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PRIVATE SECTOR INITIATIVE FOR AFRICA

ISSUES IN DIRECT ASSISTANCE

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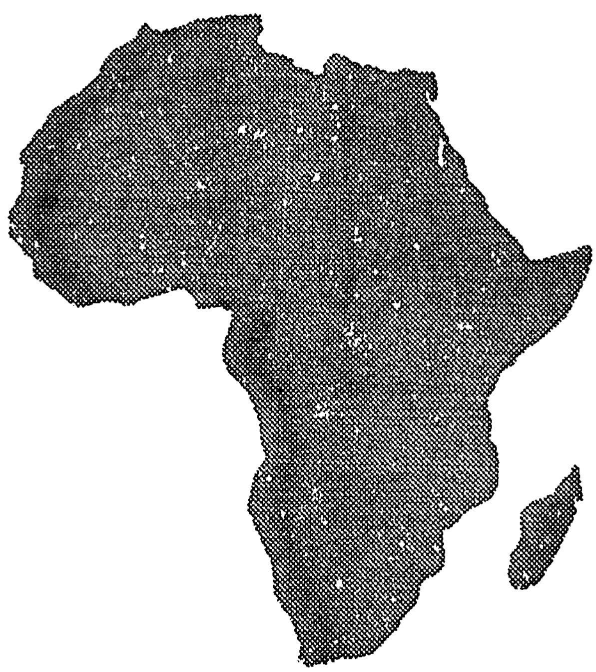

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CAN DEVELOPING ECONOMIES ATTAIN levels of productive efficiency that allow them to achieve sustainable growth and to become competitive at home and abroad? As Michael Porter, the contemporary authority on industrial competitiveness, has argued,[1] governments cannot create competitive industries; only firms can do so.

A government takes an important step toward economic development when it seeks to create an environment in which private initiative is unencumbered by superfluous regulation and official rents. Nonetheless, experience suggests that although a liberal policy environment is a precondition for private sector growth, the contribution of firms to economic growth may be stunted by other factors as well.

Donor assistance can play a critical role in helping developing nations' private sectors to overcome many of the historical disadvantages that they encounter in managing investment capital, acquiring technology and know-how, improving management capabilities, and expanding into new markets.

The provision of development assistance directly to the private sector raises numerous issues relating not only to development philosophy but also to management of the development process. Many A.I.D. missions in Africa and elsewhere have included direct assistance to the private sector in projects and programs; however, many others have expressed reticence or confusion regarding the perceived complexities that apply to this form of aid.

Most people in the development community interviewed for this report recognized the important contribution to development that for-profit firms can make. Nonetheless, many informants expressed skepticism with regard to the provision of direct assistance to the private sector. The principal thrust of their concerns can be summarized in two questions:

- Doesn't direct assistance to the private sector run counter to A.I.D.'s mission of helping socially and economically disadvantaged people?
- How can we reconcile the management mandate for fair play and competition with direct assistance to for-profit firms?

This report responds to those concerns by providing a framework for evaluating ways in which A.I.D. missions can comply with policy and regulatory guidance as they seek to support the initiatives of private firms in the developing world.

Direct assistance to private sector firms in less-developed countries (LDCs) and to U.S. companies operating in LDCs is not a new area for A.I.D., nor is such assistance beyond the mandate of Agency activity. Nonetheless, programming for direct assistance to the private sector is somewhat outside the mainstream of development activity as it has generally been

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[1] *The Competitive Advantage of Nations* (New York: Free Press, 1990).

practiced by A.I.D. during the past fifteen years. Skepticism within the development community regarding direct assistance to the private sector is, at least in part, a reflection of the established practice of working principally with public institutions.

This report discusses the role of direct assistance within the general context of A.I.D. policy logic and the development purposes that direct assistance may help to accomplish. It also summarizes A.I.D. policy on the provision of direct assistance and identifies windows of opportunity for A.I.D. missions (this summary ["Policy Guidelines for Direct Assistance to the Private Sector," below] as well as A.I.D. policy guidance [summarized in Appendix A], should help to allay many concerns and misconceptions regarding direct assistance).

WHY DIRECT ASSISTANCE TO THE PRIVATE SECTOR?

Rethinking the Role of the Private Firm in Development

Although A.I.D. has long been involved in assistance to the private sector through a wide variety of programs, in recent years it has channeled most development assistance to private enterprise through government and quasi-public institutions. Individuals and private firms have continued to benefit from these programs. However, the focus of programming on and through institutions has tended to emphasize the collective benefits of improving the policy environment for business rather than the contributions of individual firms to economic growth.

The development literature and planning documents reviewed for this report (see "Bibliography") generally view the for-profit firm (defined in its widest sense) as a vehicle for achieving broad development goals—such as economic and social equity, productive efficiency, growth, and employment—by virtue of its competitive mandate and its self-sustaining nature. In the policy logic of A.I.D., as well as that of other donors, the contribution of the firm to development rests not on profit for its own sake, but rather on the link between profit and sustainable contributions to economic growth in the aggregate. An A.I.D. private enterprise development policy paper has noted: "Private enterprises that respond to profitable opportunities in a free market produce jobs, managerial skills and economic growth. They contribute wealth to society and improve the quality of life. Moreover, significant equity objectives can be achieved when market forces operate to stimulate an economy toward full employment."[2]

Private sector entities are often viewed as tools for accomplishing development purposes that may be traditionally unrelated to the private sector economy in LDCs—for example, delivery of social or economic services, management of public infrastructure and utilities, and technical service delivery to the population at large. Within the context of adjustment programs and private sector development initiatives, private firms have also generally been viewed as essentially responsive elements in the development process: if monetary systems are stabilized, if capital markets are managed competitively, if public sector dominance in the marketplace contracts, and if market information systems and promotional opportunities are established, then private firms will respond to newly created opportunities in the pursuit of profit.

[2]U.S. Agency for International Development, "Private Enterprise Development (Revised)," A.I.D. Policy Paper (March 1985).

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Well-designed direct assistance can play an important role in helping firms to achieve sustainable growth and competitiveness. Programs to facilitate investment in efficient, productive capital (including facilities, equipment, technology, and know-how), to improve management and marketing capabilities, and to encourage innovation permit firms to overcome historical disadvantages and to capitalize on their competitive strengths. Programs to assist firms in identifying markets not only lead to improved sales but also open valuable windows to potential joint ventures, partnerships, and other types of corporate cooperation.

What Impacts Are We Looking For?

According to A.I.D. policy documents (see "Bibliography"), direct assistance to the private sector must be justified by a development purpose that targets one or more of the following outcomes:

- Measurable contributions to the public good (including improved efficiencies and cost-effectiveness in the delivery of essential services to the general public)
- Expanded collective benefits beyond the principals of the firm itself (including social equity and improvements in the quality of life for A.I.D. target populations)
- Measurable economic growth
- Measurable gains in the competitiveness of industry, markets, and the institutions that serve them

The development impacts of direct assistance can be categorized under several rubrics:

- Distribution or equity impacts (including employment and income generation)
- Demonstration impacts (including technical innovation)
- Contributions to the public good (for example, improvements in the quality and efficiency of service delivery)
- Contributions to economic growth (measurable in gross domestic product or trade balances)

Distribution Benefits

The distribution benefits of development aid to private sector firms is at the heart of concerns regarding the appropriateness of this form of assistance. This is particularly true with regard to mandates for free and fair competition and equitable access to development assistance. The degree to which economic benefits of assistance are likely to be concentrated among a small group of individuals (for example, equity holders) or redistributed beyond the firm is the principal measure employed in this regard.

Criteria for assessing distribution impacts include such factors as employment generation and income generation for employees, suppliers, and distributors. Improved performance of a firm may result in a widening of the network of suppliers or even the creation of new markets for heretofore underutilized raw materials and inputs.

Redistribution of equity (for example, through public offerings of shares in a firm) may also be a legitimate criterion for impact assessment. For instance, development assistance can sometimes be linked directly to improvements in the value of a firm that lead to public offerings or subsidization by the firm of savings mobilization programs (including credit unions and pension schemes).

Negative distribution impacts that may result from aid to a private firm include changes in the capital-labor ratio resulting from layoffs of workers as operating efficiencies are intro-

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duced. Although these changes might also lead to certain economic benefits beyond the firm—including lower-priced and higher-quality goods and services available to the public at large—development planners must consider the social costs of reduced employment.

Demonstration Benefits

The adoption or innovation of new technologies can be a vital catalyst for economic growth, particularly in countries where these techniques can be emulated elsewhere in the economy. Under certain conditions, direct assistance (in the form of training, research and development grants, feasibility studies, and the brokering of joint ventures) to technological pioneers and innovators can give rise to competitive infant industries with potential for a broad impact on national and regional economies.

An inherent risk in this regard is that direct assistance may be poorly targeted; if the relative factor endowments of a particular locale are not adequately evaluated, technological innovation may not be sustainable in the absence of subsidies.

Technological innovation may not be without social costs, however. Innovation can render some existing businesses uncompetitive, contributing to failure rates among them. Changes in labor-cost ratios resulting from technical innovation can also render some workers redundant and increase unemployment for segments of the population. Most vulnerable are those who cannot adapt to the higher level of skills that may be necessary once new technologies are adopted. However, training for skills improvement among workers can sometimes lower the social costs of this eventuality.

Contributions to the Public Good

Certain direct assistance may encourage the provision of services, activities, or other outcomes that enhance the general welfare of a population or its resource base. The impacts of such assistance can include improved quality and cost-effectiveness of social, technical, and economic services, such as health care, waste management, utilities, and infrastructure. Secondary impacts might include reduced environmental hazards, enhanced quality in essential goods and services, and systemic enhancement of technologies available to the public.

Contributions to Economic Growth

Assistance to the private sector must generally be consonant with the goal of inducing demonstrable growth in the recipient economy beyond the growth that would occur in the absence of such assistance. However, firms that do not produce a profit are unlikely to make medium- to long-term contributions to higher national income. Hence, the provision of assistance only to firms whose activities offer a satisfactory economic rate of return (ERR) is the principal means of ensuring positive development impact. If real the value added to the activities of the firm by assistance does not exceed the real cost of capital (including a margin for risk), it is unlikely that a firm can make a positive contribution to the economy.

Enhancing the contribution of exports to economic growth has been a key element of A.I.D.'s and other donors' development programming in LDCs. Programming in this regard generally focuses on assisting host-country firms in acquiring information on target markets, in establishing business contacts in those markets, and in brokering sales contracts or joint ventures between host-country and foreign firms. A.I.D. programs have registered some of their most impressive results through such assistance. However, in most instances donors have provided aid by financing intermediary export and investment promotion agencies.

When Does the Environment Justify Direct Assistance?

A.I.D. has learned valuable lessons from its efforts to effect policy change in African nations and elsewhere. These lessons must not be set aside in a fashionable rush to focus on direct assistance to private enterprise. Rather, direct assistance should be programmed in environments where liberal markets are in place—or at least where there are tangible grounds for optimism—and where political leaders are committed to the substantive autonomy of private enterprise. These preconditions are not ideological; they are practical.

In economies undergoing structural adjustment, political leaders have often accepted high levels of risk with the hope that private firms will move to occupy niches in the economies formerly occupied by the state. These leaders expect private firms not only to generate new economic growth but also to offset the jarring social consequences of adjustment by generating new employment. Under such circumstances, direct assistance to the private sector can increase prospects for stability and sustainable growth.

A.I.D. cannot isolate the goals and objectives of direct assistance to the private sector from the overall environment created by the quality of governance and policy orientation, as well as their effects on the functioning of markets. The Agency should use such assistance to enhance the gains of improved governance and sound economic policy.

In environments where policy distortions weigh heavily on the efficiency of markets, only limited positive outcomes can be expected to result from development programming in the private sector. In nations where public administrators use monopolistic power to control business, development assistance to private enterprise can become a catalyst or pretense for abusive controls, protection, or even retribution.

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SUPPORTING REFORM AND ACCELERATING MARKET LIBERALIZATION

Direct assistance can be critical in helping private firms to enter newly liberalized markets and to improve efficiency in the distribution of agricultural inputs critical to the national economy.

In Cameroon, the Fertilizer Sub-Sector Reform Program helped to create a private market for fertilizer by establishing links between commercial banks, private importers, and distributors. A.I.D. assisted commercial banks in screening and selecting eligible firms and provided funding for import loans.

In Mozambique, Private Sector Rehabilitation Programs assisted private firms in entering markets for agricultural inputs previously dominated by government monopolies. Private companies were selected as agents for the importation and distribution of program-funded fertilizer, vegetable seeds, and agricultural machinery.

PROMOTING VERTICAL MARKETS

Achieving well-integrated production and marketing is a major challenge to isolated rural industries. Direct assistance can help firms to achieve verticalization.

The Swaziland Commercial Agricultural Production and Marketing Project is seeking to "close the gap" of technical and management deficiencies among Swazi agribusinesses. Direct assistance to companies of varying size and experience will provide training in horticulture and specialty crop marketing, market information, quality control, and business planning, and management.

Criteria for participation by Swazi firms include the production of business plans for vertically integrated development and expressions of interest from financiers who will fund participant firms.

How Can Direct Assistance Help to Graduate the Informal Sector?

In recent years A.I.D. and other donors have "discovered" the informal sector, recognizing it variously as a symptom of systemic inequity in national economies, a form of everyday resistance to overly centralized economic authority, a hotbed of entrepreneurial innovation, and a potential catalyst for economic growth. One implicit goal of adjustment programs in LDCs is to close the gap between the formal and the informal sectors, effectively embracing the informal economy as a force for growth.

To the extent that A.I.D. has accorded legitimate priority to disadvantaged populations (including farmers, the rural poor, and women), programming has tended to concentrate assistance in the informal sector, where the "firm" may in fact be an unincorporated communal enterprise, a family farm or microenterprise, or a group united informally for some economic purpose. The stated objective as well as the underlying incentive for participation in development programs by these groups is usually the enhancement of social and economic equity, measured as improved employment and income.

Although donors view assistance to the informal sector with high hopes and enthusiasm, they are less at ease with assistance to firms that have successfully evolved into the formal sector. Consequently, a major challenge to development planners at this juncture is to identify appropriate and desirable "next steps" for promoting the evolution of small enterprises that are emerging from the informal sector.

Although A.I.D. has established guidelines for the promotion of microenterprises, firms that graduate from this loosely defined category generally must compete with larger firms for access to formal credit and other forms of assistance in the public marketplace.[3] Added costs of operating as a formal sector enterprise and competing directly with larger firms can often be so high as to render graduating firms uncompetitive. A.I.D. would do well to con-

[3] According to an A.I.D. Policy Determination, "There is no precise definition of a microenterprise. As a working definition . . . a microenterprise should have no more than approximately 10 employees." Microenterprise recipients of aid will generally include "(a) individuals in the poorest 50 percent of the population, (b) businesses owned by women, and (c) businesses owned and operated by the poorest 20 percent of the population." (A.I.D., "Microenterprise Development Program Guidelines," [Policy Determination no. 17, October 10, 1988].)

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sider formulating guidelines and programs for disadvantaged small enterprises that have successfully emerged from the informal sector.

This will necessarily involve fostering a flow of information, technology, and capital to private firms so that they are able to derive optimal benefits from ongoing policy reform programs and increasingly competitive markets for their goods and services.

POLICY GUIDELINES FOR DIRECT ASSISTANCE TO THE PRIVATE SECTOR

Restrictions and Opportunities in the Provision of Direct Assistance

Section 601 of the Foreign Assistance Act of 1961 (as amended) contains probably the most detailed statement of U.S. development policy, as defined by Congress, as it pertains to the private sector:

> The Congress of the United States recognizes the vital role of free enterprise in achieving rising levels of production and standards of living essential to economic progress and development. Accordingly it is declared to be the policy of the United States to . . . foster private initiative and competition . . . to improve the technical efficiency of [LDC] industry, agriculture, and commerce . . . and to encourage the contribution of United States enterprise toward economic strength of less developed friendly countries, through private trade and investment abroad, private participation in programs carried out under this Act (including the use of private trade channels to the maximum extent practicable in carrying out such programs) and exchange of technical information.

The act goes on to establish a firm mandate for development assistance to be provided to and through the private sector in LDCs and including, wherever possible, U.S. private enterprise. Included within provisions calling for the use of U.S. private expertise in the implementation of development projects is language that calls for "the transfer of equity ownership in [projects] or programs to private investors at the earliest feasible time" [section 601(b)8].

The act complements these provisions with restrictions that prohibit U.S. development programs from displacing or competing with private investment or commercial activity. In some instances these restrictions are commodity specific and discourage, but do not prohibit, support for export-oriented development programs that would increase competition for those commodities.

Guidance governing the provision of direct assistance to private sector firms is found in a number of A.I.D. policy documents.[4] Although a number of restrictions are universally applicable, others allow for exceptional cases and circumstances. A.I.D. policy suggests several general observations.

The provision of assistance to the private sector is circumscribed by four principal guidelines. The first three are both rigid and absolute in their application:

1. A.I.D. may not acquire equity in private sector firms at home or in recipient countries

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[4] See "Bibliography" for a listing of seventeen principal policy papers and policy determinations reviewed for this study.

FACILITATING MARKET ENTRY BY BUILDING SKILLS

One of the more frequent forms of direct assistance to private firms is training and technical assistance to improve management and technical skills. Such aid can be valuable in helping promote entry by small firms into unfamiliar, but lucrative, new markets.

The Human Resources Development Assistance Project has conducted training seminars for representatives of private firms throughout Africa to improve the capacity of successful local businesses to enter regional export markets. Training focused on such difficult-to-acquire skills as market assessment, competitor intelligence, product distribution, and export financing.

The South Africa Black Private Enterprise Development Project provided technical assistance and training to established small businesses. Training focused on overcoming complex financial, skills-related, and attitudinal constraints that inhibit leadership and decision making.

The Mauritius Industrial Diversification Project is providing direct training and promotional assistance to twenty firms, to help them identify and enter new markets for informatics and electronics manufactures. Individual firms are being trained to adapt production techniques to new products and to evaluate prospective markets.

2. Direct assistance to private firms must be justified on basis of both its fit within A.I.D. country development strategy and its stated development impacts for a target population
3. Funding assistance must be used for activities for which it was appropriated

The fourth guideline, while pertinent to all direct assistance initiatives, enjoys relative flexibility in its application:

4. Direct assistance should be subject to competition or competitive access

Where exceptions to guideline 4 are found, they are generally based on the likelihood of enhanced development impacts of a particular initiative or unique constraints characteristic of particular development problems. In almost every instance, exceptions appear to be granted over a medium-term horizon, to support private enterprise during transitional phases of development or innovation. This is particularly applicable to A.I.D. support for privatization of state-owned enterprises and public services.

Several illustrations are pertinent. 1988 grant restrictions state that grants to private enterprises may be used for the purposes of training and technical assistance only if such assistance is programmed "in such a way that provides competitive access for many enterprises rather than one enterprise"[5] However, an earlier A.I.D. policy governing assistance to private enterprise interprets restrictions more liberally, stating that the appropriateness of a grant "must be based upon the unusual innovations or developmental risk assumed. That is, the loan or grant must be based on the externalities of the project which go beyond the business itself (examples: development of a new, easily replicable technology, introduction and marketing of new services, etc.)."[6]

[5]U.S. Agency for International Development, "Financial Market Development Policy Paper" (August 1988)

[6]U.S. Agency for International Development, "Private Enterprise Development Policy Paper" (May 1982).

A.I.D. policy regarding assistance to privatized firms also appears to provide for exceptional authorities. Financial assistance for privatization is available in the form of both loans and grant activities:

> Grant funding can be used and is encouraged for assistance to buyers who desire to set aside equity shares for partial employee ownership plans .... There are instances when grant assistance can 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) or when the grant assistance facilitates other A.I.D. objectives such as widespread public ownership of shares, or partial employee ownership shares.[7]

Authorities granted to the Development Loan Fund in 1957, though little used since the early 1960s, are nonetheless still in force and provide a potentially creative mechanism for dealing with the equity problem.[8]

Development Loan Fund authorities did not extend to the purchase of equity or the awarding of grants; however they did allow the fund to acquire and dispose of real, personal, or mixed property, including mortgages, bonds, debentures, liens, pledges, and other collateral. It is possible that in the future, fund authorities could be used to justify equity acquisition and disposition under other programs, particular where equity will ultimately be transferred to employees.

Other forms of assistance—including technical and informational assistance and training—appear to be restricted only where they are not simultaneously offered to some collectivity of interests, beyond those of a single firm.

In its application, the fourth A.I.D. guideline appears less focused on competition in the strict sense than upon ensuring that the benefits of assistance are shared on a equitable and collective basis by the maximum number of beneficiaries. As elsewhere, the stated development purpose or objectives that justify assistance are pivotal in this regard.

Issues in Design, Monitoring, and Evaluation

A number of issues for design, monitoring and evaluation are raised by direct assistance to private enterprise. They are summarized below.

Fungibility

The issue of fungibility is most pertinent to programs in which capital (credit, grants, or commodities) is provided for a designated purpose.

The development community has often tended to conceptualize capital as a productivity input, ignoring the ease with which funds or in-kind assistance can be converted to unprogrammed purposes. Capital is fungible; it may be easily mobilized for purposes other than those designated in original grant or loan agreements. The justification provided for a

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[7]U.S. Agency for International Development, "Implementing A.I.D. Privatization Objectives," A.I.D. Policy Determination no. 14, (March 1991).

[8]The Development Loan Fund was established in 1957 to provide financing through loans, credits, or guaranties to economically, technically, and financially sound projects, and in 1961 it was merged with the International Cooperation Agency to create A.I.D. During its first four years, the fund allowed loans to be repaid in local currencies. It used tied procurement as a means of ensuring maximum reasonable benefits to the U.S. private sector. The principal instruments of fund activity in the private sector were direct loans and convertible debentures. The convertible debenture mechanism was designed not to allow A.I.D. to become an equity participant, but rather to provide worthy projects with a means for expanding their equity base at some later date through the sale of debentures.

capital transfer may have little relation to the activities stimulated at the margin by access to additional funds. From an accountability perspective, this suggests a need for effective controls to ensure that capital is not diverted for inappropriate ends. Just as important, however, is the need to be able to monitor and evaluate the effectiveness of capital transfers as a catalyst for the achievement of stated development goals and purposes. In either case, where capital is channeled through private sector firms for a development purpose, practical consideration must be given to the management load that will result for A.I.D. missions in monitoring the effective uses of capital.[9]

When assistance is provided through intermediaries (such as financial institutions, and cooperatives), A.I.D. can rely to a certain extent on accounting and control systems used by those institutions to manage risk. Those systems are not always in place or efficiently managed when A.I.D. provides direct assistance to a private firm.

Additionality

The problem of additionality—whether assistance genuinely provides for an outcome that would not have occurred in the absence of aid—is related to the fungibility issue. Would a firm that receives a loan to adopt a new technology have invested in innovative techniques and processes in the absence of a loan? Has a lending guarantee program led financial institutions to increase the number of new borrowers in proportion to program funds provided? Do farmers having increased access to credit increase their purchases of inputs by amounts equal to the loans they receive?

The measurement of additionality is difficult, if not impossible, given the inability of project managers or technical advisors to know exactly what recipients of assistance would have done in the hypothetical absence of aid. However, even an imperfect assessment of the effects of development assistance with regard to additionality is necessary for justification of capital transfers and for the evaluation of programs involving capital transfers.

A.I.D. has acquired a mass of experience with regard to fungibility, additionality, and substitution issues, particularly within the context of rural credit programs. On the basis of sometimes costly and painful experience, rural credit managers now recognize the hazards of using directed credit or additional liquidity to prompt specific production outcomes. The long-standing assumption that formal credit is necessary in order to prompt farmers, small businesspersons, and innovators to adopt new technology remains unproven and much in question.

In programs providing direct assistance to the private sector, it is critical to view grants, credit, and in-kind transfers as additional liquidity, rather than as production inputs. The use of additional liquidity provided by a capital transfer for its stated purpose is only probable if recipients are convinced that targeted outcomes are the most profitable or satisfying uses of additional liquidity.

Measuring Contributions to the Economy

Whatever the context and stated objectives of direct assistance may be, a satisfactory ERR is the principal indicator of positive development impact on a private firm. If the real value added to the activities of the firm by assistance does not exceed the real cost of capital (including a margin for risk), it is unlikely that the firm can make a positive contribution to the economy.

ERR criteria should measure the inputs and outputs of a firm vis-à-vis their opportunity cost

[9]For an excellent and detailed discussion of fungibility and additionality, see J. D. Von Pischke, Dale W. Adams, and Gordon Donald, eds., *Rural Financial Markets in Developing Countries: Their Use and Abuse* (Baltimore: Economic Development Institute of the World Bank, Johns Hopkins University Press, 1983).

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to the economy. Hence, a tradable good should be valued at its import price (c.i.f.) or its export price (f.o.b.) rather than at an internal price. This is because the latter may be affected by market distortions, including price controls, subsidies, protection, and taxes. Nontraded goods (for example, labor, services, or local transport) should be valued at their international equivalent prices, adjusted for distortions related to regulation, taxes, and monetary values. Projections of costs and returns should be made on a constant price basis (net of inflation) and using the real cost of funds in the local economy.[10]

The inclusion of particular costs and revenues in ERR calculations may depend on whether or not they constitute real costs to the economy, rather than solely to the firm. Domestic taxes on the firm may not be included in ERR cost calculations, whereas wear and tear or improvements in public infrastructure may be counted as costs even if the firm does not subsidize them.

The contribution of the firm to gross national product—in the form of "return to the domestic economy"—can also be calculated by netting out the contributions of assistance to the firm from donors or foreign-based entities, as well as any revenues that may derive from participation in the firm. (Obviously, revenue payments will only apply to situations where donors or foreign entities hold equity in the firm.) This is also a useful means of identifying whether or not foreign partners are obtaining higher revenues than local ones: if the standard ERR is lower than measures of return to the domestic economy, a higher proportion of revenues are flowing to nonlocal participants.

Quantifying secondary contributions of the firm to the economy is more difficult. External benefits of direct assistance to the private sector to producers and consumers may result in greater availability or improvements in the quality of goods and services. This can be measured in the supply and cost of goods in the marketplace and the degree to which they may be competitive with both domestically produced and imported ones. Alternatively, for firms that are introducing technological innovations, it may be possible to measure the rate at which those innovations are being emulated by other firms; this will be reflected in subsector growth and productivity gains.

Guidelines and Opportunities for Direct Assistance

The principal challenge in designing direct assistance initiatives for the private sector is not in selecting mechanisms that will work in boosting the corporate bottom line; it is no considerable challenge to bestow the advantages of enhanced information, technology, or know-how on a single firm to obtain positive bottom-line results. Rather, the challenge to development is in identifying targets of opportunity for inducing positive systemic change. A.I.D. policy is unequivocal in emphasizing that development purpose provides the key to identifying whether direct assistance is appropriate in any single instance.

Unlike efforts to promote policy reform on a societal scale, direct assistance is a strategic response to critical bottlenecks to economic progress at the micro level. The probability of success in any single instance is critically linked to correct diagnosis of where those bottlenecks are found.

The justification for direct assistance must be derived from the appropriateness of the proposed solution and its likelihood for achiev-

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[10]This discussion is adapted in part from criteria for project evaluation developed by the International Finance Corporation. For an excellent discussion of ERR, see International Finance Corporation, *The Development Contribution of IFC Operations*, Discussion Paper no. 5 (Washington, D.C., 1989).

ing stated outcomes. This may seem to be a statement of the obvious, but the critics of direct assistance do not hesitate to point to instances where this has not been the case.

Lowering the Information Barrier

The relative geographic isolation of many LDCs is compounded by their isolation from the global flow of information on markets, technologies, products, and processes. This situation has long been exacerbated by restricted flows of information even within individual countries.

The most effective means of providing information to private business in LDCs is undoubtedly through institutional intermediaries: commercial attachés, public media, and chambers of commerce and other business associations. However, to compete and to expand markets, businesses often require information that is tailored to their highly individual needs.

A.I.D. missions enjoy little comparative advantage as a source of such information. However, in the absence of host-country trade promotion agencies or similar institutions, A.I.D.'s regional bureaus are well placed to facilitate the flow of information through missions. Such assistance can seek to establish ties between private businesses in LDCs and their counterparts abroad and can lead to emerging partnerships in the form of joint ventures, marketing agreements, and technology licensing.

Such efforts in the field are unlikely to be successful without significant backstopping in the United States. Successful organization of informational and similar assistance, however, would impose a significant management burden on A.I.D. missions. For such a program to be effective, lead responsibility would have to be delegated within missions and contacts would have to be established and regularly maintained with functional counterparts at A.I.D. and in other U.S. government agencies.

Agency guidelines with regard to fair and competitive access do not constrain this type of activity if it is carried out through institutionalized programming; if it is adequately publicized in the host country and, if relevant, in the United States; and if it is implemented on a nondiscriminatory basis.

Promoting Technology Transfer

The technology gap between LDCs and developed markets is one of the greatest impediments to economic development. As in the case of information, it is not the absence of suitable technology that impedes development, but rather its relative inaccessibility to LDC entrepreneurs.

Technology transfer is a complex process requiring identification of needs, identification of appropriate technical solutions to the problems of businesses, sourcing of technology (including products and processes), obtaining financing for the appropriation of new technology, and transferral of skills necessary to optimize and maintain the value of new technology. Direct assistance can play a key role in facilitating each step. A.I.D.'s recently instituted Entrepreneurs International program is a useful step in this direction, helping LDC entrepreneurs to visit U.S. facilities to familiarize themselves with new products, processes, and markets. However, the program provides little or no follow-up assistance to help entrepreneurs to obtain technological capital and know-how.

Under A.I.D. policy, the direct provision of technology to LDC firms (for example, the provision of computer equipment, breeding stock, or assay equipment) would qualify as a grant of capital and would be subject to all incumbent restrictions. The appropriateness of such a grant must be derived from the grant's

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FACILITATING JOINT VENTURES

The Trade and Investment Services Program of the A.I.D. Private Enterprise Bureau has established an effort that targets creation of joint ventures between firms in developing nations and overseas partners.

Volunteer executives work over a two- to three-year period in a target country to link local firms with potential U.S. partners that are interested in establishing joint ventures, licensing, or equipment and product purchase agreements. Assistance can also include aid in negotiating and finalizing agreements. Costs of this program are generally covered by grants from the local USAID mission.

Successful efforts of this type have already been undertaken in the Dominican Republic, Ecuador, Egypt, Guatemala, and Morocco.

PRE's Private Investment and Trade Opportunities Project is an Asia-based effort to expand private sector trade and technology transfer between the United States and Asian nations. The program identifies U.S. joint-venture partners for Asian firms, facilitates meetings between prospective partners, and provides follow-up assistance for companies pursuing joint ventures.

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development purposes. If the grant were to promote replicable, innovative processes or to pioneer a new industry, if new technology is to contribute to improved quality or efficiency in critical public services, if the new technology is to add value to existing industry by expanding or diversifying production and if the risks of adopting the new technology were deemed to be prohibitive for LDC pioneers, then it is likely that the grant would qualify for approval.

Identifying Opportunities for Investment

A variety of U.S. agencies have established programs to assist U.S. business to conduct prefeasibility and feasibility studies for investment projects in LDCs. No such programs exist to help LDC entrepreneurs assess the viability of self-initiated investment projects or even to assist in the preparation of business plans and other analytical planning documents.

This presents a promising avenue for A.I.D. direct assistance to the private sector. No legal or regulatory restrictions prevent A.I.D. from making grants to private business for such studies, so long as they have an acceptable development purpose (unusual innovations or developmental risk assumed) and so long as grant funds are used for their stated purpose.[11]

The principal administrative obstacle to support for such studies is obtaining assurances that grants are awarded impartially, as the result of free and fair competition among a pool of eligible firms. Under exceptional circumstances (for example, the absence of a competitive pool of similarly oriented firms) this criterion might not apply.

Overcoming Capital Constraints

The provision of capital to private firms is subject to strict guidelines under A.I.D. policy.

[11]This topic was the subject of a legal analysis by the A.I.D. general counsel (see Robert Sonenthal, "Doing Business with Business: Grant Financing of Prefeasibility Studies [A.I.D. internal memorandum, July 21, 1990]).

These are less a regulatory impediment to capital assistance than they are an administratively complex barrier.

A.I.D. traditionally has provided capital assistance to private firms through intermediary programs and institutions for specific purposes. Loan guaranty facilities, targeted credit pools, and local currency proceeds from Commodity Import Programs have all been used to support private sector development.

The principal policy guidelines for these programs would apply to any hypothetical new assistance program for private firms: capital is generally provided in the form of a loan or loan guaranty, conditioned to lending on the basis of conservative evaluation criteria and repayment at market rates.

Although A.I.D. policy generally discourages concessionary capital assistance, notable exceptions exist for private sector training and assistance grants that are aimed at improving the competitiveness of industry or facilitating the adoption of new technology by industry.

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Developing Human Capital

Human resource development is one of the most promising forms of direct assistance that A.I.D. can provide to the private sector in developing nations. A.I.D. policy on private enterprise and sectoral development emphasizes that the improvement of technical and managerial skills in LDCs is a priority of the highest order.

Training assistance to private firms can be designed to meet a dynamic range of critical needs: improvement of managerial efficiency and controls, upgrading of skills in support of technological transfer and innovation, and skill enhancement in low-productivity occupations and in new sectors of the economy.

A.I.D. policy is clear in noting that private-sector workers should have access to any local training programs, training support services, and follow-up professional services that are provided by A.I.D. missions to those in the public sector. Policy guidelines for training assistance to the private sector encourage, but do not require, reimbursement in part or in full for training costs to the maximum extent possible.

PROMOTING COMPETITION IN CAPITAL MARKETS

Direct assistance can be used to accomplish multiple development purposes. In Kenya, the Private Enterprise Development Project expanded local sources of equity capital while promoting competition among equity capital firms. A.I.D. helped to establish a new company, Kenya Equity Capital Ltd., and provided a local line of term credit for investment in new projects, including start-ups, expansions, and restructurings. Additional funds and technical assistance were provided for pre- and post-investment advisory services carried out by Kenya Equity Capital and an older firm, Investment Promotion Services (Kenya) Ltd.

The outcome of direct assistance in this case was an expanded pool of equity capital, competition to invest in the most promising new ventures, and improved business planning services for companies poised for growth.

Facilitating Direct Assistance

As noted throughout this report, A.I.D. guidance on direct assistance to private firms is spread throughout a variety of documents: congressional authorities, appropriations legislation, and internal Agency policy and policy guidance papers. For this reason alone, many A.I.D. personnel mistakenly believe this form of assistance to be administratively complex. However, Appendix A summarizes Agency guidance for direct assistance and makes it clear that the focus of policy guidance is on identifying, rather than limiting, opportunities for assistance to private firms.

To facilitate understanding of A.I.D.'s position on direct assistance to the private sector and to lower barriers of administrative reticence, this topic could be the subject of a separate Agency policy paper or policy guidance document. Rather than merely unifying official guidance on this topic, a policy paper could provide guidance on the issues pertaining to design, implementation, and evaluation that have been raised in this report. It could also provide a checklist of considerations and clearances for direct assistance with regard to such critical concerns as the definition of appropriate development objectives, development risks, the relationship of assistance to country development objectives, and competitive access to aid.

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Appendix A

A.I.D. POLICY GUIDANCE FOR DIRECT ASSISTANCE TO THE PRIVATE SECTOR

Subject	*Policy*	*Source*
AUTHORITIES, RESTRICTIONS, AND REQUIREMENTS		
Development purpose	Recognizing that concessional assistance to a private sector firm is, in essence, a grant of capital to the owners of equity in the firm, its appropriateness must be based upon the unusual innovations or risk assumed. The loan or grant must be based on the externalities of the project that go beyond the business itself (e.g., development of new, easily replicable technology; introduction and marketing of new services).	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13)
Competition	If an indigenous private enterprise is to receive and manage A.I.D. resources to accomplish a specific development objective and several firms are capable of carrying out the activities, the firm to be used should be selected by an appropriate competitive process.	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13)
Equity	A.I.D. will not take an equity position in a private enterprise.	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13); sec. 635(g) of the Foreign Assistance Act, as amended
Grants	Grants to private enterprises are permitted to finance direct training and technical assistance, although such assistance should be programmed in a way that permits competitive access for many enterprises rather than one enterprise.	A.I.D., "Financial Markets Development Policy Paper," August 1988 (p. 11)
Grants and loans	A.I.D. may use grants or loans with concessional rates to finance direct training of and technical assistance to LDC private enterprises.	A.I.D. "Private Enterprise Policy Paper," May 1985 (p. 13)
Provision of financial capital	Provision of financial capital to private enterprise will be subject to the following conditions: • When its purpose is to provide financial capital to a financial institution so that it can increase its current on-lending to a specific A.I.D. target group • When its purpose is to initiate an entirely new venture or activity in the LDC's private sector to reach a target group not previously served	A.I.D., "Private Enterprise Policy Paper," May 1985 (pp. 13–14)

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Subject	*Policy*	*Source*
AUTHORITIES, RESTRICTIONS, AND REQUIREMENTS (continued)		
Credit to private enterprise	Interest rates to be charged on A.I.D.'s direct loans to private enterprises should be set within the context of lending through intermediate financial institutions. Interest rates • Shall, at a minimum, be at or near the prevailing interest rate paid on U.S. Treasury obligations of similar maturity at the time of obligating such funds, to the maximum extent practicable, and • Should not be less than terms prevailing locally or a rate that approximates the opportunity cost of capital in that country.	A.I.D., "Financial Markets Development Policy Paper," August 1988 (p. 12)
Credit to venture capital firms	Funds lent to venture capital firms should be at market rates; grants or equity contributions are not permitted.	A.I.D., "Financial Markets Development Policy Paper," August 1988 (p. 15)
PRIORITIES AND RECOMMENDATIONS		
Equity	Although A.I.D. may not take an equity position in a private enterprise, long-term or subordinated debt or convertible debentures may be permitted where it is appropriate that A.I.D. share in the risk or the growth of a new operation.	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13)
Grants and loans	Concessionary assistance is particularly useful when • Training and technical assistance have as their direct objective the improvement of competition in the industry and • New technology is transferred to the country.	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13)
Grants	Concessionary assistance to firms for the purchase of new technology should be proportionate to the transfer of technology (not the normal commercial risk) and should not hurt the marketing of such technology by the U.S. private sector through normal commercial channels.	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 13)
Directed credit	A.I.D. discourages excessive reliance on directed credit. The Agency should encourage developing countries to rely on market mechanisms to allocate capital to its most productive uses.	A.I.D., "Financial Markets Development Policy Paper," August 1988 (p. 7)
Credit to private enterprise	Concessional rates should not be used to encourage private enterprises to undertake activities that are not commercially feasible at market rates.	A.I.D., "Financial Markets Development Policy Paper," August 1988 (p. 12)

Subject	*Policy*	*Source*
PRIORITIES AND RECOMMENDATIONS (continued)		
Credit to microenterprises	Average loan size in microenterprise credit activities should not exceed $300 unless there are indications that larger-sized loans are needed to achieve the objectives of this program. For programs where prevailing country conditions make the $300 limit unreasonable in terms of meeting program objectives, USAID missions should set forth the reasons for the higher loan size in project or program documentation.	A.I.D., "Microenterprise Development Program Guidelines," Policy Determination no. 17, October 10, 1988
Credit to or through private financial institutions	When the purpose of financial capital is for on-lending to a specific A.I.D. target group, the Agency's resources should be channeled only to development activities that are • Consistent with A.I.D.'s country development strategy and • Unable to attract the full amount of required financial capital from commercial sources.	A.I.D., "Private Enterprise Policy Paper," May 1985 (pp. 13–14)
Credit to or through private financial institutions	When the purpose of financial capital is for on-lending to a specific A.I.D. target group, on-lending to the target group should be at LDC market-determined rates (interest and repayment period).	A.I.D., "Private Enterprise Policy Paper," May 1985 (pp. 13–14)
Credit for new ventures or activities	When the purpose of A.I.D. provision of financial capital is to initiate an entirely new venture or activity in the LDC's private sector to reach a target group not previously served, • Concessionality may be warranted to finance the extraordinary start-up costs associated with introducing the new venture or activity (i.e., costs that would not be incurred by subsequent investors that enter the market on the basis of the success of the initial enterprise; • Concessionality may be linked to project components, such as advisory services and training; or • Concessionality may be warranted to finance special costs arising from the newness of the venture or the requirement of direct benefit to a specific A.I.D. target group (e.g., the need to hedge certain risks and provide for a normal profit).	A.I.D., "Private Enterprise Policy Paper," May 1985 (p. 14)
Privatization	Complete privatizations of state-owned enterprises that result in joint ventures with U.S. firms, widespread stock ownership by the general public, and/or partial stock ownership by employees are the preferred A.I.D. approaches to privatization.	A.I.D., "Implementing A.I.D. Privatization Objectives," Policy Determination no. 14, January 1991

Subject	Policy	Source
PRIORITIES AND RECOMMENDATIONS (continued)		
Privatization: technical assistance	A.I.D. can provide technical assistance for privatization in such areas as the following: • Sector- or industry-specific analyses • Enterprise-specific analyses • Policy, legal, or regulatory analyses • Project design, implementation, and evaluation efforts related to privatization • Efforts to determine the appropriate brokerage mechanisms for privatization	A.I.D., "Implementing A.I.D. Privatization Objectives," Policy Determination no. 14, January 1991
Privatization: financial assistance	Finance for privatization is available only in special circumstances where market failure or market imperfections are likely to prevent a privatization deemed important by a USAID mission. Although A.I.D. will not take a direct equity position in private enterprise, Agency assistance can be used for participation in financial restructurings, including debt-equity swaps. A.I.D. can also provide assistance to buyers that desire to set aside equity shares for partial employee ownership plans (normally, these plans do not exceed 15% of outstanding shares). Agency funding may be provided to a buyer to cushion a burdensome covenant imposed upon the buyer by the seller for political purposes or when grant assistance facilitates other A.I.D. objectives, such as redistribution of equity among workers or through sale to the public.	A.I.D., "Implementing A.I.D. Privatization Objectives," Policy Determination no. 14, January 1991
Training	A.I.D. support for privately sponsored training should be encouraged. Agency support is appropriate as needed to assist private sector training initiatives with logistic arrangements, external placement, planning, and assessment. Direct costs of local and external training should be met by employers, the business community, or the individual to the maximum extent possible. Privately employed individuals and local employers of professional personnel should have access to any local training programs, training support services, and follow-up professional services supported by A.I.D. Private sector employment of Agency-financed trainees is consistent with A.I.D. development policy, provided that employment is in the country of origin and in a field for which the training was initially justified. Where trainees are expected to be privately employed, the employers should play a role in trainee selection.	A.I.D., "Participant Training," Policy Determination no. 8, July 13, 1983 (pp. 8–9)

Subject	*Policy*	*Source*
SECTOR GUIDANCE		
Agriculture	A.I.D. encourages an expanded role, where appropriate, for private enterprise in the provision of agricultural research and the dissemination of improved technology as well as in the processing, preservation, and marketing of agricultural commodities.	A.I.D., "Food and Agricultural Development Policy Paper," May 1982
Agriculture: facilitating direct and joint investment	A.I.D. will develop mechanisms and processes to facilitate the involvement of the U.S. private business community in food and agricultural development, including technical assistance and training as well as direct and joint investment.	A.I.D., "Food and Agricultural Development Policy Paper," May 1982
Agricultural exports	A.I.D. assistance to agricultural export activity is constrained by the following factors: • Export potential of the commodity in question • Magnitude of production likely to result from the project • Likely export markets • Volume of U.S. exports of the commodity in question and similar commodities • U.S. share of the world or regional market that could reasonably be expected to be affected by increased exports of the commodity	A.I.D., "Assistance to Support Agricultural Export Development," Policy Determination no. 15, September 13, 1986
Agriculture: palm oil, citrus, sugar, and related products	Although USAID missions are not prohibited from developing project ideas pertaining to these commodities, A.I.D. should only finance such projects when their development rationale is strong and their likely impact on U.S. producers is low.	A.I.D., "Policy Determination: A.I.D. Financing of Palm Oil, Citrus and Sugar Projects and Related Products," May 12, 1978
Agriculture: food industries	Private sector initiatives can enhance public investments in nutrition, particularly in the areas of agribusiness, food processing, and fortification. Technical assistance to food industries through U.S. private sector representatives is a type of collaboration that A.I.D. seeks.	A.I.D., "Nutrition Policy Paper," May 1982

Subject	*Policy*	*Source*
SECTOR GUIDANCE (continued)		
Development communications	The entire range of communications technologies and media is appropriate for support. Although A.I.D. resources will not be used for direct investment in or subsidy of private sector initiatives, private sector investment and entrepreneurship in communications-related activities may be supported through the following: • Technical assistance, training, and advisory services to the private sector • Using private sector suppliers of communications goods and services needed for project implementation • Using private communication channels, where they exist, for disseminating project-related information	A.I.D., "Development Communications," Policy Determination no. 10, April 1983 (p. 7)
Energy	A.I.D. will consider direct financing of energy production (in selected countries where A.I.D. finances resource transfers) when Agency funds act as a catalyst for private investment. A.I.D. will tie Agency-financed activities for industrial and commercial energy applications to A.I.D.'s support for private enterprise (U.S. and local). A.I.D. will encourage indigenous and external private investment in energy resources or systems development by conducting assessments, analyses, and feasibility studies integrating the capital investment criteria and informational needs of commercial lenders and energy enterprises.	A.I.D., "Energy Policy Paper," July 1984
Forestry enterprises	A.I.D. will focus on programs that increase the efficiency of production, marketing, and utilization of enterprises, including management and technical skills of the private sector in undertaking forestry activities. The Agency will expand the role of private enterprise as a means to establish an industrial base for forest development, improve the production efficiency of forests, and promote the utilization efficiency in conversion and consumption of forest products.	A.I.D., "Forestry Policy and Programs," Policy Determination no. 7, May 16, 1983

Subject	*Policy*	*Source*
SECTOR GUIDANCE (continued)		
Health	A.I.D. will support feasibility studies to assess the potential for private sector involvement in LDC health products and services, and the Agency is prepared to provide seed capital for experimental private sector programs. Innovative programs that A.I.D. may support include the following: • Retraining of private practitioners for the provision of primary health care • Establishing private logistics and distribution channels for health products • Promoting indigenous manufacturing of generic drugs, where quality control can be assured, at significantly lowered costs compared with imported ones • Promoting joint ventures between U.S. and LDC enterprises for the provision of health products and services	A.I.D., "Health Assistance Policy Paper," December 1982
Water and sanitation	A.I.D. endorses the role of private enterprise in water supply and sanitation activities, particularly with respect to operations and management. Where private entrepreneurs are interested, franchises can be auctioned off by the public sector for building and/or operating urban water systems. A.I.D. should fully explore the feasibility of expanding and improving these activities.	A.I.D., "Domestic Water and Sanitation Policy Paper," May 1982
Women's training	A.I.D. must encourage attempts to break the pattern of women's relegation to low-productivity occupations with no growth potential. The Agency can design into projects the expansion of employment opportunities in sectors where women have not traditionally worked and in those relatively new sectors of the economy where gender-specific work roles are not yet entrenched. A.I.D. can support and fund occupational training programs for women at two basic levels: • Technical and industrial skills programs should be used to prepare younger women for entry into profitable employment sectors where there are shortages of skilled workers • Management skills programs should be used to prepare women for entry into white-collar occupations that require knowledge of basic accounting and administrative skills	A.I.D., "Women in Development Policy Paper," October 1982