problems confronting investing and business development in West Africa including equity and loan funding, impact of government policies, negotiating deals, accessing international financial markets

Panel Members: Head, U. S. Chamber of Commerce, Abidjan

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Esom Alintah, President Ashland Oil, Nigeria

John Moore

Adrian Ford

R. Loth

One or two more members may be added

Moderator: H.Munson

FRIDAY, SEPTEMBER 26

PROMOTING FOREIGN INVESTMENT

USAID and IFC actions to promote foreign private investment in Africa

8:30 - 8:40

Summary: OPIC/Booker T. Washington project

Speaker: H. Munson

8:40 - 9:00

Presentation: The IFC Africa project Development Facility (APDF)

Speaker: A. Crocco, IFC APDF Office, Abidjan

9:00 - 10:-00

Panel Discussion: How can U.S. government and multinational organizations best promote local and foreign investment, and private sector development in Africa?

Panel Members: Stanley Cleveland - Managing Director Togo steel mill. Previously, U.S. head Togo Investment Bureau, President, Bendix International and career foreign service officer

A. Crocco

E. Elintah

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L. Bond

Moderator: H. Munson

10:00 - 10:15 — Coffee Break

Readings:

Termination of the Booker T. Washington Project AFR/PRE, H. I. Munson Memorandum

IFC's African Project Development Facility IFC

Assessment of Investment Promotion Activities SRI International

PROMOTING SMALL SCALE INDIGENOUS BUSINESS

10:15 - 10:30

Introduction: Opportunities and problems in promoting development of small scale business and entrepreneurs

Speaker: Michael Farbman, S&T/RD/ESE

10:30 - 11:00

Presentation: Chad VITA Project

Speaker: A.I.D. Chad representative

11:00 - 11:30

Presentation: Liberia Small Enterprise Finance Organization (SEFO)

Speaker: H. Marwitz, A.I.D. Liberia Program Officer

11:30 - 12:30

Panel Discussion: Major issues in promotion of small scale enterprises - costs vs benefits; self-sustainability; impact of government tax, foreign exchange, import and other policies

Panel Members: 4 Mission representatives to be determined in Abidjan

H. Munson

Moderator: M. Farbman

12:30 - 2:00 Lunch

Readings:

Small Scale Industry in Sub-Saharan Africa: Empirical Evidence and Strategic Implications C. Liedholm and D. Mead

Policy and Program Planning Issues in the Private Informal Sector Harold Lubell, USAID/Senegal

Chad VITA Small Enterprise Project - to be handed out at Workshop

Liberian Small Enterprise Finance Organization (SEFO) AFR/PRE

AID/W RESOURCES AVAILABLE TO MISSIONS

2:00 - 2:45

Explanation of AID/W resources available to support Mission private sector strategies and programs

AFR/PRE resources - C. Buchanan

PRE Bureau resources - C. Patalive

S&T Bureau resources - M.Farbman

2:45 - 4:00

Private Sector Workshop Wrap-up

Panel discussion: Review of the major factors involved in and what was learned about: planning and implementing Mission private sector strategies; and the kinds of initiatives and actions typically employed to utilize the private sector in development, and to promote private sector development. Obtain recommendations from Mission participants on how AID/W and USAIDs in field can improve management and support of private sector utilization and promotion.

Panel Members: 4 mission representatives to be determined in Abidjan

C. Peasley, Director AFR/P

Moderator: H. Munson

AFRICA BUREAU
PRIVATE SECTOR WORKSHOP
NAIROBI, KENYA
September 28-30, 1986

SUNDAY, September 28, 1986

8:30 - 9:00

Welcoming Remarks — Ambassador Gerald Thomas
REDSO/ESA Director, Arthur Fell
AAA/AFR/PRE, H.I. (Bud) Munson

PRIVATE SECTOR STRATEGY

9:00 - 10:00

Agency and Africa Bureau Private Sector Policy and Strategy

Overview: Development and Implementation of Africa Bureau Private Sector Strategy. Speakers will solicit Missions' views and suggestions.

Speakers: AFR/DP, Jerome Wolgin; AFR/PRE, H. Munson

10:00 - 10:15 — Coffee Break

Readings: AA/AFR Mark Edelman Statement before the House Appropriations Committee Subcommittee on Foreign Operations, March 18, 1986.

Africa Private Sector Development Policy and Strategy AFR/PRE-DP-PD.

AID's Experience with the FY 1985 African Economic Policy Reform Program (AEPRP) AFR/DP

DEVELOPING AND IMPLEMEMTING A COUNTRY
PRIVATE SECTOR STRATEGY

10:15 - 12:00

Presentations: Kenya Private Sector Strategy Development

Speaker: DAA/PRE Bureau, Charles Gladson

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Presentations: (continued)

Somalia Private Sector Strategy

Speaker, AID Somalia Mission Director, Lou Cohen

Moderator: Deputy Director, AFR/PRE, Charles Buchanan

Readings:

USAID/Kenya Private Enterprise Strategy Summary Statement - USAID/Kenya

Developing a Private Sector - Mauritania Case Study - AFR/PRE

12:00 - 1:30 Lunch

FINANCIAL MARKETS DEVELOPMENT

1:30 - 1:40

Introduction:

Common Components of Financial Markets, the Criticality of Appropriate Policies

Speaker: J. Wolgin

1:40 - 2:15

Presentation:

Kenya Private Enterprise Development Project Venture Capital, Export Credit, Investment Promotion, Technical Assistance for Management

Speaker C. Gladson

2:15 - 3:45

Case Discussion:

Kenya Rural Private Enterprise Project - Considerations in Establishing a Credit Fund through Local Banks

Participants will be divided into three sub-groups which will analyze the case separately (2:15-3:00) and report findings and recommendations back to the plenary session (3:00-3:45)

Coffee available during sub-group sessions

Discussion Leaders: C. Gladson
H. Munson

Project Resources: Richard Loth, PRE/I
Elizabeth Rhyne, AID/Kenya

3:45 - 4:15

Presentation: Factors in Developing a Stock Market, comments on the background paper "Considerations in the Establishment of a Stock Exchange"

Speaker: To be announced at Workshop

Moderator: J. Wolgin

4:15 - 4:50

Panel Discussion: Financial Market Development Potential in East African Countries

Panel Members: 3 Mission participants to be selected in Nairobi

Business Representatives: To be announced in Nairobi

R. Loth

Moderator: H. Munson

4:50 - 5:00

Summary: Major Factors, Problems and Opportunities in Financial Market Development

Speaker: J. Wolgin

Readings: Excerpts from Draft Policy Paper on Financial Markets Development - AFR/PRE

Financial Constraints in African Private Enterprise Development - World Bank

Kenya Private Enterprise Development Project AFR/PRE

Kenya Credit Facilities - AFR/PRE

Considerations in Establishment of a Stock Exchange - AFR/PRE

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MONDAY, September 29, 1986

PRIVATIZATION

8:30 - 9:00

Review: AID Privatization Policy
Solicitation of Missions' views and suggestions

Speaker: PRE/PD, Paul Haire

9:00 - 11:30

Privatization Activities in East Africa - a seris of 20 minutes presentations.

Factors and issues that have emerged in promoting privatization including AID policy; scope of work, time and effort required; political considerations and risks; and financial demands.

- Overview of Privatization/Divestiture in East Africa

  Speaker: John Baker - Coopers & Lybrand, East Africa

- Privatization in Somalia

  Speaker: L. Cohen

- Privatization in Malawi

  Speaker: AID Malawi Representative

- Privatization in Rwanda

  M. Mescher - AID Rwanda Prime Project Manager

  Moderator: H. Munson

11:30 - 12:30

Panel Discussion: Review of Privatization Issues and Lessons Learned to Date

Panel Members: 3 Mission representatives - to be determined in Nairobi

John Baker

Paul Haire

Moderator: H. Munson

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Readings: Policy Guidance on Implementing AID Privatization Objectives - AID/PPC-AID/PRE

Privatization in the Agricultural and Agribusiness Sectors - Dr. Ian Marceau

Zimbabwe: Agriculture and the Private Sector Eric Witt, USAID/Zimbabwe

Agricultural Input Privatization - Country X Case - AFR/PRE

Agricultural Development and Marketing Corp. (ADMARC) - AFR/PRE

12:30 - 2:00 Lunch

INVESTMENT AND BUSINES DEVELOPMENT IN AFRICA

2:00 - 3:15

Panel Discussion: Opportunities and Problems Confronting Investing and Business Development in East Africa Including Equity and Loan Funding, Impact of Government Policies, Negotiating Deals, Accessing International Financial Markets

Panel Members: Local American business representative - To be announced in Nairobi

Locan Kenyan business representative - To be announced in Nairobi

R. Loth

One or two more members may be added

Moderator: H. Munson

3:15 - 3:30 Coffee Break

PROMOTING FOREIGN INVESTMENT

USAID and IFC Actions to Promote Foreign Private Investment in Africa

3:30 - 3:40

Summary: OPIC/Booker T. Washington Project

Speaker: H. Munson

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3:40 - 4:00

Presentation:	The IFC African Project Development Facility (APDF) Speaker: Richard Parry, IFC APDF Office, Nairobi

4:00 - 5:00

Panel Discussion:	How Can U.S. Government Multinational Organiztaions Best Promote Local and Foreign Investment, and Private Sector Development in Africa?
Panel Members:	R. Parry Two or three local Kenyan and U.S. business representatives - To be announced in Nairobi Moderator: H. Munson
Readings:	Termination of the Booker T. Washington Project - AFR/PRE, H. Munson Memorandum IFC's African Project Development Facility Assessment of Investment Promotion Activities, SRI International
5:00 - 6:30	Break

PROMOTING SMALL SCALE INDIGENOUS BUSINESS

6:30 - 7:00	Cash Bar

7:00 - 7:15

Introduction:	Opportunities and Problems in Promoting Development of Small Scale Business and Entrepreneurs Speaker: Michael Farbman, S&T/RD/ESE

7:15 - 7:30

Presentation:	Kenya Rural Private Enterprise Project - Small Enterprise Component Speaker: Fred O'Reagan, World Education, Inc

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7:30 - 8:00

Presentation: Liberia Small Enterprise Finance Organization (SEFO)

Speaker: To be announced in Nairobi

TUESDAY, September 30, 1986

8:30 - 9:30

Panel Discussion: Major Issues in Promotion of Small Scale Enterprises - Costs vs. Benefits; Self-Sustainability; Impact of Government Tax, Foreign Exchange, Import and Other Policies

Panel Members: 4 Mission representatives to be determined at Nairobi Workshop

H. Munson

Moderator: M. Farbman

Readings: Small Scale Industry in Sub-Saharan Africa: Empirical Evidence and Strategic Implications - C. Liedholm and D. Mead

Policy and Program Planning Issues in the Private Informal Sector - Harold Lubell, USAID/Senegal

Liberian Small Enterprise Finance Organization (SEFO) AFR/PRE

AID/W RESOURCES AVAILABLE TO MISSIONS

9:30 - 10:15

Explanation of AID/W resources availabe to support Mission private sector strategies and programs

AFR/PRE Resources - C. Buchanan

PRE Bureau Resources - C. Patalive

S&T Bureau Resources - M. Farbman

10:15 - 12:00

Private Sector Workshop Wrap-Up

Panel Discussion:	Review of the major factors involved in and what was learned about: planning and implementing Mission private sector strategies; and the kinds of initiatives and actions typically employed to utilize the private sector in development, and to promote private sector development. Obtain recommendations from Mission participants on how AID/W and USAIDs in field can improve management and support of private sector utilization and promotion.
Panel Members:	Four Mission representatives to be determined in Nairobi C. Peasley, Director AFR/PD Moderator: H. Munson

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PRIVATE SECTOR STRATEGY

STATEMENT OF THE HONORABLE MARK L. EDELMAN
March 18, 1986
BEFORE THE HOUSE APPROPRIATIONS
COMMITTEE SUBCOMMITTEE ON
FOREIGN OPERATIONS

Mr. Chairman, Member of the Subcommittee.

It has become apparent in Africa that it will take more than wishful thinking and fiscal resources to hasten the pace of development. We have, over the years, told you about policy reform, agricultural developments, and improvements in social services. It has all helped, but with the exception of a few countries, development progress has slowed in Sub-Saharan Africa.

The U.S. cannot solve Africa's development problems. Although we have been the lead donor promoting innovation and change in development strategies, fundamental responsibility for Africa's development should and must rest with Africans themselves. We can provide financial and moral support for their efforts, help develop new technology and offer guidance, but even our contribution is a minor part of the total bilateral development resources available (about 14% of all official development assistance) and the overall development process. Most important for successful development is the question of African leaders' motivation and will. It cannot be borrowed or bought or sold to the highest bidder. It must come from the heart of Africa and its people.

I am not going to tell you that we have the answer to the African development quandary. Nor am I going to say that everything we are doing will be successful - although we can be proud of our record to date. But I would like to share a few of my recent observations with you.

There are two important things that have happened during the past year.

<u>The Drought</u>: For the past two and one half years, Sub-Saharan African has undergone a severe drought without the anticipated massive loss of life. This holds true not only for the Sahelean countries where crop shortages continued into a third and fourth year, but also in nations torn by civil strife. In Ethiopia, where donors received little cooperation from the government, the drought's toll, although high, was nowhere near the projections from on-the-ground observers. The donor community made an unprecedented humanitarian food aid

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contribution. We can all be proud of that effort. However, I think it is particularly significant that the important traditional, failsafe drought mechanisms of the rural populations worked once again.

<u>The Recovery</u>: The second notable occurrence over the past year has been the startling post-drought recovery that has begun throughout much of Africa. With governmental services and supply links stretched to capacity handling emergency relief, and with the donor community and private and voluntary organizations occupied with the provision of life saving services, somehow agricultural inputs have been made available to farmers, crops have been sown, the rains came, and a good harvest was gathered and is now being marketed.

This, I believe, not only demonstrates the resiliency of Africans as a whole, but also the effectiveness of the private sector and the tremendous uncharted trade and commerce patterns at work in Sub-Saharan Africa.

The two lessons learned from the drought, (the resiliency and resourcefulness of the African people, and the strength of the parallel market economy) make it increasingly clear that Africans must play to their strengths in formulating their development strategies.

Fortunately, this appears to be happening at a surprisingly rapid rate. The Africans are becoming more creative in the formulation of development policies and strategies.

We see more and more evidence that African leaders are moving away from strong centralized governments which promote over-zealous social service programs and state control of their economies. Africans are beginning to exploit the traditional strengths in their private sector and the free market economy.

In Somalia, the government has eliminated agricultural price controls and begun shifting grain marketing to the private sector. These actions have been a significant factor in increased grain production. Somalia has also adopted a policy to sell off some non-profitable parastatals to the private sector and convert others to a mixture of public and private firms.

In Togo, similar changes have taken place. Plans to sell twelve of seventy parastatals to the private sector have been announced by the government. In addition, the government is studying the possibility of getting out the the agricultural export system.

In Kenya, a cabinet level privatization panel was appointed more than a year ago, and the government recently sold Kenya Fisheries Ltd. and put up the government long-haul transport company for sale.

These are only four examples of privatization efforts occuring across the African continent. We are making a strong attempt to tailor our assistance to support the growing pace of economic reform.

Enhancing Our Development Impact

The recent drought experience illustrates the importance of our emphasis on agricultural development and the improvement of social services programs. Africa is not food self-sufficient on a year-to-year basis. Until it is, countries with a solid and progressive developmental history can be almost devastated overnight by food shortages.

Agriculture and food production will continue to serve as the foundation for our program. But we can build upon some of the lessons learned during the drought. This re-examination of our programming serves not only to justify some revised strategies, but also adds immediacy to their introduction.

The fact that we want to build on the non-governmental strengths in Africa should not come as a surprise.

I find myself thinking of Mark Twain's story about the eighteen year old boy who thought his father was the dumbest man he had ever known, and then upon reaching twenty, he was startled to see how much his father had learned in two years of time. Africans, too, have had the answer to their development dilemma all along. But it has taken the maturity caused by the drought, crushing debt burdens and declining economies to bring it to the surface. African leaders are finally realizing that growth comes through following appropriate economic policies and private sector initiative, not from government dictates.

Realistic policy based on market forces works in spite of the pervasive governmental ineptitude, and it insures that products flow in and out of markets based on actual demand rather than artificial government quotas set by ineffective parastatals. Most importantly, the private sector provides the major source of incentive and hope for hundreds of millions of people throughout Africa.

In order to tap the private sector developmental forces in Africa, A.I.D. is seeking to put an ever increasing focus on the following:

<u>Policy Reform</u>: In FY-87 we request funds for the PL-480 Title I program ($160 million); commodity import programs and cash grants ($200 million); sector and program assistance keyed to institutional and policy reform ($70 million); and, a continuation of the African Economic Policy Reform Program ($75 million). All of these efforts are designed to improve the policy environment in Sub-Saharan Africa with particular emphasis on reducing the size and control of government.

<u>Direct Private Sector Support</u>: We are planning to devote $12.2 million to new projects which will fund direct private sector support. In addition, we are making $2.1 million available for the African Private Enterprise Fund which will provide technical assistance and marketing studies to facilitate private sector development.

<u>Private and Voluntary Organizations</u>: We will continue to use private and voluntary organizations in the African program. The achievements of private and voluntary organizations during the drought were extraordinary. We want to continue to foster their participation during the coming year with non-drought related activities totaling $45.7 million.

Our intention to enhance our traditional African developmental emphasis to match the pan-African swing away from centralized governmental control is based not only on the experience of the past two years, but also on the difficult lessons Africa has learned the hard way during the post colonial period. In a recent article put together by the World Bank to explain differences in economic growth, a comparison was made between African and East Asian development patterns of the past two decades. Several important factors were noted:

-- East Asian countries stimulated private savings and initiative through low taxes and free markets. In contrast, African governments overextended themselves, particularly in the direct management of industry and agricultural marketing.

-- Economic growth is strongly correlated with real growth of domestic credit to the private sector and the share of private sector credit in total domestic credit. Growth of credit available to the private sector has been much higher in East Asia than in Africa.

-- The private sector uses its resources much more effectively than do government and public enterprises.

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-- Governments can stimulate private agricultural production in such ways as reducing price controls, permitting private sector marketing of farm products, and providing timely, adequate supplies of fertilizer and seeds to small farmers. Countries like Zimbabwe, Kenya and the Ivory Coast that have done a comparatively better job in encouraging the private farmer, have historically registered significantly higher production levels than have countries such as Ghana and Tanzania, which have had less favorable policies.

-- Many African leaders now admit that nationalized economies and statist policies are a major factor contributing to their poor economic growth record. There is, as a result, a strong movement to privatize state operated enterprises.

The necessity for African governments to divest themselves of price and marketing responsibilities has broader application than breaking up parastatals and removing price subsidies. The debt burden of African governments, when combined with the low tax base and recurring institutional obligations, leaves little or no discretionary income for developmental investments.

Expansion of necessary and appropriate social services such as health may well be more effective if partially removed from the public sector. As an example, health budgets rarely comprise more than three percent of national budgets in less developed African countries (as compared with five percent in middle income countries and eleven percent in the industrial world). This makes long-term support for publicly financed health interventions extremely difficult - particularly where the revenue base is small.

Taken as a region, Africa is the most sparsely populated geographic areas in the developing world. Thus, the per use cost of delivering services is very high due to transportation and manpower constraints.

We are implementing a strategy which will put an increasing emphasis on private sector support coupled with community controlled service systems. If curative health services are now being delivered through indigenous practitioners and druggists, then we should support them directly rather than building up another central system under government control which lacks community trust and support.

We believe the same sort of emphasis will work in agriculture. Historically, in areas where the production and marketing of crops are tightly controlled by government (peanuts in Senegal and Gambia, corn in Madgascar and until recently in Ghana, rice in Madagascar, cotton/coffee in Tanzania) production decreases. As the price for cash and food crops is allowed to float (sorghum in Sudan, and recently with corn in Ghana) production increases. Not only does the private market system work in Africa, it requires a minimal infrastructure investment from government.

In Rwanda recently, new potato varieties with the potential to more than double yields have been developed by the International Potato Center in collaboration with the Rwandan national research system. In fact, the new varieties developed on experimental test plots are in such high demand that farmers are making midnight raids into experimental fields, digging up new seed potatoes, planting them in their own fields and then selling their crops to traders who market them throughout Rwanda and Eastern Zaire. In the process, the new varieties are spreading rapidly throughout the area without government assistance.

The Job Ahead

A.I.D. has sponsored a core of returned participants throughout Africa waiting to make a contribution to Africa' development. Although some are in the public sector, many of these people are in the private sector furthering the development effort in their country.

We also have U.S. direct hire and foreign national staffs in our Missions who continue to demonstrate their extraordinary degree of dedication to duty. Their performance during the drought is only the most recent example of their work.

Certainly the upcoming years present a real challenge for us in Africa. I believe we have much to offer. Africans themselves, however, must take the lead and make the tough decisions. Most have, in fact, begun making dramatic and often politically risky changes which hold out the potential for healthier economies and improved living standards. We should not step away from them just as they finally start making the right moves.

I would be delighted to respond to your questions. Thank you.

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DRAFT AFRICA PRIVATE SECTOR DEVELOPMENT POLICY AND STRATEGY

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DRAFT AFRICA PRIVATE SECTOR DEVELOPMENT POLICY AND STRATEGY

PART I: A.I.D. Private Sector Policy

A major A.I.D. policy repeatedly enunciated by the Administrator and elaborated in the A.I.D. Policy Paper, "Private Enterprise Development," March 1985, is to strengthen and more fully integrate private enterprise development into the mainstream of Agency activity. Policy goals are:

-- To encourage LDCs to open their economies to a greater reliance on competitive markets, trade and private enterprise in order to meet the basic human needs of their poor majorities through broadly-based self-sustained economic growth, and;

-- To foster the growth of productive self-sustaining income and job producing private enterprises in developing countries.

A. INTRODUCTION

The purpose of this paper is to lay out the Africa Bureau's strategy for the development of the private sector which is inextricably linked to the development of African economies as a whole. The failure to create an environment in which the private sector can flourish has been the single greatest cause for economic stagnation in Africa. Accordingly, we must focus our efforts on limiting the role of the public sector to those economic areas which it is best suited to manage, such as infrastructure and basic education, and on creating an environment for unleashing the energies of the private sector everywhere else.

This paper is divided into two parts. Part I presents the private enterprise policy setting. Part II presents the strategy itself as a set of private sector Development Actions in terms of both the Program Development Process and Program Activities or actions.

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B. AFRICA BUREAU PRIVATE SECTOR POLICY

The Africa Bureau is committed to supporting and implementing Agency private enterprise policy with a profound conviction that private sector development is an essential element of economic development. The development of an indigenous private sector is necessary not only to broad-based economic growth, but also, over time, to the political stability on which economic growth must be founded. In this policy paper the term private sector encompasses all economic activity which is not performed by the public sector. This includes all for-profit firms from large multi-national giants to individual vegetable hawkers, - whether "formal" or "informal," foreign or indigenous, agricultural, industrial or service. It also includes non-profit private organizations such as trade associations, educational groups, labor unions, cooperative societies, PVOs, etc., insofar as those groups produce an economic service. Often, the for-profit segment of the private sector is referred to as <u>private enterprise</u>. <u>The Africa Bureau views the fostering of market-oriented private sector activity as the key mechanism for achieving the Agency's and the African government's development objectives</u>.

The development of a vigorous private sector and an expanded middle class in Africa also provides the most likely source of employment and economic growth among Africa's limited options and offers the best hope of improving local investment climates which will induce both local and foreign investment to maximize their contribution to African development.

A.I.D.'s policy and this strategy applies equally to the informal as well as the formal business sector. Micro businesses that operate with loans from family, friends and local lenders typically comprise a significant economic sector in Africa. Missions should look for ways to work efficiently and economically with these often hard-to-reach micros and informals. We should work towards developing a favorable policy environment within which these enterprises will be willing to move into the formal sector.

The fact that the Agency and Bureau emphasize development of the private sector as a major vehicle of economic development does not demean the importance of a rational public sector development role. In every economy there is an important role for the government in providing "public goods," such as defense, basic education, certain types of infrastructure, research, etc. Small LDC private sectors cannot alone finance and carry out large scale infrastructure, health and education activities. The private sector can, however, often participate in such activities and grow in doing so. LDC development needs the best efforts of both sectors and we believe that A.I.D. can utilize and promote the private sector more effectively to enhance economic development in Africa. Working with private sectors is a primary means to achieving development objectives; the private sector is no more an end in itself than is working with the public sector.

Central to a well-functioning private sector is an efficient public sector. Roads must be maintained, legal systems enforced, administrative procedures made simple and fair, the value of the currency maintained. In some special cases, the most appropriate use of A.I.D. funds may be to help rationalize and stabilize government finances. In other cases, A.I.D. development objectives may be served best by working primarily with the private sector. While A.I.D. funding of public sector programs would not be classified as private enterprise development, they would be part of a comprehensive restructuring of the roles of public and private sectors. The restructuring should include privatization, reduction of government deficits, increased efficiency in government, and policy reform aimed at improving the private sector environment.

Most importantly, Missions should seek practical ways to use the private sector as a delivery mechanism for resources and information in A.I.D. programs and projects. At least 11 African Missions are now utilizing private firms and PVOs to help implement traditional A.I.D. agricultural, health, infrastructure and other projects.

Part II. <u>AFRICA BUREAU PRIVATE SECTOR STRATEGY</u>

The Bureau and its Missions will carry out the private sector responsibilities and actions cited in this strategy to the maximum degree practicable within the varying stages of economic and private sector development that exist in different African countries. There are three central elements that underlie the

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Africa Bureau's approach to private sector development. They are:

The approach of our strategy must be making private sector development an integral part of country strategies; it must be part of the warp and woof of our programs and projects;

The focus of our strategy is competitive market development, particularly financial and agricultural markets through reducing government policy distortions, reducing investment risk and transactions costs, increasing market competitiveness, and strengthening market institutions.

The target of our strategy is primarily the development of the indigenous private sector, not promoting foreign private investment per se. Nonetheless, A.I.D. will facilitate foreign, particularly U.S., investment in partnerships with local business when it generates significant developmental benefits including employment, infusion of foreign exchange and technology transfer.

A. PRIVATE SECTOR DEVELOPMENT ACTIONS

The Bureau emphasizes the following actions in the development of private sector programs.

1. Improve A.I.D. Knowledge of the Private Sector

Missions must develop a sound knowledge of the private sector's composition, capabilities and limitations. Each Category I and II Mission must develop a private sector profile. These profiles should address the whole range of private enterprise formal and informal sectors, the rural as well as the urban economy, service and production enterprises, macro and micro enterprises and profit and non-profit organizations.

Profiles should identify constraints and opportunities with respect to governmental policies and regulations. raw material resources, foreign exchange resources, managerial and entrepreneurial capacity, labor supply and quality, credit availability, infrastructure, and information needs and other factors that affect the private sector's capability to contribute to broad based economic growth. Given their private sector profiles, Missions can then select a limited number of activities that best reinforce and institutionalize policy reforms

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and promote private sector growth.

Missions should utilize all possible sources of information including private sector personnel, organizations such as Chambers of Commerce, banks and trade associations, PVOs and NGOs, accounting firms, business consultants, academics, and so on. At the same time, the Africa Bureau may conduct a series of studies of specific issues that cut across country lines. The most important of these would relate to economic policy, administrative and regulatory practices, and financial markets. The Bureau intends to evaluate private sector interventions in Africa and other countries of the developing world, by both A.I.D. and other donors, to determine what works and what doesn't, and what conditions are necessary to obtain best results. We will also act as a clearing house, disseminating new information on useful approaches to private sector development.

2. Strengthen a.i.d. Planning, Programming and Funding for Private Sector Development

Missions in Category I and II countries, and Category III countries that have significant private enterprise programs, are to provide narrative and budget data in CDSS, ABS, Country Action Plans and Program Week submissions showing how private sector development falls within their overall country development strategy and programs. Such submissions should explain how the Mission is working toward achieving maximum practicable private sector involvement in its total development program. <u>PRIVATE SECTOR STRATEGIES ARE TO BE AN INTEGRAL PART OF OUR DEVELOPMENT APPROACH, NOT AN ADDENDUM TO THE IMPORTANT WORK WE ARE DOING ELSEWHERE</u>.

Mission program and project documents will report the flow of project and non-project assistance resources through or to the private sector by means of dollars and local currency budgeted from DA, ESF, and PL-480. Specific guidance on how to do this will be provided.

Missions' success in incorporating, funding and measuring private sector related elements within programs and projects will be an important focus of Bureau reviews of CDSS, ABS, Country Action Plans and Program Week submissions.

In designing PIDs and PPs missions should consider the

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appropriate level of private sector involvement in implementation of all suitable projects, particularly in those cases where A.I.D. experience in similar projects elsewhere shows private involvement to be feasible. Where conditions warrant, projects can be designed and include resources required to expand private business activity into new areas over the life of the project. The Africa Bureau will make private sector involvement a major factor for consideration in PID and PP reviews. For their ongoing projects all Category I and II Missions should explore the feasibility of modifying or amending projects to incorporate private sector supplied services and goods, when this will enhance the developmental impact of the project.

3. <u>AID/W Support to Field Missions</u>

A. <u>Training for A.I.D. and LDC Personnel</u>

Bureau and Mission personnel have shown high interest in learning more about business practices, business policy, management techniques, credit/capital markets, and the role of enterprise in A.I.D. programs. The PRE Bureau holds a ten-day Private Enterprise Course several times each year in the Washington area. Mission staff traveling to the U.S. and AID/W Bureau staff are encouraged to enroll. Also, AFR/PRE will help tailor this course for overseas use, and hold it in both West and East Africa during FY 1987. The overseas courses will be open to both Missions and key host country officers.

Mission and Bureau staff will develop plans and approaches for training African private and public sector leaders and technicians in roles and functions of both sectors in development. Training will emphasize short-term approaches such as workshops and travel to LDCs and the United States to observe how private and public sectors interact to promote business growth.

B. <u>Private Sector Advisor Positions</u>

REDSOs and large Missions are encouraged to establish private enterprise PSC positions when the volume of PE projects and activities warrants employing an individual with a solid business background. Private sector advisors should take the lead with Missions in analyzing and working with the private sector; assisting in the development, implementation and evaluation of private sector activities; and in designing, implementing and evaluating private sector components of projects including design of private sector delivery mechanisms for traditional A.I.D. projects in agriculture, health, etc. As examples, the advisor would assess, recommend and assist in developing actions and projects in such areas as loan funds through financial institutions, cooperatives and PVOs; bank guarantee funds; managerial assistance and training programs; important developments in the private sector; assistance to Chambers of Commerce and trade associations; and development of materials useful to Missions' dialogues with governments to obtain changes in policies and regulations concerning price controls, foreign exchange, investment codes, repatriation of funds, labor laws, etc., that inhibit private enterprise growth.

C. <u>AID/W Assistance - Africa PE Fund</u>

Missions are encouraged to draw on the services of AFR/PRE and the Africa Private Enterprise Fund to obtain and finance a wide range of technical assistance to carry out this strategy and the actions set forth in paragraph 2 below. Areas of special interest have been: development and review of private sector strategies and programs; project design and preparation; analyses of formal and informal private sectors and of agricultural, commercial and industrial subsectors; organization and operation of intermediate credit facilities (banks, cooperatives, revolving loan funds, etc.) for term lending including associated business advisory services; information on A.I.D. private sector programs, projects and activities worldwide; business/investment climate studies; profiles/feasibility studies of selected potential business ventures; analyses of government policies and practices that inhibit private sector and overall economic development; and partial funding of private enterprise advisor positions staffed by individuals with strong private sector backgrounds.

To date technical assistance has been provided on an ad hoc basis in response to each request for assistance. However, beginning in FY 1987, Missions may propose to AFR/PRE a program of requirements for U.S. business experts to assist them in analyses of private/public sector roles, private enterprise strategy planning and project design and support or other matters discussed in this strategy. Missions may present these requirements

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and budgets to AFR/PRE in the same manner as they present requests for PD and S resources. If approved, blocks of funding (up to $150,000) from the Africa PE Fund will be made available to individual Missions early in the fiscal year for direct Mission administration. This will allow Missions to operate more independently, use their own discretion on programming consultants and assume direct management of the process.

The Africa Bureau intends to undertake a major impact evaluation of private sector development programs in selected African countries. In addition, we wish to, as policy reforms undertaken by African governments take place, assess their impact on the private sector. We believe that such on-going analysis will be invaluable to both the Bureau and field Missions.

B. <u>PRIVATE SECTOR PROGRAM ACTIONS/ACTIVITIES</u>

Four categories of program actions are described below for Mission consideration in developing private enterprise strategies. These are the priority areas for private enterprise programming. The list is not exhaustive nor immutable but will be adjusted and refined by continuing experience. Nor do we expect Missions to develop programs in every area. Rather, Missions should be careful not to scatter financial resources and stretch staff resources with too many activities, but chose those areas where they can be most effective. As A.I.D. resources become more scarce, Missions face increasingly difficult choices as to which projects best achieve development objectives. PL 480, DA and ESF local currencies should be used more widely to offset dollar budget reductions. As an important financial resource, A.I.D. is making a concerted effort to make better use of local currencies. In this regard, the 1985 Food Security Act calls for increased use of Title I local currencies for private enterprise credit programs.

1. Promotion of Policy, Regulation and Procedural Reforms

A. Reform: An A.I.D. Priority: One of Missions' top priorities should be to continue to assist and influence host governments to adopt durable policies and practices that improve the environment in which the private sector operates.

In order to effectively promote necessary policy reforms it is imperative that policy dialogue be rooted in rigorous, on-going economic analysis which identifies, describes in appropriate detail, and quantifies when necessary or possible, the reforms being proposed. Such analysis will establish credibility during the policy dialogue process, host country (and other donor) acceptance, and lead to reforms with full host government commitment. Policies and practices sought include:

-- efficient product prices;
-- efficient factor prices, especially wages and interest rates;
-- an exchange rate that is not overvalued;
-- freely functioning markets with little control and with multiple marketing channels;
-- a well functioning, well-articulated financial market, with market-determined interest rates for saving and borrowing;
-- a tariff system which does not introduce unjustified and inappropriate effective protection;
-- taxes which do not distort incentives;
-- moving economic functions out of the public sector into the private sector;
-- a legal system that ensures private property rights, enforces contract obligations, and encourages expanded capital ownership among private entrepreneurs and workers;
-- labor laws that allow firms to adjust employment levels to their own needs and reduce the use of wage floors to the minimum;
-- and absence of undue governmental interference with private business or crippling administrative burdens on the conduct of business.

To accomplish this effectively, Missions should conduct business/investment climate assessments aimed at identifying actions for Missions to take to eliminate policy and institutional constraints. Missions should search for ways to include policy and regulatory reform conditionality provisions in their own projects and activities, and to coordinate those provisions fully with multinational and other bilateral donors.

Fundamental to policy reform is rationalizing the roles of the public and the private sectors; privatizing public sector activities which are performed more effectively by the private sector, and reducing the controls and regulations which inhibit private entrepreneurs from investing their energies, capital and labor efficiently.

Given our objectives to increase income, employment, and private ownership, we are interested in efforts to improve the environment for small entrepreneurial businesses, particularly those that are rural based or have backward and forward linkages with rural and urban areas. This does not mean skewing incentives in favor of such firms, but rather, removing impediments to their growth and development.

B. Mission Policy Dialogue Agenda: Each Category I and II mission must develop a policy reform dialogue agenda, describing which policies they think A.I.D. can best work at reforming, why these policies are important, and how the A.I.D. program will be directed at achieving these reforms. The agendas should be included in all Action Plans with annual updates in the ABS. In developing reform agendas and pursuing change, Missions will consult with appropriate public and private sector representatives.

2. Financial Market Development

Fundamental to any private sector development strategy is the development of a well-articulated financial market. The function of financial markets is to intermediate between savers and investors. In a well-functioning market, savers will have reasonable incentives to put off consumption, and to balance return of different financial assets with the risk of each asset, and investors will be able to borrow on terms commensurate with their project's expected risk and return.

An important aspect of financial markets is their articulation. By this, we mean the development of a broad series of financial institutions able to provide many different financial instruments. On the lending side this includes short-term working capital loans, real property loans, trade credit, medium term investment for capital equipment, etc. On the saving side this would mean the development of money markets, bond markets, stock markets, savings and thrift institutions, credit unions, etc. Lending would be available for a variety of purposes, under various conditions of risk and return, with different sorts of collateral. Credit would be available to all sectors from agriculture to industry to services. A well-articulated financial system would include all types of institutions such as export credit agencies, venture capital firms, traditional deposit banks, investment banks, development finance institutions, and traditional money lenders. In such a system government regulation would be limited to overall control of the monetary system, reserve requirement rules, protection against fraud, etc.

Of course, few countries in Africa are ready for a financial intermediation system as sophisticated as that described above. Yet, we should not underestimate the potential for financial market development if policies are permissive. One need only examine the sophisticated instruments developed in the Gulf States by Sudanese and Somali nationals to offer financial services to expatriate workers in these areas to understand that the possibilities are greater than we currently imagine. In any case, financial development is a very important element of the Bureau's private sector strategy.

All A.I.D. financial intermediation programs will operate under the basic A.I.D. policies with respect to credit terms and access. Subsidized credit is unacceptable. The end user of credit must pay all the costs of credit including transactions costs, a premium for the risk of default, and a positive real interest rate that reflects the opportunity cost of savings. The cost of long-term technical assistance to institutions or borrowers should also be covered by interest rates and fees. Interest rates for savers should be sufficiently high to encourage domestic resource mobilization.

The basic role of A.I.D. assistance must not be to increase the domestic supply of credit, although that is likely to be a concommitant feature of our programs, but to improve the efficiency of financial institutions and markets, broaden capital ownership, reduce transaction costs, and reduce risk.

3. Privatization

An important element of the Africa Bureau's policy involves privatization of economic and business functions such as marketing of agricultural inputs and commodities, production of agricultural and manufactured goods, and services such as curative health care, certain training and educational services, veterinary services, agricultural extension, etc. Not all of these activities in all African countries will be amenable to privatization. Nevertheless, depending on the availability of private sector service purveyors, the comparative advantage of private sector in supplying the service, etc. Missions are encouraged to investigate privatization opportunities, both with respect to services provided by Government Ministries and those provided by parastatals.

A.I.D.'s privatization policy with respect to parastatals is described in the policy guidance dated May 6, 1986 which states "A.I.D. assistance to or through a parastatal should be given in the context of exposing the parastatal to market forces and scheduled divestiture of the government interest ... A.I.D. projects designed to improve parastatal performance must have identifiable benchmarks upon which substantive progress towards divestiture can be measured. The latter sentence is the ultimate condition upon which assistance is to be granted. In other words, the selected benchmarks must represent substantive evolutionary progress in moving the parastatal towards market-based operations and divestiture in order to qualify for A.I.D. assistance."

4. Market Growth and Development

Missions should consider ways to improve market functioning by increasing competition in markets or reducing transaction costs. There are several approaches A.I.D. can consider to achieve these objectives:

A. Developing Information Services: Just as improvement in transportation broadens markets so does improvement in market communications. Market information systems in particular can serve to improve market competitiveness. Helping the development of mass media market information services, technology or market development advisory services, trade journals, etc. can be justified as increasing equity and competition.

B. Agricultural Markets: Private agricultural market institutions must also emerge in rural areas and market towns to stimulate trade and make operative the reforms instituted in macro-economic policies as they affect the agricultural sector. Examples of private market institutions are: credit mechanisms, regional markets, and storage facilities, including bazaars and wholesale/retail outlets, private packaging and transport facilities, sales outlets for farm inputs, market news services and local private business associations active in monitoring, critiquing and recommending changes in government policies and practices that would relieve constraints on or open opportunity for business growth.

C. Infrastructure: Africa has a woefully underdeveloped transport and communications network. Efficient development of these systems reduces transactions costs, encourages production, increases competition, and reduces consumer prices. A market system cannot operate if transactions costs are so high as to exclude many producers and consumers from the market. In particular, Missions should encourage selective rehabilitation of existing infrastructure and investment in new transport links with high rates of expected economic returns. A.I.D.-sponsored analysts can identify infrastructure improvements that could accelerate private sector transactions. Given limited A.I.D. resources, financing for the capital improvements themselves should be sought from domestic, IBRD or other donors before the use of A.I.D. resources is proposed.

D. Business Services: Missions are encouraged to provide support to local business organizations, Chambers of Commerce, consumer groups, labor unions or trade associations so that they might better articulate business community views on legislation and public policy. Technical assistance can also help such associations expand their services to members, train members in policy dialogue, promote open trade practices, and train managers and workers of local industry, and help members identify markets and sources of credit.

Also, Missions can sponsor business advisory services to assist small business start ups and turn-arounds or provide management training through financial or technical support. These services might be effectively extended to reach micro and informal businesses. However, services to profit making businesses should not, and need not in most circumstances, be subsidized. Such services should be operated on a self sustaining

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basis and A.I.D. support should be provided with this objective in mind. That is, organizations providing subsidized services to business must consider and show how the subsidies will be eliminated over the period of A.I.D. assistance. A.I.D.'s aim normally will be to help establish or expand business consulting services that operate on a fee basis.

E. Investment Promotion: Promoting business investments whether in small scale indigenous enterprises, or larger joint ventures with foreign partners is not a discreet activity in and of itself. It is a process involving all actions set forth in this strategy; done effectively it calls for reform measures, market liberalization, market information, business advisory services, and financial market access. A.I.D. assistance to the process should be done in light of these controlling factors.

AID's Experience With The FY
FY 85 Agrica Economic
Policy Reform Policy
(AEP P)
DP Memorandum - May 14, 1986

The AEPRP offers AID a unique opportunity to provide a new and independent voice in policy dialogue issues in Africa. This program has energized our Missions to redirect and expand the policy dialogue component of our programs; acted as a magnet in attracting other donor programs in support of policy reform objectives; and provided AID with an important entree with African governments in the policy dialogue process.

The following brief review of the FY 85 AEPRPs is divided into two major sections: (I) a review of the FY 85 programs themselves; and (II) a discussion of the lessons learned in the design process. In addition, there is an annex: (A) a summary of the FY 85 programs in graphic form.

I. CAPSULE SUMMARIES OF THE FY 85 PROGRAMS:

MALI ($18,000,000)

PURPOSE: To begin the process of reduction of Government involvement in the economy, and to provide the environment for increased private sector activity.

POLICIES: (1) Tax reform and reduction to improve private sector incentives; (2) restructuring expenditures to begin reduction of civil service payroll and increase funds available for non-wage expenditures; (3) revision of commercial code; (4) relaxation of price controls.

USE OF FUNDS: (1) Cash grant of $8,335,000 to reimburse GOM for shortterm revenue shortfall; (2) cash grant of $8,365,000 to help the GOM increase its share of expenditures on non-personal costs; and (3) technical and commodity assistance of $1,300,000 to aid in computerization of budget and tax collection.

ZAMBIA ($25,000,000)

PURPOSE: To liberalize agriculture marketing in the two major commodities still controlled by the Government, maize and fertilizer, in order to create the right incentive structure for agricultural development.

POLICIES: (1) Elimination of subsidies on maize and fertilizer; (2) Introduction of regional pricing for maize and fertilizer; (3) Allowing private sector marketing in maize and fertilizer

USE OF FUNDS: Commodities financed under a CIP will be provided to improve agricultural marketing. These will include small trucks, tires, railway and truck spares, road maintenance equipment, and possibly POL. Local currency generations will be used for credit to private sector traders, for credit to the co-operative sector, and to provide targetted subsidies for the poorest groups adversely affected by food price increases.

MALAWI ($15,000,000)

PURPOSE: To rationalize fertilizer policy in order to promote agricultural diversification.

POLICIES: (1) Reduction of fertilizer subsidies; (2) shift from low nutrient, high cost fertilizers to high nutrient, low-cost fertilizers.

USE OF FUNDS: Cash grant of $13,100,000 to be used to maintain the integrity of two credit funds associated with the purchase of fertilizer; technical assistance of $1,900,000 for studies and assistance in budgeting, agricultural marketing including divestiture of parastatals, storage, and policy with respect to strategic grain reserves.

RWANDA ($12,000,000)

PURPOSE: To create an improved environment for the development of small and medium private enterprises.

POLICIES: Specific changes include: 1) liberalizing price controls, 2) examining the entire tariff structure; and 3) increasing access of small and medium enterprises to tax incentives and credit guarantees.

USE OF AID FUNDS: A cash grant of $10,000,000 will support a small and medium enterprise credit fund and offset short-term revenue shortfalls to the Rwandan Government from these policy changes. Technical assistance of $2,000,000 will be provided for studies and short term advisors to examine and improve the whole incentive structure for private sector, including a comprehensive review of tariff and trade policy.

MAURITIUS ($5,000,000)

PURPOSE: The purpose of this program is to aid Mauritius in its reform of its industrial incentive system.

POLICIES: Among the policies being called for are (1) imposing a ceiling of 100% on all tariffs; (2) reducing marginal personal tax rates; and (3) improving export incentives.

USES OF AID FUNDS: AID is providing a cash transfer to offset the fiscal loss of these reforms.

BROAD PROGRAMMING COMMONALITIES

CONDITIONALITY AND TRANCHING: Each of the AEPRPs is divided into several tranches. Programs are authorized in FY 85, but disbursements will occur over the CY85 to CY88 period. Before any tranche can be disbursed, recipient Governments must provide AID with proof that the Conditions Precedent (CPs) to that tranche have been met. These conditions vary from announcing new prices which reduce subsidy levels (Malawi and Zambia) to passing legislation or announcing administrative decisions to increase access to certain credit guarantees (Rwanda) to changing tax and tariff policy (Mali and Mauritius).

IMPACT OF AEPRP ON PRIVATE SECTOR: All of the AEPRPs are aimed at either reducing government activity in the productive sectors of the economy, reducing or rationalizing government controls on the private sector, or both:

- In Zambia, the entire program is designed to reduce the Government's role in agricultural marketing to the level needed to ensure competition.

- In Rwanda, the program is designed to reduce government price controls, to broaden access to credit, and to rationalize the tax system to improve the climate for small enterprises.

- In Mali, while the major thrust of the program is to improve fiscal policy, a concommitant part of this initiative is to improve the investment climate for private sector activity through tax reform, reductiion of price controls, and changes in the investment code.

- In Mauritius, the major objective of the program is to increase efficient private sector activity by reducing tariffs and marginal tax rates.

- In Malawi, major studies are to be undertaken examining the role of ADMARC, the marketing parastatal, with particular emphasis on developing a capacity to privatize many of ADMARC's current functions.

II. LESSONS LEARNED: While we are still implementing these proposals, the process of design and early implementation has led to some important observations.

EFFECT ON NORMAL BILATERAL PROGRAM: The AEPRPs will have an impact well beyond the programs themselves. These programs have tended to be more directed at broad development issues and our development strategies in each of these countries will be redirected to take advantage of the new opportunities offered by the AEPRP. There are three reasons for this phenomenon:

(1) Missions saw the AEPRP, because it was funded out of ESF, as being available for broad strategic programs. Indeed, three of the AEPRP programs concentrated on either the industrial sector or the broader issue of public vs. private sector.

(2) In all of the AEPRP countries except Zambia, AID has had a relatively small program focussed on a few sectoral or sub-sectoral issues. The size and nature of these programs generally precluded our discussing broad policy issues with the recipient governments.

(3) The nature of the AEPRP, a concentrated and dramatic increase in program levels, attracts considerable attention from recipients. It gives AID a basis for a continuing policy dialogue as well as a seat at the policy table which it wouldn't otherwise have.

THE IMPORTANCE OF PROCESS: Perhaps as important as the product in each of the AEPRP countries is the policy dialogue process which these programs have engendered.

-- In Rwanda, the Government set up a special inter-departmental committee to develop and review policy reform proposals as part of their discussions with A.I.D. As a result, the GOR is concentrating on policy reform issues for the first time.

-- In Mali, the AEPRP is central to the start of a long-term process to move the government out of the economy. A.I.D.'s program may be the catalyst needed to energize that process.

-- In Malawi, A.I.D. has moved from a minor donor to a major influence on agricultural policy. As part of the Malawi AEPRP, A.I.D. is entering into studies and discussions that may lead to major reforms in agricultural marketing, in agricultural pricing policy, and in divestiture of some major parastatal activities.

DONOR COORDINATION: The AEPRPs have been developed in close coordination with key donors, particularly the World Bank. Taken together, the AEPRPs and the Bank's structural adjustment programs have achieved a significant synergism not present when each was developed in isolation. Significantly, the AEPRPs have generally moved beyond what the Bank was doing, and advanced the reform process more quickly and probably more broadly than would have been the case without our presence. Equally important, the nature of these programs differs in important ways from IBRD policy reform programs, in that we have designed them to alleviate the political stress that policy reform brings.

-- In Rwanda, policy dialogue on the part of all donors had been limited to project level issues. Neither the Fund nor the Bank has had broad sectoral or macroeconomic programs in Rwanda. The AEPRP has been the leading edge of what will be a major structural reform program by the Bank.

-- In Mali, the AID program is the catalyst that has lent the necessary impetus to implementing reforms previously agreed to. Drawing on technical work done by the IMF and the UNDP, the AEPRP was the mechanism which concentrated the energies of the Malian Government, drew together different Ministries, and consolidated a number of different, and halting reform efforts.

-- In Zambia, the AEPRP tracks very closely with that of the IBRD (funding for agricultural sector rehabilitation is also coming from the AfDB). However, technical work done by AID staff helped correct several misconceptions held by other donors. Moreover, the AID program is designed to help reduce the political costs of these changes, and thus make implementation more certain. This program has also helped catalyze the British into a more active policy role in Zambia. They have committed about $10 million from their contribution to the Bank's Special Facility to the policy reform effort.

-- In Malawi, the AEPRP is part of a multi-donor effort connected to the World Bank's Structural Adjustment Loan (other donors include Great Britian, Japan, and Germany). The fertilizer policy reform is one element of the Structural Adjustment Loan. Because AID concentrated on this issue alone, because it emphasized actions to help implement reforms, and because of the excellent technical staff contracted, AID's program was instrumental in making reform in this sector possible.

-- In Mauritius, the AEPRP has been closely associated with the IBRD's trade reform program. In fact several Mauritian officials felt that the U.S. had shown far greater awareness of the exigencies of adopting economic reform measures within a changeable world economy and a democratic country than had the World Bank.

DESIGN ISSUES: Despite the fact that four of the first five programs were cash grants, these programs have turned out to be more complicated than first expected because they have been designed them in such a way as to put great emphasis on reducing the political costs associated with any changes. This has led AID to associate its program funds with technical assistance and to target the use of its non-project assistance resources carefully. For example:

In Malawi, the political problems associated with the removal of fertilizer subsidies led AID to emphasize the need to change the types of fertilizer being used. This led to involvement in agricultural research and extension, in improving the capacity of the Ministry of Agriculture to test soils, and to examining the feasibility of building a fertilizer bulk blending plant in Malawi.

In Mali, the program required both substantial technical and commodity assistance to monitor compliance and the development of private sector opportunities for retiring civil servants.

In Zambia, AID resources will be used to enable private sector traders and transporters to compete with the parastatal marketing Agency. Some of the local currencies will be used as carefully targetted subsidies to reduce the adverse impact of food price increases on the poorest urban dwellers.

STAFFING: The first generation of AEPRPs were identified and designed with substantial inputs of Washington staff, particularly economics staff. These programs require highly talented analytic staff in their design, but even more importantly, in their implementation. The ability of small Missions to monitor and implement these programs remains weak.

RISK: These programs are high-risk, high impact. It should not be surprising if some of them fail to achieve their objectives, or, if Conditions Precedent are not met and some programs are de-obligated funds.

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DEVELOPING AND IMPLEMENTING
A COUNTRY PRIVATE SECTOR STRATEGY

(P)

USAID/KENYA PRIVATE ENTERPRISE STRATEGY STATEMENT

SUMMARY

A. OVERVIEW

Kenyas's future prospects for higher living standards depend greatly on growth among her private enterprises. In view of this, AID has made private enterprise development a top priority in its program of economic assistance to Kenya. This private enterprise strategy statement describes the framework under which AID will pursue this priority.

The statement serves two main purposes. The first half discusses the challenges Kenya needs to meet in order to improve the private enterprise environment and thereby foster more rapid, sustainable growth. It describes the operating environment facing private enterprise in Kenya, comprised of government policies; human, institutional and natural resource constraints; and areas of opportunity. In many respects, Kenya's economic environment supports the private sector well. Improvements are needed, however, to insure that growth can be maintained or increased. Rather than giving an agenda for immediate action, this section suggests areas of emphasis and, within them, general directions which AID believes the Kenya Government and private sector should follow.

Second, this statement describes AID's plans for assisting private enterprise development in Kenya. The principle behind its activities will be to help establish the preconditions for private enterprise growth. Assistance will be given both through the negotiations on policy change with the Government of Kenya that accompany program assistance and through project developed in conjunction with key private institutions. The areas targeted in the second half of the statement are derived from the first half's diagnosis of needs and opportunities. They are: the financial system, management and entrepreneuria development, technology and technical skills, export promotion and finance, investment promotion and the informal sector.

B. BACKGROUND

The Government of Kenya's Development Plan, 1984-1988 states, "Growth in the private sector is the core of the development process ...Without growth in the private sector there can be n effective or widespread development in Kenya."[1] USAID agrees that a strong private sector must be the main source of economic growth and improvement in living standards for Kenya in the coming years. Kenya's private economic resources will have to be used to their fullest potential to achieve such desired growth, and this will be an absorbing and challenging task.

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To support the shared objective of greater utilization of private resources, USAID/Kenya has developed a private enterprise strategy to guide its assistance to Kenya's private enterprise from 1985 to 1990. The strategy has been developed in the spirit of AID's recent policy paper on Private Enterprise Development (March 1985). That paper, which applies to AID programs worldwide, states that the goals of AID private enterprise development efforts should be:

- to encourage LDCs to open their economies to a greater reliance on competitive markets and private enterprise....

- to foster the growth of productive, self-sustaining income and job producing private enterprises in developing countries.[1]

As will become evident throughout this statement, these goals motivate USAID's private enterprise strategy for Kenya.

The strategy is based on a diagnosis of the needs of Kenya's private sector. These needs have been identified through a review of literature on Kenya's economy, including documents produced by the Government of Kenya (GOK) and by donor agencies. This has been supplemented by a series of interviews with business and financial leaders, aimed at determining their perception of constraints to and opportunities for private enterprise growth. We found a convergence of views, both among written sources and between written sources and interview responses. Following from this widespread agreement and the extensive documentation available on the status of Kenya's economy (see Bibliography for selected items), this statement reports results and organizes them into a strategic framework. It is not intended to substitute for a full economic analysis of the private sector of Kenya.

In the area of government policies, the following have been identified as leading to more rapid and sustainable growth: favorable macroeconomic policies such as positive real interest rates and realistic exchange rates; fewer restrictions on imports, particularly of intermediate goods; fewer price controls; less government investment in production; and a more favorable set of regulations and administrative mechanisms governing new investment. The changes required constitute a move of government policy away from the promotion of large, capital-intensive industries concentrated in import substitution, and towards the promotion of industries that reflect the relative plenty and scarcity in Kenya of various

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inputs. These include plentiful labor and agricultural products and scarce capital and foreign exchange. The Development Plan itself calls for such a shift in policies. The agenda presented here and is also consistent with structural adjustment negotiations carried out during the past few years between donors and GOK.

An overwhelming message is the need to rely on market-determined prices to allocate resources, because market prices reflect relative scarcity and abundance. This attribute of market prices means that free markets tend to produce the most that can be produced from limited resources. It will be crucial that GOK policies reflect trust in the ability of markets to allocate resources efficiently. AID is willing to work with the GOK to support and encourage such policies.

No country's resource base is static. Therefore, a second kind of challenge facing Kenya is to develop the productive potential of its resource base. In some areas, such as natural resources, size of the domestic market and the quality of local inputs, constraints to growth cannot be altered or can be changed only slowly. Others however, such as human, financial and technical resources, can be improved through concentrated effort. Development of these resources is, in effect, creation of the pre-conditions for private sector growth. In addition, several sectors have high growth potential. These include agribusiness, small manufacturing, export-oriented business and the informal sector.

The second half of this statement outlines USAID's strategy of assistance to private enterprise, based on these findings about Kenya's needs and potential. The overall objective of the strategy is to promote growth of private enterprises, both by seeking to overcome the constraints that are a natural result of Kenya's current economic status and by promoting a government policy environment that allows market forces to operate more freely. AID will assign priority to industries that are labor-intensive, local resource-based and foreign exchange-earning or saving. These are the characteristics that best reflect Kenya's assets and constraints. In addition, AID's strategy will tend to promote industries of smaller size, those located in rural areas and those owned by indigenous Kenyans. All of these are priorities for GOK, and are important for developing Kenya's economic balance and self-sufficiency.

AID's private enterprise projects and program assistance will address six areas.

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In finance, AID has already developed the Rural Private Enterprise Project to supply term credit to small and medium-sized firms. It will further assist commercial lenders to make longer term loans by the creation of one or more discount facilities that will give lenders wide discretion in selecting borrowers and will include agricultural loans. It will also develop a loan guarantee fund to help ease collateral requirements for smaller firms and will work towards the creation of a venture capital fund or other source of equity capital.

In managerial and entrepreneurial skills, AID has developed the Agricultural Management Project, which will supply in-house training and technical assistance to firms in agriculture or related industries. The planned Training for Development project will provide specialized training for selected individuals, many of whom will work for private firms. Finally, the need to develop stronger entrepreneurial attitudes will give rise to an entrepreneurial development component.

In technology and technical skills, AID will fund direct transfer of technology through the consulting services of the International Executive Service Corps (IESC). The Training for Development Project will also train significant numbers of specialized technicians, and there may be additional support technical training institutions in Kenya.

In exports, AID will design a major new initiative that will cover the areas of export promotion, export finance and government policy towards exports. It will focus particularly on agribusiness and manufactures. Mechanisms to be investigated include a bills discounting system for short term export credit, an export trading company and government policies like manufacturing in bond and free trade zones.

In investment promotion, AID will support the activities of the Investment Advisory and Promotion Center (IAPC), and other government or private investment promotion groups. Possible areas for IAPC include improvements in the legislation affecting new investments, streamlining the investment approvals process and provision of industry-specific information for investors.

In the informal sector, AID is already sponsoring grants and technical assistance to private voluntary organizations whose enterprise development programs serve the informal sector. Further developments will include a search for ways to give informal sector firms greater access to credit, either by creating links to formal credit institutions or by encouragin institutions such as savings and credit societies to work mor effectively with the informal sector.

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USAID will use six main vehicles to provide the assistance just described. The provision of program assistance through the Economic Support Fund is a means of pressing for policy changes described here, as well as for providing technical assistance to GOK. This is an ongoing part of overall Mission activities. Policy dialogue relating to the private sector has focused on macroeconomics, import liberalization, export promotion and agricultural input and grain marketing liberalization. These will continue to form the main policy agenda.

Two of a total of five projects, Rural Private Enterprise and Agricultural Management, have already been developed. The remaining three projects include:

- Activities funded through counterpart funds in local currency, generated as a result of program assistance. Possible activities are:
  - -- discount facilities
  - -- IESC (technical business advisory services)
  - -- loan guarantee fund
  - -- agricultural credit
- The Training for Development Project, slated to begin in FY 1986, many of whose recipients will be from private firms.
- The 1987 Private Enterprise Development Project, which will have five components:
  - -- venture or equity capital development
  - -- export promotion and finance
  - -- investment promotion
  - -- training and entrepreneurial development
  - -- informal sector assistance

The 1987 project will be the largest in terms of both scale and coverage. The particular content of any of these activities will be subject to expansion or modification, as needed.

The target group for this strategy, private enterprise, includes any privately undertaken activity that is intended to generate enough income to make a profit or sustain itself. While most such enterprises will be traditional profit-seeking firms, other modes of organization, such as cooperatives, are not excluded. The strategy does not, however, target private organizations that depend on outside contributions for their funding, such as private charities or other non-profit associations, except to the extent that they can be used to assist target enterprises (as in the Rural Private Enterprise Project informal sector component). AID's assistance to the non-profit sector will be provided through the PVO Co-Financing Project.

The private enterprise focus enunciated in this strategy statement will guide activities in all areas of USAID's Kenya program. USAID is strongly committed to providing assistance through the private sector whenever possible. Use of private enterprises can have the triple benefits: improving service delivery, relieving burdens on government, and developing individual enterprises. This principle is reflected in the existing Agricultural Development (fertilizer) Program and in the Private Sector Family Planning Project. A determination to involve the private sector wherever possible will be particularly important in guiding USAID's agricultural development projects in the future. Agricultural enterprises are by far the largest component of Kenya's private sector. Projects now contemplated in areas such as agricultural research, small scale irrigation and grain storage, among others, will all use private enterprises as vehicles for implementation. Conversely, a major portion of the benefit from activities discussed in more detail in this document will accrue to agricultural enterprises.

DEVELOPING A PRIVATE SECTOR STRATEGY

- A Mauritania Case Study -

USAID Mauritania patterned its initial private sector strategy development efforts on USAID Burkina Faso which had reported success in organizing a USAID-private sector-Government seminar program designed to open up communications and dialogue on policy reforms required for private sector development. The Burkina program utilized consultants to develop investment climate and sectoral reviews which were then used by the private sector seminar participants as a basis for general discussions, small group workshops and policy dialogue sessions.

In early 1986 USAID Mauritania requested AFR/PPE to organize a private sector consulting team to spend one month in Mauritania to produce an investment climate study, a private sector profile and four sectoral overviews -- banking, agriculture, mining and fisheries. The scope of work also included the review and recommendation of possible private sector strategy and program alternatives, although the Mission stressed that its primary need was for "information" which could serve as a basis for organizing its own private sector-Government seminar program and for continuing policy dialogue efforts. The consultants' final report was submitted in August 1986 following several Mission working review sessions and AID/W presentations.

The case materials which follow summarize the key elements of the report presented to Mission management.

1. Investment Climate Survey
2. Private and Public Sector Oveview
3. Current USAID Projects
4. Private Sector Strategy Recommendations

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This case puts the reader in the position of the Mission Director -- and his key staff -- who now have before them a reasonably full and objective view of the investment climate, a good understanding of the private sector, a number of options open to them in developing a country private sector strategy, and a need to program local counterpart funds from the PL 480 II food grant program. The next step facing the Mission Director is the development of a private sector concept and priorities which can be used as a basis for specific programming and budgeting actions.

The case study groups are asked to focus on the formulation of a short statement of basic objective and priorities which would provide guidance to the Mission's program planning staff in developing specific action-oriented private sector initiatives.

ISLAMIC REPUBLIC OF MAURITNIA

INVESTMENT CLIMATE ASSESSMENT AND PRIVATE SECTOR STRATEGY

The stated objectives of the Mauritania Private Sector and Investment Climate Assessment survey were to assist the AID Mission Nouakchott and AFR/PRE to:

- o "Formulate programs which will help Mauritania improve the business climate and promote local and foreign investment; and
- o Identify the capabilities of the Mauritanian private sector so that private enterprises may be effectively utilized."

The report is based on an examination of Mauritania's political/regulatory and economic/business environments, a close look at the principal productive sectors, a review of the strengths and weaknesses of the banking and investment community, and detailed analysis of the composition and growth of private sector companies. A number of conclusions emerge from these investigations:

1. The Private Sector Already Dominates The Farming, Commercial And Business Life Of the Nation

   The private enterprise sector is estimated to produce 63% of Mauritania's value added and generate 71% of total employment. In addition to a Chamber of Commerce, an active privately financed and managed Employers Organization in Nouakchott has permanent offices and staff, and a membership of nearly 200 members. There is also an active and well organized private fisheries federation at Nouadhibou, the major fishing center. In addition, the informal private sector includes a broad range of micro businesses.

2. The Number Of Mauritanian Public And State Controlled Parastatals Began To Decline in 1983

   A total number of 46 such organizations were identified in 1983 -- a rise from 14 in 1972. The number declined to 39 in 1985 and is scheduled to reach 36 in 1986.

3. The Mauritanian Government Is In The Middle Of A Major Liberalization And Restructuring Program In Response To A National Financial Crisis

   Major financial problems and the near collapse of the banking system have forced a complete reappraisal of the Government's macro-economic policies and plans.
   A key element in the Government's new strategy is the encouragement of private sector initiatives in banking, commerce, agriculture and industry.

4. Mauritania Faces A Long Period Of Major Readjustment And Low Growth In Both Internal And Export Markets

There are virtually no "quick fix" solutions to the problem of achieving real growth in consumer purchasing power -- short of climatic changes and increases in world market prices of iron ore. The fisheries industry is the one expanding sector in terms of providing food for local consumption, earning important amounts of foreign exchange, and providing employment opportunities. The rest of the economy faces a period of slow growth, at best, over the immediately foreseeable future. Refer to the attached Investment Climate Summary.

5. An Energetic And Risk-Taking Private Sector Faces An Improving Regulatory Climate But Essentially Stagnant Economic Growth

Mauritanian entrepreneurs have shown themselves to be remarkably responsive to whatever opportunities there are for establishing new local businesses. Very few opportunities exist for foreign investment, aand fundamentally poor economic and market conditions face the domestic private sector, although the political and regulatory environment is showing improvement.

6. USAID Can Have A Limited But Tangible Impact on Private Sector Development Particularly In the Fisheries And Agricultural Input Sectors

Private sector strategies and policy guidelines are proposed for assisting the development of the Mauritanian private sector. Specific program proposals are also recommended. The key elements in the proposed strategy are summarized below. Refer to attached Private Sector Strategy Recommendations.

- Concentrate on a few priority programs primarily in the agriculture and fisheries sectors;
- Focus on human resources development in trade skills;
- Work with and through private sector mechanisms;
- Make judicious use of pooled donor resources on specific cooperative projects;
- Recognize the extremely limited nature of AID's staff resources; and
- Utilize funds available from existing human resources program budgets and PL 480 counterpart funds.

INVESTMENT CLIMATE ASSESSMENT

The results of the Investment Climate Survey which represent the views of a cross section of private sector businessmen interviewed during the study -- are summarized in Exhibit I which follows this page.

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EXHIBIT I

INVESTMENT CLIMATE SUMMARY - MAURITANIA
RELATIVE IMPORTANCE GIVEN BY BUSINESS EXECUTIVES TO GOVERNMENT POLICIES, REGULATIONS AND PROCEDURES IN ENCOURAGING PRIVATE SECTOR DEVELOPMENT

Factors	Favorable			Unfavorable		
	Major	Mod.	Minor	Major	Mod.	Minor
1. POLITICAL STABILITY AND RISK: Ruling elite is Arabic-Berber with strong Islamic linkages. Called a "one party non-repressive state," government considered stable and foreign relations with neighbors are good. Businessmen generally express confidence in government policies but critical of operational effectiveness. Businessmen rate stability and risk as weakly favorable.			x			
2. NATIONAL DEVELOPMENT POLICIES AND PLANS: The economy is in deep crisis. Foreign aid has markedly declined. Low iron ore prices, the drought and debt are hurting. Several "white elephant" products are essentially dead. A "painful and wrenching" program of economic stabilization, reform and liberalization being driven by IMF/IBRD. Strong private sector element in reforms. Private sector responding actively to government reform initiatives.		x				
3. BUSINESS FORMATION AND INVESTMENT INCENTIVES: While investment code provides useful benefits, private sector heavily critical of long project approval delays, short period of exoneration, benefits not competitive with other West African countries, and failure to deliver benefits. Administration of code viewed as arbitrary and overcautious and managed by officials who have little understanding of private sector.			x			
4. INTERNATIONAL REMITTANCES: Situation has improved markedly. Assuming that IMF-sponsored financial recovery program is followed there should not be major pressures in obtaining foreign exchange for legitimate foreign remittances.		x				

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Factors	Favorable			Unfavorable		
	Major	Mod.	Minor	Major	Mod.	Minor
5. INTERNATIONAL TRADE RESTRICTIONS: Import controls being liberalized. Approvals easier to obtain. Major contraband and illegal imports a major problem. Country not benefiting from membership in CEAO common market, while other member countries are securing reduced tariff entry to Mauritania. While improvements are required there are no major obstacles to import and export.			x			
6. INTERNATIONAL AGREEMENTS: Country has close links with important regional, Islamic, EEC and international organizations. Improvements are required to obtain trade benefits implicit in regional common market membership.		x				
7. TAXES: The tax system is complex and cumbersome. Tax levels are high and enforcement is uneven. National tax system being reviewed by IMF.					x	
8. LABOR LAWS: Minimum wages lower than market rates. Employer-employee relations not confrontational. Labor laws not generally enforced.			x			
9. GOVERNMENT CONTROL AND INTERFERENCE: Direct government interference is rare. Inability of government agencies to deliver services of any kind is major problem. When delivered, service is poor and rates are very high. Little understanding of private sector problems and poor response.					x	
10. AVAILABILITY OF GOVERNMENT ADVISORY AND PROMOTIONAL SERVICES: Virtually non-existent.					x	

INVESTMENT CLIMATE SUMMARY - MAURITANIA
RELATIVE IMPORTANCE GIVEN BY BUSINESS EXECUTIVES TO ECONOMIC AND MARKET FACTORS IN ENCOURAGING PRIVATE SECTOR DEVELOPMENT

Factors	Favorable			Unfavorable		
	Major	Mod.	Minor	Major	Mod.	Minor
1. ECONOMIC AND MARKET STABILITY: Major reliance on foreign aid, balance of payment and debt problems, low iron ore prices, drought, burdensom and inefficient parastatals and an inherently poor agricultural base have brought country to crisis stage. Accumulated medium and long term debt equal to 250% of GDP or five times the average of similar countries. Banking system in total disarray. Growth prospects essentially unfavorable.				x		
2. POPULATION: 1.5 million population, 2.3% growth rate, life expectancy 32-34 years, adult literacy estimated at 25%. 20% of population in Nouakchott "bidonvilles." Major cities highly inaccessible. Market size and access to markets a major obstacle to private sector business development.				x		
3. BUSINESS BASE: Mining (government) and fisheries (private sector) dominate economy. Livestock (private) historically very important. Growth of domestic businesses limited by small size of local market. Contraband continues to be major negative factor in local business development.					x	
4. MARKET POTENTIAL: Size of local market, domestic and international market access a critical negative. Growth in disposable per capita income extremely limited.				x		
5. BASIC MATERIALS AND PARTS: No major problems in obtaining materials and parts for approved private sector projects. Limited financing also available for such projects. New Nouakchott port (open in 1986) will greatly improve timely and cost effective delivery. Northern industrial area completely dependent on European and Las Palmas for parts or major repairs.						x

Factors	Favorable			Unfavorable		
	Major	Mod.	Minor	Major	Mod.	Minor
6. INFRASTRUCTURE: Availability and quality of infrastructure viewed by private sector as most important negative after market limitations. The over-the-road difficulties are enormous — increasingly subject to major sand dune invasions. Southern and northern areas of country are not linked by roads. Parastatals providing utilities, port services, insurance, PTT, commercial air services are consistent money losers and provide marginal services at high cost.				x		
7. LOCAL CREDIT AND CAPITAL: The banking sector is undergoing fundamental reorganization. Credit is tight and private sector credit is not expected to increase in the near term.					x	
8. BUSINESS SERVICES, ENTREPRENEURIAL AND MANAGEMENT RESOURCES: No offices or joint ventures with foreign accounting or management firms identified. Foreign equipment suppliers provide bulk of technical assistance. Few experienced managers and supervisors.					x	
9. SKILLED LABOR: No pool of skilled workers available.				x		

PRIVATE AND PUBLIC SECTOR PROFILES

A series of public and private sector profiles were developed for twenty private sector companies and five major parastatals to provide specific examples of size, ownership, products, investments, sales, profits and major problems identified by management. All parastatals were reviewed as possible targets for privatization.

The private sector controls a large and increasing share of the Mauritanian economy. The Government has ceased the creation of public enterprises and is currently engaged in a rehabilitation program for the public sector which includes divestiture of some of the existing public enterprises. Ten public enterprises have been divested since 1983. On the other hand, the number of private enterprises has been increasing at an annual rate of 7% in the period 1983-1986, while the number of private enterprises in the fisheries and industrial sectors has been increasing at an annual rate of 15% and 11% respectively for the period 1981-1986.

1. The Agriculture and Livestock Segments are Primarily Private Sector Controlled

   Traditional rain fed, flood-recession and oasis agriculture are completely private sector owned. Irrigated agriculture along the Senegal River Valley has been developed by the public sector due to high initial investment costs, although management of the perimeters is in the hands of private coperatives. Substantial private sector entry into irrigated agriculture has taken place in recent years.

   Livestock, which represents 24% of GDP, is totally in the private sector. The livestock segment has demonstrated an ability to survive and adjust to severe drought conditions.

2. The Important Fisheries Segment is Undergoing Major Transformation

   Government-to-government joint ventures dominate the fisheries industries as a result of Mauritania's efforts to gain some measure of control of its off-shore fishing operations. Government policy, however, is to transfer control to private sector operators who are already active in commercial fishing, freezer storage and fish processing. Private sector investors in deep sea fishing vessels are receiving active procurement and financing assistance from Mauritania's major development bank.

   The fishing industry is the country's most dynamic private sector segment and the nation's fastest growing export industry. In 1984, fisheries represented 9% of GDP, 43% of total exports and 5% of budget revenues. Increases were registered in 1985.

   Artisanal fishing, a major source of fish for domestic consumption, is large, organized and exclusively a private sector activity.

Fisheries offer one of the few segments for foreign joint ventures in fishing fleet operations, fish procesing, packaging and canning, freezer-warehousing, and export marketing.

3. Construction and Public Works are Private Sector Controlled

Some twenty private companies generate more than 94% of value added in this sector.

4. The Informal Private Sector has been an Important Source of New Jobs

The handicraft and informal sector is estimated to include 12,000 small/micro businesses employing over 30,000 people in a whole range of retail, maintenance, small manufacturing and service businesses.

5. Small Manufacturing is Dominated by the Private Sector

Small and medium sized private sector manufacturing companies -- primarily import substitution -- account for 29 of the 32 industrial units currently in production. Owners are young, aggressive and expansionist; many have foreign educational backgrounds and business experience.

6. The Private Sector Controls 80% of Trade and Transport Enterprises

While the Government maintains a monopoly on rice, sugar and tea and operates petroleum products distribution and the two port authorities, the private sector currently controls 80% of trade and transport activities.

7. Banking, Insurance and Mining are Essentially Under Government Control

USAID Mauritania programming has focused primarily on major food aid assistance, human resources development, and agriculture. Budgeted USAID programs in Mauritania approximate $3 million per year. Estimates of local currency availability for "food security" programs from PL 480 sales are $2.5 million per year.

USAID CURRENT AGRICULTURAL PROJECTS

A review was carried out of the Mission's current projects to determine their relationship to private sector planning. Exhibit II summarizes these projects.

EXHIBIT II
CURRENT AGRIBULTURAL PROJECTS
USAID MAURITANIA

PROJECT TITLE	SUMMARY
AGRICULTURAL RESEARCH PROJECT II (AGRES II)	FOUR AND A HALF YEAR PROJECT LAUNCHED IN DECEMBER 1985 TO IMPROVE AGRICULTURE AND FARMING SYSTEMS IN THE SENEGAL RIVER VALLEY. PROJECT MANAGEMENT: UNIVERSITY OF ARIZONA WORKING WITH NATIONAL AGRICULTURAL RESEARCH CENTER. RESEARCH AND ON-FARM TRIALS INCLUDING: o NOMADIC AND SEDENTARY HERDERS; o LAND PREPARATION, WATER SUPPLY, ANIMAL TRACTION AND SMALL MOTORIZED EQUIPMENT; o PRODUCTION, MARKETING, AUDIT AND SAVINGS, INSURANCE; o GRAIN, LIVESTOCK AND MEAT PRICING AND MARKET STRUCTURES; o STIMULATING FARMER USE OF NEW TECHNOLOGY; o TECHNIQUES FOR PRODUCTION OF FUELWOOD AND FORAGE; o AGRICULTURAL INPUT EQUIPMENT, SUPPLIES, FERTILIZERS, INSECTICIDES; o FARM CREDIT AND ENTERPRISE DEVELOPMENT.
SENEGAL RIVER VALLEY DEVELOPMENT	1987 PROGRAM OBLIGATION TO INTRODUCE WATER CONTROL TECHNOLOGIES FOR RECESSION AGRICULTURE INCLUDING CONSTRUCTION OF WEIRS AND SMALL DIKES. FIVE YEAR PROJECT WITH INITIAL FUNDING OF $5 MILLION.
RURAL ROAD DEVELOPMENT	EXTENSION TO ROAD BUILDING PROJECT FOR MAINTENANCE.
HUMAN RESOURCES DEVELOPMENT	PROVIDE U.S. AND THIRD COUNTRY TRAINING AND DEVELOPMNT WITH "FOOD SECURITY" OBJECTIVES.
UTILIZATION OF COAL AND PEAT RESOURCES TO REPLACE WOOD CHARCOAL	U.S. GEOLOGICAL SURVEY HAS IDENTIFIED LOCAL COAL AND PEAT RESOURCES. SAMPLES ARE CURRENTLY UNDER ANALYSIS TO DETERMINE SUITABILITY FOR REPLACEMENT OF CHARCHCAL FOR DOMESTIC USES. IF POSITIVE, POSSIBLE FOLLOW-ON FEASIBILITY STUDIES FOR PRIVATE SECTOR EXPLOITATION AND MARKETING OF RESERVES.
INTEGRATED WATER AND AGRICULTURAL DEVELOPMENT FOR ENHANCED SMALL FARMER PRODUCTIVITY	A PARTNERSHIP FOR PRODUCTIVITY PROJECT TESTING TEN HYPOTHESES FOR INCREASING FARM PRODUCTIVITY INCLUDING SEVERAL PRIVATE SECTOR POSSIBILITIES: o CERTIFIED SEED MULTIPLICATION o NEW WATER WELL TECHNOLOGY; o SMALL MACHINERY SUPPLY AND SERVICES; o PUMP SUPPLY AND MAINTENANCE; o DRIP IRRIGATION SYSTEMS.

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POLICY, STRATEGY AND PROGRAM DEVELOPMENT RECOMMENDATIONS

The consultants suggested a number of guidelines and possible program initiatives in developing a private sector strategy for Mauritania.

1. Private Sector Strategy and Programs Should Address Specific Needs Identified by Private Businessmen

   While many of the needs expressed by businessmen are generic and some involve fundamental long range national development issues, private sector strategy and program development should respond to what businessmen say they need: a broad range of short and medium term and trade finance; joint venture partners; human resources development; regulatory relief; and improved infrastructure.

2. USAID Programming Should Flow From a Clear, Agreed and Written Statement of Private Sector Strategy

   This strategy statement must be relevant to the Mission's on-going objectives, programs, budgets, staffing and technical capabilities. Programming focus should initially be limited and avoid creation of expectations to which USAID cannot respond.

3. Policy Dialogue Elements in Any Private Sector Strategy Should Have Concrete Objectives

   An appropriate approach for USAID might be to target its policy intervention at areas directly related to individual projects or food aid distribution. Earlier USAID efforts, for example, in placing pressure on food price levels was well chosen, produced results, and should continue. A review of the various areas of potential policy dialogue suggests other issues which may be useful to consider in terms of private sector development.

   o Food Aid Distribution and Marketing: CSA, the National Food Security Commission which is responsible for distribution and selling donor food aid, could be convinced to relax its hold on retail level activities to permit greater entry of small private sector distributors. The objective would be for CSA to restrict its activities to bulk storage and sales to wholesalers or large private retailers.

   o Agricultural Input Marketing: Pressure could be applied to encourage strong Government support of private sector entry into all phases of agricultural input activities on a gradual "from the botton up" approach. Efforts could be made to

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change policies so as to permit elimination of remaining controls and duties on imported fertilizers and pump spare parts destined for agricultural uses, and to liberalize margin and price controls which currently limit profits and discourage private sector suppliers from offering credit and aftersales service.

- <u>Building-In The Private Sector</u>: The Government and all donor agencies should be encouraged to use local private services where available to support development projects; e.g., in the supply and maintenance of equipment, spare parts, etc. USAID could set a leading example in the implementation of its own projects.

- <u>Private Sector Seminar</u>: USAID Mauritania has proposed and budgeted for follow-on work which would organize and present a private sector-Government seminar to explore policy issues related to private sector development. This program of organized dialogue could serve a number of useful purposes, but it must obviously be carefully planned so that public and private sector participation is willingly secured, its objectives are clear and USAID commitments are understood.

In summary, USAID should remain highly selective in the policy dialogue issues it chooses to pursue. It should stay close to USAID's own field of operation and expertise, and ensure that there will be staff continuity in developing, presenting and pursuing such issues with senior Government officials.

4. <u>The Fisheries Sector Should Receive High Priority in any Private Sector Strategy</u>

The fisheries sector is probably the country's only "growth industry," is a major exporter and foreign exchange earner and has been targeted for major private sector development by the Government. Industry spokesmen are looking for capital infusion, joint venture partners and international marketing relationships -- across the whole range of offshore fishing operations, fish processing and storage, and international sales and distribution. They believe, however, that an essential requirement underlying industry growth will be human resources development at all levels.

5. <u>A Private Sector Strategy for the Fisheries Industry Could Concentrate on Human Resources Development</u>

The centerpiece for a private sector strategy for fisheries could be built around the modern and well equipped and staffed technical training institute located in Nouadhibou currently operated by the National Mining Comany (SNIM). This large center, fully equipped with specialized workshops, classrooms, dormitories, food service and recreational facilities, is now operating at a very low level of its capacity. SNIM executives and World Bank representatives agree that SNIM no longer has an operational need for the center, and it may soon have to be closed as part of the current economy drive. SNIM would welcome a proposal which would serve to keep the center and its staff operational by means of outside subsidization of training for apprentices and specialists destined for the Nouadhibou-based private sector fishing industry. FIAP, the private sector industry federation, has indicated a willingness to sponsor a program of USAID scholarship support. SPPAM, the private sector artisanal fishing company, would undoubtedly wish to participate in the program also.

The SNIM technical training center represents a unique national asset which could, with only minimum changes in its program, be adapted to the urgent technical training needs of the fishing industry. The survey team strongly recommends that USAID Mauritania fund and support a survey in cooperation with FIAP, SNIM, and SPPAM to design the training program and lay out a program of action and a budget for launching a program for the initial intake of fisheries industry technical apprentices.

Such a program, being directly related to national food security objectives, should in the team's opinion be eligible for financing from PL 480 II 206 local currency funds. It should be noted that the need is almost entirely for local currency, and the foreign exchange requirements of such a program would be minimal. The training center program would also be in line with Human Resources Development projects already approved.

Other private sector projects in the fisheries sector deserving close attention include:

- A survey proposed by the U.S. Food and Drug Administration to improve the quality of seafood export products from Mauritania with a view to eventual approval for export to the U.S.

- Visits of private sector fisheries industry personnel to the U.S. for training, orientation and joint venture discussions, under existing USAID programs and budget authorizations.

- Assistance to FIAP in obtaining a dry dock for temporary ship repairs in Nouhadibou.

- Technical assistance in the establishment of fish-canning operations.

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FINANCIAL MARKETS DEVELOPMENT

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EXCERPTS FROM DRAFT POLICY PAPER ON

FINANCIAL MARKETS DEVELOPMENT

A draft policy paper on financial markets development, dated August 1, 1986, prepared by PPC/PDPR, is now under review in AID/W. The paper attempts to clarify in one document related guidance in the Private Enterprise Development Policy Paper, the Guidelines on Terms of AID, and Policy Determination #14 "Policy Guidance on Implementing A.I.D. Privatization Objectives."

The policy emphasizes that, "Financial markets are extremely important to economic growth. A healthy economy is dependent upon the efficient transfer of funds from savers to firms and individuals who need capital from cost-efficient and responsive financial markets. Financial markets serve these requirements by encouraging and mobilizing savings for productive use. Financial markets perform the following functions

- encourage savings by providing vehicles and instruments for investments;

- assemble or mobilize these savings for the users of funds through various appropriate instruments and institutions;

- allocate the funds to those enterprises which can provide the highest rate of return for the use of funds, and which reflect the country's comparative advantages;

- provide enterprises with the ability to increase their capacity to produce more goods and services and jobs; and

- provide enterprises with the ability to increase owners' equities or to sell these equities to obtain cash or to switch to alternative investments."

The principal components of the financial markets development policy paper are excerpted below for background reading in preparation for the Private Sector Workshop session on financial markets.

A. <u>A Financial Markets Strategy</u>

"Missions should develop a comprehensive financial market development strategy before pursuing additional financial market projects in order to maximize the benefits of AID's assistance and ensure AID's efforts are designed to resolve, and not compensate for, the fundamental economic distortations in the

LDC economy and its financial sector... Policies which need to be changed before our project goals can be achieved need to be identified and acted upon by the host government before initiation or replenishment of AID credit assistance...

"Missions should coordinate their efforts to help the LDCs solve their development finance problems with those of other multilateral agencies and other bilateral donors so that our efforts are mutually reinforcing... There are many opportunities for small Missions and posts...to piggyback on IMF/IBRD efforts..."

B. Policy Dialogue

"Policy dialogue should focus on improving LDC policies to encourage increased domestic savings, more effectively mobilizing savings for productive enterprises, and avoiding policies that create additional market distortions."

"Missions should ensure that the LDC private sector participates in the policy dialogue to ensure that policy changes are responsive to their problems and needs."

1. "AID should not finance the capitalization of credit programs in financially repressed settings unless significant policy changes toward financial liberalization are taking place, or there is reasonable prospect that such changes will be initiated by the LDC government. Continued support of such projects will be conditioned on successful policy changes. Under circumstances in which the financial policy framework is not conducive to the growth and viability of private IFIs or other financial institutions, then further credit projects should be postponed until such time as evidence exists that the LDC government is prepared to correct its policy deficiencies."

   "AID should discourage reliance on directed credit and encourage reliance on the free market and market devices (such as market-determined interest rates) to allocate capital to its most productive uses."

2. LDC Credit Allocation Policies

   "AID should encourage LDCs to eliminate interest rate ceilings, which inhibit capital formation and individual savings and encourages capital outflow, and to adopt policies that allow interest rates to be set by the forces of supply and demand."

3. Legal Regulatory Constraints

"Missions should encourage LDC governments to review the regulatory framework with a view toward: "(a) streamlining and simplifying the regulatory responsibility among government agencies; (b) establishing comprehensive and uniform public reporting and auditing requirements; and (c) improving the capabilities of regulatory bodies to enforce appropriate laws, rules, and regulations."

4. Tax Polices

"Missions should encourage LDC governments to employ tax incentives for savers and borrowers that promote capital market development... In other words, tax laws should not treat all financial instruments equally for tax purposes."

C. Institutional Development

"AID should focus its efforts on improving the LDC's capability to attract and lend capital and to attract and trade equity instruments through private, profit-making financial institutions...

"The three major approaches to institutional development ..., in order of preference, are improving the performance of the existing private sector institutional system, restructuring the existing...system, and establishing new private sector institutions."

"Only in rare instances, such as where the policy environment is appropriate and there are no barriers to market entry and the financial institutions still do not emerge, should AID establish new financial institutions."

D. Selected Approaches to Affect Financial Market Development

1. Credit Projects

a. The relationship between donor funds and the cost of capital to IFIs: "AID should utilize fees or interest rate spreads that provide the IFI with a profit that is comparable to profits derived from non-AID supported activities... Therefore, the IFI will not receive an unfair competitive advantage vis-a-vis other local financial institutions lending in the same market. Furthermore, in cases where government entities (e.g. central banks) assume the foreign exchange risk," the discount rate charged to the financial institution by the government entity should reflect the real cost of lendable capital to the IFI within that LDC, including the foreign exchange risk."

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"In addition, AID will take such steps as are necessary to negotiate loans on more realistic terms then have been negotiated in the past, particularly for those countries with a greater ability to repay."

b. Interest rates to private enterprises and other ultimate borrowers: AID will continue to support its policy that interest rates to be charged to a private enterprise "(1) shall be at or near the prevailing interest rate paid on Treasury obligations of similar maturity...and (2) should not be less than the free market terms (interest and repayment period) prevailing in the LDC or a rate which approximates the opportunity cost of capital in the individual LDC."

"Although AID believes that market-based credit is the most effective way to promote economic growth and financial market development, there are instances when political, security, or economic imperatives will sometimes require the use of subsidized or concessional credit. ... [However] Missions should use concessional aid sparingly. ... The provision of concessionality should be a one-time occurance that is provided only if it can be demonstrated that, after the expiration of the concessional loan, the institution will be self-sustaining or continue to engage in a particular type of activity and not require U.S. or other donor concessions after the initial outlay."

c. The Provision of Equity by AID: "...AID will not take an equity position in a private enterprise."

2. Targeting of AID Resources: "Moderation and caution should be exercised in the design of credit projects directed at target groups. [Farmers, rural small firms, etc.] AID needs to take care in copying the devices used by LDCs to direct credit resources into neglected priority areas because of the risk that some of them may continue or enlarge the role of government in capital markets and further distort, or continue to displace, market allocation of capital."

3. PVO Lending Activities: "When PVOs are used in projects it should be demonstrated that they will not require outside funding sources to continue operations after the organized AID grant or loan runs out. ...The focus of AID's assistance should be on changing policies, laws, and regulations that restrict private initiative and on removing the barriers that restrict or discourage entry into the formal sector. ...To the extent that AID directs its assistance toward the informal sector in lieu of substantive changes in the formal sector, it ignores the principles of policy dialogue and accepts a superficial, short-lived solution to a systemic problem. ...PVOs or other non- or not-for-profit groups are not to be utilized in those instances where an indigenous private enterprise is capable of performing the desired activity or program."

4. Financial Training and Standards Development: "AID should emphasize... the importance of (a) adequate training and licensing requirements for accountants and auditors, (b) generally accepted accounting principles and auditing standards, and uniform reporting requirements, and (c) a proper balance between self-regulation and public regulation of these matters."

5. Developing New Financial Instruments: "AID should work with LDC governments to promote the policies that will encourage the development and utilization of new debt and equity instruments for directing scarce capital resources into the most productive investments." (e.g., debentures, leases, trade credit).

6. Venture Capital: "AID may provide loan funds to venture capital firms at market rates, but not grants or equity contributions."

7. PL 480 Local Currency Lending for Private Enterprise:

   "The Food Security Act of 1985...mandates a new program for the on-lending of local currency for private enterprise promotion... Two major components of the legislation are summarized below:

   "Section 106...provides that private enterprise promotion activities should be operated in conjunction with sales of agricultural commodities for dollars or convertible local currency or credit terms. Local currency proceeds from the sale of these commodities are placed in 'jointly programmed accounts' and then on-lent to IFIs for relending to eligible private enterprises.

   "Section 108...deals with U.S.-owned local currencies. This section allows for the sale of Title I commodities for local currencies. The local currencies are paid to a U.S.-owned depository account. Disbursements from this account are made to IFIs pursuant to the terms of loan agreements between the United States and IFIs.

8. Parastatal Financial Institutions: "Missions should refer to Section V.D. of the Private Enterprise Development Policy Paper for guidance on dealing with parastatal financial institutions. The guidance states that 'AID funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does

not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved.'

"In addition... loans provided to SOEs producing goods and services for sale in commercial markets, capable of producing revenues, or in competition with private enterprises will be at the same rate charged to private enterprises."

FINANCIAL CONSTRAINTS IN AFRICAN PRIVATE ENTERPRISE DEVELOPMENT

Issues and constraints in providing investment and working capital to small and medium sized private businesses in Africa. Taken from the IBRD publication, "Creating A Better Environment For Private Enterprise In Africa," May 1986.

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Shortage of investment funds and working capital is holding back development of the private sector, particularly small and medium enterprises (SMEs), throughout Africa. In part, this scarcity is simply a reflection of low income levels and the persistence of large subsistence (non-monetized) segments of their economies. But it also springs from weaknesses in policies and institutions which hamper resource mobilization and restrict the private sector's access to available finance. Six constraints are examined: first, financial market regulations which reduce savings deposits and discourage banks from lending to SMEs; second, the absence of stock markets and merchant banks able to mobilize equity capital; third, foreign exchange allocation systems which restrict the supply of foreign exchange funds to private firms; fourth, crowding-out of the private sector from financial markets by excessive borrowing by government and public enterprises; fifth, heavy taxation which squeezes corporate profits and entrepreneurial incomes and therefore limits their capacity to generate internal investment funds; and sixth, public investment programs which monopolize the use of foreign loans and grants.

1. Financial Market Regulations

A World Bank analysis of interest rate policy in a number of developing countries from 1970 to 1982 revealed that by and large nominal interest rates were set by government, rates changed little overtime, and hence real rates were primarily determined by variations in the rate of inflation. Real deposit rates over the period were negative; in many countries they were 3 to 6 percentage points below the real rates that prevailed in the developed countries in this period, thus encouraging outflow of funds. In countries with very high inflation, deposit rates were substantially negative, sometimes reaching levels below minus 20 percent. The variability of real rates, as well as the level affected resource mobilization.23/ As a result, in many African countries total domestic credit that could be made available to borrowers (public and private) by the monetary authorities and banks expanded slowly in real terms over the past decade, and in some countries actually declined in relation to GDP.

In Kenya, for example, although its financial depth as measured by the ratio of money and quasi-money (M_2) to GDP compared favorably with other countries in the same income category, its financial depth was seriously eroded during the period 1978 to 1983. The ratio of M_2 to GDP fell from 32 percent to 25 percent. The resurgence of inflation and the ceilings on loan rates, along with the substantial reserves the Government required the banking system to hold, kept deposit rates low and weakened the ability of the commercial banks to mobilize deposits. The decline in

23/ See World Bank, Financial Intermediation Policy Paper, July 1985 and A Review of Interest Rate Policies in Selected Developing Countries, December 1984.

the financial depth was accompanied by a slide in the domestic saving rates. The ratio of gross private saving to GDP deteriorated from a peak of nearly 27 percent of GDP in 1977 to a low of 11 percent in 1983.[24]

Similarly, in Ghana the M_2/GDP ratio declined from 29 percent in 1977 to 12 percent in 1984. At the same time, there was a decline in the banking habit, an increasing preference for holding liquid funds outside the banking system, and an increasing velocity in money circulation as firms and individuals sought to move out of financial assets and into fixed assets as hedges against inflation. These trends were aggravated in 1982/83 by a substantial drop in public confidence in the banking system following the demonetization of ¢ 50 notes and the freezing of all bank accounts in amounts above ¢ 50,000. While the government has taken important steps to address these problems since 1983 as part of the economic reforms under the Economic Recovery Program, the process of reversing past trends is still at an early stage and public confidence in the banking system has yet to be significantly restored.

Low loan rate ceilings fixed by governments have also restricted the operating "spreads" of financial institutions and discouraged lending to smaller, riskier businesses. In Nigeria, for example, low interest rates applicable to agricultural credit makes lending to smallholders extremely unattractive given the high costs of administering numerous small loans and low recovery rates.[25] In some countries, governments have tried to compensate for these financial market disincentives through direct credit programs aimed at disadvantaged groups. Most of these directed credit programs are not designed to reallocate financial resources per se, but to affect the allocation of physical resources through financial reallocation and to offset differences between economic and financial returns through explicit or implicit interest rate subsidies. Experience has shown that much of the subsidized credit programs went to wealthy individuals or those with political influence, while smaller borrowers had to pay higher interest rates in the informal credit markets. Directed credits often induced recipients to use overly capital-intensive methods.

Many governments have recognized that in the past they have overextended their capacity to manage the economy through intervention in resource allocation. A number of countries are moving toward greater reliance on market forces for credit allocation. Complex systems of credit allocation are being dismantled and interest rates are now being allowed to reflect the state of the credit market and the foreign exchange market, plus differentials in risk and maturity. In Ivory Coast, for example, the central bank has pursued a more realistic interest rate policy since 1981, keeping domestic rates more in line with international ones to avoid large outflows of domestic surplus funds and enable deposit money banks to attract large foreign depositors. Real rates of return on time and saving

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24/ See World Bank, Kenya Industrial Finance, April 1985.

25/ See World Bank, Financial Intermediation in Nigeria, February 1983.

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deposits became positive for large savers in 1981 and all savers in 1982. The private sector's financial savings responded positively.26/

Under the Second Structural Adjustment Credit to Kenya, the Government proposed to keep the level and structure of interest rates under review to ensure that they continued to be appropriate, given the domestic rate of inflation and the structure of international interest rates.27/ In Malawi, the government raised deposit rates by two percent in May 1983 and proposed to make adjustments, as need arises, to keep interest rates positive.28/ In Senegal, as a step towards improving mobilization of personal savings, a new social housing bank was established.29/ In Guinea, the government has decided to completely rebuild the banking system. The central bank is being reorganized and strengthened. A new Banking Law has been adopted which creates an appropriate basis for the establishment and regulation of commercial banks and other financial institutions. And the six existing state banks will be gradually liquidated and independently managed commercial banks will be promoted to replace them. The International Finance Corporation is providing financial and technical assistance for the establishment of a multipurpose bank--Banque Internationale Pour le Commerce et l'Industrie de la Guinee (BICI-GUI) as a joint venture with French commercial banks.30/

In late 1985, the Malawi government agreed during negotiations for a World Bank industrial and agricultural credit project to annually review and revise interest rates to ensure that the rates charged by INDEBANK (the Industrial and Development Bank of Malawi) and the commercial banks on their agricultural loans are positive in real terms, in line with the overall interest rate structure in the country, adequate to enable the

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26/ See International Monetary Fund, Ivory Coast-Recent Economic Development, May 1985.

27/ See World Bank, President's Report on a Proposed Loan and Credit to the Republic of Kenya for a Second Structural Adjustment Operation, June 1982.

28/ See World Bank, President's Report on a Proposed Credit to the Republic of Malawi for a Second Structural Adjustment Project, November 1983.

29/ See World Bank, President's Report on a Proposed Credit to the Republic of Senegal for a Structural Adjustment Credit, December 1980.

30/ See International Finance Corporation, President's Report on a Proposed Investment in BICI-GUI - Republic of Guinea, December 1985.

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institutions to cover their administrative expenses, provide for possible losses and earn adequate profit margins.[31]/

2. Lack of Equity Funds

Very few African countries have active equity markets, either in the form of stock exchanges or merchant banks which can provide a full range of securities related services: underwriting, brokerage, dealership, corporate financial advisory services, investment management, etc. The financial policies of many countries have inadvertently had an anti-equity bias. In the 1970s inflation with low interest rates deepened equity values through retained earnings, but retarded the growth of equity markets external to firms. A second source of anti-equity bias has been many government programs, which in one way or another reduced the cost and risk of debt, but not of equity, finance. Such programs include explicit or implicit insurance that covered not only small depositors but large sophisticated investors; lender-of-last-resort facilities that guaranteed the liquidity of financial intermediaries; special institutions (Development Finance Institutions, agricultural banks, etc.) and lending programs that provide debt at subsidized rates; aspects of tax policy that made equity financing more expensive, in particular by treating interest as a cost before calculating profit taxes and the double taxation of dividends; and lastly, bail-outs for corporations that diminished the danger of excessive financing with debt. Equally important, controls on output prices often reduce corporate earnings and hence their ability to raise equity funds. However, nascent capital markets do exist in some countries.

In Kenya, secondary trading in long-term securities is carried out by six Nairobi-based stockbroking firms whose association, formed in 1954, is known as the Nairobi Stock Exchange. This Exchange has no physical trading floor. Instead, brokers hold a daily call-over at which prices for concluded transactions and for securities still on offer are announced. The broker act only as agents for clients and typically match buy and sell orders in-house. New issues of long-term private-sector securities in Kenya are controlled by Government through a Capital Issues Committee set up in 1971 under the Ministry of Finance and Planning. This Committee approves issue prices, the timing of sales and the allotment plan for shares. However, since the Committee's inception there have been very few new public issues of equity securities.

At the request of the Kenyan Government, an IFC mission undertook a study in 1984 which recommended several measures to facilitate the development of the capital market in Kenya. These measures included:

- establishment of a Capital Markets Development Authority to promote the disclosure of corporate and market trading information, registration and regulation of securities professionals and measures to provide adequate protection for investors;

31/ See World Bank, Staff Appraisal Report on Malawi Industrial and Agricultural Credit Project, December 1985.

- promulgation of a Capital Markets Law to provide the legal basis for the development activities of the Capital Markets Development Authority;

- review and amendment of other laws, such as the Companies Act and the Foreign Investments Protection Act, which may hamper the primary issue, investment in and trading of capital markets securities.

- setting prices of all equity and debt securities issues by negotiations between the issue and his underwriter(s) rather than by the Government through the Capital Issues Committee.32/

IFC followed up this study in 1985 by providing additional finance to Industrial Promotion Services (Kenya) Limited, a private venture capital company, to expand its program of equity finance for small and medium enterprises in Kenya.33/

Capital market studies should be undertaken in other African countries to ascertain the scope for similar action and to identify ways of eliminating their anti-equity biases. In general these measures are likely to include removing interest rate subsidies, eliminating double taxation of dividends, ceasing to bail-out loss-making enterprises, creating specialized equity-financing institutions and funds and adopting legislation to promote the disclosure of corporate and trading information and registration of stockbrokers.

3. Foreign Exchange Allocation Systems

At present, only Zaire, Guinea and members of WAMO allow their currencies to be freely converted into foreign exchange. The rest have adopted centralized systems of foreign exchange budgeting and allocation usually managed by the Central Bank combined with import licensing by Ministries of Finance and Trade. The systems are intended to limit aggregate imports to the amount of foreign exchange available and to regulate the structure of imports to maximize economic benefits. These are desirable objectives, but in practice the use of administrative systems rather than price as the allocative mechanism has resulted in distorted incentives, cumbersome and drawn-out bureaucratic procedures and biases in the rationing process which favor those with political power or economic influence over the allocating authorities.

In Ghana, for example, the import licensing system is generally perceived by the private sector to be procedurally complex and overly rigid and time consuming, often resulting in substantial delays in arrival of imports, significant additional administrative costs and considerable uncertainties in production planning at the plant level (one firm indicated that it had taken 5 months and some 65 visits to different government

32/ See IFC, Kenya: Money and Capital Markets Study, October 1984.

33/ See IFC, President's Report on a Proposed Equity Line for Investments in Parallel with Industrial Promotion Services (Kenya) Limited, September 1985.

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offices to process an import license). Further uncertainty arises because .ssuance of an import license does not ensure a firm of access to foreign exchange cover, for which approval has to be obtained subsequently from the Bank of Ghana. This has resulted in additional delays, as in the past import licenses have been issued in excess of foreign exchange availability. The system is said to focus principally upon the requirements of larger firms (mostly SOEs), and discriminates against small enterprises despite the fact that their products tend to be less import-intensive and could contribute to output at a lower unit foreign exchange cost.34/

These weaknesses are now being recognized by several countries and action taken to minimize if not eliminate them. In Malawi, for example, the foreign exchange allocation system operated jointly by the Ministry of Trade and Industry and the Reserve Bank of Malawi came under considerable pressure due to adverse economic conditions that Malawi was then experiencing. This led the Reserve Bank to try to reduce imports through delays of foreign exchange allocations. These allocations also became concentrated in the established traders and discouraged the development of new, indigenous entrepreneurship. As part of a Third Structural Adjustment Program, the Government intends to pursue an active exchange rate management policy which will hopefully make an allocation system redundant.35/

In June 1985, the Government of Zambia presented <u>An Action Program for Economic Restructuring</u> to the Consultative Group for Zambia. This <u>Action Program</u> spelled-out the defects of the existing foreign exchange allocation system in these words--"in order to cope with the severe shortages of foreign exchange that have characterized the economy during the past several years, a centralized system of foreign exchange budgeting and allocation has been instituted. It is necessary to have both an import license and foreign exchange backing prior to importing an item. The system has proved to be cumbersome and costly to administer; officials have to make foreign exchange allocation decisions on a firm-by-firm and product-by-product bases. Budgeting of foreign exchange has also been problematic, with the result that a considerable over-hang of import licenses issued without foreign exchange has developed .... The foreign exchange control and import licensing systems, by excluding a wide range of competing imports of consumer goods from the domestic market, has provided high protection to import substituting activities and tended to reinforce the protection effects of the tariff structure."

The <u>Action Program</u> went on to say that "GRZ is convinced that the allocative formula must eventually include:

(i) increasing the reliance upon market forces rather than administrative mechanisms for allocating resources. This implies the

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34/ See <u>Report of World Bank Private Sector Mission to Ghana</u>, February 1986.

35/ See World Bank, <u>Staff Appraisal Report: Malawi Industrial and Agricultural Credit Project</u>, December 1985, and World Bank, <u>President's Report on a Proposed Credit to the Government of Malawi for a Third Structural Adjustment Operation</u>, November 1985.

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gradual dismantling of the foreign exchange controls, import and export licensing and interest rate regulations;

(ii) restoring balance and increasing the uniformity of the incentive system, particularly between exports and import substitutes, as well as between agriculture and industry. This implies a major reform in the trade regime with greater reliance on the exchange rate as a mechanism for allocating foreign exchange, elimination of import restrictions, rationalization of the tariff structure and review of investment incentives; and

(iii) introducing greater automaticity into the determination of the exchange rate consistent with the long-run prospects for exports and terms of trade.

The Government of Zambia has begun to take action along the above lines. They provide useful guidelines for other African countries to follow. The broad objective should be to dismantle foreign exchange controls and import and export licensing, leading to free convertibility of currency.

4. Crowding-Out by Public Sector Borrowing

Private firms' access to bank credit has been restricted in many countries because governments and public enterprises have been given first claim on financial resources, both foreign and domestic. The latest IMF data show that the public sector's share of outstanding domestic credit from the monetary authorities and banks topped 60 percent in 14 out of 35 countries covered by the statistics. The private sector's share was less than 25 percent in six countries—Burundi, Ethiopia, Ghana, Sierra Leone, Tanzania and Zaire. Only in Botswana and Cameroon were governments net lenders rather than borrowers of domestic financial resources.[36/]

Governments' demands for domestic credit increased for three basic reasons. First, the growth of expenditure on public investment and current services outpaced the growth of revenue, resulting in widening budgetary deficits. For example, deficits reached 10.6 percent of GDP in Kenya in 1980/81,[37/] 16.5 percent in Malawi in 1981,[38/] and 11.5 percent in Senegal in 1980/81.[39/] Second, the income of public enterprises did not cover their operating costs. The gap was filled by additional loans provided directly by the banking system or by government subsidies which, in turn, were financed by government borrowing. In Ghana, for example, the combined operating deficit of SOEs in 1982 amounted to 2,880 million cedis (net of their hidden costs and subsidies), equal to 3 percent of GDP and the same as total government expenditure on education, health, social security and welfare that year.[40/] Third, although foreign aid grants and concessionary loans from abroad finance a significant proportion of their

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36/ See IMF, International Financial Statistics, March 1986.

37/ See Kenya SAL, 1982.

38/ See Malawi CEM, October 1985.

39/ See Senegal SAL, 1986.

40/ See World Bank, Ghana Private Sector Report, op.cit.

public investment programs, some African countries found it increasingly more difficult to borrow in international commercial markets. They therefore drew more heavily on private domestic savings to meet their residual financing needs.

However, there is evidence that African countries are becoming increasingly aware of the negative effects of budgetary deficits and heavy government borrowing on private sector opportunities and the efficiency of resource utilization in the economy as a whole. Steps are being taken, sometimes in the context of structural adjustment programs, to curb the public sector's financial appetite in several countries. These measures include:

- restraining the expansion of public sector employment and wages (for example, in Kenya and Senegal);
- reducing recurrent expenditure by cost savings in such fields as education and housing (Mauritius and Ivory Coast);
- reducing losses of, and subsidies to, public enterprise by restructuring, stricter monitoring of their performance and divestiture (Togo and Senegal); and
- subjecting public investment programs (PIPs) to more rigorous scrutiny and pruning potential "white elephants" (Kenya, Malawi, Mauritius, Ivory Coast, Senegal, Togo).

In many cases, African governments are also trying to eliminate their budgetary deficits by raising tax revenues. This may be achieved without negative repercussions by broadening the tax base or improving tax collection. But there is a risk that imposing higher marginal tax rates on individuals and firms which are already heavily burdened by taxes may be counterproductive: encouraging tax evasion and corruption; reducing the citizen's willingness to work, save and invest; and squeezing profits which could have been ploughed back into the business to expand capacity, raise productivity or diversify output. This risk is discussed more fully below.

5. Heavy Taxation Squeezing Corporate Profits and Entrepreneural Incomes

All countries must seek a balance in their fiscal policies between the need to raise revenue to pay for essential government services and the need to create adequate incentives to work, save and invest. They must also aim for an equitable sharing of the tax burden, both within and between different income groups, and avoid undue distortions in the after-tax returns to different economic activities.

In many African countries it has proved to be difficult to reconcile these objectives. The rates of taxes on corporate income are frequently high by international standards. For example, they are 60 percent in Ghana, Zaire and Sudan compared with 30 percent in Taiwan and Korea and 18.5 percent in Hong Kong. And depreciation allowances are usually based upon historical costs. So in countries which have experienced rapid inflation the effective tax rate on real net income has been significantly greater.

Rates of personal income tax also tend to be high in Africa. The top marginal rate is 80 percent in Zambia and Rwanda, 70 percent in Sudan and 60 percent in Zaire and Ghana. These rates are reached at relatively low income thresholds.

High corporate and personal income taxes have had four negative effects. First, they have reduced the private sector's capacity to accumulate reserves to finance expansion, modernization and diversification projects and reduced savings for initial investment in new enterprises. Second, they have deterred foreign investors (especially in "footloose" labor-intensive industries like textiles, clothing and electronics) who have found more hospitable fiscal environments in East Asia. Third, entrepreneurial efforts have been diverted from formal productive activities, where financial transactions are more readily audited, to real estate speculation, trading and "underground" activities where earnings can be more easily hidden from the tax authorities. Fourth, high tax rates have increased the pressures for corruption of lowly-paid tax officials. Widespread corruption has undermined the integrity of public administration and weakened respect for the law.[41]

In some countries, the net result has been a contraction of the tax base and lower tax revenues. Government attempts to stem the fall in revenues by raising tax rates still further have only accelerated the decline. Ghana, for example, introduced a series of tax measures such as a special sales tax on imports, excise taxes and advance tax payments for selected manufacturing sectors and a substantially higher registration fee for retailers. Moreover, Ghana postponed or kept to a minimum crucial adjustments in the tax system such as the level of personal exemptions, depreciation allowances for corporations and personal income tax brackets. These adjustments were needed to take account of rapid inflation and devaluation of the exchange rate. Consequently the tax burden on those individuals and private enterprises which abided by the tax laws increased sharply, while the actual tax revenues dropped from 13.8 percent of GDP in 1975 to 6.5 percent in 1984.[42]

Similarly, in Sudan the maximum tax rate on personal income was raised from 60 to 70 percent and new development and defense taxes were imposed, but the tax revenue/GDP ratio declined from 15.2 percent in 1976 to 12.3 percent in 1984. As GDP in constant prices also fell during this period, the real decline in government revenues was even greater. In Zaire, "bracket creep" has resulted in the top marginal income tax of 60 percent being applied on incomes as low as $1,200 per annum. An IMF study of the tax returns of a sample of 20 enterprises found that the average employee paid 39 percent of his gross earnings as income tax. Enterprises

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41/ See, for example, David J. Gould, Bureaucratic Corruption and Underdevelopment in the Third World: The Case of Zaire (Pargamon Press, New York, 1980).

42/ See IMF/World Bank, Memorandum on the Tax System of Ghana, September 1985 and Vito Tanzi, Taxation in Sub-Saharan Africa - Statistical Analysis (IMF, Washington, March 1981).

are subject to a turnover tax which increased from 13.5 percent to 18.0 percent of sales, and a development tax amounting to 7 percent of sales. Yet total government revenue in Zaire fell from 29.7 percent of GDP in 1974 to about 15 percent in 1984.43/

A reappraisal of tax policy is underway in several African countries. In Ghana, a recent IMF/World Bank fiscal mission has recommended that the corporate tax rate should be lowered to 45 percent. For personal incomes, the mission proposed a three-fold increase in the tax exemption level, and a reduction of the top marginal rate to 40 percent. The mission further recommended an adjustment in depreciation allowances to permit corporations to maintain their income generating assets in the face of exchange rate adjustments and other price escalations.

In Zaire, several studies are being undertaken to assess the incidence of current taxation practices on the competitiveness and investment behavior of industrial enterprises. These studies are financed under the World Bank's SOFIDE III Credit. The adoption of a tax reform program satisfactory to the Bank would form part of the conditionality for the release of the second tranche of the proposed Industrial Sector Adjustment Credit for Zaire.44/

Mauritius is an example of a country which has successfully used fiscal incentives to diversify its economy and create employment. Its Export Processing Zone Act (EPZA) of 1970 granted: (1) tax holidays on corporate profits for ten years (extended up to 20 years on a declining basis since 1980); (2) tax holidays on dividends for any five-year period during the first 10 years; (3) free repatriation of capital and dividends; and (4) duty free entry of capital goods and inputs. These incentives were available only to firms exporting all of their output.

Further measures introduced in 1984 included a reduction in the corporate tax rate on non-EPZ firms from 65 to 35 percent and a system of corporate tax benefits to non-EPZ exporters in which the rate is reduced by 2 percentage points for each 10 percent of output exported. The 1985/86 budget limited the corporate tax rate of EPZ firms to 15 percent over the whole life of the firm and exempted dividends from income tax for a period of 10 years.

Against this background, the share of manufacturing in GDP rose from 8.0 percent in 1970 to 15.9 percent in 1983 and its share of total employment went up from 6.4 percent to 19.0 percent over the same period. Manufacturing, which contributed only 2.2 percent of Mauritian exports in 1970, accounted for 38.6 percent in 1983. The period 1983-85 has witnessed a further industrial boom. Manufactured exports rose by 35 percent to

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43/ See IMF, Government Finance Statistics Yearbook, 1984 and IMF, Aide-Memoire of a Technical Assistance Mission to Zaire, February 1986.

44/ See World Bank, President's Report on Industrial Sector Adjustment Credit for Zaire, February 1986.

reach US$156 million and in 1985 are expected to surpass sugar as Mauritius' main exports. The number of exporting enterprises increased by 118 to reach a total of 237 firms in mid 1985. Fixed investment in plant and machinery increased by 50 percent in 1983 and by nearly 130 percent in 1984, reaching about $12.2 million. Export firms created 22,300 additional jobs in 1983-1984.45/

Botswana, which has one of the fastest growing economies in Sub-Saharan Africa, has a corporate tax on capital gains and income of 35 percent. The Financial Assistance Program introduced in 1982 offers liberal grants and tax holidays for productive ventures by local and foreign investors producing goods for export or import substitution.46/

In Malawi, the Government is carrying out a study of its tax system. The study will investigate ways to improve the responsiveness of the tax system and its efficiency, i.e., to remove or reduce disincentives for savings and distortions in resource allocation.47/ In Niger, the Government has recognized that the fiscal regime discriminated against private enterprises by exempting parastatals from the turnover tax. In its new Standby Program with the IMF, it is committed to introducing a value-added tax. The emphasis under its Structural Adjustment Program with the World Bank will be on improving the efficiency of the tax system. A reform of the Investment Code will be included in a broader study of fiscal incentives and taxes and duties on external trade.48/ Such studies are called for in other African countries as a basis for much needed reforms of their tax and investment codes, including reducing the reliance on import duties as the major source of revenue and lowering high marginal tax rates to strengthen incentives and opportunities to save and invest and to decrease pressures for tax evasion and corruption.

6. Public Investment Programs Monopolizing the Use of Foreign Loans

Private domestic saving are low in many African countries, for reasons already indicated. Public savings have also declined because government current expenditure has risen faster than government revenue and many state-owned enterprises have incurred losses. Thus African countries have had to rely increasingly on foreign savings, that is financial flows from abroad, to finance their gross domestic investment. This is true particularly of IDA eligible countries (low-income countries) in Africa. In 1970-74 gross investment in these countries averaged 17.9 percent of their GDP. 84 percent of this investment was financed by domestic savings (public and private). By 1984, however, their investment/GDP ratio had

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45/ See World Bank, Draft President's Report on an Industrial Sector Loan to Mauritius, November 1985.

46/ See U.S. Department of Commerce, Investment Climate in Foreign Countries, Volume III, Africa, August 1985.

47/ See World Bank, Malawi: Economic Recovery: Resource and Policy Needs, October 1985.

48/ See World Bank, President's Report on Proposed Credit for a Structural Adjustment Program in Niger, January 1986.

dropped to 14.3 percent and foreign savings accounted for 55 percent of total investment.49/

Private enterprises have had very limited access to medium- and long-term loans from abroad, either directly or indirectly through domestic financial intermediaries. This is shown by an analysis of foreign debt data classified by type of debtor.50/ At the end of 1984, outstanding and disbursed medium- and long-term debt to Sub-Saharan African countries amounted to $56.5 billion. Only 0.6 percent of this total represented direct loans to private enterprises, whereas public enterprises received 13.9 percent and mixed public/private enterprises 1.6 percent. These figures cover MLT lending in all forms--suppliers credits, bank loans, bonds and loans and credits from multilateral and bilateral aid organizations.

Loans to development banks accounted for a further 0.8 percent of outstanding foreign debt. This is a very low figure considering that these DFI's were intended to be the principal source of investment funds for enterprises in the private sector. And the amount available for private enterprises was even less, because SOE's were also beneficiaries of DFI subloans in most African countries.

Governments provided most of the initial equity capital for development banks during the 1960s and early 1970s. But subsequently there has been little injection of loanable funds from public treasuries. Nor have DFI's been very effective in mobilizing domestic private savings. So they have been largely dependent on funds from abroad. The response from foreign lenders, both official and private, has clearly fallen far short of the African private sector's needs.

The responsibility for this neglect of the private sector may lie more with governments than with foreign lenders, however. Governments guarantee repayment of this debt. Governments therefore have the final say in how the funds are used. The data demonstrate that African governments have preferred to use foreign MLT loans for their own public investment programs and to cover their external and budgetary deficits on current account. Loans to central governments and central banks for these purposes accounted for three quarters of total foreign debt. Equally evidently, foreign lenders have acquiesced with these priorities and perhaps even encouraged them. Some official sources of concessional loans may have shared the preference of governments for public investment, because it allowed foreign donors more direct involvement in the selection of projects and in procurement. Some lenders may not have wished to challenge a government's choice of a public sector executant for a given project, on the grounds that overt support for the private sector might be regarded as interfering with a nation's political sovereignty. Whatever the reason,

49/ See World Bank, Financing Adjustment with Growth in Sub-Saharan Africa, 1986-90, February 1986.

50/ See World Bank, Economic Analysis and Projection Department Computer Print-outs, April 1985.

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the net result is that foreign loans have reinforced the heavy public sector bias of African investments.

In the case of the World Bank, IBRD and IDA loans and credits for DFI's in Sub-Saharan Africa amounted to just $109.6 million in FY84 and FY85 combined, out of total Bank commitments to the region of $3,964.9 million in those two years. World Bank lending for small enterprise development in Africa reached only $41 million in this period.51/ However, it should be pointed out that some agricultural and rural development projects include agricultural credit components intended for private farmers and smallholders. Bank and IDA cumulative agricultural credit operations represented 3 percent of total IBRD/IDA lending to Africa by June 30, 1985. Also, some proportion of non-project lending and sector loans has reached private firms to ease their foreign exchange constraints on raw material inputs and spare parts. Sector and non-project lending accounted for 10 percent of the cumulative total.

There are signs of a reappraisal of investment strategies on the part of both foreign lenders and African governments in recent months. Guinea and Togo, for example, have requested foreign aid organizations to help finance their privatization programs by providing loans to private enterprises willing to take-over, invest in or acquire the physical assets of state-owned enterprises. A USAID policy paper states that "AID resources should be channelled through the private sector rather than the public sector, when host country conditions make this possible. In many cases, it may be feasible to contract with a private sector firm to provide what might have been provided through a government ministry".52/ The World Bank is expanding its sectoral and structural adjustment lending to provide quick-disbursing funds which can be allocated to a larger number of private enterprises through commercial banks. The issue of how to achieve a better balance in the distribution of aid resources between the public and private sectors should be included on the agenda of meetings of consultative groups and aid consortia. Priority consideration should be given to action in three areas: (i) allocating a higher proportion of foreign aid funds to local development finance institutions and commercial banks for onlending to SMEs; (ii) encouraging private investors to take over inefficient state-owned enterprises and to undertake new projects currently included in public investment plans by guaranteeing long-term loans to match the investors' own equity contributions; and (iii) introducing Private Sector Development Loans to meet the short- and medium-term foreign exchange requirements of private enterprises, linked to policy reforms that promote competitive markets and efficient resource utilization.

51/ See World Bank Annual Report 1985, Tables 4.2 and 4.5.

52/ See U.S. Agency for International Development, A.I.D. Policy Paper: Private Enterprise Development, Washington, D.C., 1985.

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KENYA PRIVATE ENTERPRISE DEVELOPMENT PROJECT

INTRODUCTION

Recently, the AID Mission-Nairobi submitted a Project Identification Document (PID) for a 10-year $63 million Private Enterprise Development Project to be initiated in 1987. The purpose of the project is to increase the productive capacity of the Kenyan private enterprise sector through changes in the policy, financial and institutional framework surrounding private enterprise activities. The proposed project will focus on these three areas of change through three component: finance, management/technical assistance and investment promotion.

Each of these components will involve several separate Mission activities working directly with the private sector rather than through the government. The project will require $40 million in AID grant funds and $23 million equivalent from Kenyan sources.

FINANCE COMPONENT

Description

The finance component of the project has three activities: formation of a new venture capital firm, support to an existing venture capital firm, and establishment of an export credit facility.

Venture Capital, New Firm. Through this activity AID will support the formation of a KShs. 24 million (about $1.3 million) venture capital fund, to be formed and managed by an experienced independent venture capital management company. Investors in the fund will consist of up to seven Kenyan private financial institutions and the management company. This "two tier" structure, typical of venture capital companies in the United States, insures that the management company has a stake in the success of the investments. The fund will take minority shareholding positions in five to ten new business projects, and will provide intensive management, marketing and technical inputs to its portfolio companies, in preparation and early operational stages. AID's participation will take the form of a line of term credit, in shillings, that can be accessed by the management company in tandem with equity investments by the fund. AID will also provide partial funding for

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the management company's first four years of operation and co-financing of business plan preparation for up to six projects per year, of which one or two per year would be expected to become a fund investment. Once the project reaches maturity, the venture fund will sell its shares, freeing its capital for new investment.

Venture Capital, Existing Firm. The only currently operating venture capital firm in Kenya, Industrial Promotion Services (Kenya) Ltd. (IPS(K)), has developed an ambitious but reasonable expansion plan to carry it through 1991. IPS(K) already operates in the way described for the new venture firm: it makes minority investments in new projects, and provides intensive management assistance through the project identification, preparation and operation phases. Leather Industries of Kenya is one of its recent investments. IPS(K)'s program for 1986-1991 has three parts: 1) matched lines of equity from IPS(K) itself and the IFC, 2) increased technical assistance staff for project development and monitoring, and 3) a line of credit to provide long term loans to portfolio companies. AID will provide about half of the overall technical assistance requirements and will be the sole source of the term loans made by IPS(K).

Export Credit Facility. AID will establish a medium-term (1 to 5 year) credit facility for pre- and post-export finance to be made available to small and medium-sized exporters through commercial banks and non-bank financial institutions (NBFIs). It will finance production against firm export orders. A trust will manage the facility and pre-qualify banks and NBFIs. Once pre-qualified, these institutions will be eligible to access the facility. A reasonable spread and minimum of red-tape will be crucial to use of this facility by banks and NBFIs. All sub-borrowers will receive loans at commercial rates. Technical assistance will also be provided to financial institutions to support developmnt of expertise in export finance.

MANAGERIAL AND ENTREPRENEURIAL ASSISTANCE AND TRAINING

The two venture capital companies are appropriately considered under this component as well as under finance. One of the strongest reasons for adopting venture capital models in Kenya is that the minority shareholder's position is particularly effective for delivering management assistance and developing entrepreneurs. Other component activites are:

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International Executive Service Corp. IESC provides short-term (about three months in most cases) management and technical consultancies to existing Kenyan businesses, using retired U.S. executives who work on a volunteer basis. Normally, these executives have skills not available within Kenya. This project will enable IESC to expand its program from ten consultancies per year to twenty per year, for ten years, and it will allow it to reduce the fee it charges clients to a more reasonable level for small Kenyan firms. AID will reimburse IESC for a portion of the per-project cost of each completed consultancy.

Kenya Management Assistance Program (K-MAP). K-Map is a new institution intended to show that the larger Kenyan business community can be a source of managerial expertise for small Kenyan firms. It proposes to mobilize volunteer Kenyan executives from larger businesses to provide management advice to small firms. It will adapt the U.S. Service Corps of Retired Executives (SCORE) concept to the Kenyan context, with the change that most volunteers will be active managers rather than retired. AID will provide a core funding grant that will cover a decreasing portion of expenses during K-Map's first four years of operation, and will reimburse K-Map throughout the project period on a per-consultancy basis, in order to provide icentives for an active program.

Kenya Small Scale Business Association (KSSBA). This association will be a source of short-term training, seminars and information for small modern sector businessmen on topics ranging from basic management skills to government policies affecting small businesses. An AID grant to KSSBA will enable it to 1) establish a secretariat, 2) publish a journal, and 3) hold educational seminars and workshops on practical topics (e.g. entrepreneurial attitudes, how the import licensing process works, and how to locate overseas markets).

INVESTMENT PROMOTION POLICY

Investment Promotion Centre. This activity will support the ongoing efforts of IPC, the lead GOK promotional agency, to bring about improvements in GOK policy toward private enterprise. It will also assist the development of IPC capacity to promote Kenya as an investment site and provide services to prospective investors. In policy, AID will fund analytical and feasibility studies for potential GOK reforms. Specific studies will be identified at the PP stage, from among topics such as: securities market reform, export processing zones, simplification of the investment approvals process, reform of

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foreign investment protections, privatization work-ups for specific parastatals and export credit insurance. Investment promotion activities will include preparation of an investor guidebook and other promotional materials, investment missions of potential foreign investors to Kenya, and promotional campaigns abroad. Investor services will consist of development of information on promising industrial sectors and an investor resource center, co-financing of feasibility studies and assistance to individual investors in negotiating investment approval. AID's grant will support in-service training for IPC staff and short-term advisors to help carry out these activities.

Kenya Association of Manufacturers (KAM). The purposes of assistance to KAM will be to enable it to play a greater role in the assessment and articulation of government policy reforms, and to improve the services it provides its members, especially smaller ones. An AID grant will fund studies on policy change. These studies will focus on the private sector contribution to policy change. For example, private ownership of export processing zones, joint private action to overcome export handling constraints, or the private role in stock market reform are all possible topics. The grant will also finance one or more technical advisors in industrial specialties who can provide assistance to members, particularly regarding technical issues in GOK policies. It will also co-finance the participation of small businesses in KAM services similar to the seminar on food packaging presented by Project SUSTAIN.

In April 1986, during PID preparation, the Kenya Mission had a cable sent to AID/W. The cable set forth project design issues and proposed that the Director of the Regional Management Finance Center and the Project Development Officer meet with representatives from AFR, FM, GC and PRE to discuss these issues. The text of that cable follow:

1. USAID/Kenya is now designing the 1987 Private Enterprise Development Project. The goal of the project is to generate growth within private enterprises in Kenya. In order for Kenya's economy to achieve self-sustaining long run growth, its resource use must be realized through changes in the policy, financial and institutional framework surrounding private enterprise. the project will focus on these three areas of change through three components: financial sector innovations, management assistance, and investment promotion/policy. Each of these

components will involve several separate activities. Wherever possible, the project activities will emphasize types of industries that make most efficient use of Kenya's resources. These are: exports, natural resource based production and labor intensive businesses. At present, we anticipate working directly with the private sector, rather than through the Government to finance many of these activities. The purpose of this cable is to seek guidance on two concerns: first, making local currency loans to end users, and second, obligating mechanisms.

2. The first issue is lending in local currency. In designing this project USAID/Kenya confronts an important issue that may arise wherever AID contemplates credit assistance to private enterprise. The target group, local private businesses, require credit that is lent and repaid in local currency (Kenyan shillings). This affects all proposed activities within the financial innovations component: lines of credit to two venture capital firms, an export credit facility, direct investment in individual project and a loan guarantee fund for small business. The situation is especially difficult in Kenya because although the Government of Kenya has approved AID's assistance to the private sector in principle, it is unwilling to take on foreign exchange risk for private firms, and it prefers that AID work directly with private firms, not using the Government as a conduit for funds. The issue is how best to reach the target group with appropriate forms of credit, financed by AID, given the situation that exists in Kenya.

3. Throughout most of the 1970s, development finance for businesses in Kenya was provided by donor-funded development banks, usually in hard currencies. This was the major form of long-term debt, and it was used to finance businesses producing for the domestic market as well as export firms. During the 1980s, the Kenya shilling was devalued, partly due to demand by the IMF and others that Kenya adopt a more realistic exchange rate as part of a structural adjustment. Between 1980 and 1986 the dollar rose 220 percent against the Kenya shilling. European currencies rose slightly less. More rapid inflation within Kenya has only mitigated this effect slightly for domestic market firms. As a result most of the clients of development banks have had severe difficulties in repaying their dollar denominated debt, and some, with operations that are profitable within the Kenyan context, are facing bankruptcy. Given this recent

experience, Kenyan businesses are rightfully reluctant to borrow in foreign currency. Yet no source of development finance in local currency has been created. The development banks have none and the commercial lenders do not provide term credit for capital investment. Mission is well aware that the broader issue is one of GOK willingness to expand real private sector credit generally, and in this context, for commercial banks to be in areas of agrobusiness, investment proposal based term lending. The broad issue of private sector credit is proposd for discussion at the upcoming CG, and is to become part of continuing macropolicy dialogue.

4. The purpose of the financial segment of the Private Enterprise Development Project is to relieve constraints in strategic areas of the financial system. Many or most of the firms served through project financed lines of credit will sell their products in Kenya. Thus, in the normal course of their operations, the end users will not confront foreign exchange risk. If AID assistance contains such funds, the demand for credit will be very low. Firms will judge foreign exchange risk on debt service to be too high a price to pay for term financing. It would not be appropriate for AID to endanger the financial soundness of the businesses it is attempting to assist by bringing in this otherwise extraneous risk. In short, the proposed project activities are feasible only if credit can be made available to end users on terms close to those of the Kenya commercial context.

5. Position of Government of Kenya. One possible arrangement is for the host country government to absorb the foreign exchange risk before passing the funds to private financial institutions or businesses on commercial terms. The difference between AID's soft loan terms that the government must meet and the terms on which it is repaid by the private borrowers are sufficent to cover the foreign exchange risk under most circumstances. This is the approach used in USAID/Kenya's Rural Private Enterprise Project. However, since that agreement was signed, the Government of Kenya has made a policy decision that it will no longer absorb foreign exchange risk for non-governmental entities. It took this decision as part of its overall strategy for reducing its foreign debt service obligations. Kenya's need to adopt such a strategy reached near emergency proportions during the first half of the 1980s. AID supports GOK's overall debt reduction strategy, and accordingly, most of its assistance to Kenya in the near future will take the form of grants.

6. A second reason for the Government of Kenya's position is its preference that AID assistance to private firms be given directly, using agreements to which the government is not a part. This practice is already embodied in the PRE Leather Industries of Kenya project and in the PVO co-financing project. The reluctance of the government to be a conduit for funds stems from two motives, both sound. First, such a role places additional strain on the already overburdened government bureaucracy. The government does not want to be placed in the politically awkward position of appearing to have control over the allocation of funds to specific private businesses. In other FORA, AID has en couraged the government to reduce its role in areas where the private sector can do the job. Thus, government and AID policies mandate that AID assistance be provided directly to the private sector.

7. Given the position of the government, and given the need of end users for local currency, AID must seek a fully private mechanism for making credit available on commercial terms in Kenya shillings. The original form of asistance from AID could be a grant, a loan or a mixture of both, as long as the final product is shilling loans at commercial rates. USAID/Kenya requests assistance from AID/W to find a solution to this problem.

8. Second issue: Obligating mechanism. As currently envisioned, the project would involve separate obligating agreements for a number of activities. Some of these would be with private entities and some with the government. The reasons for this have been outlined above; both AID and GOK prefer that AID go directly to the private sector without passing funds through or signing agreements with government. This avoids political and administrative problems for both AID and the government. Once we move outside the framework of the government it becomes advantageous to obligate most of the activities separately. No private (or public) institutions in Kenya have experience providing umbrella administrative support for activities performed by other private organizations. This is particularly true for the management assistance component, where assistance is contemplated to up to four organizations, some relatively new. At this early stage in the history of AID's work with the Kenyan private sector, the focus is on developing nascent institutional capacity. It would be premature for AID to push any of these organizations to assumptions of responsibility for oversight of others. Guidance is requested from AID/W on how best to implement this approach.

9. Mission proposes a one week TDY starting April 28, 1986 by Harold Collamer, Director, Regional Financial Management Center, and Raymond Rifenburg, Project Development Officer, to meet with representatives from AFR, FM, GC and PRE to discuss the above issues.

10. Request concurrence for proposed TDYS.

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USAID/Kenya followed-up the issues cable by sending two project design executives to Washington for design discussions and subsequently submitted a PID for AID/W review. Although the ECPR review held in July approved the PID and noted that the PID was well written and reflected a creative effort by the Mission to develop innovative ways of supporting the private sector, it also cited several design issues that must be resolved before the project could be approved. On 24 July AID/W cabled the following ECPR guidance to USAID/Kenya.

Subject: ECPR Guidance: Private Enterprise Development PID (615-0238)

1. The ECPR chaired by DAA SAIERS on July 2 approved the Private Enterprise Development PID. AID/W will be the approval venue for the PP. The ECPR noted that the PID was well written and and reflected a creative effort by the Mission to develop innovative ways of supporting the private sector. The ECRP recognized that there are several important design issues which must be resolved before the project can be approved. ECPR guidance is detailed in the following paragraphs:

2. Equity Capital.

(A) Liquidation: The success of this component depends on the ability of investors to sell out when projects mature, thereby realizing their capital gains. The ECPR noted that despite opportunities for private placement or co-sponsor buy-out, limited capital market activity in Kenya would make this difficult. The Mission should address this problem in two ways. First, the PP must describe methods of liquidation to be used by the new venture capital company, and should be able to demonstrate a strong likelihood that these channels will be available. Second, the Mission should move capital market reform higher on its policy dialogue agenda, and should be able to show by the time of PP approval that a linkage has bewen developed between this project and such policy dialogue.

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(B) Lines of Credit: The ECPR raised two points concerning lines of credit to the two equity capital firms. First, the review asked if the commercial financial system could administer such lines of credit, and second, whether the system could provide the necessary funds without further injection of AID resources. The ECP encouraged structuring the lines of credit for eventual takeover by the commercial financial system as that system will have to provide term credit for venture firm clients in the long run. During PP design the Mission must consider these questions: A. Is a special source of credit for venture firms necessary? B. Must it be provided outside the normal banking system? C. What will be the source of debt funding for the venture firms' projects after the AID-funded lines of credit expiret? Another concern is the allocation of credit risk: should the venture firms take on additional credit risk beyond their equity position by extending loans to firms in which they have an equity stake?

(C) Technical Assistance: While there is no legal problem with AID grant support to the two equity firms, there is a policy concern which the Mission should note during PP design: the grant assistance should not be used to give the AID-assisted firms a long-term competitive advantage over potential new entrants. Full or partial reimbursement of AID funds should be considered as one way to deal with this.

3. Export Credit.

The ECPR noted that the medium term portion of the export credit facility appears to overlap with finance provided under the Rural Private Enterprise Project. The Mission must demonstrate why an additional injection of medium-term credit, and this amount, is needed. The Mission must also quantify and justify the need for short-term credit by describing current financing practice and potential end users. An issue that must be addressed is whether the short-term credit problem is due to lack of funds or banking practice(s). If the latter reason, the Mission should consider alternatives to direct provision of funds, such as risk sharing or guarantee arrangements as now commonly used by PRE/W. The Mission should continue with design of the trust fund, taking account of legal issues including:

A. The trust must be valid under local law.

B. Conflict of interest between trustees and beneficiaries must be avoided.

C. The trust must constitute a valid obligation of AID funds, and principal and interest must be suitably disposed of upon dissolution of the trust.

D. The trust must not simply be a means of avoiding the intent of provisions in the Foreign Assistance Act (FAA), such as those requiring AID to make loans repayable in U.S. dollars. Resolution of this issue depends both on the design of the trust and on the legislative intent of the relevant FAA sections.

The Mission should keep informed of the progress on other agency attempts to establish trust mechanisms to ensure that is design conforms to agency policy.

5. Macro Policy.

The PID states that no changes in GOK policy are required before project activities can go forward successfully. This should be thoroughly demonstrated in the PP. Each project component should be shown to yield an acceptable economic rate of return equal to or greater than the opportunity cost of capital. Individual project components should be examined for financial viability to ensure adequate incentives for participants. The PP should discuss how other Mission mechanisms, e.g., ESF and other projects, will support policy change that will enhance private sector competitiveness.

6. Investment Promotion.

Reviewers noted that AID worldwide has had poor results from many of its efforts to support investor services provided by government agencies because those agencies often lack dynamism and commitment. USAID/Kenya maintains that IPC is an energetic and effective advocate for the private sector, and therefore is an appropriate focal point and coordinator for such activity. The review observed that IPC's activities are best limited to policy-related concerns and that the project should ensure that various investor services and other activities readily available from private concerns are provided by the private sector (preferably on a competitive basis).

7. Funding Level.

The review discussed the resource constraints facing the Kenya Mission, and noted that they could have an impact on the size, scope, and duration of this project. The choice of how to meet budgetary requirements, among and within projects, will be faced by the Mission once it has received parameters from the Bureau. As an alternative to dollar financing, the Mission should seriously consider the possibility of funding local currency portions of this project with counterpart funds from ESF or Food for Peace generations.

8. Because this is an innovative project concept, there is a need for a well thought out monitoring and evaluation plan to elucidate the lessons to be learned by the Mission and the Agency.

The PP should detail this plan.

9. PPC/WID recommends that the social analysis for the PP include gender as one of the information characteristics gathered regarding both owner and employee beneficiaries, and that this data be used to encourage female participation on the project. Shultz

KENYA CREDIT FACILITIES

BACKGROUND

Kenya has a scarcity of good agricultural land, only 0.6 hectares per capita. Much of this land is owned by smallholders who now earn more than 40 percent of their income from off-farm activities. Four-fifths of Kenya's population live in rural areas, but a substantial number of households own no land. The population growth rate is four percent annually. The labor force is expected to increase from 7.3 million to 15.7 million by the end of the century. Consequently the AID Mission-Nairobi believes that it is essential to increase employment, income and production in rural areas by expanding off-farm employment opportunities through accelerated development of private enterprise located in rural areas and other businesses with strong backward and forward linkages to agriculture.

Two AID projects have been initiated in Kenya to contribute to the goal of increased rural production by providing rural enterprises of various sizes with a package of medium and short term credit, business advisory services, and technical assistance through commercial banking institutions with extensive rural branch networks and PVOs:

- The Kenya Commercial Bank Project, and
- The Kenya Rural Private Enterprise Project.

These two projects are unique for AID Missions in sub-Sahara Africa, although AID has initiated a number of similar projects in Latin America and the Caribbean.

Currently, several Missions in Africa are planning or considering projects to develop credit facilities. It should be helpful, therefore, to examine the Kenya experiences in planning and implementing these two credit facility projects to determine what problems were confronted and what lessons have been learned. Consideration should also be given to the replicability of these projects elsewhere in Africa, and to what extent the two projects conform with the draft Financial Markets Development Policy Paper now being reviewed in AID/W (excerpts from that draft are enclosed in the readings).

KENYA COMMERCIAL BANK PROJECT

In January 1983, the Private Enterprise Bureau (AID/PRE) initiated a three-year project with the Kenya Commercial Bank (KCB) and its affiliate, the Kenya Commercial Finance Company (KCFC), whereby AID/PRE provided a $2.5 million loan which was matched by $2.5 million in local currency from KCFC to form a $5 million fund for on-lending to small and medium sized private Kenyan agribusiness and light manufacturing enterprises. In addition, PRE provided a $250,000 grant to the bank to cover the costs of hiring and training bank staff to evaluate smaller loans and to provide business advisory services at regional and branch levels.

PRE's primary project goal was to strengthen KCB/KCFC institutional capability to reach out to new, primarily rural, agribusiness borrowers with medium to long term fixed rate credit accompanied by business advisory services to encourage solid new long term rural enterprises to assure highest potential portfolio quality.

The AID loan was provided direct to KCB at 8 3/4 percent per annum. Both AID and KCFC funds are on-lent at prevailing commercial rates (which were set by law at 19 percent, inclusive of any fees. All sub-borrowers paid to the GOK an additional one percent fee on AID funds to cover foreign exchange risk. All on-lending, however, was in local currency. KCFC is current on its interest payments to AID.

By June 1986, 94 loans had been made. Of those, 56 are to food processors (bakeries, slaughter houses, coffee, corn and sunflower processing), 31 to agribusiness and related services (hauling, saw milling, and ploughing) and the rest (7) to light manufacturing (construction cable and adhesives). Loan-size ranged from $4,400 to the maximum allowable size, $500,000, 50 percent of which is from AID funds. Eighty percent of the loans went to new businesses, 40 percent to expansions of existing businesses. Small businesses (assets less than $750,000) got 38 percent of funds and comprised 99 percent of loans with $4.4 million of funds disbursed and an average loan of $46,000. Approximately 2/3rds of the loans were to women-owned businesses. The average cost per new job created is approximately $3,700, with 50 percent from AID. Business Advisory Services report a client load of 61.

A mid-term evaluation of the project was completed in June 1984. That evaluation concluded that the "project is off to an excellent start with respect to desired development impacts and rural outreach." It also reported that from a compliance standpoint, KCB/KCFC had drawn down funds as scheduled; was current on all payments to AID, provided timely and complete reports to PRE on a quarterly basis; and was using AID and KCB/KCFC funds in accordance with project objectives, loan terms and covenants. These compliance conditions have continued to be met to date (September 1986).

The 1984 evaluation also indicated that KCB/KCFC had not taken the steps required by the loan agreement to staff its Business Advisory Services (BAS) department as planned and to disseminate BAS capability to its branches. However, these steps were subsequently implemented through recruitment and training of existing bank officers.

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The KCB project is about to end and a final evaluation is about to commence. Since both AID and the GOK are expanding the use of commercial lenders as vehicles for support to the same target group of sub-borrowers, it is important in the final evaluation to analyze the impact of the loans on sub-borrowers. The mid-term evaluation did not cover that subject but rather addressed the loan making proces within KCB. Currently, there is little information available about how these businesses work, how they finance themselves, how loan funds were used and how successfully. An evaluation along these lines would provide insight into this critical target group and into the impact of commercially-based credit programs in Kenya.

KENYA RURAL PRIVATE ENTERPRISE PROJECT

Project Description

The Mission's $62 million RPE Project, approved in August 1983, was designed to increase rural production, employment and income in Kenya through three basic interventions. The principal one was a $24 million AID loan through commercial financial institutions to rural enterprises (to be matched on a one-to-one basis by commercial bank funding). The loan program would be backstopped by management and technical assistance to project borrowers (banks) and sub-borrowers (businesses), and management, technical and financial assistance to informal sector enterprises through PVO's.

Of the $62 million total project costs, $48 million -- including the $24 million matching fund contributed by the participating commercial banks, was for on-lending. The $12 million AID grant, supplemented by contributions of $2 million from the commercial sector and PVO's, was divided among the implementing agencies and PVO's to hire, train and provide technical advisory services to borrowers and administer and monitor the project and its effectiveness.

Project mechanics were similar to revolving loan funds established in several Latin American countries which have had mixed success.

o AID would lend $24 million to the GOK on concessionay terms (40 years with a ten year grace period, with interest at two percent annually during the grace period and three percent during the repayment period).

o The GOK would lend the funds to commercial banks at an interest rate to be negotiated, but between 10 and 13 percent -- probably close to ten percent. Thus, the GOK would have a spread of about 7 percent. The GOK loans to the commercial banks would have a grace period of two years and principal repayment in ten years.

- The commercial banks would lend funds to private businesses (sub-borrowers) at prevailing commercial rates, but not to exceed the maximum interest rate fixed by the GOK (currently 19 percent). Thus the banks would have a spread of about six percent to cover costs and commercial risk, which the commercial banks have agreed to assume. The banks would provide funds from their own resources to match AID funds (at least one-for-one) or arrange for such matching through syndication of third party funds. It was estimated that not more than 50 percent of the AID funds would be used for foreign exchange costs. The total loan to a business would have a grace period of two years and the principal repayment in not more than eight years nor less than three years. Banks would also be encouraged to provide working capital requirements of sub-borrowers, not to exceed 50 percent of bank matching funds.

- Repayments from commercial banks to the GOK (less any fee charged by the government for assuming the foreign exchange risk) would be deposited to a Special Account at the Central Bank. Funds from this account could be used by the GOK to repay the AID loan at the rate of exchange in effect when the overall agreement is signed. Residual funds would be used for further medium term lending to rural private enterprises. Theoretically, if the foreign exchange rate remains constant and commercial banks repay all loans to the GOK, residual funds in the Special Account could grow to over $70 million by the end of the 40th year if the CBK relends all repayments at a spread of 7 percent.

<u>Procedures and Criteria for Reviewing and Approving Loans and Sub-Loans</u>

USAID would approve all GOK loans to commercial banks. When AID approves the loan agreement, AID would establish a Letter of Commitment in the entire amount at a U.S. bank with representation in Kenya. The borrowing bank would then draw down, directly from the U.S. bank, local currency based on its estimate of local currency disbursement requirements in the next 90 days for approved subloans. Normal commercial bank proceduree would then be used for disbursement to the sub-borrowers. For foreign exchange disbursements, the borrowing bank would obtain government approval and then request the U.S. bank to establish a Letter

of Credit in favor of the intended supplier. Payment would then be made in accordance with normal Letter of Credit procedures.

To the maximum extent possible, the procedures and criteria for reviewing and approving sub-loans would be those already in use by the commercial banks, within the parameters set by the loan agreement. However, in order to ensure achievement of project objectives certain basic criteria would be established as follows:

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- Types of Enterprises:

  - fifty percent owned by Kenyan citizens or be an integral part of the Kenyan economy;
  - no limit on size of firm;
  - must be located outside Nairobi or Mombassa, except for agribusiness projects approved by AID;
  - excludes commodity trading, real estate development, finance, insurance, or speculation; and
  - on-farm production activities would also be excluded unless part of a vertically integrated processing enterprise.

- Loan Criteria:

  The project would also have to meet one of the following conditions:

  - be labor intensive (investment of no more than $5,000 per job created);
  - have potential to increase net foreign exchange; and/or
  - provide increased markets, inputs, or services for agricultural or other rural production based on locally available inputs.

- Loan Size:

  - maximum AID contributon $750,000 (unless approved by AID); and
  - no minimum, but banks would receive incentive payments for loans under $75,000.

- Loan Use:

  - must be for new investment (either business establishment or expansion);
  - refinancing of existing debt excluded; and
  - must be used to acquire fixed assets (e.g. land, building, machinery) and related services (e.g. equipment installation).

Management and Technical Assistance

Since rural private enterprise in Kenya face management and technical as well as financial constraints, the project provides management and technical assistance through participating banks. Banks assistance would be modeled on the business advisory service of the KCB which conducts feasibility studies of proposed loans on a cost-sharing basis with potential clients. These feasibility studies include cash-flow analysis which provides credit managers with an alternative to collateral as a means to assess a client's credit worthiness. The KCB would continue the business advisory services established by the AID/PRE KCB Project. The other commercial banks would establish an internal capability to provide such services, in part with the help of an AID grant.

In addition, through a contract, Deloitte, Haskins and Sells (DHS) would supplement the banks' efforts by providing assistance in analyzing the overall feasibility of proposed investments, on going management assistance to borrowers, and management and technical training to upgrade entrepreneurial and other skills.

Project Targets

Based on a study completed prior to project design, the majority of investments would be for agribusiness with emphasis on processing (fruits and vegetables, sisal, fish, edible oils, hides wood and livestock processing) and small manufacturing (hand tools, footware, soap and other consumer goods).

The project is expected to create a minimum of 6,000 jobs directly and 12,000 jobs indirectly, not including employment generated through PVO programs.

USAID would monitor closely the lending profiles of the banks, particularly during the first year of the project. Any substantial deviation from desired lending patterns would be corrected through modified lending criteria or incentives for further credit allotments.

Currently, the parastatal KCB and two private banks (Barclays and Standard) have agreed to participate in the Project.

Project Status

Contracts were signed in May 1984 with World Education, Inc. (WEI) to manage the informal sector program and DHS to manage the bank program. WEI has developed a staff, established a review committee and made nine subgrants totaling $1.4 million to non-governmental organizations assisting informal sector enterprises. USAID/ Kenya is satisfied with progress to date on this portion of the project.

DHS has assisted AID in discussions with commercial banks, prepared an operational manual for participating banks, conducted promotional visits to potential subborrowers (one of which resulted in a totally bank-financed loan for an oil seed processor), monitoring and system support to WEI, and completed several projectrelated studies. However, the bulk of the DHS effort is tied to implementation of the loan program which has been held up for nearly two and one-half years due to an impasse with the Ministry of Finance over the handling of repayments by commercial banks to the GOK.

According to the project agreement, loan repayments to the GOK from commercial banks were to be deposited in a Special Account with the Central Bank of Kenya (CBK) to provide a refinancing mechanism for additional rural enterprise loans, to repay the AID loan, and cover GOK foreign exchange risks and administrative costs. As the program was similar to one operated by the CBK under the 1982 PRE program grant, no major stumbling blocks were anticipated. The first year of project implementation therefore concentrated in selecting the project contractor, the cooperating agency for the informal sector program, and participating banks. Negotiations at the staff level on the precise terms, conditions and procedures for the operation of the refinancing mechanism were carried out during January - June 1985. This longer than anticipated process resulted in the issuance of a Project Implementation Letter (PIL) in July 1985 proposing the operational details of the refinancing mechanism. When this PIL was not countersigned, policy-level discussions by USAID Kenya with the GOK began in August 1985.

Even though the Project Agreement, duly ratified by the Attorney General, included provisions for this refinancing mechanism, the Treasury officials responsible for implementing the project felt there were legal, administrative and policy problems with the refinancing arrangements. As Kenya had never had such a refinancing mechanism for medium-term credit, and since the program would promote private sector growth through other than the traditional parastatal development finance institutions, it was controversial.

As negotiations proceeded, it became clear that Treasury was either unable or unwilling to undertake the project. Consequently, the AID Mission took the matter to the Minister of Finance (who committed himself to move the project forward) and the Chief Secretary in the Office of the President.

During the period of negotiations and discussions, USAID was on the verge of suspending the loan portion of the project or eliminating the revolving fund, but it was decided to continue policy dialogues. Finally, the GOK decided to find ways to implement the project as a model for establishment of a much larger refinancing facility augmented with social security and insurance funds, as well as other donor resources.

Two specific factors contributed to the government's interest in the project:

First, the need to find financing for grain millers to build warehousing as part of their increased role in private sector grain marketing. As agribusiness investments, financing construction of such warehousing would fit neatly into RPE and at the same time make a crucial contribution to liberalized grain marketing.

Second, concurrently, USAID was working closely with the Investment Promotion Center (IPC) to develop new strategies and techniques for promoting private enterprise (both domestic and foreign) investment in Kenya. Not surprisingly the IPC became a strong advocate with the Government for the Rural Private Enterprise Project in general, and the refinancing mechanism in particular.

Thus, AID's insistance that the refinancing mechanism be established before any disbursement of loan funds, combined with its continuing dialogue with and support to the IPC, the Ministries of Finance and Planning, the Central Bank and the Office of the President, have been critical factors in developing the growing consensus within the GOK concerning a central re-financing mechanism.

DISCUSSION QUESTIONS

1. What are the major factors and considerations involved in establishing and implementing the RPE project?

2. The controversy over the refinancing mechanism of the Special Account at Kenya Central Bank has delayed implementation of the commercial financial institution loan program for almost two years. Is that roadblock one that is likely to occur in other African countries?

3. Are there practical and legal alternatives to using Government institutions as the implementing agency for the revolving fund, for example, going directly through a private bank?

4. Do you believe that the KCB and RPE Projects are replicable elsewhere in Africa? For example in the CFA countries? What changes in project design would you suggest? Are similar projects necessary elsewhere (e.g. is lack of medium-term credit a serious constraint? Is development of off-farm, rural private enterprise a high priority item?). Do the Projects' basic concepts and strategy conform to the proposed Financial Markets Development Policy Paper?

CONSIDERATIONS IN THE ESTABLISHMENT

OF A STOCK EXCHANGE

Active equity markets are rare in Africa. Very few stock exchanges, merchant banks, venture capital funds or other financial institutions are active in organizing private sector stock flotations and maintaining secondary market securities trading facilities. Government development banks -- many in serious trouble -- have favored public sector investments and deal primarily in debt -- as opposed to -- equity financing.

Government financial and tax policies which have resulted in low and often negative interest rates on loans have favored debt over equity financing. Debt "pardoning" in some countries has also worked to make loans an attractive approach to financing. Heavy double taxation on profits/dividends has also made equity investments unattractive.

KENYA

There are small stock markets in Abidjan, Ivory Coast and Nairobi, Kenya. The Nairobi exchange formed in 1954 by six Nairobi-based stock brokering firms has no physical trading floor. Brokers announce offering and buy prices daily acting as agents for their clients. The market serves 55 large, well established companies -- and has added only one new company in the last ten years. The Abidjan market is very small and relatively inactive.

The public sector -- government and development banks -- has been a major source of equity financing. This source has largely dried up due to major liquidity problems. Foreign equity investments have also dwindled in recent years. Kenya estimates, for example, that formal sources of equity will provide no more than 5% of Kenya's gross fixed investment in 1988. The balance will come from retained earnings, insider investments, and informal business sources -- business contacts, family and religious groups. High debt-to-equity ratios prevail in Kenyan businesses, estimated to be 8/10 to 1 in 1984.

The GOK has recently pledged to reform capital and money markets and encourage a more active stock exchange and increase opportunities for raising equity capital via formal financial channels.

SENEGAL

A preliminary review was recently made of the possibilities for creating a stock exchange in Dakar, Senegal. A brief summary of the conclusions reached by the consultant follows.

There are a number of pre-conditions necessary for the creation of a stock exchange:

1. Confidence and Accountability

   Potential investors must have confidence in the individual enterprise based on full and accurate disclosure of the company's financial condition under explicit accounting disclosure laws, standards and practices, as verified by recognized independent auditors.

2. Volume of Shares Available for Trading

   There must be a sufficient volume of shares available for trading from a minimum number of relatively large individual companies organized under the law as limited liability shareholding enterprises permitted to sell their shares in an open market.

3. Interested Buyers

   There must be a sufficient number of potential buyers -- individuals and institutions -- who believe that investments in local companies offer an acceptable profit-making alternative to other potential investments, and who have the readily available investment resources.

4. Trading Mechanisms

   Responsible trading intermediaries must exist -- banks, brokers, broker/dealers -- able to provide initial flotation of new issues and willing to make markets for security traders.

Some regulatory/policing agency must be in place -- a Securities and Exchange Commission type body -- able to establish and enforce the rules governing the issuance and trading of securities, and monitor the activities of firms engaged in securities trading. This agency would be obliged to set forth accounting and reporting policies and standards of listed companies and police adherence to these regulations.

The consultant concluded that in the current regulatory and economic climate of Senegal, it was premature to attempt to organize a stock market. Neither the pre-conditions necessary for successful launch of an exchange listed above nor the general economic climate were such as to warrant further study at this time. The alternative of a regional securities market within the West African Monetary Union, however, might bear further investigation -- possibly utilizing the small Abidjan Stock Exchange as a springboard.

The consultant stated that successful long term general economic reforms were essential -- parastatal privatization in particular -- before any major organized efforts to establish a formal Senegalese stock market should be launched.

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PRIVATIZATION

A.I.D.

POLICY DETERMINATION

IMPLEMENTING A.I.D. PRIVATIZATION OBJECTIVES

1. Introduction. The Deputy Administrator, speaking for the Administrator, announced the following Agency objective for privatization at the International Conference on Privatization (February 17 - 19, 1986). He said:

> "... To take advantage of the momentum generated by this conference, the Agency for International Development is setting a goal for itself. We have substantial staff and resources in about 40 countries. We will ask each of those missions to engage in discussions with their countries about privatization. Our goal will be for A.I.D. to be involved in an average of at least two privatization activities in each of these missions by the end of fiscal year 1987. Now I say average because we recognize that not all countries are going to be interested, but, clearly a number of countries are very excited..."

The Agency's privatization objective is based upon the pragmatic realization that the entrepreneur and the private sector are the most appropriate mechanisms for economic growth. A healthy independent private sector and secure individual economic freedoms also serve as a strong base from which to ensure that democratic institutions are brought into existence and remain free from centralized political control. Privatization of functions, activities, or organizations currently in the public sector should contribute to the achievement of these goals.

Implementation of the privatization objective must begin with the determination of which public activities are appropriate for the private sector. The appropriateness of public versus private sector should be determined on the basis of which sector is more likely to produce a higher level of economic efficiency, innovation, and incentive, and, therefore, the greater economic benefit. Experience has demonstrated that a private enterprise (rather than a wholly or partially state-owned enterprise or parastatal), operating in a truly open and competitive environment, is usually the more likely to meet goals of economic efficiency and growth.

The purpose of this Policy Determination is to provide (1) additional policy guidance on implementing A.I.D. privatization objectives and (2) information on sources of technical assistance for Missions undertaking privatization activities. This PD and the revised Private Enterprise Development Policy Paper (March 1985), which discusses the privatization technique of divestiture, should be used as companion documents in developing privatization plans and activities.

2. Definition. For the purposes of Agency policy, privatization is defined as the transfer of a function, activity, or organization from the public to the private sector. (Related activities discussed in Section 4B of this paper, but not falling within this definition, may be justified with reference to the revised Private Enterprise Development Policy Paper.) The major techniques for privatization, for the purpose of complying with this PD, are discussed in section 4A below. The term "privatization" is not synonymous with private enterprise. Privatization is an important and unique aspect of our private sector program in that it brings together policy reform, institutional development, and utilization of the private sector. Our private enterprise goals and program are described in the Private Enterprise Development Policy Paper.

3. Policy Guidance.

A. Existing Agency policy. Previous Agency policy guidance on privatization is contained in sections V.F. ("Parastatals and Government Authorized Monopolies") and V.D. ("Assistance to the LDC's Private Sector") of the revised Policy Paper on Private Enterprise Development (March 1985). The guidance in section V.F. of that policy paper is limited to the privatization technique of divestiture. Briefly stated, that guidance stipulates that "A.I.D. assistance to or through a parastatal should be given in the context of exposing the parastatal to market forces and scheduled divestiture of the government interest ... A.I.D. projects designed to improve parastatal performance must have identifiable benchmarks upon which substantive progress towards divestiture can be measured." The latter sentence is the ultimate condition upon which assistance is to be granted. In other words, the selected

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benchmarks must represent substantive evolutionary progress in moving the parastatal towards market-based operations and divestiture in order to qualify for A.I.D. assistance.

Missions have, in the past, utilized technical or capital assistance to make state-owned enterprises (SOEs) more efficient, more responsive to market forces, or more attractive for buy-outs. It should be recognized, however, that enormous amounts of donor funds committed to help SOEs meet the goal of greater efficiency have been largely unsuccessful. There is no reason to believe that new A.I.D. resources will be better spent for that first goal unless the process is linked clearly to both making the SOE more responsive to market forces and actual divestiture. Therefore, the use of A.I.D. funds in a manner that only improves the capability of the parastatal to respond to market forces in the absence of true policy reforms (such as improving an SOE's accounting procedures as opposed to revising the tax code for all enterprises in a particular industry) does not comply with this policy.

The guidance in section V.D. deals with parastatal financial institutions and applies the privatization technique of partial divestiture. The guidance states that "A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved." Based upon this guidance, the responsibilities of the parastatal financial institution would be separated into its purely public functions, which it would retain, and functions that can be carried out by the private sector, which are divested to the private sector.

B. <u>Coverage and scope of new policy</u>. This PD and its targets apply to the A.I.D. Missions listed below. Each of these Missions is directed to engage in discussions with its host country about privatization, with the objective of having at least two privatization activities in each Mission by the end of fiscal year 1987, and two new privatization activities every year thereafter. Although adherence to the guidance is not mandatory for non-Mission field operations (A.I.D. representatives, A.I.D. affairs offices, sections of embassies, and regional offices), it is hoped that those overseas operations will attempt to implement this guidance.

Missions Subject to Guidance

AFRICA	ANE	LAC
Botswana*	Bangladesh	Bolivia
Burkina Faso*	Egypt	Costa Rica
Cameroon	India	Dominican Republic
Ghana	Indonesia	Ecuador
Kenya	Jordan	El Salvador
Lesotho*	Morocco	Guatemala
Liberia*	Nepal	Haiti
Malawi	Pakistan	Honduras
Mali	The Philippines	Jamaica
Mauritania*	Sri Lanka	Panama
Niger	Thailand	Peru
Senegal	Tunisia	RDO/C
Somalia	Yemen	
Sudan		
Swaziland*		
Zaire		
Zambia		
Zimbabwe		

* These Missions are exempted from complying with the PD for FY 87. The application of the guidance to these Missions in FY 88 will be reviewed at a later date.

C. Short-term and Long-term reporting requirements. It is expected that privatization will become an integral part of each Mission's programming. Therefore, both short-term and long-term reporting requirements are described below.

(1) Overview. Missions may submit an overview of their plans for meeting the Agency's privatization objective in the 1987/1988 budget submissions due in June 1986. The overview should contain (a) your current privatization activities; and (b) your strategy and schedule to achieve the privatization objectives. Annex L of the ABS has been reserved for the overview. (Submission of an overview is optional.)

(2) Short-term. Missions are requested to submit detailed privatization plans in an amended Annex L by July 1. These plans should identify (a) short- and long-term targets of opportunity for privatization; (b) the Mission's proposed strategy for addressing privatization; and (c) a projected timeframe for achieving the goals of the privatization plan.

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Missions may also wish to take this opportunity to develop their medium- or long-range privatization strategies. An essential first step towards framing a privatization program and determining priority actions would be to assess and lay out an overview of the relative role and influence of private and public sector institutions and organizations in individual countries. Some of the considerations listed in section 9 of this guidance would be important elements in these plans.

(3) Long-term. Following submission of the initial privatization plan in the 1988 ABSs, Missions are required to integrate their privatization plans into the regular reporting system for ABSs, CDSSs, and Action Plans.

4. Techniques for privatization.

A. Primary techniques for privatization. The successful privatization process, which depends upon the country strategy for privatization and the reasons privatization is being undertaken, involves selection and implementation of an appropriate privatization technique. Privatization can take a range of forms, some of which involve change of ownership status and transfer of decision-making authority from the public to the private sector (complete and partial divestiture) while others entail only the transfer of decision-making authority (contracting out and partial privatization). The major techniques for privatization, for the purpose of complying with this PD, may be classified as:

(1) complete divestiture - in which an SOE is (a) sold, operationally intact, to a private sector entity (such as another firm, individual investors, the firm's own managers or workers, or the general public through a stock offering or auction); or (b) operationally terminated and liquidated, with its business operations halted and its assets sold off piecemeal. Complete divestiture is the preferred Agency approach to privatization of SOEs.

Liquidation should be considered as a positive form of privatization as it (a) relieves the recurrent cost burden of an unproductive asset on the host country budget; (b) ends the need for special subsidies or incentives for noncompetitive SOEs; and (c) contributes to a greater market allocation of resources.

(2) partial divestiture - in which (a) the host government enters into a joint venture with private investors (with the government retaining only a minority equity position that allows actual control to pass to private hands and the enterprise to operate as a private entity); or (b) responsibilities of the SOE are separated into purely public functions, which are maintained by or absorbed into the Government (such as setting quality control standards for agricultural products), and functions that can be carried out by the private sector, which are turned over (or "spun off") to the private sector (such as the sale of agricultural inputs that currently may be under the control of a ministry or government-owned or -controlled marketing board).

(3) contracting out of service delivery - in which the responsibility to provide certain public services (and, in some cases, ownership of the assets) is retained by the host government, but the implementation of certain functions (typically operation and maintenance of facilities and equipment) is delivered by private entities through such mechanisms as service contracting, franchise agreements, or lease, or reliance upon such instruments as a voucher system or regulatory and tax incentives.

(4) partial privatization - in which the Mission encourages reduction of the public sector role through privatization of (a) different activities in the SOE such as management (by hiring a private company to conduct management - e.g., in the U.S., many public hospitals have contracted out management to a private company), production (by contracting output and services), and finances (by requiring users to pay the real (unsubsidized) costs associated with provision of the product or service that they receive); or (b) entire subsidiaries of vertically integrated firms (such as fertilizer importation and retail distribution). Partial privatization should be viewed as a short-term or interim approach, and should be utilized as part of a longer-term process leading to complete divestiture within the life of the same particular privatization project or activity.

A variety of factors in the host country influence the country's privatization strategy as well as the privatization techniques chosen. These factors include the: (1) purpose for undertaking privatization;

(2) business climate; (3) commercial viability of public enterprises; (4) availability of capital (locally or internationally); (5) availability of local managerial and technical talent; (6) side effects (such as displaced labor); and (7) sociopolitical environment of the country.

B. Other options. Missions are encouraged to be innovative and realistic in developing their privatization projects. In those instances where the host government has stated that it is unwilling to divest SOEs to the private sector or transfer functions to the private sector, there are still options available to Missions to comply with this PD. One option is to encourage direct competition to the SOE by private firms by deregulation of markets. Another is to seek to change the policy environment to allow for competition by persuading the host government to (1) eliminate all market entry and protectionist barriers, subsidies, and other measures that reduce competition; (2) reduce government monopolies; and (3) force its SOEs to operate more like private entities in a free and competitive market environment.

Where there is no permitted private sector alternative and the SOE or parastatal is not likely to perform competitively or to be privatized, the Mission should seek to remove itself from those sectors of the economy in which such functions are non-competitive and exclusively public. They should shift to other sectors of the economy where A.I.D. may more effectively operate.

5. Policy conditions important for privatization. Commitment to privatization, in any form, must be accompanied by the adoption of a policy environment that allows for competition and the operation of market forces in the sector in which the enterprise exists or an activity is performed. Economic activity must be open to competitive market forces (with no laws, regulations, or subsidies which would deter competition with what was the SOE). Governments must be made aware that if industries are protected from market forces, little will be gained from privatization.

Policy reform is essential for the success of all techniques of privatization. The policy conditions needed for privatization to be successful include (but are not limited to) market-based prices (and the concomitant removal of price controls); low, common tariff levels; prompt and fair enforcement of contracts; equal application of controls (in those cases where elimination of these

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factors is not feasible); equal access by all to credit and to foreign exchange (where exchange market manipulation is practiced); the elimination of protectionism; market-based interest rates; reform of employment or labor codes; and elimination of any other policies that would inhibit the emergence of lower-cost and, therefore, more efficient competitors. Reform of the legal framework, investment code, licensing procedure, and tax code are also critical to the success of privatization.

For example, for Employee Stock Ownership Plans (ESOPs) to be a useful divestiture tool, it is generally necessary to change a country's tax code. Changes in the legislative or administrative laws of a country may be needed to provide incentives for the firm's current owners to distribute stock shares to their workers and for the employees to purchase the stock. (ESOPs are encouraged as a method of transferring parastatals to private ownership in section V.F. of A.I.D.'s revised Private Enterprise Development Policy Paper.)

6. Divestiture and ownership issues. Private ownership and control of a firm are critical issues in privatization of SOEs. In some instances, it is possible for control of an enterprise to be transferred to the private sector without the transfer of ownership. These instances, in which ownership and control are divisible, through establishment of management contracts, should be viewed as short-term or interim approaches, and should be utilized as part of a longer-term process leading to complete divestiture. In that interim, the management of the SOE should be expected to exercise the same type of authority as the management of a privately-held firm. However, it is preferable for ownership and control to be transferred together whenever possible.

The new owners of a former state entity, and the managers employed by them, must have the right or freedom to undertake actions they deem important to respond to competitive conditions in a timely manner, including restructuring of the firm, altering the firm's product and its price, changing lines of activity, using subcontractors, and expanding some activities while closing down others. Other areas in which the owners should not be restrained are employment and compensation decisions, sourcing, production engineering, cost structure, financing, investment, and innovation. Such flexibility comes with private sector ownership and control. It is rare under public ownership.

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Preference for simultaneous transfer of both ownership and control is based on other considerations as well, including: (1) the tendency, where ownership remains with the public sector, or when clear title is ill-defined, for property assets to be undervalued by the private sector; (2) the possibility that the motivations of the firm's owners (the state) may still be more socially-oriented than profit-oriented and that this may lead to less efficient allocation of resources; and (3) the fact that public ownership might affect or distort the judgments made by the firm's managers on such critical issues as assessing political risk.

A critical issue associated with divestiture in LDCs is who is allowed to buy the SOEs. For a variety of political and social reasons many LDCs exclude certain groups from purchasing SOEs (especially foreign businesses, multinational corporations, and some local entrepreneurs of certain minority or ethnic groups). These people are often excluded by the political process, explicitly or implicitly, from the purchase of state enterprises. This issue is largely irrelevant in industrial countries, where the major issues are building a constituency for privatization and utilizing the appropriate sale mechanism.

There is some concern that these foreign-owned enterprises or local individuals or firms (who may already own or control a large share of the LDC's economy) will, in fact, purchase the parastatals and increase their control of the LDC economy. Their predominant role in the LDC economy and potential participation in the privatization process is, in the view of some LDCs, contrary to public policy.

Missions should encourage LDC governments to accept all potential buyers into the privatization process and not exclude any potential buyers on the basis of race, nationality, or economic position.

7. Private delivery of services. The conventional approach to providing many services is for government to collect the revenues needed to support the service and to deliver the service as well. The implicit premise in this view is that local public services are all "public goods" (i.e., goods or services that can only be produced and paid for collectively). Yet, most local public services have few attributes of true public goods. Most of them (including garbage collection, transit, and aspects of police and fire protection) have specific, identifiable users, who are the services' principal beneficiaries. To

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the extent that discrete beneficiaries or users can be identified, these services are viable targets for privatization. Moreover, even for services that are closer to being pure public goods, it is not at all clear that government must be the deliverer of the service.

Many national, state, and municipal governments are discovering that public services do not necessarily have to be delivered by government or paid for by taxes. Many studies have found that the services provided via privatization are generally produced more cost-effectively than services provided by tax-funded local monopolies. Privatization of public services offers governments a way to decrease the cost and improve the quality of services.

8. <u>A.I.D. instruments and resources for implementing privatizations</u>. Missions should encourage, where possible, the private sector (indigenous and other) to undertake the entire range of activities related to privatization without A.I.D. assistance. In those instances where that is not possible, A.I.D. has a variety of instruments available for privatization. These instruments are technical assistance that prepares an SOE for divestiture or assists a public organization in achieving private delivery of its services, and financial assistance in the form of loans and grants.

A. <u>Technical assistance</u>. Preparing a country privatization strategy (and, therefore, preparing SOEs for divestiture and public organizations to privatize their services) is a complex task. Therefore, the technical assistance needs associated with privatization may cover a wide range of topics. Some of these include: (1) sector- or industry-specific analyses, including financial, agricultural, industrial, transport, service industries, etc; (2) enterprise-specific analyses, including organization, production processes, finance, audit, marketing, personnel, restructuring, etc; (3) policy/legal/regulatory analyses; (4) project design, implementation, and evaluation related to privatization; or (5) determining the appropriate brokerage mechanism for the sale of SOEs.

B. <u>Financial assistance</u>. A great deal of risk and expense are involved in financing privatizations, and Missions should proceed with care. A.I.D.'s financial assistance for privatization is limited to loan and grant activities (as described below). Consistent with A.I.D.'s revised Private Enterprise Development Policy Paper and the Foreign Assistance Act, A.I.D. will not take an equity position in a private enterprise.

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Missions should encourage the private sector to undertake the entire privatization financing package without A.I.D. assistance. If a Mission decides to participate in providing loan funds for privatizations, it should: (1) maximize its catalytic role in stimulating private capital by minimizing the percentage of loan funds it contributes to financing the privatization; and (2) direct the bulk of its capital assistance towards assisting the private sector purchaser, as opposed to the government seller, in the transaction. A.I.D.'s involvement in this type of privatization financing should be designed to maximize private sector participation in this activity.

There may be instances when some grant assistance could be provided to a buyer to cushion a burdensome covenant imposed upon him by the seller for political purposes (such as a requirement to continue all current employees for a limited time). As execution of the covenant may be considered a grant from the buyer to the seller, an off-setting A.I.D. grant to the purchaser may be appropriate. In such instances, A.I.D. should first encourage the seller to accept a lower sale price as a condition for acceptance of the covenant and only as a last resort provide a one-time, directed grant to the purchaser. (For example, if the purchaser must provide job retraining to X number of employees as a condition of the sale, and the privatization depends upon the acceptance of that requirement, A.I.D. may consider providing the funds for the training.) Missions should investigate such cases as they arise and identify these issues when they submit their privatization activities to AID/W for approval. Missions should not develop a broad-based project that provides for grant assistance in anticipation of instances such as those described above. The availability of such funds may distort market forces and private sector decisions in privatization.

C. Resources for privatization. Sources of technical assistance is found in the Annex to this PD. Resources additional to OYB levels will not be made available for privatization. We recognize, therefore, that some Missions will have to adjust or amend existing priorities and programs to meet the new Agency privatization objective. (This should not present an obstacle to Missions that have already initiated privatization efforts.) It is assumed that Missions will make funds available to support privatization from all appropriate accounts.

9. Conclusion. All too often governments have tended to see divestment as a simple process of announcing a willingness to sell and finding a suitable buyer at the price the government was willing to accept. One of the more difficult tasks facing Missions will be to convince governments that privatization is not a process in which only one side sets the terms, and it may be a long, slow and often frustrating activity.

In formulating and implementing privatization plans and activities, Missions should be aware of the following considerations:

- The process of privatization is essentially political although economic forces may prompt it. Prior understanding of the local political situation, the power bases, and the sources of influence must be achieved before explicit proposals for privatization are laid before the government. Missions should develop a conceptual dialogue with the host government, be understanding of the political risks the host government will be taking on when it embarks upon privatization, and be able to suggest ways of mitigating these risks.

- Privatization plans are more likely to be seriously considered by political decision makers if they contain a variety of options rather than a single course of action.

- Before embarking on privatization a government must have a clear idea of its objectives for the program and why it is being undertaken. Countries may engage in privatization for a variety of reasons, such as to generate immediate cash income, immediate foreign exchange, or future cash income; settle foreign debt; encourage industrial development; encourage foreign investment; improve or create efficiency of operations; develop capital markets; or pursue a free market philosophy.

- Governments tend to be most sensitive to the fiscal and employment aspects of privatization. It becomes important, therefore, to design options which will reduce the subsidy burden without seriously undermining current levels of employment.

- Any strategy for privatization must take into account the groups whose interests may be harmed if divestment is successful. These may include labor groups and current managers of the firm, bureaucrats whose positions and power may be eliminated, political groups that favor public enterprises, local private enterprises that will suffer competition if the sale is to non-nationals, and enterprises which are protected from competition through their relationship with the public institution. A divestment program must include strategies to deal with these opposing groups.

ANNEX

AID/W offers a variety of services to provide USAIDs with the technical assistance and information needed for achieving successful privatizations. These include privatization services available in PPC, PRE, S&T, and Africa bureaus, as discussed below; the briefing book and background papers prepared for the International Conference on Privatization, which have been pouched to all Missions; and the report on the conference, which will be made available to Missions later this year.

A. Agency-wide Resources - PPC. In addition to providing policy guidance on privatization and working with PRE, PPC offers a variety of independent assistance to Missions in their efforts to assist with country divestment and privatization plans. PPC has available a privatization specialist who will respond to requests from Missions for advice on proposed privatization projects. He will apply the experience of other countries to the specific problems faced by the requesting Mission. Missions in Honduras, Indonesia, Jamaica, Mauritania, the Philippines, R/DOC, and Thailand are among those that have received assistance. PPC assistance was discussed in 1985 STATE 224591. For additional information, please contact L. Gray Cowan, PPC/PDPR.

PPC also has several studies on privatization and divestment available for distribution to Missions upon request. These include "Divestment and Privatization of the Public Sector, Case Studies of Five Countries" L. Gray Cowan (December 1983), "The Private Provision of Public Services and Infrastructure" by Steven H. Hanke (May 1984), and "Privatization of Municipal Services in Sub-Saharan Africa" by Dr. Ian Marceau (October 1985).

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Shorter studies are also available to Missions on specific aspects of the privatization and rationalization process such as management contracting, business analysis, problems faced by LDC governments in privatization planning and the contract plan, as well as case studies of individual country plans (such as Tunisia, Malaysia, Thailand, and the Philippines).

PPC is having prepared a technical assessment on privatization and divestment techniques which will be completed later this year.

B. Agency-wide Resources - PRE. PRE is currently contracting for assistance to Missions in policy dialogue with host governments, strategy development for divestiture and privatization, and technical assistance for the beginning stages of privatizing specific organizations. The PRE contract with Analysis Group, Inc. and its Center for Privatization will provide assistance over a two year period primarily through short-term consultancies in a wide range of specialties. This contract is discussed in 1985 STATE 386291. For additional information, please contact Paul Haire, PRE/PPR.

That PRE contract is designed to provide assistance in developing and implementing strategies and projects for the divestiture and privatization of state-controlled enterprises. This assistance may include sector or industry specific analyses in the agricultural, industrial, and financial sectors or in service industries. Enterprise specific analyses including organization, production processes, finance, audit, marketing, personnel, and restructuring may also be provided, as can general analyses of the policy, legal or regulatory environment. Help with policy dialogue on utilizing private sector alternatives to state ownership and strategy development for divestiture and privatization plans can be supplied.

PRE will also manage the Agency's Privatization Fund, which is currently being developed. Additional information on the Fund will be made available when its operating guidelines are established.

C. Agency-wide Resources - S&T. S&T has available a variety of technical resources that can be used to assist Missions in developing different aspects of their privatization plans. A few of these are summarized below. Please contact Mike Farbman, S&T/RD/EED, for additional information.

The Employment and Enterprise Policy Analysis project (Harvard, Michigan State Univ. and Development Alternatives, Inc., contractors) has a buy-in provision under which short- and long-term TA is available to analyze sectoral and macro-policies that may affect privatization efforts.

An S&T/RD cooperator, the Industry Council for Development, has substantial experience working with USAIDs in designing action plans, assisting in political and interest group consensus-building, and assisting directly the process of privatization/commercialization of LDC seed industries.

S&T/RD supports RSSAs and PASAs with the U.S. Department of Labor (DOL) through which assistance in analyzing labor markets and/or strengthening labor market institutions may be obtained. The array of labor redundancy, ESOP, retraining, and similar employment issues that accompany some privatization efforts may be addressed through DOL assistance.

The Local Revenue Administration Project (LRAP) has supported national tax reform programs aimed at improving the environment for the private sector in several countries over the past four years. It has a buy-in mechanism under which Mission funds can be used to support tax reform programs and carry out applied research through September 1987. (Please contact Ken Kornher, S&T/RD, for more information on this project.)

A new FY 1987 activity will provide mission support and applied research in government reforms to foster private sector development. S&T/RD is especially interested in working with missions on feasibility and implementation of "contracting out" of construction, maintenance, or other public services to increase the role of the private sector and improve economic efficiency. Pending an FY 87 RFP, S&T/RD can accommodate some mission-funded TA requirements under an existing project (Performance Management).

D. Additional Resources for Africa Missions. In addition to accessing agency-wide sources of assistance, Missions in Africa have available several sources to obtain technical and financial support for privatization. A major source for East Africa Missions is the IQC set up in 1985 by REDSO/East with a group of companies led by Coopers and Lybrand in Nairobi. Others in the IQC group are Morgan Grenfell Bank, Arthur D. Little, and Technoserve. There

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is a very limited amount of funding in this IQC so Missions will need to utilize their own funding.

In addition, the Africa Bureau Private Enterprise Fund, managed by AFR/PRE, can provide limited funding for short-term business consultant services. Consultants are obtained through existing umbrella contracts with two consulting firms (one of which, Equator Bank, offers specialized banking services) should they be required. This same contract also has a buy-in provision which allows Missions to acquire services using their own funding.

E. Private Sector Resources. Although Missions are encouraged to avail themselves of the privatization services offered by AID/W, there are myriad resources available for privatization in the U.S. and LDC private sector. Many management consulting firms, accounting firms, investment banking firms, and other private enterprises offer assistance in the various aspects of privatization. These firms maintain specialists in the areas noted in Section 8A of the PD. Business, trade, and membership organizations are also sources of information. Missions should utilize these resources as well.

M. Peter McPherson

June 16, 1986
Date

PRIVATIZATION IN THE AGRICULTURAL AND AGRIBUSINESS SECTORS

Dr. I.W. Marcean
Presentation to the USAID Privatization Conference
February, 1986

INTRODUCTION

The most frequently recognized interventions by government in the agricultural economies of developing countries are the operations of marketing boards through which States attempt to exert monopoly control over production, pricing and marketing of agricultural products, especially food staples. These organizations have been dealt with in a companion paper by this author. There are many other, less wellknown interventions which occur, carried out by statal or parastatal organizations implementing governmental policies through legal coercion.

In most developing countries, the heavy hand of government is found in the markets for agricultural production inputs such as seed, fertilizer, chemicals, farm equipment, fuel, irrigation water and land. Services such as extension and research and development (to the limited extent that they exist) are much more often than not the province of governmental ministries or parastatals. Provision and operation of infrastructure -- the transportation, water supply, product storage and communications systems critical to effective agricultural economies -- are almost exclusively by governments, and in most LDCs, are heavily tilted toward urban interests at the expense of the rural sector. The importa tion of production inputs from more developed nations is often hampered by shortages of foreign exchange, resulting from external factors in export markets for agricultural and mineral products and worsened by the general incompetence of those who "manage" the parastatals controlling export enterprises in many countries. Government-dictated currency exchange policies result in over-valued currencies which discriminate against export products in international markets while multiple exchange rates and tariffs, applied selectively by governments seeking to protect infant industries and to foster import substitution discriminate against rural interest in favor of urban areas where there is the need to create employment and to bestow favors to buy-off potential political opposition.

The parastatal organizations have, in most developing nations, access to financial resources at very low (or no) cost. They borrow with government guarantees, which lower their risk to investors and give them an advantage over the private sector in gaining access to domestic credit. They are usually free from public or private scrutiny in their operations, rarely being required to account for the expenditure of funds or to disclose losses. Profits are usually required to be returned to the Treasury, but this is a rare event. Being, as are the marketing boards, labour sinks, providers of sinecures to relatives, friends and political cronies of ruling elites and sources of enrichment for corrupt politicians and bureaucrats, the parastatals are not designed to operate as efficient economic entities with a motivation to make profits. Rather, they are political entities used by governments, through their regulatory powers, to reward political support and to punish opposition. Their regulatory powers provide opportunities for the seeking of special benefits and favours by the politically influential. The small farmers, the key to effective economic development in countries where agriculture is the engine that, properly fueled, would drive that development, are not among the politically potent.

The outcome of the selective use of the privilege and regulatory powers of the parastatals is that special interests important to the government benefit. Agro-industrial interests, urban-oriented and protected by tariffs and exchange-rate inflation, get low-cost agricultural products as raw materials as a result of low prices paid to farmers by marketing boards. Employers in industry and government get low-cost urban labour paid in large part by cheap food procured from the farmers. Governments get tax receipts extracted from farmers in the form of the low prices, to transfer to development projects benefitting urban interests. Bureaucrats and politicians get wealth and power by dispensing privilege. The small farmers, the drivers of the development engine, get very little incentive to produce marketable surpluses and, practicing normal risk-aversion, retreat into subsistence and barter. Where the withdrawal is not complete, the small farmer enters the informal (illegal) economy, relying for inputs and sale of products on the private traders that operate, usually with impunity, parallel to and in competition with the parastatals.

The involvement of these inefficient enterprises in the agricultural and agribusiness sector markets for inputs, capital and products of course results in price distortions and misallocation of resources and contributes to economic inefficiency. Therefore, from an economic viewpoint, the parastatals are harmful and should, in the opinion of some, be abolished forthwith, to be replaced by private sector activities.

However, because they contibute to maintain governments in power, the parastatals often contribute to stability in inherently unstable areas. They are therefore politically effective and have been and are likely to be retained by governments acting in their own self-interest, regardless of their economic inefficiency.

International donor organizations therefore are faced with the problem of how to improve the effectiveness of development assistance in the face of the parastatals' continued existence, at least in the short-term. The problem becomes one of improving the economic efficiency of the recipient governments' policies while recognizing that these policies will continue to be implemented through parastatal organizations.

THE DIMENSIONS OF THE PROBLEM

In many developing nations, the parastatals number in the hundreds. In those countries in which agriculture and agribusines are significant contributors to GNP, many of the parastatals are concentrated in those sectors. Although the data on parastatal involvement by sectors in developing countries are poor and there are no reliable quantitative data on the amounts of investment by public and private enterprises in agriculture or agribusiness, the scope of parastatal involvement is illustrated by the following:

o In a 1983 World Bank report on state-owned enterprises (SOEs), Mary Shirley reported that in the early 1980's, the non-financial SOE share of total domestic credit in developing countries ranged from a low of 7.2 percent in Jamaica to 91.5 percent in Indonesia. These statal and parastatal organizations (including agricultural and agribusiness enterprises) were responsible for more than 25 percent of domestic credit in (then) Upper Volta, Ivory Coast, Niger, Somalia, Mali, Senegal, Bangladesh, Bolivia, Gambia, Benin, Burma, Guinea and Indonesia. Fifty percent of 1980 government tax revenues in Brazil were transferred to state-owned enterprises, while between 1976 and 1980 the government of Peru assumed foreign debts incurred by SOEs in an amount totalling 31 percent of the total foreign public debt of that nation in 1980.

o In a 1981 World Bank report on Sub-Saharan Africa, Elliot Berg and others examined the procurement and distribution of agricultural production inputs in 39 countries of the Sub-Saharan region. They reported that:

  -- With respect to fertilizer supply, in only four countries, Kenya, Zimbabwe, Swaziland and Mauritius was there private sector supply. In nine countries, there existed mixed private-public supply. In the remaining 26 countries, fertilizers were procured and distributed by the public sector.

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-- The same pattern applied to seed supply, chemical supply and farm equipment supply.

Since in almost all countries of the region these agricultural inputs are imported, it is obvious that the roles of the state enterprises in most nations are pervasive throughout the factor markets from the national arena down to the individual farmer. When combined with the marketing parastatals, it becomes evident that the involvement of government is pervasive throughout the agricultural and agribusiness sectors.

It is noteworthy that while most nations of the Sub-Saharan region experienced decreases in per capita agricultural production during the period 1963-71 to 1977-79, increases were achieved in Kenya, Swaziland and Mauritius, three of the countries where the private sector dominates the procurement and distribution of agricultural inputs.

ISSUES IN PRIVATIZING THE AGRICULTURAL AND AGRIBUSINESS SECTORS

In addition to the involvement in these sectors by the marketing boards, discussed in a companion paper by this author, governments intervene using statal and parastatal enterprises in all facets of the agricultural industries of developing countries. The issues for consideration in privatization of the agricultural and agribusiness sectors are as follows.

Production Inputs

Involvement in the procurement and distribution of physical inputs, seeds, fertilizer, chemicals and equipment by state enterprises is pervasive. The argument made by the proponents of this situation are that in developing countries with poor infrastructure and means of delivery, limited resources and scarce foreign exchange, it is necessary for effective delivery of inputs to those producers most important to the economy that centralized coordination be undertaken.

The question that arises concerns the relative efficacy of private or centralized governmental procurement and distribution in stimulating agricultural output in developing nations. The fact that the Sub-Saharan nations in which the private sector is ascendent increased their per capita agricultural output while those with extensive governmental involvement experienced per capita decreases strongly suggests that the proponents of centralism are incorrect. Experience in recent years in fertilizer distribution by private traders in Bangladesh provides further evidence that private sector handling of production inputs can be undertaken successfully in developing countries.

The issues to be dealt with in privatizing procurement and distribution of production inputs are:

- o methods of devolving to private traders the monopoly powers of the parastatals;
- o mechanisms for facilitating access of traders to the capital needed to finance procurement and marketing of inputs. Of particular importance is access to foreign exchange at real exchange rates;
- o the role of government in providing the transportation and communications infrastructure necessary to facilitate access of traders to rural market centres;
- o the proper role of government in facilitating availability of credit enabling farmers to buy production inputs and non-subsidized market prices.

Capital Resources

The available data show that in many developing countries the statal and parastatal enterprises, having access to cheap (or free) capital and enhanced borrowing power due to governmental loan guarantees, consume a large proportion of the domestic and foreign credit available.

Since access to capital by privte businesses and their farmer customers is crucial to privatization of the agribusiness and agricultural sectors, the key issues to be addressed are:

- o ways of decreasing the unfair advantage of the parastatals over private interests in credit markets;
- o removal of barriers, including artificial exchange rates, to the availability of the foreign exchange required by the private sector to purchase production inputs from abroad.

Land and Capital Investments

Given the availability through the private sector of the necessary inputs and financing, the remaining key to privatization of the agricultural and agribusiness sectors is the sanctity of property rights. Without the guarantee of long-term interest in the land required to farm and the capital goods needed by entrepreneurs to engage in business, privatization will fail.

Therefore, the issue here is the development of ways to guarantee the rights in property or in the use of property by the individual in the private sector. Thus the issue is that of guaranteeing either the right to ownership and reasonably unfettered use or the right of access to resources over the long-term for reasonable purposes.

Options for Privatizing the Agricultural and Agribusiness Sectors

The options available for privatizing these sectors are as follows.

- With respect to production inputs:

  -- devolution to the private sector of the present monopoly powers of the parastatals can be accomplished only by governments making policy decisions to do so. The case of Mali and the removal of the monopoly powers of the grain parastatal OPAM provides a model. The key to the donors group's success in inducing the government of Mali to change its policy to a free market stance was the provision of guaranteed financial assistance in buffering the privatization process. A similar approach of conditional inducement could be used for other parastatals.

  -- facilitation of access by the private sector to the financial capital required to fund procurement and distribution of agricultural inputs by agribusiness can be achieved by removing restrictions on the ownership of or access to the foreign currencies needed to purchase these inputs abroad, where necessary. Of importance here is the requirement that artificial exchange rates maintained by many countries be abolished.

  -- concerning the provision of infrastructure, especially transportation and communications, a recent survey of the situation in Sub-Saharan Africa by this author has shown that the likelihood of privatization of these services is extremely remote. Therefore, to facilitate privatization of other components of the agribusiness sector, the most feasible option is to use conditional aid to change the urban-tilted policies of most governments to ones which more equally share resources with rural regions.

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-- to provide farmers with access to credit adequate to enble them to purchase production inputs at market prices, the most attractive option is the establishment of rural credit programs, charging market interest rates and backed by governmental loan guarantees. To assist in the early stages, donors could consider concessional assistance to induce this policy change.

o With respect go capital resources:

-- to decrease the competitive advantage of the remaining parastatals in credit markets, they should be required to borrow at market interest rates and should not be protected from their own poor management by government loan guarantees.

-- the removal of barriers to private acquisition of foreign exchange has been discussed above.

o With respect to land and capital investments:

-- constitutional or at least statutory protections against expropriation of private property should be put in place and protected by appropriate judicial procedures;

-- where private ownership is not appropriate, statutory rights of usage of resources under leasehold or other legally enforceable forms should be established. This is common practice in the U.S. where forest land are often publicly owned but guaranteed private use has allowed a long-term forest products industry to develop.

ZIMBABWE

AGRICULTURE AND THE PRIVATE SECTOR

The USAID/Zimbabwe agricultural development program is directed to supporting Zimbabwe's efforts to increase agricultural production and incomes in the small-holder agricultural sub-sector. This sub-sector includes: small scale commercial farmers with title to their land and with up to 100 acres and small-scale farmers without title to their land and with access to small plots of five acres. The other agricultural sub-sector is the large scale commercial farmers with farm sizes of several thousand acres.

A striking aspect of Zimbabwe's agricultural sector is the strong network of agricultural institutions and infrastructure that serves agriculture. This network includes roads, agricultural training institutions, research facilities, marketing organizations, private firms, farmer organizations and a very commercially oriented farming community.

The Zimbabwe Agricultural Sector Assistance (ZASA) program is USAID's major agricultural activity. It was initiated in September 1982 for $45.0 million (an amendment to the program for $17.0 million is expected to be authorized in early 1986). The initial allocation of funds was split between a commodity import program (CIP) and technical assistance, training and equipment.

A total of $31.0 million has been allocated to the importation of equipment and supplies for the agricultural sector. Approximately 85 percent of these funds ($26.0 million) have been made available to private sector importers. It is expected that the imported goods will generate approximately Z$44.0 million. These local currency funds are jointly programmed by USAID and the Ministry of Finance to support the agricultural sector.

To date, funds have been used to finance three major activities: agricultural education (expanding the facilities at two agricultural colleges and the Faculty of Agriculture at the University of Zimbabwe), and the further development of irrigation and grain storage infrastructure.

USAID and the GOZ are interested in increasing the access of smallholder farmers to agricultural goods, information and services which will result in increased production and higher farm incomes. One of the options available to USAID and the GOZ is to make increasing use of private firms serving the farming community. To a certain extent this has already been accomplished through USAID's commodity import program and its agricultural sector assistance program. That is, foreign exchange allocations have been made available to dozens of private firms needing to import raw materials or equipment. There are, however, additional opportunities available to USAID and the GOZ to utilize further the skills and expertise of Zimbabwe's commercial firms.

Local currency funding has been made available to several firms and other activities are being reviewed for possible funding. The major criteria for funding assistance is to identify firms that are providing goods, services or information to smallholder farmers. Funding support has been given to:

- the Cotton Training Center (CTC) for dormitory construction and a scholarship fund. The CTC is managed and operated by the Commercial Cotton Grower's Association, a private commodity association. The CTC is now providing training courses to 2,400 people annually. Included in its curriculum is a three week cotton production course designed for the small-scale producer.

- the Farmers' Coop, a private cooperative whose members are large scale commercial farmers, is providing a six person team to work with 60 cooperatives (whose members are small-scale farmers) during the next year. The Farmers' Coop will help develop their business management and merchandising skills.

- the Murimi/Umilimi is a national farmer's magazine that is commercially produced and sold. Funds are being provided to the magazine to help it develop articles and editorial material that would be appropriate to the interests of small-scale farmers and to assist in the distribution of the magazine to these farmers.

- the Pig Industry Board, an association of private pig farmers, funds the costs of its own research station. ZASA funds are being provided to assist this station in conducting research on the use of animal wastes in agriculture.

Several new proposals utilizing commercial firms have been submitted for funding approval and are being reviewed by USAID and the Ministry of Finance, Economic Planning and Development. These include:

- the Commercial Farmers' Union is the private association of large scale commercial farmers and has a strong political/economic voice in Zimbabwe. On an informal basis CFU members, i.e., large scale commercial farmers, have provided year long training opportunities on their farms to agricultural college and university students. There has been a substantial expansion of the number of students studying agriculture at the nation's colleges and university. There is a requirement that each agricultural student spend one year on a commercial farm prior to graduation. It is felt that the program must now be "institutionalized" and the CFU has proposed the Farm Pupil Scheme with strong Ministry of Agriculture support. The program would provide agricultural students, as well as other young farmers, with a closely monitored training experience on large scale commercial farms. Additionally, the program would be managed directly by the Commercial Farmers Union.

- two local accounting/audit firms have been requested to develop short-courses in accounting and financial audit procedures for the staffs of various cooperatives.

- a training fund has been proposed to provide for short-term training opportunities in the U.S. for representatives of private sector agricultural firms and organizations. The program will be competitive (i.e., program will be advertised through the local newspapers) Priority will be given to firms that are actively serving the small-scale agricultural sector and/or firms that are seeking improved technologies that will assist in keeping Zimbabwe agriculture competitive.

- a local manufacturing firm, primarily manufacturers of irrigation equipment, have requested a "guarantee" of a two year allocation of foreign exchange for certain irrigation equipment from the U.S. With this assurance the firm will institute a private program of smallholder drip irrigation development. The firm will pay for the foreign exchange with Zimbabwe dollars which will be programmed for additional rural development activities.

To date these are some of the new private activities that have been approved for funding or have been submitted for a formal review prior to a decision regarding funding. These are all activities which are directly involving private sector firms/organizations in the agricultural development process.

There are additional agriculture sector activities which USAID is funding which benefit private firms or individuals in Zimbabwe. For example, loan funds have been made available to two financial intermediaries to loan to farmer cooperatives or individual farmers. These funds have been used to purchase input supplies that are manufactured and sold by local firms. Additionally all construction that USAID has funded (for example new classroom facilities) has been undertaken by private construction firms.

USAID believes there are further opportunities to those summarized above which could help support the services of private firms and organizations in our agricultural development program. In order to assist this process USAID contracted for a study of "Agriculture and the Private Sector". We requested: a list of private firms serving agriculture in Zimbabwe; a detailed description of those firms that view Zimbabwe's 900,000 small-scale farmers as an expanded market opportunity; and, in the latter case, the constraints and successes these firms were experiencing. The study identified 285 private firms that are directly serving the agricultural sector (and this does not include the 100's of retail outlets for agricultural products located throughout the country). Of these, 75 firms were described in terms of services they are already providing small-holder farmers. USAID will be using this study as a guide to enlarge support to the private companies that are providing credit, extension, training research and technology transfer to the emerging smallholder. This is an important emerging partnership and we have underpinned the process.

Eric N. Witt
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USAID/Zimbabwe
January 10, 1986

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AGRICULTURAL INPUT PRIVATIZATION

COUNTRY X

- A Composite Case Study -

This "case" is a composite with the facts drawn from actual situations in several African countries. The problems are real and representative and address a common privatization problem in Africa: how to support private sector entry into the agricultural input business to fill the gaps caused by parastatal withdrawal.

The case considers the almost seamless linkages between successful privatization policy dialogue in the agricultural sector and the follow-on actions required once a government has agreed to withdraw services, products and subsidies provided by agricultural parastatals. The government in such cases usually continues to look to the donor community for assistance in encouraging private sector entry to fill service and credit gaps left behind by parastatal withdrawal.

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BACKGROUND

USAID in Country X has led and strongly supported coordinated donor efforts to convince the Government to withdraw from financially and operationally bankrupt parastatal involvement in the supply, financing and subsidy of agricultural outputs and inputs: cereals marketing, fertilizer distribution, cereals seed multiplication and distribution, and agricultural and irrigation equipment supply and maintenance. The major agricultural parastatal now being dismantled had national responsibility for agricultural credits, physical distribution of fertilizer, seeds and equipment, and management of large irrigated agricultural projects.

The Government has officially announced its new agricultural privatization policies and has taken specific actions to implement a long range strategy of maximum but planned withdrawal from agricultural input operations in favor of local private sector operators. Parastatals are being closed down and consolidated, significant reductions are being made in their programs, budgets and staffing, and subsidies are being phased out.

The Government continues to maintain close policy dialogue with the donor community and is seeking advice and tangible support in encouraging active private sector entry to the vital agricultural sector. USAID's role in the country and within the donor community is important due to substantial food aid, major funding for fertilizer subsidies, and a long history of general support and cordial relationships.

PRIVATE SECTOR RESEARCH RESULTS

A key element in the Country X Mission's strategy is to provide substantial financial and technical assistance to ensure successful removal or rundown of the agricultural parastatals and their orderly replacement by the private sector. Results of substantial research on this problem carried out by Mission staff and consultants over a two year period are summarized below.

1. Consumption Of Fertilizers And Animal Traction Equipment Is Down Dramaticaly Following Parastatal Exit

   All-time historical lows are being recorded in purchase of fertilizers and agricultural equipment following withdrawal of the Government from agricultural supply and credit activities. Field reports show that farmers have no access to credit through formal channels following the withdrawal of parastatals from credit programs.

2. The Private Sector Could Readily Handle Fertilizer Procurement And Distribution On A National Basis

   The private sector in Country X has ample experience in procurement and financing of imported fertilizers. Country X also has equity ownership in a neighboring regional fertilizer plant capable of producing all types of quality NPK blends at world market prices and reasonable transportation costs. Fertilizer distribution poses few logistic problems. Several large private sector companies could easily "piggyback" fertilizers on their existing national transport and distribution systems.

   The private sector is not concerned about financing fertilizer inventories. More important are lack of consumer demand and mistrust of the government's intention to stay out of subsidized fertilizer supply.

3. The Private Sector Can Currently Meet Any Conceivable Demand For Agricultural Equipment

   A combination of artisanal shops, small factories and large importers can meet national demand for animal traction and mechanized equipment and irrigated water systems. Maintenance and spare parts services are available, including modern overhaul shops and extensive spare parts warehousing services.

   The private sector suppliers states that their main problem is lack of farmer demand resulting from a generally depressed farm economy, low farmer purchasing power and lack of farm credit.

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4. <u>Cereals Marketing Is Already Dominated By The Private Sector</u>

Purchase, storage, movement and resale of domestic and imported cereals are already dominated by the private sector. Competition is strong and operations are low cost. All indications are that profit margins are moderate.

5. <u>The Private Sector Is Reluctant To Enter The Cereals Seed Multiplication Business Without Offtake Guarantees</u>

The private sector is concerned about the lack of certified breeder seed stocks with proven field production track records. They also believe that market demand may not exist for more costly seeds due to lack of farmer purchasing power. Private sector companies, however, are already importing certain specialized seeds for sale to profitable vegetable and rice farming operators.

6. <u>Farm Credit Is Not Available From The Commercial Banking System</u>

All commercial banks interviewed -- both private and government controlled -- are unwilling to enter the agricultural credit markets. They cite a combination of liquidity problems and a historically low recovery rate as the primary reasons. They also are convinced that the interest rate limits placed on loans to the agricultural sector could only mean gradual erosion of their capital bases even with high loan recoveries.

7. <u>Agricultural Credit Responsibilities Of The Major Parastatals Are Being Transferred To The Government's National Development Bank</u>

The National Development Bank (NDB), which was created as a project finance institution, will absorb the agricultural credit operations of major agricultural parastatals which provided farm credit on a national basis. The NDB has had no previous small borrower experience and has no national branch banking network.

8. <u>Private Sector Sales Are Made On a "Cash-And-Carry" Basis</u>

Importers, wholesalers, large and small merchants and shopkeepers traditionally deal on a cash-and-carry basis. Equipment sales are normally made on a cash percentage down and full payment on delivery. There is little likelihood that these long-standing business practices will change.

9. **Farmers Place Fertilizers Low In Their Ranking Of Priority Needs**

Farm level surveys indicate a very low order of priority for fertilizers in the farmers' listing of priority needs, even though substantial quantities were sold when government credit and subsidies were available. Food, seeds, birth and marriage ceremonies, and small agricultural equipment take precedence. Farmers are not convinced -- at least for basic rain-fed cereal crops -- that fertilizers make a major difference in agricultural output.

10. **The Key Problem Emerging From The Research Is How To Address The Farm Level Credit Problem**

Physical distribution of agricultural inputs does not appear to be a major problems for the private sector. Their concern is focused on consumer demand. It appears that until such time as private sector agricultural input suppliers experience consumer demand -- that is, farmers willing and able to order and pay for inputs -they will remain on the sidelines. They will also have to be convinced that the Government will not suddenly jump back in to provide free subsidized inputs to farmers.

IMPLICATIONS FOR MISSION STRATEGY

The Mission now faces a private sector strategy development problem. While the primary focus is "privatization" it is obvious that any successful strategy which seeks to solve the privatization issue will also involve consideration of credit mechanisms.

Consultants and Mission staff involved in the background research have raised a number of other questions which appear to have relevance in considering most agricultural privatization programs.

1. Should donor privatization dialogue take into account -- before the fact -- how, when and by whom essential agricultural input gaps are to be filled?

2. How important is consultant and Mission assessment of the private sector's willingness and capability to fill these gaps?

3. Can rural farm credit programs work successfully through private sector commercial banks given the banking community's reluctance to lend to small farmers, an environment of regulated low interest rates, and a history of farm sector loan repayment problems?

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- Can private sector importers, wholesalers and retailers be expected to provide credit to farmers?

- Do private sector businessmen capable of providing agricultural inputs need formal credit sources to enter the market -- and expand their range of products and services?

4. Can rural credit programs be launched via private sector financial intermediaries in the absence of some form of government-donor supported financed, subsidized or guaranteed farm credit mechanisms?

5. Are there essential services being provided by agricultural parastatals which can only be provided at a loss or via subsidy?

investments have been profitable, e.g., PEW (coach building) United Transport of Malawi (bus company), and David Whitehead (textiles), but the profits of these firms were not adequate to compensate for the losses of other holdings, in particular two major investments in sugar mills.

ADMARC's financial problems were magnified when it was required by the GOM to bear the cost of acquiring, maintaining and storing strategic grain reserves, particularly when compounded by the generally poor performance of the investment portfolio, the declining prices of cotton and tobacco, price controls on ADMARC's domestic sales, and skyrocketing transportation costs on imported inputs and crop exports. Profits fell from 29 million MK in 1978, to 4.3 million MK in 1985, to a projected negative 26.0 million MK in 1986. The company now faces a severe liquidity crisis despite GOM efforts to bail it out.

AID'S Program

The AID program is divided into a $15 million cash grant element and a $500,000 grant for technical assistance and training to support the attainment of the program's objectives. The release of the initial $10 million is conditional on a minimum of MK 30 million of divestitures of ADMARC's equity share holdings. The funds will be disbursed at a ratio of $1.00 for MK 3.00 ($1.66) of divestiture as the sale of these assets to the private sector occurs. Six firms are targeted for immediate divestiture as discussed below.* The grant funds will help to provide urgently needed foreign exchange to the GOM who, in turn, will use local currency counterpart funds to purchasee the strategic grain reserve and silo storage complex from ADMARC.

There are two options, or a combination of the two, governing the release of the $5 million grant balance:

- Further divestiture of MK 15 million in equity holdings, or

- Development of a strategy for handling the remaining assets, for example, through the establishment of an independent holding company with buy-in provisions for private investors.

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*It is anticipated that these divestitures will be completed within one to four months of signing the Grant Agreement.

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PARASTATAL DIVESTITURE

AGRICULTURAL DEVELOPMENT AND MARKETING CORPORATION

(ADMARC)

USAID/MALAWI

Introduction

USAID/Malawi's ADMARC Divestiture Program was initiated in August 1986. The goal of this US $15.5 million African Economic Policy Reform Program (AEPRP) is to assist Malawi in its efforts to re-establish a stronger financial and institutional basis for sustained economic growth. The program focuses on the divestiture of ADMARC's investments in agroindustry, manufacturing, transportation and finance. The total value of ADMARC's equity share holdings in these firms is MK 46.6 million (US $25.9 million).*

Through this policy reform program, the GOM has agreed to a minimum of MK 30 million (US $16.7 million) in divestiture, which represents 64 percent of ADMARC's investment portfolio. The program also encourages the GOM to move toward the eventual divestiture of MK 45 million (US $25.0 million) or 97 percent of the holdings.

ADMARC

Founded as a for-profit government parastatal, ADMARC's primary responsibilities were to provide crop inputs to small holders, purchase crops offered to them and resell those crops at a profit both domestically and internationally. The parastatal has a legal monoploy for the purchase of tobacco and cotton, and a *de facto* monopoly for groundnuts and maize. In the early 1970's, the company was also given powers to invest in government and private companies through both loans and equity participation.

ADMARC performed its marketing functions very profitably, principally from the sale of tobacco, but its investments incurred substantial losses. It acquired a portfolio of medium-sized estates as a last resort buyer of undercapitalized ventures facing closure. ADMARC assumed the assets of these estates as well as their debt liabilities. Also, GOM policy encouraged ADMARC to participate in foreign owned companies so that those companies would not have substantial control of Malawi's economic activities. Some of these

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* Converted at Malawi Kwacha (MK) 1.8 = $1.00 US.

ADMARC is canvassing the other share holders in the six companies to ascertain their interest in purchasing its holdings. Because these are privately held companies, partners must be given the first option to purchase. Several of the share holders have expressed a willingness to exercise their option to buy. In some cases where the partners have declined, ADMARC has identified other potential international and domestic buyers and is proceeding with preliminary discussions.

In order to promote maximum private sector participation in the companies owned by ADMARC and to decrease their dependence on ADMARC's management and financial resources, AID has stipulated that any investment holding company or trust established to manage assets which remain after MK 30 million have been divested must embody sound business principles, attract private sector investors and rely on commercial sources of capital to meet its financial requirements. In a business and financial community dominated by only a few large international and domestic corporate enterprises, this may present several practical problems. To attract smaller investors, it has been suggested during the design of this program that the GOM and ADMARC explore the options for incorporating the holding company as a public limited one instead of private limited. There are already in Malawi a few public stock companies such as Southern Bottlers, the manufacturer of soft drinks. Although the Malawian Companies Act permits public stock companies, the absence of a formal market for share capital creates a potential problem of trading shares. The limited public share capital in existence in Malawi is bought and sold through commercial banks and corporate law firms.

One of the key objectives of this program is to assist in the development of a stronger basis for long-term investment in Malawi's economy. It is important this this foundation be developed further to increase the stability of the financial system, to attract additional investment resources and to establish a more broadly-based capital market. An effort will be made to incorporate these objectives into the capital market studies.

Other Special Issues

There was during the development of the PAAD and in recent technical reviews with the World Bank and IMF, one major policy concern on the part of the GOM and ADMARC which has been taken into account in the design of this program. Both the World Bank and USAID had suggested that the GOM agree in advance to the divestiture of all of ADMARC's assets and that, if any investment holding company were established that it be self-liquidating over time. The GOM, while acknowledging the principle of removing government and statutory bodies from direct management and involvement in manufacturing and industry, was unwilling to commit itself *a priori* to this for political and economic reasons. First, the GOM was concerned about the potential implications of increased foreign control and participation in the economy

The divestiture of assets and sale of the strategic grain reserve will allow ADMARC to repay its bank debts, freeing liquidity in the banking system. However, there is currently no mechanism for providing loans to Malawians interested in making equity investments in divested firms. Therefore, it is proposed that the GOM undertake a series of studies of the Malawi capital market and options to improve it. These studies will be financed from resources available in the $500,000 technical assistance component of this program. That grant will also be used, on a cost sharing basis with the World Bank, to recruit and pay for a "Divestiture and Restructuring Coordinator" who will coordinate the divestiture program and manage the remaining ADMARC portfolio. The Grant will also provide funds for short-term assistance and for training.

Status (September 1986)

The divestiture process is proceeding reasonably well. The GOM and ADMARC have designated six firms to be completely or partially divested. A list of the firms and proportions of shares to be sold to the private sector are listed in the Table below. ADMARC holds MK 31.5 million of shares in the six companies, of which the Corporation plans to sell off MK 24.1 million or 76.5 percent. Reduced interests will be retained in two of the six firms.

Planned Asset Divestiture of ADMARC's Equity Shares
(in millions of Malawi Kwacha)

Name of Firm	ADMARC Share Holdings		ADMARC Shares to be Divested		Balance	
	Value* MK	Percent	Value MK	Percent	Value MK	Percent
Dwangwa Sugar Corp. Ltd	10.7	38	10.7	38	0.0	0
Sugar Corp. of Mal. Ltd	9.3	49	5.5	29	3.8	20
Lever Brothers (Mal) Ltd	0.6	20	0.6	20	0.0	0
David Whitehead and Sons (Malawi) Ltd.	8.8	49	5.2	29	3.6	20
PEW Ltd.	0.7	87	0.7	87	0.0	0
United Transport (Malawi) Ltd.	1.4	35	1.4	35	0.0	0
TOTAL	31.5		24.1		7.4	

* Value as of March 31, 1985.

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without a parallel expansion in Malawian participation as a counter balance. Second, in the absence of a stronger and more diversified capital market, the GOM felt that there was a need for some form of investment company to promote and encourage investments in agriculture-related industries, but was unsure how much private interest could be attracted to support the development of these businesses. Nevertheless, the GOM has agreed that the private sector will be encouraged and is desirable. This represents a major shift away from Malawi's development strategy of the 1970's. One of the important tasks of the investment coordinator will be to identify ways in which greater participation of the private sector in agro-related industries can be actively fostered.

The World Bank's Proposed Reform Program Vis-a-Vis ADMARC

The ADMARC divestiture program complements those of the World Bank and the International Monetary Fund. AID's involvement will make a critical contribution to the World Bank effort to improve the agricultural marketing system.

The major objective of the World Bank's reform program is to reduce ADMARC's role in agricultural marketing to that of a buyer and seller of last resort. The Bank is considering funding this program in the amount of approximately $38.0 million ($8.0 million IDA credit) for approval on or about late-December 1986 or January 1987. The World Bank's proposed reform program is envisioned to address the three major elements discussed below:

A. Increased private sector participation in agricultural marketing. - Examples of activities that are being considered include: (1) public announcement by the GOM that the private sector is strongly encouragd to be involved more heavily in agricultural marketing; (2) adoption by the GOM of a system of differential pricing; (3) reduction in the number of ADMARC marketing outlets; and (4) provision of credit to enable the private sector to assume a heavier role in agricultural marketing.

B. Improvement of ADMARC's financial viability. - This requires a narrowing of the scope of ADMARC's activities as a means of addressing the financial crisis that it currently faces. In addition, measures will be recommended to improve ADMARC's management and operations, including reduction in the number of ADMARC's personnel.

C. Achievement of food security. The extent and nature of food insecurity in Malawi will be assessed, and recommendations will be made to address factors that affect the achievement of food security. The World Bank is further considering making a recommendation to the GOM to establish a Food Security Planning Unit to undertake the activities envisioned under this element of the reform program. The Unit will be staffed by 1 or 2 economists and several support staff.

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PROMOTING FOREIGN INVESTMENT

THE AFRICA PROJECT DEVELOPMENT FACILITY

In recent years, a growing number of African entrepreneurs with experience gained in trade, commerce or in the traditional small-scale sector have been willing to make the transition into the modern industrial sector. In 1986, the African Development Bank (ADB), the International Finance Corporation (IFC), and the United National Development Programme (UNDP) joined in an effort to assist African entrepreneurs in promoting viable medium sized businesses.

This joint effort has resulted in the establishment of the Africa Project Development Facility (APDF) to provide advisory services to private African entrepreneurs in the preparation of viable projects. While the Facility does not provide project financing, it works with the entrepreneurs to secure financing from banks and appropriate sources of capital. It also helps them in obtaining technical and managerial assistance needed to start up projects.

Objectives of APDF

The overall objective of the APDF is to accelerate the development of productive enterprises sponsored by private African entrepreneurs, as a means of generating self-sustained economic growth and productive employment in sub-Saharan Africa.

The Facility expects to assist in promoting projects ranging from agriculture through processing, distribution and transportation as well as manufacturing of agricultural equipment. The largest category, though, is expected to be agro-related projects.

The APDF supports projects with investment in the U.S. $0.5 to U.S. $5 million equivalent range, but considers smaller projects according to economic conditions in various countries.

Sponsors of APDF

The APDF has been established as a United Nation Development Programme project with IFC as executing agency and the African Development Bank as regional sponsor. In addition to the sponsoring agencies, twelve donor countries are contributing to the financing of the APDF, including Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, and the U.S.A.

Services of APDF

- assist African entrepreneurs in formulating and screening project ideas;
- provide guidance and selectively make technical and consultancy services available to African entrepreneurs to promote and implement sound project ideas;
- assist African entrepreneurs to identify and obtain appropriate technical and managerial personnel;
- assist African entrepreneurs to select project partners and sources of equity and loan finance on appropriate terms;
- advise foreign investors or financial institutions seeking to identify investment opportunities and/or local partners on sub-Saharan Africa by bringing the parties together and helping to negotiate fair and equitable terms of cooperation; and
- advise African entrepreneurs interested in acquiring local companies from foreign shareholders or acquiring parastatal enterprises which member countries wish to privatize.

Structure of APDF

The APDF staff consists of two teams of project development experts. The teams are headquartered respectively in Nairobi, to cover Eastern and Southern Africa, and in Abidjan, to cover Western and Central Africa. Each office is headed by a senior IFC officer with a staff of seven professionals. The APDF office locations enable the staff to take advantage of the IFC, IBRD and UNDP Representatives offices based in the same cities.

The staff has experience in development finance, commercial and merchant banking and is familiar with the requirements and policies of various multilateral and bilateral agencies. The staff has also relevant experience in the private sector and can work effectively with entrepreneurs in assisting them to prepare bankable projects and obtain financing.

The two teams are supervised and coordinated by an APDF coordinator seconded by IFC but based at headquarters in Washington. He also helps the APDF staff to benefit from IFC's expertise in private sector development in Africa.

The APDF staff is responsible for identifying and selecting short-term consultants to carry out feasibility, market and technical studies.

An Advisory Board reviews policies and provides guidance on activities. The Board members are from the private sector in Africa and from the participating donor countries and agencies. The Board meets yearly.

How APDF Works

The staff identified projects and proposals in the course of regular country visits. ADB, IFC, UNDP, local and regional development banks as well as other institutions active in the region also refer project proposal to the APDF. After initial assessment, the APDF staff selects projects which appear to have a significant economic impact and then works directly with the private sponsors.

The APDF agrees on a work program, budget and time schedule for the necessary project development work in cooperation with the African sponsors. The cost of project preparation work, including additional assistance from technical, marketing or other consultants and experts, is shared by the sponsor, the APDF, and funding available from other agencies.

The APDF staff follows the project development work closely and assists in defining the terms of reference for preparing the necessary feasibility report by independent consultants. Thereafter, the APDF staff assist the entrepreneur in presentation of projects and in negotiations with investment authorities, suppliers of equipment, contractors, financial institutions and potential technical partners.

The APDF can also assist in identifying and selecting professional staff and in helping to design management organization structure.

July 29, 1986

MEMORANDUM

TO: S&E DISTRIBUTION

FROM: AFR/PRE, H. I. Munson

SUBJECT: Termination of the Booker T. Washington Project

In an attached letter (Attachment I)*, Booker T. Washington Foundation's EVP, Charles Tate, notified OPIC that pursuant to BTWF-OPIC-AFR/PRE conversations -- "the pilot program originally contemplated in the grant agreement between BTWF and OPIC is terminated." Jerry West, OPIC VP - Development then advised me by letter (Attachment II) that "OPIC, and I assume A.I.D., concurs with BTW's letter and considers the project terminated."

Basically, the three parties involved in this project mutually agreed to terminate because an outside evaluation showed that; results at the project's 18 month mid-point were well below targets; as presently structured the project would yield at best, but not necessarily, two or three joint venture deals; and that the project could not produce significant results and should not be continued unless there were a major restructuring of the project and an infusion of substantially greater funding. Neither OPIC nor AFR/PRE considered such action feasible.

The evaluator believes that two or three potential projects now being worked on have some chance of proceeding to firm joint venture completion. OPIC is negotiating with BTW to have Joe Fisher, an OPIC employee, seconded to BTW several months ago as Washington office project head to continue those few joint venture possibilities for a time with OPIC paying his salary but making no overhead contribution of any kind to BTW. The outcome of those negotiations is not yet certain.

Although the Executive Summary (Attachment III) of the evaluation covers the multiple factors involved, I would like to emphasize here those particular factors that I consider most crucial to the decision to terminate the project. While

* Attachments cited in text not included with this paper.

certainly open to further examination, those factors at least give us a beginning for setting more realistic provisions in designing future projects aimed at stimulating foreign, especially U.S., investment in Africa. A quick review of the most critical factors is as follows:

Project Description

The BTW project, formally titled "The Minority and Small Enterprise Trade and Investment Project" was an OPIC project aimed primarily at promoting joint ventures between African and U.S. entrepreneurs, in particular small minority firms already included in BTW's "Network" that had performed quite well in doing subcontract work for DOD equipment suppliers. Although project business deals were not limited to "network" firms, it was postulated that they constituted a major BTW asset in reaching out to potential U.S. investors. Project financing was $1.6 million. OPIC provided $.6 million to fund the U.S. operations. A.I.D. provided $1 million to fund the West African operations.

The project established Washington and Abidjan offices with a project area anchorman in each location. The two were co-equals. A second professional assisted the Abidjan office head. BTW management assumed project management responsibility for directing daily operations of the project and the two offices. OPIC provided overall policy guidance and review of project progress. AID/AFR/PRE participated in quarterly progress reviews and in requesting support from African USAID's.

The BTW Abidjan office personnel were to identify joint venture business deals and investors in Liberia, Cameroon, Ivory Coast and Nigeria, send detailed venture information back to the D.C. office and provide technical assistance such as helping to secure financing, developing feasibility studies, and keeping business negotiations moving. Some months after project startup Senegal replaced Liberia as a target country because of political turmoil in the latter country. The D.C. office was to publicize the project within the U.S. by holding seminars and mailings and "signing up" interested, financially capable firms, particularly "network" firms as potential U.S. joint venture partners. The Washington office also was to provide technical services similar to those provided by the Abidjan office.

Project Mid-Point (18 month) - Achievement of Target Objectives

The chart, next page, shows that the project failed by a considerable margin to meet six of the seven measurable targets. However, many of the 31 investment opportunities identified versus the 28 targeted were backed by little investigation and information making 31 a highly questionable number. These disappointing results were caused by BTW organizational and management inadequacies, and at least equally, by project design inadequacies that OPIC, A.I.D. and BTW did not foresee during project design.

BTW Organization and Management Factors

Major points cited in the evaluation are:

- Initially during project startup, BTW management guidance and surveillance seemed adequate. However, there was too little hands on guidance as the project progressed. As a illustration, as the project developed both OPIC and AFR/PRE clearly and urgently consulted with BTW a number of times as it became increasingly obvious that achievement of project objectives was steadily and increasingly falling behind schedule. The evaluator states that it is not clear what management oversight BTW provided but that it was not extensive.

- The initial assumption that the minority firms currently listed in the domestic marketing system ("network") of BTW represent a prime market for joint venturing in Africa is not valid. In fact, BTW was not able to put the network together as it hoped, and those firms almost universally lack the management and financial depth needed to engage in joint ventures overseas.

- The corollary initial assumption that BTW's name, reputation, expertise and track record in small and medium-scale enterprise generation in the United States could be translated easily into a similar position with respect to enterprise generation in Africa accordingly has also not been borne out.

- OPIC and AFR/PRE as well as ~~A~~ BTW were responsible for selecting the Washington and Abidjan office heads. Although the evaluator found the selection reasonable,

EXHIBIT A

PROJECT OBJECTIVES AND MEASURABLE ACHIEVEMENTS

Indicator	Project Year			Cummulative Due By June 4, 1986	Actual June 4, 1986
	I	II	III	IV	V
1. U. S. Minority Business Firms in the Project Portfolio	50	100	150	75	10 max.[1]
2. Investment Opportunities Identified in Target Countries	15	50	100	28	31[2]
3. Prospective African Joint Venture Partners on the Project Portfolio	20	50	75	33	10 max.[1]
4. Detailed Venture Project Profiles Prepared	10	10	25	13	0
5. Investment Opportunities Matched to U. S. Firms and African Joint Venture Partners	3	15	30	12	4-8[3]
6. Clients/Deals Receiving Technical Assistance	25	50	50	38	2 max.
7. Qualified Business Deals Brought to the Agreement Stage, or Presented to OPIC, AID, EXIM, etc., or the Private Sector for Insurance, Financial, or Other Assistance	3	10	12	6	0-2 max.[4]

1 Even the 10 maximum is stretching the point. The type of detailed information required to move beyond identification to deal matching generally is not available for most of the firms in the portfolio credited here.

2 The investment opportunity statements credited here contain far less data than that specified in the BTW proposal of 14 July, 1983 (see page 19).

3 Based on initial year's work plan for definition of match.

4 Of the two deals that may be considered to have gone to stage 7, one was abandoned and one is on hold.

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given facts available at the time, both men later experienced personnel problems. The initial Washington anchorman was overqualified having sound experience in international government lending, and too little experience in lending to small businesses. He was also afflicted by personal problems. Further, he did not mesh well with the Abidjan project anchorman who, a promoter and dealer to the core, proved unable to put together project profiles and other information needed to seriously approach potential U.S. investors. Both men were replaced after the project was slightly more than a year underway.

Project Design Factors

OPIC and AFR/PRE did not foresee clearly during project design some of the findings that the evaluation states should be factored into design to give such a project a reasonable chance of success, particularly in a high risk investment climate area. The major factors and considerations presented by the evaluation are:

- Because of generally weak investment climates it is not easy to identify potential business ventures and validate them. Nonetheless, there are some. However, project identification is easier than persuading U.S. investors to put money into what they consider a very high risk situation. For the same reason, local investors are equally reticent about investing medium and long-term capital.

- The project was under-funded on two counts. First, it should have been provided with its own investment funds which it could invest directly as seed money in selected projects to attract equity capital contributions from other investors. Second, the project needed more "communications" funds, that is money for travel, phone conversations, telex messages, entertainment and the like. Identifying business ventures, "selling" them to investors and negotiating final deals and financing require a lot of talk and dinners.

- Promotional projects like this should include an incentive compensation system to motivate promoter personnel. A modest base salary would keep the

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promoter going but the real monetary reward would be a large bonus paid when a business deal is brokered to completion and investors lay down equity money. Preferably, the firm selected to run the project would have sufficient investment money to take an equity stake in some ventures.

- Even with the best project design and management 18 months is too short a time to identify, develop, negotiate, finance and get joint ventures on-stream in Africa's tough investment climate situation. More time is needed to fully establish project results. Also more time than 18 months is necessary before an evaluation is made or, as in this BTW case, project personnel will too soon start looking for follow-on employment rather than concentrating on identifying and brokering business deals.

Conclusions/ Recommendations

The evaluation concluded that the BTW project should not go forward and should be terminated unless the project could be restructured and given a substantial increase in funding. The evaluator stated that unless those actions were taken there was no real basis or assurance that even the few prospective deals now being worked on would result in a favorable conclusion. Neither OPIC nor AFR/PRE could accept those conditions.

Actions to Fully Terminate the Project

I have already notified DP of project termination (Attachment IV). We are also submitting a TN to DP by Wednesday 30 July. In addition, I will write to Jerry West concurring with his decision to terminate OPIC funding for the project as currently structured. OPIC personnel at all times worked very well and very closely with AFR/PRE as, I believe, we did with OPIC. I will express those sentiments also. Finally, although there were some differences with BTW during project operations, Charles Tate was a very thoughtful participant in assessing results and recommendations of the evaluation, and in arriving at a mutual understanding with AFR/PRE and OPIC to amicably and regretfully end project work. I will send a personal note to Charles.

Future Africa Bureau Promotion of Investment in Africa

In the immediate future, the Bureau - AFR/PRE should concentrate on keeping in close touch with the two following investment promotion organizations.

IFC's Africa Project Development Facility (APDF). The Africa Bureau has made a major financial contribution to the APDF which has the same objectives as the BTW project. However, APDF has massively more funding, approximately $14 million, for professional and other staffing, feasibility studies, business plans, plant layout, brokering and promotion, searching for equity financing and so on. At present, APDF has no investment fund to use as a financing catalyst although its IFC connection will facilitate entre to multiple sources of funds. APDF development should be closely monitored to ensure that solid business prospects are relayed to appropriate U.S. investors. The AFR PE Fund will finance a highly qualified Private Sector officer on the Abidjan and Nairobi REDSO staffs. As APDF units also will be headquartered in those two cities, the PS officers should be able to keep in very close contact with those IFC operations.

The Private Sector Coordinator (PSC) newly attached to the office of the Deputy Administrator has an assignment of helping to promote U.S. investment in LDC's, particularly in Latin America but in other areas as well. AFR/PRE will cooperate closely with the PSC.

Please advise if there are additional actions you believe should be taken.

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INVESTMENT PROMOTION

In January 1984, SRI-International completed a study for the Bureau for Private Enterprise (AID/PRE). entitled An Assessment of Investment Promotion Activities.

The SRI project team conducted five country case studies of investment promotion programs which had varying degrees of success. The purposes of these analyses were to (1) help establish a methodological framework for evaluating investment promotion programs, and (2) provide guidance on establishing cost effective programs.

Attached are excerpts from the "Executive Summary" of the SRI report.

EXECUTIVE SUMMARY

A Framework for Designing and Assessing Promotion Programs

Investment promotion is a set of activities which seek to encourage private entrepreneurs or businesses to invest in new or expanded ventures. In this report, the SRI International project team has focused on those efforts undertaken by or in conjunction with official government organizations. The ultimate objective of investment promotion is go bring about increases in employment, income, foreign exchange earnings or other economic benefits associated with those ventures.

In functional terms, investment promotion *per se* is neither mysterious nor necessarily complex. It simply involves the employment of various techniques to attract the interest of potential investors and sustain that interest from the point of initial investor inquiry to the time at which new ventures are implemented. Promotion can be likened to any marketing effort which aims to achieve a specified market share. The "market" in this case is not customers for a manufactured product, but rather the relatively limited pool of domestic and international capital.

The mystery and complexity sometimes associated with investment promotion result from several factors. First, investment promoters are often government officials with little experience in the private business sector, and hence have limited understanding of business attitudes and approaches. Second, promotion agencies often must operate within the context of byzantine bureaucratic and legal structures, which have the effect of complicating otherwise simple activities. Finally, promotion is more art form than science, with no fixed set of rules which assure that programs will be effective. Once these complicating factors are isolated, promotional activities can be easily understood.

Both the positive role and the effective limits of investment promotion should be taken into consideration by host country governments. Running first to the limits, the impact of all promotional activities is relatively small in relation to other factors involved in the investment decision process.

Investment decisions are reached on the basis of analyses by investors of a complex array of objective and subjective factors. The set of variables relates to the overall investment climate: the international and domestic business climates, local opportunities and operating conditions, and the nature of the incentives package offered. A second set of variables refers to considerations internal to prospective investors: overall business plans and straategies, capital and managerial resources, commitment to the project, and even random events and corporate idiosyncrasies.

Despite the breadth of these factors, one should not conclude that official promotion agencies can only play a minor role in bringing about new private business ventures. On the basis of its research on individual country experience, the SRI project team has concluded that carefully developed and properly managed promotion programs can in fact be employed effectively to improve the investment climate, stimulate investor interest, and bring to fruition new business activities.

Significant government involvement in investment-rlated activities can be divided into two sets of activities. The government as a whole is responsible for shaping the contours of the business climate: adopting an appropriate mix of monetary, fiscal and development policies; defining objectives and an official stratgy for private investment; managing the process of investment screening and approvals; and regulating ongoing business activities.

In addition to these duties, host country governments -- and often investment authorities -- undertake three other separate sets of activities which are more specifically directed toward pomotion: publicity, investor assistance, and the provision of investment incentives. Publicity programs consist of those efforts designed to attract initial investor interest, and include advertising, seminars and promotional missions, as well as direct contacts with potential investors. Investor assistance involves services provided too prospective investors in an effort to bring them closer to arriving at positive investment decisions. These services include project counseling, assistance in dealing with relevant government agencies, prefeasibility studies, and cost-sharing programs for investment missions and/or individual feasibility studies. Investment incentives offered by host country governments constitute fiscal inducements such as tax holidays, exceptions from trade restrictions, subsidized plant facilities, utility rates, etc., which are extended to encourage and complete investment transactions.

In some cases the role of government agencies charged with investment promotion is limited ot just that -- promogion. The project team found that more effective programs provided a role for promotion agencies in other investment-related activities, particularly in the formulation of investment policies and in the administration of approvals. Promotion

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agencies can act as an important bellwether of prevailing investor attitudes, and can provide advice on the efficacy of various policies and programs.

In the development of new programs or in the evaluation of existing programs, governments undertaking promotional efforts should address a number of important considerations prior to the initiation of new activities. An adequate understanding of the objectives, attitudes and policies related to private investment in the host country is necessary. Too often there is confusion on these matters, which in turn is magnified in the eyes of prospective investors. Investment promoters also need to have a clear conception of the host country's "balance sheet," that is, those assets which attract new investments as well as those liabilities which tend to deter investors. Finally, before new efforts are undertaken, strengths and weaknesses of past or current programs should be taken into consideration. An adequate initial comprehension of these factors will enhance a proposed program's chances for success by avoiding unwarranted expectations and ill-designed strategies.

Investment promotion programs vary considerably in size and cost, depending on the needs and goals of the host country. However, a certain critical mass is necessary for a program to be effective. A "core program" for a small country would consist of a central promotion office located in the host country, a small number of foreign branch offices, and promotional material in the form of informtion packets and brochures.

Promotion agencies can operate from within existing government ministries, or they can carry out their activities independently. To enhance their effectiveness, however, they should display certain characteristics. Promotion offices should have easy access to information relating to the business climate and investment policies, should maintain cooperative working relationships with other relevant agencies, and should be structured in such a way as to avoid unnecessary duplications of effort. It is also important for promotion agencies to be as uncomplicated as possible organizationally, and for lines of authority (both within and outside the agency) to be clearly defined.

A bare bones effort would be relegated to "reactive promotion," or rarely responding to unsolicited investor inquiries. More aggressive programs include the use of promotional techniques to elicit investor interest actively. These include the production of more sophisticated promotional literature, advertising campaigns, additional field offices, active press relations, investment seminars and missions, and the preparation or financing of feasibility studies.

There is no magic formula to determine which among these techniques is the most effective, since results vary as a function of the country being promoted, the nature of the intended audience, and the quality of the activity. In fact, most successful programs use these techniques in different complementary combinations. However, a number of governing principles can be applied to any promotional activity. Promotion efforts should be based on clear, objective goals by which ongoing performance can be measured and strategies can be changed. The activities should also be supported by a strong follow-up system, lest investor leads generated be lost due to lack of procedures to pursue them vigorously. These and other attributes can be built into programs to increase the likelihood that scarce promotional resources will be used more efficiently.

In th course of its research, the SRI project team identified a number of general principles which should underlie all investment promotion efforts:

1. Before promotional programs are developed, an honest examination of the host country's investment climate assets and liabilities should be undertaken.

2. Investment promotion agencies should be involved in the development and review of investment policy.

3. Investment promotion activities should be staffed by highly-motivated, private enterprise-oriented individuals with business experience (directly, or at least by academic training) and excellent communications skills.

4. Promotion program goals should be as specific as possible in order to increase the likelihood of effective design and execution.

5. Initially, investment promotion activities should be characterized by modest programs and expectations.

6. The promotion of indigenous investment should be a fundamental objective of investment promotion activities.

7. Promotion agencies should develop and nuture domestic constituencies in support of private sector initiatives.

8. Promotion programs should be tested, reviewed, and adjusted regularly as changes in the marketplace and the host country environment warrant.

9. Investment promotion programs should be allowed sufficient time to work.

Careful application of these largely common sense principles to a country's unique character should help to substantially increase the yield of investment promotion programs.

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PROMOTING SMALL SCALE INDIGENOUS BUSINESS

Small Scale Industry in Sub-Saharan Africa: Empirical Evidence and Strategic Implications

by C. Liedholm and D. Mead

I. INTRODUCTION

The role of small scale industries in the development strategies of African countries has recently emerged as an important concern among policymakers, international donor agencies, and researchers. The Lagos Plan of Action (OAU, 1982), for example, argues that, as part of their industrial strategies, countries should aim at "creating a network of small and medium scale industries as well as actively promoting and encouraging the informal sector." Unfortunately, even today, relatively little is known about many of the important characteristics of these activities in Africa;[1] consequently policymakers and planners charged with the formulation of policies and programs to assist small scale industry are frequently forced to make decisions that are "unencumbered by evidence." This paper aims to help fill the knowledge gap by setting forth what is known about small scale industries in Sub-Saharan Africa and what the implications of these findings are for policy and programs.

II. DESCRIPTIVE PROFILE

This section will examine the extent, composition, nature, and growth of small scale industries in Sub-Saharan Africa. Before proceeding, a clarification of the term "small industry" is in order. Our coverage of industry includes not only manufacturing (ISIC code 31-39) but also the repair of manufactured goods (ISIC code 951), a treatment that is consistent with most manufacturing census and studies.[2] Small scale in this paper is defined as those establishments with less than fifty workers. Although somewhat arbitrary, such an upper-bound limit would tend to exclude most foreign owned firms with more modern and sophisticated management skills, often using more capital intensive production techniques, and with greater access to capital, technical assistance and government incentive schemes.

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[1]For a review of existing studies, see Liedholm (1973), Page (1979), and Page and Steel (1984).

[2]Mining, construction, trading, and transport are not included in this review.

A. Overall Magnitude and Importance

Just how important are small scale industries in Sub-Saharan Africa? A marshalling of the available evidence indicates that small scale firms are a significant if not dominant component of the industrial sectors of most African countries. Not only are the overwhelming majority of industrial establishments small, but these small establishments account for the vast firms in the five countries covered (Sierra Leone, bulk of industrial employment in these countries. Small scale firms in the five countries covered (Sierra Lone, Nigeria, Ethiopia, Kenya) never account for less than 59 percent of total industrial employment; indeed, in one country, Sierra Leone with quite complete and accurate data, the figure is 95 percent. Moreover, most of the employment is concentrated at the smallest end of the size spectrum, with relatively little employment found in firms in the 10-49 worker size range.

Small scale firms also generate an important portion of the value added of Africa's industrial sectors, although their relative value added contribution usually is not as great as their relative employment contribution. Nevertheless, small firms' share of total manufacturing value added ranges from 26 in Ghana to 43 percent in Sierra Leone to 46 percent in Ethiopia to 64 percent in Burundi. In terms of the entire economy, small firms share of total GDP varies from 2.9 in Ghana and Sierra Leone; to 4.5 percent in Ethopia and 3.2 percent in Burundi.

B. Composition

What are the most important types of small scale industrial activities undertaken in Sub-Saharan Africa? An examination of the available data, indicates that clothing production, primarily tailoring, predominates in most countries, ranging from 25 percent of all establishments in rural Burkina Faso to 52 percent of Nigeria. Wood production, primarily furniture making, generally follows, with metal working (usually blacksmithing), food production (primarily baking), vehicle, shoe, electrical and bicycle repairs also found with some frequency. In the rural areas of several countries, such as Burkina Faso and Botswana, been brewing, which is usually undertaken by women, is a dominant activity. In general, small scale firms are concentrated in the production of "light" consumer goods: clothing, furniture, simple tools, food and drink.

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C. Location

Where are most of the small industries located? A surprising yet importaant finding is that in most countries the vast majority are located in rural areas.[3] Moreover, employment in small rural manufacturing industries often exceeds that generated by all urban manufacturing firms. In Sierra Leone, for example, 86 percent of the total industrial sector employment and 95 percent of the industrial establishments were located in rural areas (Liedholm and Chuta, 1976). Similar findings have been reported elsewhere in Africa and in other parts of the World (see Liedholm and Mead, 1985). These figures may actually understate the true magnitude of rural industry because country census often fail to pick up the smallest of the rural industries.[4]

D. Size

What is the average size of these small scale industries in Sub-Saharan Africa? The overwhelming majority of these firms are very small, with most employing fewer than 5 persons. Studies in Nigeria (Aluko, 1972), Sierra Leone (Liedholm and Chuta, 1976) and Ghana (Ghana, 1965) have found that 95 percent or more of the small scale firms employ fewer than 5 individuals. Many are simply one person enterprises. In rural Burkina Faso (Chuta and Wilcox, 1982), for example, 52 percent of the small scale firms were one person activities while in Sierra Leone (Chuta and Liedholm, 1976) the figure was 42 percent. Such findings indicate that most small scale industrial firms in Sub-Saharan Africa are tiny. In view of their large numbers and generally low incomes (see Chuta and Liedholm, 1979), they constitute a potentially important target group for policy-makers concerned with the poor.

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[3]The U.N. definition of rural, localities with fewer than twenty thousand inhabitants, is used in this paper. The conclusions do not change markedly if other definitions are used.

[4]Rural manufacturing employment had been underestimated in Sierra Leone by almost one-half (Liedholm and Chuta, 1976).

E. Ownership

What are the ownership patterns of small scale industry in Sub-Saharan Africa? The available evidence indicates that the overwhelming majority of small firms are organized as sole proprietorships. In Nigeria (Aluka et al., 1972), Sierra Leone (Liedholm and Chuta, 1976), and Burkina Faso (Chusta ahd Wilcox, 1982), for example over 97 percent of the small firms are set up in this fashion. Female sole proprietors dominate certain small industries in a number of countries. Beer brewing in Burkina Faso (Chuta and Wilcox, 1982), Botswana (Haggblade, 1984), and Ghana (Steel, 1981), gara dyeing in Sierra Leone (Liedholm and Chuta, 1976), and clothing production in Ghana are examples of some of the small scale industries in which female owners predominate. There are a few limited liability companies, partnerships, and cooperatives but almost no small enterprises in the public sector. Indeed, the vast majority of the private industrial establishments in Sub-Saharan Africa are small scale.

F. Labor

What are the major characteristics of the labor used by small scale industries in Sub-Saharan Africa? A review of the available data indicates that hired labor is generally a minor component of the small industry labor force. An interesting finding is that apprentices play a dominant role in parts of West Africa (Nigeria, Ghana, and Sierra Leone), but are quite minor elements of the labor force in East Africa, where there has been no long tradition of an organized, indigenous apprenticeship system. Proprietors and family workers play a key role in small scale industries. Most of the entepreneurs have little formal education, learned their technical skills as apprentices in other small scale enterprises, and lack extensive training in marketing, financing, or management (see Liedholm and Chuta, 1979).

G. Capital

What are the major sources of capital for small industries in Sub-Saharan Africa. The available evidence indicates that the overwwhelming source of capital, either for establishing or expanding the firms, is from personal savings, relatives, or from retained earnings. In these countries, less than 4 percent of the funds come from formal sources. The paucity of funds that small scale industries obtained from either the commercial banking system or the government is striking.

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H. Growth

Have the number of small scale industrial establishments and employment in them been growing in Sub-Saharan Africa. Although systematic information on industrial growth is limited the available evidence indicates that small scale industrial activity in Africa has been increasing. Small industry employment, for example, grew at a 6 percent annual rate during the 1960's in Ghana (Steel, 1981), and at the same rate over the 1974-80 period in Sierra Leone (Chuta and Liedholm, 1981). Whether small scale has been increasing at a faster rate than large scale industry is not clear. In Sierra Leone, small scale employment grew at a faster rate than did the large, but in Ghana the opposite pattern occurred.[5] Nevertheless, since small scale industries account for such a large portion of industrial employment, even if small were to grow at slower rates than the large, the absolute increase in small scale employment could still be substantial. In Ghana during the 1960's for example, small scale industries absorbed five times as many workers as the large scale firms, although the latter grew at a faster rate.

What kinds of small scale enterprises are growing most rapidly? By firm size, the limited evidence from Sierra Leone and from other developing countries outside of Africa indicates that the one person firms are increasing the least rapidly (indeed, in Sierra Leone they are declining), while those in the 10-49 size group are the fastest.[6] By location, it is in the urban areas that the number of and employment in small firms appear to be growing the most rapidly. In Sierra Leone, for example, small industry employment grew at a 6 percent annual rate from 1974 to 1980 in urban areas but at less than half that rate in rural areas. By enterprise types, food related activities (such as baking and milling), tailoring and dressmaking, furniture making, and metal-working, have generally grown rapidly, even after

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[5] In Tanzania it appeared that small industry's share of industrial output fell from 1966 to 1974 (Wynne-Roberts, 1980)

[6] In Sierra Leone, the one person firms were declining at a 4 percent annual rate, the firms in the 2-9 workers category increased at a 3.5 percent annual rate, while those firms with from 10 to 49 workers increased at a 12.7 percent annual rate (Chuta and Liedholm, 1982).

large scale domestic factory production in these subsectors has begun. Moreover, several newer types of activities, such as bicycle, auto, and electrical repair, have grown particularly rapidly. On the other hand, activities such as spinning and weaving, shoe and leather goods production, and pottery generally appear to have been declining in importaance. These differential growth patterns are important to recognize in the design of policies and programs directed towards small scale enterprises.

III. DETERMINANTS OF THE ROLE OF SMALL SCALE INDUSTRY

What are the main determinants of both the existing and future patterns of small industry employment and income? These can be usefully understood by focusing on factors influencing the demand for and the supply of these activities.

A. Demand Prospects

What is the major source of demand for small scale industry products in Sub-Saharan Africa? The overwhelming bulk of the products made in small scale firms are simple, consumer goods that cater primarily to the needs of relattively low income urban and rural households. Consequently, a key issue is whether or not the demand for these types of products increases as local income increases. Most entrepreneurial surveys in Africa indicate that lack of demand is an important constraint facing most small firms. Although some have argued that those types of products are inferior goods (i.e., their demand would decline as incomes increase), the few empirical studies indicate that there is a strong, positive relationship between local income and the demand for small scale industry products. In Sierra Leone, for example, King and Byerlee (1978) report, on the basis of their pioneering survey and analysis of rural expenditures, that an income increase of ten percent would increase the demand for the products of small scale firms by almost nine percent. Consequently, the growth of demand for small scale industry products would appear to be closely linked to corresponding increase in household incomes, particularly among the rural and low income segments of the population.

Are there important sources of demand for small industry products that stem from their backward and forward production linkages with other segments of economy? In general, these sources of demand appear to be less developed in Sub-Saharan Africa than in other parts of the developing world. The strongest of these production linkages in Sub-Saharan Africa, however, exist with agriculture, where the processing of several agricultural crops, such as rice and oil palm in West Africa (see Spencer et al., 1976, and Miller, 1965), and the production of implements for traditional agriculture

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(see Chuta and Liedholm, 1976) are frequently undertaken by small scale firms. The production linkages with large scale industry appear particularly weak in Sub-Saharan Africa; very few subcontracting relationships between large and small industrial firms appear to have been developed as yet. What about the foreign demand for small industry products? At present, the foreign demand is relatively small and limited to a few specialty products such as gara dyed cloth from Sierra Leone (Chuta and Liedholm, 1976) or baskets from Botswana (Haggblade, 1984).

B. Supply Factors

Are small scale industries more labor-intensive than their larger scale counterparts? Since in Sub-Saharan Africa capital and foreign exchange are relatively scarce, and labor, particularly unskilled, is relatively abundant, those firms that generate more employment per unit of capital would appear to represent activities or techniques most appropriate to the country's factor endowments. Both aggregate and industry specific data consistently show that small firms in Sub-Saharan Africa generate more employment per unit of scarce capital than larger scale counterparts (see Chuta and Liedholm, 1979 and Page and Steel, 1984.)

A key related issue is whether these same labor-intensive small scale firms use the scarce factor, capital, more effectively than their larger scale counterparts. Aggregate data are limited and do not show any consistent result. A few industry specific studies have been completed, in which firms in the same industry with approximately the same degree of vertical integration are grouped together. The findings from these studies, indicate that small scale firms in these industries generate more output per unit of scarce capital than their larger scale counterparts.

IV. POLICY AND PROJECT ISSUES

A. Introduction

The preceding discussion makes clear that small enterprises are widespread and diverse in Sub-Saharan African economies, and that they apparently are quite efficient in their use of resources. In view of their potential contribution to future growth in income and employment, it is appropriate that they should be the target of policy - and project-focused attention from African governments as well as aid donors. A focus on small producers also fits well with AID's current interest in the encourgement of private enterprise, one of the "four pillars" of emphasis in current aid programs.

All of this leads to questions concerning the design and implementation of policies and projects to support the growth of small producers. In the discussion of this section, we make distinction between general policies, designed to affect broad classes of producers, on the one hand, and projects based on a patron-client relationship, to provide assistance to particular designated firms, on the other. For each of these, we find it helpful to separate policies and projects which operate on the "supply side" (i.e. which focus on the availability of inputs and production conditions), as distinct from those whose major focus is on demand considerations. Our discussion deals first with policy issues: the policy context in which small enterprises currently operate, and ways in which these policies might be improved. We then turn to an examination of projects which have been adopted in the past for small enterprise development, and make suggestions concerning appropriate new project activities. Section V of the paper explores the implications of these findings for government and donors, examining as well some issues of implementation of projects and of policy reform.

B. Policies

1. General Consideration. Industrialization was a major goal in virtually all countries of Sub-Saharan Africa in the immediate post-independence period. In large measure, this meant an emphasis on large-scale firms, generally using the most modern technology, usually implying a high level of capital intensity. Inevitably, much of this was characterized by an import substitution focus (see Ewing, 1968). This approach subsequently came under attack on two related counts: it often involved considerable economic inefficiency in resource use; furthermore, it led to only minimum absorption of labor in the manufacturing sector (see Frank, 1968, and Morawetz, 1974). The result was a widespread disillusionment with large-scale industrialization as a central focus for development policy.

This disillusionment led also to an awakened interest in exploring the possibilities of industrialization through small enterprises. Most governments in Sub-Saharan Africa have stated that they favor and support the growth of small producers (see, for example OAU, 1984); yet when one looks in detail at the policies which they have adopted, there are only few such policies that might be considered as directly supportive of the growth of small firms. In fact, the most pervasive impacts of current government policies on small producers arise from unintended side-effects of policies adopted with other targets or goals in mind. In large measure, this means that the central effect of these

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policies on small producers is negative, operating in ways which discriminate against them rather than encouraging their development.

This happens in two important ways. First, a considerable amount of assistance is provided through policies which are restricted in their design and specification to large producers. A typical example is the Development Ordinance enacted in Sierra Leone in 1960, which gave income tax holidays and import duty exemptions, but these were restricted to firms planning to invest $50,000 or more in plant and equipment (Liedholm and Chuta, 1976). Secondly, even for policies which in principle apply equally to all types of enterprises, implementation of such policies is often undertaken in such a way as to have strongly differential impacts as between producers of different types and sizes. In Rwanda, for example, small enterprises do not benefit from import duty exemptions granted to most industrial enterprises, since they do not import their inputs directly but buy them from local importers, who are subject to the higher tariff rates. In a similar way, in Rwanda as in many other countries of Africa, small firms find it difficult if not impossible to act as suppliers to the government, since the procurement packages are too large, and there are no provisions for partitioning of contracts, so these could be handled by smaller firms.

In this situation, the most important first step in instituting a policy regime suupportive of small enterprise growth is to eliminate the existing policy biases against the small producer. This might be expressed in terms of a need to "level the playing field."

2. Supply Side Policy Issues

There are a number of different policy areas which concern the availability and costs of inputs and related questions pertaining to the production process. These are discussed under headings of credit, foreign exchange, other inputs, labor, and rules and regulations.

a) Credit. One important area where policies have a major impact on small enterprises concerns interest rate ceilings. Studies suggest that it generally costs more per dollar lent to process loans to small compared to large borrowers; risks of default may also be higher than for more established firms. In such a situation, interest rate ceilings make it unprofitable for financial institutions to lend to small producers at all. The result is that small enterprises are often forced to turn for their credit needs to informal

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sources, which generally charge much higher interest rates. In Sierra Leone, for example, the maximum official interest rate in 1974 was 12 percent, but the informal market rate was over 160 perent (Byerlee et at., 1983). Official interest rate ceilings in Africa generally run from 10 to 20 percent, while informal rates frequently are 100 percent or more (see Chuta and Liedholm, 1979). Efforts, then, to protect small borrowers from bearing the full costs of their credit needs means that they are forced to rely on even higher-cost alternative credit channels.

The policy implications here are straight forward. It is important to work towards the elimination of interest rate ceilings as a move towards ensuring that interest rates more closely approximate the opportunity costs of capital for small borrowers.

b) Foreign trade and foreign exchange. Small producers often find themselves at a disadvantage in terms of their access to foreign exchange. Where there is licensing of imports, the obtaining of a license requires skills and contacts with government bureaucracies which small firms often do not have; they find it difficult to obtain the needed imports. Beyond this, tariff rates are generally set in a decision-making context based on a response to pressure; small firms often find that they do not have the required influence. Partly as a result of this, partly as a result of simple ignorance, the setting of tariffs often takes little account of the needs of small producers. In the case of tariffs on textile machinery in Sierra Leone, for example, large garment producers were covered by the country's industrial incentive package, and so were able to import their machines duty-free; small scale tailors, by contrast, found that the sewing machine, their basic capital input, was classified as a luxury consumer good and taxed accordingly, with no duty relief. Similarly, dyes used large-scale textile firms were admitted duty free, while dyes used in the making of gara cloth were subject to the full import tariff (Liedholm and Chuta, 1976). Such differential treatment of large and small firms with respect to foreign exchange access and tariffs should be eliminated.

c) Access material inputs. In many countries, the government has a policy of exercising extensive control over the distribution of industrial inputs. This may reflect a suspicion of "unscrupulous merchants" and their "excessive mark-ups;" or it may be a part of a policy aimed at the control and regulation of supplies of imported inputs. In such cases, there is often a bias in the implementation of such controls in favor of larger producers.

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Unless the government makes a conscious effort to ensure that these inputs are also equally available to smaller firms, it will generally be the larger producers who end up benefitting from the controlled markets. These problems arise most clearly in relation to imported inputs, handled by public sector distribution systems; they also appear, though, for local products, distributed through public sector channels. In both cases, the most common picture involves unequal access as between large and small users of the inputs. The most effective way of removing this bias is to work towards a system based on reduced governmental control and intervention in the distribution system.

d. Rules and Regulations. There has been considerable interest in Africa in exploring the position of a category of small producers referred to as the "informal sector." While we have not found this categorization to be particularly helpful in our studies, there is one characteristic highlighted by that literature which is of importance; this relates to issues of government controls and regulations (Page, 1979). In many ways, small producers are beyond the horizon of government officials, in terms of providing assistance to them, but also in terms of taxing, regulating or controlling them. In some cases, the laws explicity states that they do not apply to small producers (small firms are not required to obtain certain kinds of licenses, to obey certain labor regulations, or to pay certain types of taxes.) In many other cases, though, the laws are written as if they apply to all producers, regardless of size; this is often the case even when all agree that enforcing the laws for very small producers is quite unrealistic. Following this procedure of stating the laws in broad terms but then interpreting them more restrictively not only has the effect of breeding contempt of the law; it also opens small producers to threats that unless they "pay off" the appropriate officials, the laws in question will be put into effect against them, with the risk that they can be put out of business. Frequently, the implementation of such laws for small producers is highly arbitrary and erratic, making it virtually impossible to engage in sensible business planning. In general, care should be taken to screen industrial regulations to make sure that there is a workable and equitable way of implementing them for small producers, or that these small producers are explicity exempted from their coverage.

3. Demand-side Policy Issues. Numerous studies have made clear that perhaps the single most important constraint facing small producers, particularly in rural areas, is the problem of finding markets for their output. Many of these producers sell only in local or regional markets. Conversely, a significant share of the low-cost consumer goods sold in such

rural markets are produced by small enterprises located in the same region. What this means is that policies supportive of increases in income in rural areas will have significant multiplier effects through expanding demand for the output of small manufacturers. Probably the most important set of policies for the encouragement of small manufacturers, particularly in rural areas, concerns the expansion and equitable·distribution of agricultural incomes. Policies slanted against agricultural development lead not only to a stagnant agricultural sector, but also to stagnant demand for products of rural small manufacturers.

C. Projects

1. General. In the area of small enterprise development, most of the attention of African governments and donor agencies has until recently been focused not on the overall policies described above that affect small businesses generally, but on targeted, client-focused projects or programs that involve some form of patron-client relationship with individual establishments. In the 1950's and early 1960's, most of these projects in Africa focused on the provision of an integrated package of inputs to a relatively limited number of "modern" small business, following the "Indian model" developed and applied earlier in Asia and Latin America by Stanford Research Institute and the Ford Foundation (see Staley and Morse, 1965). After the hiatus of about a decade, interest in small industry in Sub-Saharan Africa reemerged in the garb of appropriate technology and the informal sector. Currently, most of the focus of this interest is on firms at the lower end of the size distribution, typically with a rural orientation and involving subsidized assistance for a small minority of producers. Perhaps reflecting the normal lag between theory and practice, however, many projects are still designed on the earlier model, with relatively high cost assistance being provided to a relatively small number of firms.

2. Supply-side projects

a) Credit and Financial Assistance. In recent years, credit projects have been the most commonly used method of providing direct assistance to individual small enterprises in Sub-Saharan Africa. These programs have been designed to overcome the small firms' lack of access to formal credit sources and greater "perceived" constraint, as viewed by the producers themselves. A number of countries in Sub-Saharan Africa (such as Cameroun, Zambia and Kenya) have designed special credit programs aimed specifically at the small producers (Kilby and D'Zmura, 1984). Very often, though, these have been aimed at the top end of the small enterprise sector,

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leaving the smaller producers with a continuing limited access to institutional credit. These programs have often been based on a set-aside of a tranche of funds from outside assistance, lent to a certain category of borrowers at subsidized interest rates. These below-cost interest rates raise the potential danger of spreading to small producers the same perverse excessive capital intensity which has often charactrized the larger firms. They also make it unlikely that local funding agencies will step in to continue this credit flow, when external assistance is no longer available.

Only a few of these credit projects in Sub-Saharan Africa have been evaluated, and no overall study of them exists for Sub-Saharan Africa. It is frequently argued, however, that the administrative costs and risks of lending are much higher for small than for large firms (see World Bank, 1978). Concern is also expressed with regard to the extent of small industry's demand for credit and the effectiveness of the delivery channels for supplying this credit. Two recent reviews of several small industry credit schemes in Africa and elsewhere (Kilby and D'Zmura, 1984 and Liedholm, 1985), however, indicate that several of these credit projects have been successful, generating benefit costs ratios consistently above one, and frequently possessing administrative costs and arrears rates below 10 percent of the loan value. Some of these reviewed projects, such as the Partners for Productivity Rural Interprise Development Project in Burkina Faso, are located in Africa. Most of the successful ones have some particular common characterists that should be considered when designing new schemes. First, the successful projects have provided primarly working capital rather than fixed capital that is the focus of most lending schemes.[7] Such a result is consistent with the findings of most of the recent small industry studies that point to the lack of working rather than fixed capital as a primarly financial constraint facing most small scale firms, particularly those at the lower end of the size spectrum. Secondly, the delivery mechanisms of these successful credit projects differ significantly from the standard credit schemes. Loans are screened on the basis of character rather than on project feasibility and/or collateral. Moreover, the initial loans are small for short periods, and loan volume per loan officer is high. Finally, the interest rate has been high enough to cover operating expenses including the cost of funds. In several countries,

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[7]The emphasis on fixed capital stems from aid donors' interest in lending schemes with high foreign exchange components, and orientation of academic economists toward fixed assets, and a paucity of requisite statistics.

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formal credit institutions, including commercial banks, have been able successfully to modify their loan procedures to meet these characteristics.

Two steps may be taken to encourage formal sector financial institutions to lend to small firms. One would be to help pay a share of the administrative costs for commercial banks or other financial institutions, as well as providing loan guarantees while they learn about lending to these small producers. This could be done on a temporary basis, with the share of costs covered from outside and/or the magnitude of the guarantee declining over time. Secondly, consideration might be given to providing technical assistance to financial institutions to enable them to develop lower-cost screening mechanisms for lending to very small producers (Liedholm, 1985).

b) Labor, Training and Technical Assistance Issues. Technical and managerial assistance schemes have been a popular method of providing direct support to small firms in Sub-Saharan Africa. As early as 1962, Industrial Development Centers designed to provide technical and managerial assistance to small businesses were established in Zaria and Cwerni, Nigeria, with USAID assistance (Hawbaker and Turner, 1972). Similar centers were subsequently established in many other African countries, including Ghana, Botswana, Tanzania, and Kenya (Livingston, 1977). Although there have been a few evaluations of individual centralized assistance centers (see for example, Hawbaker and Turner, 1972), there has not yet been a systematic analysis of the experience with or the effectiveness of technical assistance schemes for Sub-Saharan Africa. It is frequently argued, however, that the demand for such services on the part of business is very small.[8] Another often-heard criticism is that such programs have ended up concentrating a large volume of resources on a relatively limited clientele and that consequently their delivery costs per client are unduly high (see Kilby, 1982).

A review of a number of technical assistance projects in Sub-Saharan Africa makes it possible to isolate several common characterists that seem to accompany succesful technical assistance projects. First, these projects tend to be industry- and task-specific. As an example, one might cite the highly regarded training program in Botwana that imparted

[8]See for example, Page and Steel, 1984, and Liedholm and Chuta, 1976, and the Economic Commission for Africa (1982), which state that "it must be kept in mind that most small scale enterprises are unaware of the need for these services."

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joinery skills to carpenters to enable them to produce coffins for the local markets (Haggblade, 1982). Second, these projects addressed situations where only a single "missing ingredient" needed to be supplied to the firm, rather than an array of ingredients.[9] The Botswana Mud Oven Training course, which ws designed to teach women to make mud ovens and bake bread for sale, provides a graphic example of the importance of this characteristic. Those women in the scheme who previously had baked other products for sale were successful in increasing their incomes substantially, while those women without any prior commercial baking experience all failed (Haggblade, 1982). The latter group had too many "missing ingredients." An implication of the single "missing ingredient" characteristic is that projects assisting existing firms are more likely to be successful than those that attempt to establish new firms. Third, before the successful projects are launched, prior surveys of industries had been undertaken to uncover the demand for the activity and number and type of "missing ingredients." Such surveys are important because evidence is accumulating that the constraints facing small scale industries in Sub-Saharan Africa vary importantly from country and indeed from industry to industry (see Chuta and Liedholm, 1984). Finally, successful projects tend to be built upon proven existing institutions.

Although these may frequently be formal institutions, it is important that existing informal institutions not be overlooked. The apprenticeship system is an example of such an informal institution that can provide a low-cost alternative for the delivery of technical and management assistance to small firms in Sub-Saharan Africa. One of the striking features of the labor market in West Africa concerns the central role of the apprenticeship system in the training of workers in small enterprises. The contrast with East Africa (as well as with most other countries of the world) is quite marked. This makes clear that, in East Africa, government training programs play a particularly important role in supplying skilled manpower to the small enterprise sector. Care is needed to ensure that these training programs are designed with the needs of smaller producers in mind. Beyond this, there are things which could be done to support the effective expansion of apprenticeship systems, in East as well as West Africa. A comparsion of apprenticeship systems with government vocational training programs makes clear that

[9] Peter Kilby (1979), developed this notion when reviewing ILO/UNDP small enterprise project worldwide.

are reported to be relatively rare in Africa, although this may primarly reflect the fact that one often does not see them unless one is looking for them. Arrangements based on contracts between small producers and merchants or traders can be found in some African countries, often aimed at the marketing of craft products. An excellent example is Botswanacraft, which in the 1970's provided the single, missing marketing link that was needed to support the commercial production of basket-making in rural Botswana (see Haggblade, 1983). Where they are effectively done, such contract production and subcontracting systems can play an important role in establishing linkages between isolated producers and more dynamic markets. Consideration should be given to exploring ways of expanding the nascent role of subcontracting in Sub-Saharan Africa (Mead, 1985).

V. IMPLICATIONS FOR AFRICAN GOVERNMENTS AND DONOR AGENCIES

A. Introduction

Small enterprises are of considerable importance as sources of employment and income in Sub-Saharan Africa today. This importance is likely to increase over time, as population growth puts strains on available cultivable land, and as the number of people seeking work outside of agriculture exceeds the absorptive capacity of large-scale industrial and service enterprises. The discussion of previous sections suggests a number of things that can be done to facilitate the expansion of small enterprises, and to channel this expansion in productive directions.

B. General Policy Issues. One can draw three major conclusions concerning small enterprise policies, the ways these policies currently impinge on small producers, and the needs for more effective policy support in the future. The first is that the major impact of current policies on this group of enterprises has been negative: discrimination against the small producers in favor of their large-scale and better-connected competitors. This discrimination arises both from the ways in which laws are written and the ways in which these laws are implemented. This suggests a clear need for African governments and donor agencies to better understand the ways in which existing policies operate in practice, with a goal of eliminating this discrimination and establishing more equal competitive conditions for large and small enterprises. Changes in the tariff structure are a particularly fruitful area for elimination of this differential effect.

The second major conclusion is that the key constraint hindering the growth of small enterprises, particularly in rural areas, relates to the deficiency of demand. The governments' overall development policies can play a key role in overcoming this deficiency. In particular, agricultural policies aimed at a rapid growth of rural incomes are important not only in their own right, but also because they contribute in a major way to the growth potential of non-agricultural, rural small enterprises. Efforts to establish pricing systems which provide incentives to farmers to increase their output, to encourage the development of effective marketing systems for selling their products, and to institute agrarian reform leading to an equitable sharing of the benefits of increasing agricultural output, all can contribute in major ways to the potential for growth among small non-agricultural producers.

The third major point is closely related to the previous two. It involves a recognition that, in thinking about the effects of policies on small producers, African governments and donor agencies must adopt a comprehensive view, looking far beyond the traditional sphere of industrial policy to include agricultural pricing and income policies as well as the general foreign exchange regime of the country.

C. Projects

Projects or client-specific programs in Sub-Saharan Africa have focused in the past primarily on eliminating or reducing supply constraints. There is clearly a useful continuing role for African governments and donor agencies in this area. In summarizing the project implications of the preceding discussion, it is helpful to make a separation between credit projects and all others.

1. Credit. The majority of projects directed at the support of small enterprises have been in the area of credit. This may partly reflect the fact that many small enterprise projects are best designed as small projects, which means that they generally require only small amounts of funding. AID donors are often under pressure to "move money;" one of the few ways of doing this in significant volume is to concentrate on credit activities.

A review of successful credit projects indicates that there are useful things that can be done to facilitate the growth of small enterprises. The key characteristics of successful credit programs for small enterprises, in Sub-Saharan Africa as elsewhere in the world, include the following: a) concentration on working capital rather than fixed capital; b) screening of loans based on the character of the applicant rather than the characteristic of the project; c) decentralization of decision-making to local institutions and local individuals; and d) granting of loans in small amounts, for short periods, to encourage and facilitate high repayment rates.

2. Other types of projects. Among the key findings concerning small enterprise projects in areas other than credit, the following may be singled out as being of primary importance in the design and implementation of future projects. a) Useful projects will generally be carefully targeted to a limited range of enterprises, probably in one or a few closely related

industries. b) Projects are more likely to be successful if they can be targeted to deal with one or a limited range of missing components, rather than trying to introduce a complex range of changes all at once. c) Similarly, it is generally advisable to start from existing institutions, rather than seeking to start from scratch with a new focus and staff. d) There is often a useful contribution to be made by projects aimed at the establishment of more effective links between dispersed producers and more dynamic and often more distant markets. d) All of this implies that there is a need for careful field research, to determine the needs of small producers in particular situations, so projects can be effectively targeted.

D. Policy Reform and Implementation Issues

The process of policy change is a complex one, involving pressure groups and compromises which are difficult for an outsider to understand, much less lead. Experience suggests some rules about the most effective way of working towards policy change. i) Policy change is generally a long-term process. Almost any policy change will mean that some groups benefit while others lose; efforts to move things too rapidly can cause great social turmoil, during the course of which all possibilities of improvement may be frozen. ii) The most effective route to policy reform often centers around the involvement of actual and potential policy makers in studies focusing on the ways in which policy currently works and how alternative policy configurations might operate. Well-focused policy-oriented studies can provide important insights into the ways in which policies are currently working, thereby providing (intellectual) ammunition for those who wish to affect changes.

With judicious government policies and carefully formulated direct assistance measures, the already sizable contribution of small scale industries in Sub-Saharan Africa can be even further enchanced.

POLICY AND PROGRAM PLANNING ISSUES IN THE PRIVATE INFORMAL SECTOR

Harold Lubell, USAID Senegal, raises a number of interesting and provocative ideas in the two brief papers attached:

- Dealing With the Informal Sector
- Patterns of Organization In the Informal Sector

There is evidence - such as in recent studies in Mauritania - that small-micro business may be a more important source of new employment than larger companies, particularly in countries with very small domestic markets. As such, these informal businesses must be considered in terms of planning a private sector strategy. Harold Lubell's paper leads to a number of questions in this regard. Some are:

1. Should the informal sector be left to itself on the assumption that it flourishes best with little need for modern management techniques and can finance itself via informal credit channels?

2. If the informal sector is to be assisted by formal USAID programs, how can this best be accomplished?

3. Can credit to the informal sector ever be profitable for normal commercial bank lenders? Are there other financial intermediaries available who can be assisted to enter informal private sector lending without eventual erosion of the lender's capital base?

4. What interest rates would have to be charged to make lending to the small-micro sector profitable for the lender?

5. With most governments attempting to increase the tax base and strengthen tax collection systems, what impact would such an effective tax system have on the small-micro business sector which essentially operates on an "underground economy" base?

Patterns of Organization in the Informal Sector

Harold Lubell, USAID/Senegal*

It has become evident from research and observation over the last decade that the term "unorganized" is a misnomer as a description of the informal sector. The informal sector has its own inherent organization - as does any social or economic activity. The individual economic agents function in organized physical, sociological and market frameworks that influence the way producers operate. There are several facets to this obvious fact that are relevant to policy.

Spatial Relationships

The spatial allocation of informal sector activity in urban areas has both physical and marketing dimensions:

- There is a limit, either natural or enforced, to the population that any potential street front or market place will bear. In Dakar (Senegal), the number of beggars, shoeshiners and peanut sellers under the arcade in front of the 30 meter facade of the Banque pour le Commerce et l'Industrie au Senegal on the Place de l'Independance stabilizes at about a dozen; the number of market-lady sellers of tomatoes and flowers and male vendors of imported bananas stationed across the street from the downtown Score super-market stabilizes at about ten.

- Street locations have a market value. In Bogota (Colombia), the better locations on the main streets for selling cigarettes have long since been appropriated and are well protected by their occupants from infiltration of outside competitors, by strong-arm methods if necessary. What has become a "traditional" right to given street location may also be bought and sold.

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* The opinions expressed in this note are those of the author and do not necessarily reflect those of the organization to which he is attached.

- Street-side metal working near the Bulaq quarter of Cairo (Egypt) grew up in the late 1940s out the of availability of scrap metal left behind as the debris of World War II. the small shops continue to congregate in the area because they are able to serve each other as sources of parts and contract work. The shops in the area function in part as an informal assembly line factory operation producing kitchen utensils, containers, furniture elements and other metal products.

- The metal workshops of Howrah, the industrial suburb of Calcutta (India) across the Hooghly River to the west of the metropolis, function in a similar fashion but on a much more massive scale. The engineering industries of Howrah grew up alongside the great Indian railway repairshops and railroad wagon factories of the 19th century. The dense network of small scale contractors and subcontractors inside the crowded industrial area of Howrah increases the dependence of the individual producers on the proximity of their location to their immediate suppliers and customers.

- the small footwear producers in the older parts of downtown Alexandria (Egypt) work in crowded quarters in the upper floors of decrepit office and apartment buildings where working conditions are deplorable, lighting is poor, and placement of work tables is badly organized because of lack of space. However, downtown Alexandria has the unequaled advantage of accessibility for the work force and proximity to suppliers and to customers.

Sociological Aspects

The middle man can play a significant role in informal sector activity:

- The informal assembly-line operation of interdependent Cairo metal workshops mentioned above is in part organized by a merchant-boss who organizes the supply of inputs and the marketing of outputs. The informality of the system lies in the small scale of the individual producing units, but it is organized in a hierarchical leader-client framework.

- The market for provincial informal sector non-farm producers in Kalyubia and Fayoum (Egypt) is for the most part limited to their immediate locality, except for hand-knotted rugs where a middleman with marketing connections to Cairo and abroad is an essential element of the system.

Caste, class and ethnicity are relevant factors:

- One of the perennial economic development puzzles is what determines who become the entrepreneurs in a given society, as merchants, craftsmen and suppliers of services. In Senegal, the Mourides, one of the indigenous Islamic brotherhoods, have been agricultural pioneers for the past century. With the flood of rural to urban migration of the past two decades, many Mourides have moved to the cities, to which urban members of the brotherhoods have transferred their work ethic. In the Dakar metropolitan area, Mourides are numerous among the urban craftsmen. Some of the Mouride leaders, the grands marabouts, have accumulated considerable wealth from agriculture; but as their disciples (talibe) have moved off the land, the marabouts have shifted their financial resources into urban activities, including inter-urban road transport. Like the Sikhs in India who used to be predominant in road transport, many of the independent truckers in Senegal are now Mourides who have moved to the cities and whose vehicles and some working capital have been financed by the marabouts.

- In sub-Saharan Africa, the non-African traders, in West Africa the Lebanese and in East Africa the Indians and Pakistanis, have long since been pushed out of their former informal intermediary role by local nationalisms, with the result that they have moved up to become formal sector merchants and producers. In Senegal, there is a class of Maures (from Mauritania) who fall between the informal and the formal, as silversmiths and small grocery storekkeepers.

Policy Implications

Several policy suggestions follow from the examples given above with respect to spatial patterns:

- In general, governments and aid organizations should avoid disrupting existing economic relations (especially out of ignorance of the existence of such relations) unless something clearly better will be introduced.

- Proximity to immediate suppliers and customers is essential for small scale producers, unless there is a road and transport system that permits efficient communication and transport. Even so, small scale operation is facilitated by proximity. Moving small scale producers out of town to an industrial estate makes sense only if they are functioning as sub-contracting appendages to larger scale plants that also are or will be established in the industrial estate.

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A central business district sidewalk is one of the best informal selling areas in a city. The authorities should think twice about interfering with the outcome of street-level market forces, unless the spatial distribution process becomes violent.

An effort should be made to discern the pattern of the sociological infrastructure to marketing and financing arrangements before we attempt to improve upon what is already in existence:

- Trying to eliminate a "rapacious middle man" may turn out to be a quick way to destroy a viable marketing system and to leave informal sector producers worse off than before.

- the most efficient way to develop informal sector activity and to increase its productivity may be to operate through the existing relationships that already give it a framework: e.g. by channeling credit through traditional money lenders and merchant intermediaries if the cost is lower than trying to use top-heavy branch banking; and by trying to co-op social organizations such as the religious brotherhoods in Senegal into mutually beneficial development activities by giving them a productive itermediary part to play.

DEALING WITH THE INFORMAL SECTOR

Harold Lubell [1]

Academic and bureaucratic interest in the informal sector on the part of international organizations, bilateral aid agencies and national governments is a reaction to the need to alleviate the problems of poverty and unemployment in the developing countries. A parallel interest in the phenomenon of the underground economy developed in the industrialized countries as employment rose during the economic recession of the late 1970s and early 1980s. Research, analysis and practical experimentation over the last decade and a half have been successful in identifying the economic value of informal sector activity. They have been less successful in identifying a context for workable means of encouraging the development of productive informal sector enterprises. Two questions that were asked at the beginning are still central. The first is whether the informal sector is better off if the authorities continue to ignore it or if the authorities try to help it. the second, and practical, question is how to go about helping it if that is the option chosen.

Ignoring the Informal Sector

There are several cogent arguments for leaving the informal sector alone. The first argument concerns the trade-off between the present realized advantages of informality and anonymity and the future potential benefits of assistance from government sources. There are several advantages to informality. One is that anonymity serves, above all, as protection from the tax collector (although not necessarily from exaction by the police). Another is tht informal economic inter-relationships that develop among suppliers, producers, and customers have an internal coherence that outside intervention is likely to disturb. The following are a few examples. The small scale metal workshops of Howrah

[1] USAID Mission to Senegal, Dakar. The views expressed here do not necessarily reflect those of the organization with which the writer is affiliated.

(metropolitan Calcutta) sub-contract parts of a job to their close neighbors as a matter of course; any attempt to improve their physical environment by moving them would disrupt existing networks of production and supply, probably without providing a substitute. The same phenomenon of shop-to-shop subcontracting occurs in the Bulaq metalworking section of Cairo, where individual workshops along the street function on an informal assembly line for the manufacture of kitchen utensils. In Kaolack (Senegal), retail merchandising to the poor involves a chain of sellers that includes one with enough cash to buy a sack of rice which he divides up into smaller quantities that he can advance on credit to mini-retailers at extremely high implicit rates of interest: intervening in such an arrangement in order to eliminate a "rapacious middleman" is likely to wipe out both the middle and the mini-retailers.

Another argument against outside intervention in informal sector production is that instead of bringing about a general improvement, the result may turn out to be simply an increase in the productivity of a select few of the informal sector producers whose increased output will drive some of their former peers out of saturated market.

Helping the Informal Sector

Official recognition of the informal sector as groups of producers of goods and services who deserve assistance can have some potential advantages to informal sector participants. The most useful, or at least the one that would be most appreciated by the informal sector, would be a reduction in the extent of harrassment by the police on grounds of various illegalities such as illegal occupation of public space (e.g. urban sidewalks) that offers access to customers, and non-compliance with (often dubious) health and other standards set by officials with their own goals in mind. Such goals have included the attempted elimination of informal sector kiosks in Nairobi in order to make way for an organized network of kiosks owned by friends of a city official, the proposed elimination of Lambretta three-wheel suburban jitney taxis because riding in such conditions was considered undignified by a Saigon official in the 1960s, and the discouragement of private sector transport networks because they competed effectively with (inadequate, inefficient, and loss-making) Government-owned systems.

Other potential effects of official recognition that might been seen as advantages by informal sector participants are access to credit, easier access to inputs, easier physical access to customers, and access to more convenient workplaces. They probably do not feel a need for the accounting and management advice that the development experts consider essential.

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The development specialist expect a variety of results from encouraging the informal sector, depending in part on how they view the phenomenon in the first place. Some see the informal sector as producers of goods and services for the poor in an essentially dualistic economy. Others want to see the informal sector transformed into respectable elements of the formal sector.

For the first group of specialists, encouraging informal sector activity will help satisfy the needs of the poor without really affecting the nature of the dual economy. However, informal sector production for the poor in any given location and economic situation is likely to be in a state of uneasy equilibrium unless there is a drop in raw material costs (corresponding, for example, to an increase in supply) or an increase in demand (resulting, for example, from an inflow of income from sources outside the community of informal sector producers due to a sharp increase in agricultural production or the injection of emigrant remittances in cash from abroad or from the capital city or other center of economic activity). The opportunities for increasing informal sector production in a situation of stagnating effective demand are few.

There are, of course, some areas where informal sector production for the poor does offer an opportunity for expansion of activity. One such area is housing, which can be a major outlet for informal sector activity since there is room for small scale contract construction as financial resources and some family labor become available, and for artisanal output of furniture and furnishings to put into houses as they are built. Nevertheless, for such informal sector activities really to prosper, there needs to be a source of income outside the community of the poor (e.g. salaries from which the savings for construction are derived) or access to markets outside the immediate community.

Other specialists want to encourage informal sector enterprises to develop to the point where they become proper capitalist firms, complete with management accounting, access to bank credit, production for inventory, and increasing sales as they are able to break into wider markets than those already supplied by other informal sector producers.

Credit

When informal sector entrepreneurs are asked what is their most pressing need, the usual reply is that lack access to credit, as they tend not to be aware of their own management shortcomings. (The two are linked, of course, since improper management will quickly manifest itself in an inadequate cash flow situation.) The need for credit is difficult to satisfy because micro-enterprises are by their nature not bankable clients: they do not possess bankable collateral; their sales perspectives are uncertain; they are not likely to have any previous experience with banks or other formal credit institutions; and they may be volatile. In addition, small transactions are too costly for most credit institutions to finance at conventional rates of interest and fees. To aggravate the situation further, governments have the unfortunate habit of obliging the banks to lower their charges on the loans they do make to small and micro-enterprises on the social grounds that the loan recipients are needy and in activities whose productivity is low. Imposing such preferential rates increases the reluctance of any bank that is interested in profits to make any loans at all to small and micro-enterprises. The result is limited availability if not a complete lack of credit to small and micro-enterprises.

A USAID-financed small enterprise project recently started in the Sine Saloum region of Senegal has taken a hard look at the problem of giving credit to small enterprises. A pre-project survey found that credit was indeed available to small traders and to artisans in the informal credit market, but for short periods and at interest rates in excess of 100 percent per year. The project designers initially proposed a credit component that would lend at about 50 percent - which is half the informal rate but twice the legal rate of interest plus charges applied by banks (for large loans, of course) - to cover the administrative and indigenous assistance costs of the project. The proposal was rejected because charging such "usurious" rates as part of a formal bilateral project would make for bad public relations in addition to being illegal. The interest rate finally adopted was 24 percent, the going rate for interest plus bank charges. The intention of the project is to create a self-sustained credit operation that incorporates a business extension (technical assistance) component. Experience with the project will show how long it takes to decapitalize the initial credit fund at the 24 percent rate of interest.

<u>The Informal Sector and Government Policy</u>

There are not two perennially contradictory tendencies in government policy that derive from different conceptions of what makes up the informal sector and from the ambivalent attitudes toward it. Once conception is that the informal sector is a source of output of goods and services. In this framework, government policy tries to encourage expansion of

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productive informal sector activities in order to absorb otherwise unemployed human resources. The other conception identifies the informal sector with the tax evasion and fraud of the "underground" economy. Since the boundaries of the informal sector remain ill-defined, both attitudes are comprehensible. A range of non-agricultural activities in rural areas are likely to be carried out on a small-scale or an artisanal basis: repair of agricultural equipment; commercialization of agricultural inputs and outputs; local level processing of agricultural outputs (e.g. rice husking and peanut oil pressing in Senegal); and local transport (trucking and bush taxis). Even in these activities, the spheres of the informal sector and the underground economy intersect. In Senegal, the capital invested in some of these activities is substantial, for example in small rice milling machines or in motor vehicles; the likely sources of financing of these investments are the religious leader-landowners who have accumulated untaxed funds from agriculture and merchants in the Dakar markets whose activities are based on imported goods smuggled across the border from the Gambia or passed fraudulenty through customs in Dakar. The individual operating units (a mobil rice mill or a bush taxi) are informal enough; it is the ownership network that is part of the underground economy.

The Government of Senegal is currently faced with two specific employment concerns. The first of these is the need to respond to emergency situation: the dismissal of relatively large numbers of employees of parastatal enterprises whose functions are being drastically curtailed. The other is the desirability of taking advantage of the possibilities that will be created by water control of the Senegal River when the Manantali dam is completed in Mali in 1987. It is in this context that the Government is trying to find ways to provide credit and technical assistance to medium, small, and micro enterprises, particularly in rural areas. However, the Government also is concerned with collecting taxes and with expanding the income tax base beyond government employees and the small number of formal sector factories and trading houses that are now on the tax rolls. Viewed from this angle, the more prosperous elements in the informal sector are the obvious candidates for expanding the tax base. The practical problems then become those of tax administration: how to identify the assets and income sources of the underground economy; and how to tax them without destroying them or driving them further underground. Achieving that balance is not easy, since the normal reflex of the tax authorities is to push too hard.

SMALL AND MEDIUM ENTERPRISE DEVELOPMENT AND SUPPORT PROJECT (SMEDS-SEFO) - LIBERIA

INTRODUCTION

The Liberian Bank for Development and Investment (LBDI) perceived in 1980-1981 a need for a financing "window" or facility to assist small scale enterprises (SSEs) and began negotiations with the Netherlands Development Finance Company (FMC) to provide funding. In the negotiations, it was determined by FMO that such a facility was needed, but that it should be a separate entity.

The Small Enterprise Financing Organization (SEFO) was incorporated in August 1981 as a private Liberian corporation for the purpose of assisting in the development of Liberian-owned and operated small-scale productive enterprises by providing financial assistance. SEFO gives preference to projects which aid in the development of Liberia by creating employment, increasing local value added, reducing imports, increasing exports and developing technical and entrepreneurial skills.

The initial stockholders were the LBDI, Liberian Finance and Trust Company (LFTC) and Partnership for Productivity, Liberia (PFP/L). FMO provided an interest-free loan of $250,000, plus financing up to $1,375,000 at 2.5%. Subsequently, the interest-free loan was converted to capital.

In 1984, USAID approved the "Small and Medium Enterprise Development Support" (SMEDS) project. This project finances a program undertaken by Partnership for Productivity, International (PFP/I) to provide technical assistance through a Business Advisory service (BAS) and up to $750,000 in grant funds to augment the equity capital of SEFO. Up to $500,000 of the grant funds were to be provided without condition, with the remaining $250,000 to the disbursed only upon evidence that the SEFO had obtained an equal amount of equity capital or "soft" loans from other sources. As of December 31, 1985, $500,000 had been disbursed under this grant to SEFO. See Exhibit I for summary financial and operating data.

Under the BAS program, a field service is provided to assist existing and potential SEFO clients through marketing and business development work to attract potential borrower/, identify and specify projects and loan requirements, assist in loan application preparation, and advise and monitor the progress of SEFO client business.

BAS is funded by USAID through PFP/I and is managed by PFP/I separately from SEFO.

SCOPE OF WORK FOR THIS PROJECT

The SMEDS Project was scheduled for a life of 5 years with a mid-term evaluation in 1987 and a final evaluation in 1989. Due to the economic conditions in Liberia, the financial conditions of SEFO, and the relationships between SEFO and BAS, it was decided by all parties that the mid-term evaluation should be moved forward. International Science and Technology Institute was requested to provide an evaluation team for the period from January 20, 1986 through February 23, 1986.

The objectives of the evaluation are to make an assessment of the SMEDS Project, as well as to provide recommendations for changes and modifications to the project, and to the operating procedures of SEFO and BAS.

The SEFO analysis and review consist of the following:

a. A review and assessment of financial performance and viability, capital structure, progress in obtaining additional funding, and the implications of the activities for performance.

b. A review and assessment of internal policies and practices as these relate to project identification, development and assessment, loan collections, and accounting procedures.

The BAS analysis and review consists of the following:

a. A review and assessment of the policy, procedures, training and performance in providing technical assistance to clints of SEFO and to small enterprises in Liberia.

b. A review of the assistance provided to SEFO in developing new prospective financing to clients, and in helping existing clients to improve performance and repayment.

In addition to the analyses of SEFO and BAS, a review and assessment was made to determine the ability of SEFO to absorb the BAS function at the end of the SMEDS project, and of the requirements for continuing support to both elements by outside resources.

While the evaluation, by necessity, had to consider SEFO and BAS separately, the purpose of the SMEDS project was taken as the guiding principle and the operations were viewed as a whole.

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THE ECONOMIC ENVIRONMENT IN LIBERIA

There are no sources of information on the number or economic value of SSEs in Liberia. Sawyer-Mason (1979) estimated 7,000. Based on experience in other developing countries, (Panama, Peru, Jamaica), a general relationship that can be projected is one SSE for each 50-100 persons in the population. Panama, with 1,500,000 persons has 30,000 SSEs or one for each 50 persons. Lima, Peru has a population of 5,500,000 and over 300,000 SSEs. Given the population of Liberia of 2,000,000, the number of SSEs would range from 20,000 to 40,000. Probably one-half of these would be petty traders without employees (market women, here-now boys, barrow-boys), and the remainder in the informal market employing 49 or fewer persons.

The commercial banking system in Liberia is unresponsive to the SSE sector. Opening a bank account requires significant minimum funds, currently said to be $25,000. This amount is beyond the reach of the SSEs. Because of the failure of the check clearing system through the National Bank of Liberia (NBL), commercial banks generally do not accept checks drawn on other banks for deposit or for cashing. In addition, the ability of the commercial banks to serve their larger customers for the importation of goods is severely constrained by the lack of foreign exchange.

Although the Liberian economy maintains a dual currency standard with the U.S. dollar circulating officially at par with Liberian coins, the inability of the banking system to provide adequate foreign exchange resources has created a ceasing of new bank deposits, a disappearance of U.S. currency and a cash economy. There is some trading of the Liberian coins at a discount, said to reach up to a 20% discount when larger sums are involved. There is a drift toward a de facto national monetary system, a flight of capital, and the beginnings of the emigration of talented persons.

The economic malaise is demonstrated by the steady decline in the per capita GDP, now declining at about 8% per year. The stagnant economy, political environment, and banking crisis have created a "wait-and-see" attitude on the part of business generally and SSEs in particular. Most businessmen have a very short time horizon and are not now contemplating any expansion or growth of their businesses. Economic reform initiatives with sustained implementation are required to create the climate necessary for the private sector to grow.

The segment of the business sector that the SMEDS project is to serve is the SSEs in the formal market which employ from 1 to 49 persons. This segment is characterized by business based on cash, lack of record keeping, short-term outlook seeking high turnover and profit, and lack of significant business assets.

The Liberian-owned SSE sector can be divided into the following subsections:

1. Casual - hawkers, barrow-boys
2. Artisenal - single person, fixed premises
3. Informal - small scale enterprise with 1-5 employees
4. Informal - small scale enterprise with 6-29 employees
5. Formal - small scale enterprise with 30-49 employees

The characteristics of these businesses are as follows:

1. Few fixed assets with job creation requiring an investment of $500-$2,000.
2. Intense competition.
3. Distrust of bureaucracy and a motivation to get around it.
4. Single management.
5. Flexibility when not overburdened with assets.
6. Probably lack success models, have a survival motivation, have a willingness to risk the small capital base, and see the business as a part of the extended family.

A financial institution seeking to assist businesses in these segments must be able to provide short-term credit, quick approval, and regular, extensive and intensive servicing and collection efforts.

SUMMARY OF PROGRAM EVALUATION FINDINGS AND RECOMMENDATIONS

The following is a summary of the major findings of the evaluation and the recommended actions for change which will make it more likely that the SMEDS project will achieve some success and SEFO will become viable in the future.

A. Major Findings

1. Financial viability of SEFO cannot be achieved within the SMEDS time frame under current operating practices.

   a. The volume of new loan applications has declined and is inadequate to reach and maintain a viable portfolio.

   b. The current portfolio has excessive arrearages and a major portion is probably uncollectable.

Loss reserves should be increased to an amount in excess of 35% of the portfolio.

c. Loan analysis and evaluation is rigid, time consuming, and fails to predict client performance. Delays in granting approval of loan applications has given SEFO a reputation of being a slow mover. Loan amounts are excessive to the requirements of the client, and in the current economic environment, have too long repayment terms.

d. The collection system is non-agressive and inadequate. Demand notices are not timely and are generally inaccurate. Borrowers are required to come to the SEFO office to make payment. The system as operated, precludes any significant recovery of loan funds or interest thereon.

e. There is a significant emphasis on collateral, leading to less attention to the ability of the business to generate sufficient net income to repay the loan.

2. The continuing existence of SEFO beyond the end of 1986 will depend on obtaining additional donor funds or soft term loans to cover operating costs and to provide new loan funds.

   a. Operating costs for 1985, excluding depreciation, were $392,000, and were covered by the $415,000 capital donated by USAID. Loan volume for the year was only 38, probably because of the poor economic environment. Operating costs per loan in 1985 were over $10,000 per loan. Total loan amount was $506,000, or a cost of $778 per $1,000 loaned.

   b. The major source of loan funds in 1985 (75% of total loans made) was the NBL/IDA line of credit which has a cost to SEFO of 10%. In addition, the terms of this line of credit require that the loans be longer term and be partially for fixed capital.

3. There is a lack of consensus between SEFO and BAS which leads to uncoordinated client acquisition and servicing efforts, and concentration of the technical assistance (TA) on a few clients.

   a. Record keeping and client files are fragmented and not coordinated.

   b. Under a new, trial working relationship entered into in January 1986, SEFO and BAS seek to improve the coordination and the flows of information concerning clients between the two organizations.

c. BAS has devoted significant atttention and effort in pursuing new types of endeavor and prospects for development of new businesses which might not result in application for financing to SEFO.

d. The emphasis of TA has been on assisting clients in record keeping. Insufficient attention has been given to the other functions of business, particularly marketing.

4. The following are other findings from the client survey:

a. Separate files on each client are maintained by the Comptroller, the Project Analysis Division, and by BAS. These files are redundant and often incomplete. The computer records are often incomplete and are not up to date.

b. Interest calculations are done manually although such calculations could be done more easily and more accurately by the computer.

c. Original loan documents were found in working files.

d. The owners of the businesses in the survey were Liberian nationals.

e. Funds disbursed were used as stated in the application.

f. The average number of employees besides the owner was three.

g. Thirty-five percent of the clients surveyed had no previous experience in the firm's industry, and the business was started with the SEFO loan.

h. Most of the clients had heard of SEFO through friends. Twenty percent had heard through advertising or publicity. While none of the clients in the survey had heard of SEFO through BAS, a number of applications have been generated through BAS.

i. The loan processing time (from application to disbursement), as estimated by the clients, ranged from one month to two years with a median of six months. Delays were often because of problems in documenting deeds and other collateral.

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j. The loan size averaged $12,400 in the survey, in contrast to the average size of $8,500 for the full portfolio. In 80% of the cases reviewed, the evaluators judged the loan to be too large.

k. About one-half of the proceeds in the majority of the loans reviewed were for fixed assets. This was considered by the evaluators as the source of overfinancing.

l. In one third of the cases reviewed, there was no increase in sales. In only one case did increased profits (after the owners' withdrawals) exceed the monthly principal amortization on the loan.

m. Only twenty percent of the clients surveyed had current profits (after owners' withdrawals) greater than the amortization of the loan.

n. Only fifty percent of the cases reviewed reported employment increases after the loan. The average loan amount per job created was $12,000.

o. Clients did not differentiate between SEFO and BAS.

p. Seventy percent of the clients surveyed indicated that lack of sales was their major problem.

q. The B.O.s of BAS are considered to be dedicated, well trained, and sensitive to the clients' needs.

r. The analysts of SEFO are industrious, but have insufficent experience and exposure to the needs of small-scale enterprises.

B. <u>Major Recommendations</u>

1. SMEDS should adopt a new strategy which concentrates effort and resources to locate existing SSEs that employ from 1 to 49 persons, and to provide short-term financing of the critical needs of these firms. The strategy would aim to develop a continuing financial relationship with these firms, and as satisfactory experience is gained, additional financing would be provided for expansion and growth.

   a. This strategy assumes that there are sufficient numbers of existing SSEs in the Liberian economy. No direct data is available. Based on information from other developing countries, (Panama, Peru) there are between 5,000 and 12,500 SSEs in Liberia, most in Monrovia.

b. This strategy requires a streamlining of both TA and financing activity to provide loans on a prompt basis, no later than 2 weeks after application for the first financing, more quickly thereafter.

c. SMEDS will have to develop a client profile. The minimum characteristics would include: (1) existing enterprise, (2) evidence of successful operation for a period of at least one year, (3) owned and operated on a full time basis by a Liberian national, (4) have an expectation of growth in income and employment with the infusion of capital by SEFO, and (5) have at least one employee other than the owner/operator.

d. SMEDS will have to attract clients meeting the profile through a concentrated and continuous publicity campaign using differing modes of communication.

2. The SMEDS project must be reorganized to provide for the unification of the top management and policy direction of the separate entities SEFO and BAS to concentrate energies and resources on the new endeavor.

a. A Liberian organization should be formed to perform the BAS function. This organization would have a Board of Directors which had some common members with the Board of Directors of SEFO. This overlapping would insure that the interests of both entities would be given full review at the policy level. It is expected that the Board of Directors of BAS would appoint as Managing Director of BAS the same person who is the Managing Director of SEFO. Separate funding and administration would occur. For economies of scale, the accounting functions and administrative requirements of BAS would be assumed by SEFO under an agreement. Funding for BAS would pass from USAID to PFP/I and then to the new organization.

b. SEFO must establish an adequate reserve for losses in its current portfolio. We recommend an increase to $800,000 on loan principal and to $140,000 on interest and other arrears. Loans in arrears over 180 days should be fully reserved against and turned over to the attorney to pursue legal action. Management effort could then be focused on the development and implementation of the new strategy.

c. A functioning management information system should be established to track clients from first contact to final payment to provide management with timely, accurate data for decision purposes.

d. A field collection system should be established to make regular, timely and persistent collection efforts at the owner's place of business.

e. SMEDS should plan to charge, beginning in 1989, a $50 annual fee to all borrowers to partially cover the cost of TA.

f. Financing of the TA function and the expatriate positions of trainer/advisor in BAS and financial/ management advisor in SEFO should be continued through the end of 1989. The continuing costs of TA after 1989 would need to be partially covered with funding from outside the SMEDS project.

g. Prior to any commitment for additional financing, donors should require the management of SEFO and the management of BAS to present a thorough analysis of their organizations and effective changes made in operations, staffing, costs and utilization of resources to meet the challenge of the new strategy.

3. Other recommendations are:

a. The Operations Manual should be updated and used. A section on field activities of business officers and a section on techniques of analysis should be included.

b. The existing fragmented files should be consolidated into a single client file, maintained in a central filing unit with check-out procedures. Client files should be accessible to both BAS, B.O.s and SEFO analysts.

c. Negotiations should be continued with NBL/IDA to improve the interest rate paid by SEFO and to permit the use of the funds in support of the new strategy. Collections from disbursed loans financed by NBL/IDA should be repaid to NBL.

d. The authorization requirements should be reviewed and revised to provide for more flexible repayment in line with the borrowers' requirements. Such changes would include equal monthly payments, capitalization of grace period interest, and cyclical repayments when appropriate.

e. The redundant and unenforceable requirements in the authorization should be reviewed and modified. These include requirements for bank accounts, monthly/ quarterly reports, etc.

f. An intensive review process during the commitment and disbursement stage should be established with requirements for updated operational and financial information, and an ability to cancel commitments and disbursements in adverse change situations.

g. The original loan documents should be removed from working files and placed in a theft and fireproof vault.

h. The duties of the existing Review Committee should be expanded to function as a Credit Committee to make recommendations for approval to the Managing Director.

i. Authorizations and loan documents should be reviewed by the attorney for legal sufficiency prior to disbursement. The attorney should be put on a retainer.

j. Technical assistance should be confined to support existing clients and to develop prospective clients for financing. A major emphaasis of TA should be on marketing.

k. Loans should be made only to existing businesses with demonstrated operational success.

l. Demand notices should be generated from computer calculations.

m. Regular, informal contacts between analysts and B.O.s should be developed to resolve client problems.

Adoption of these recommendations will redirect the effort and activity of the SMEDS project. A model was constructed for a phased increase in activity which would enable SEFO to reach partial viability by the end of 1989. The model requires additional donor grants or soft loan funds. The total required over the period is $4,430,000 or approximately $3,300,000 over the amount now remaining in the SMEDS budget. These additional funds would be used primarily for new loans, and also to cover operating losses in the transition, the TA function, and the extension of the two expatriate positions through the end of 1989. The model also assumes that, given succssful progress, the TA costs beyond 1989 would be underwritten by outside organizations, perhaps by the Government of Liberia.

MEMORANDUM OF UNDERSTANDING

The program evaluation summarized above resulted in a Memorandum of Understanding signed by USAID and the major partcipants in the SEFO operation. This Memorandum is attached.

MEMORANDUM OF UNDERSTANDING

On April 24 and 25, 1986 the donors and shareholders of the Small Enterprise Finance Organization, in light of the difficult external circumstances and the January 1986 ISTI evaluation, convened to discuss the immediate future and survival strategy for SEFO. The undersigned agreed on the following:

I. Organization and Management Structure

A. To ensure a collaborative working relationship between SEFO and BAS a management team will be established to guide their functioning and operations. This management team will be composed of a President, a General Manager for SEFO and a General Manager for BAS. The main outline of roles and responsibilities within the Management Team are shown below.

B. The President, formerly Managing Director, shall be responsible for external relations. As President, he will head the management team.

C. The General Managers, to be financed by USAID, will be responsible for and have authority to manage the day-to-day operations of their respective activities which may include field and operational procedures, managment information system, as well as personnel maters. SEFO's General Manager will streamline the organizational structure and operations, especially loan appraisal, implementation and supervision, collections, management information system, among other areas. BAS' General Manager will especially ensure the coordination with SEFO and the effective operation of the Business Advisory Service.

D. The President and the General Managers of SEFO and BAS will operate in a team-like fashion to ensure a smooth and effective operation of SEFO and BAS.

E. SEFO and BAS will continue to operate as separate entities with the combined leadership provided through the management team.

F. A mid-term evaluation of the management team function and the implementation of proposed measures will be conducted in December 1986. A final evaluation of the results of the restructuring and reorientation of SEFO and BAS will be conducted in December 1987.

II. Lending Target, Budget, and Lending Strategy

A. Given the experience of the past and the difficult economic conditions in Liberia at this time, SEFO's projected lending operations are anticipated to range from $400,000 to $600,000 annually. The lending limit will be determined by:

- o SEFO's liquidity position
- o NBL/World Bank refinancing facility
- o Collections

This period will be one of consolidation and limited experimentation. The above lending levels can be accomplished within the financial resources currently available and envisaged for SEFO.

B. In light of SEFO's income projections, SEFO will present a consolidated two year budget reflecting a cut in operational expenditures in the region of $50,000 for 1986 and $100,000 for 1987. Budgetary cuts should be concentrated in areas which will not hamper the lending operations or collections. It is the view of the donors and shareholders that the present staffing levels are not in line with the current lending projections and personnel reduction is recommended.

C. A future lending strategy should be based upon a thorough analysis of the present portfolio. The analysis should review the portfolio according to the following criteria: 1) loan size, 2) loan terms, 3) sector, 4) industry, 5) region, 6) new or existing business, 7) years in operation, 8) absentee ownership, 9) age of owner, 10) sex of owner, 11) education level of owner, 12) prior business experience, 13) if owner operates more than one business, 14) BAS assistance, frequency of client calls, 15) project analyst, 16) period in which loan was made. The analysis should be presented to Directors and Donors on or before May 9, 1986

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QUESTIONS RAISED BY THE SMEDS-SEFO CASE

As an example of small business financing, this case raises a number of questions such as the following which are probably generic in programming financial support programs for the small business sector.

1. Did preliminary program planning focus adequately on "demand" -- the potential borrower and his needs and capabilities?

2. What are the chances for success in small business lending utilizing a newly created financial institution?

3. What are the implications of loan volumes, interest rates and loan generation costs on profitability? Can they be forecast before the fact?

4. Can small business loans based on "collateral" and conventional asset-based appraisals be successful?

5. Can a "business advisory service" designed to assist in project identification, loan application assistance and loan monitoring be carried out successfully as an independent activity operating under different management and business practices from the lending institution?

6. What should the loan mix be between short-term and medium-term?

7. What are the major obstacles to successful operation of the "new strategy" recommended by the consultants?

8. What would it take to make the SEFO project succeed? Can it succeed?

EXHIBIT I

SMALL AND MEDIUM ENTERPRISE DEVELOPMENT AND SUPPORT PROJECT

SMEDS-SEFO

FINANCIAL AND OPERATING SUMMARIES

Total Loans, Grants, Technical Support - All Sources ($000)

ITEM / YEAR	LOANS	GRANTS AND TECHNICAL SUPPORT	TOTAL	USAID PORTION (ALL GRANTS)
82	1,375	750	2,125	---
83	---	---	---	---
84	300	395	659	395
85	380	1,024	1,404	1,024
86	---	749	749	499+
TOTAL	2,055	2,918	4,973	1,319+

Loan, Collection and Operation Data

ITEM / YEAR	83	54	85	86*
Loan Applications - Number	423	205	115	110
Loans Approved - Number	74	84	31	8
Portfolio Outstanding - $000	372	362	1,166	1,199
Principal Collections - $000	79	116	138	80
Years Pay Back on Principal	2.4	5.3	7.3	14.7
Interest/Fee Collections - $000	48	81	131	128
% Return on Average Portfolio	25	13	13	11
Operating Cost - $000	337	340	340	---

*First six months annualized.