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# CONCEPT PAPER: DEVELOPING A POVERTY REDUCTION STRATEGY IN PARAGUAY

**PARAGUAY MUNICIPAL AND RURAL FINANCE (PMRF) PROJECT**

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# **PARAGUAY MUNICIPAL AND RURAL FINANCE (PMRF) PROJECT**

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## CONCEPT PAPER

### DEVELOPING A POVERTY REDUCTION STRATEGY IN PARAGUAY

#### Background

USAID/Paraguay recently received approval to develop an economic growth strategic objective. This document outlines possible directions for developing the strategic objective. It takes a medium-term perspective and recommends a mix of action program and policy elements suitable to the Paraguayan context. Poverty reduction lies at the heart of the strategy. The strategy also traces out how the directions suggested mesh with intermediate results currently included in the Mission's strategic objective framework.

#### Objective

##### Purpose

The purpose of the recommended strategy would be to reduce poverty in selected economic regions of Paraguay.

##### Results

The results expected from the strategy would be increases in sales of businesses, expansion of employment, and a boost in investment in plant and equipment in selected economic regions of Paraguay.

Additional results would include more aggressive entry into export markets and expanded financial services, especially for rural producers, in selected economic regions of Paraguay.

##### Linkage to USAID Strategic Objective Framework

The strategy's purpose corresponds to USAID/Paraguay's Strategic Objective for Economic Growth, Agriculture, and Trade, "Increased Incomes for the Poor in Selected Economic Regions."

The results expected would contribute to two Intermediate Results under the Strategic Objective:

The strategy suggests using technical assistance in the form of business development services to achieve the results outlined above. Programmatically, the services would take the market as their starting point and work back to resolve whatever problems stand in the way of expanding the sales of businesses and

creating jobs. A key element of the resultant “value chains” would be the financial services that allow them to function. In nurturing and consolidating the chains in question, the strategy not only would facilitate the expansion of functional financial services, but highlight models for replication elsewhere. In so doing, it would therefore contribute directly to Intermediate Result 2, “Financial Services Increased.”

By demonstrating that it is possible for small businesses to tie into export networks and thereby expand both sales and employment, the strategy would contribute to the achievement of Intermediate Result 3, “Business Environment for Micro and Small Businesses Improved.” By addressing policy obstacles to the expansion of small business activity, especially for export, the policy dialogue component of the strategy would make a contribution as well.

### Statement of the Problem

Recent studies conducted by the Paraguayan Bureau of Statistics and Censuses estimate that poverty has increased in recent years. Approximately one third of Paraguayans currently live below the poverty line. The problem is more severe in rural areas, where the percentage rises to over 40 percent. The rural communities in question present similar characteristics: numerous small farmers using rudimentary production practices, with limited access to output markets, both foreign and domestic, and with limited access to input markets, including credit.

Democracy remains the centerpiece of U.S. policy in Paraguay, but the challenges to it are large and growing. The recession in Paraguay is now in its fifth year and shows little sign of abating. Increasing dissatisfaction with the national government has led to considerable unrest in the countryside. At a minimum, Paraguayan democracy must be able to demonstrate credible commitment to improving economic conditions, ensure the provision of basic services to the country’s citizens, and provide incentives for private parties to create jobs for a rapidly expanding population. If democracy does not deliver a promised better life, people may lose faith and embrace the populist solutions proposed in the recent past. Moreover, a worsening economy in the countryside may encourage increased involvement in illicit drug production and marketing.

In short, Paraguayans do not live by economics alone, but unless the economy begins to show some sustained buoyancy, it will place in jeopardy broader development objectives.

### Suggested Response

With the relatively modest resources at the Mission’s disposal for economic growth activities, it is imperative for USAID to adopt an economic growth strategy that is both focused and catalytic. The suggested strategy attempts to respond to that need.

In essence, the strategy outlined here would take a two-pronged approach. First, it would launch action programs in economic regions of the country that satisfy two criteria, economic potential and relatively high levels of poverty. In other words, they would go where both the money and the poverty are. The programs in question would provide business development services to enable businesses to increase sales, jobs, and investment. The resultant value chains not only would expand economic activity themselves, but would provide models for adoption elsewhere. Although the strategy does not contemplate lending funds to businesses, it would nurture financial arrangements that increase the participation of small producers in the value chains, and document those arrangements for use by others.

The second prong of the approach would be policy dialogue. By their nature, action programs take a transactional, problem-solving approach and, as such, are not up to the task of solving problems that are more systemic in nature. For such problems, it is often necessary to address the norms, regulations, etc., that govern business activity across the board. In principle, there are a panoply of policy issues the strategy could tackle. Fortunately, the strategy's action programs could serve as a natural ground-truthing filter for figuring out what issues call for priority attention. Once such an issue surfaced, the strategy would develop options for its resolution and lobby the appropriate level of government for change.

### Key Operating Principles

For the strategy to have maximum impact, it is important to learn from best practices elsewhere. This section therefore presents key operating principles to adopt.

***Both macro-economically and locally, the major constraint to development in Paraguay is lack of effective demand. As a result, connections with outside markets are essential. In other words, Paraguay must trade, both externally and internally.***

Nationally, Paraguay's productive apparatus is constrained by the low level of effective demand -- that is, purchasing power -- within the country. As a practical matter, therefore, Paraguay has no choice other than to look to external markets for buyers of its goods and services. Opening up to trade is not a luxury, but a necessity.

Micro-economically, it is very common in Paraguay to debate production potentials. Too often, the debate focuses almost exclusively on technology and abstracts from market considerations. Unless there are markets to absorb increases in production, emphasizing productivity alone will be counterproductive. This is especially true for Paraguay's rural poor, whose markets are small and price-sensitive.

***Not only is lack of effective demand the key constraint to development in Paraguay. Demand is the point of entry for attacking its poverty.***

All constraints to reducing poverty – and all points of entry for attacking it -- are not created equal.

Most development practitioners are willing to accept the argument that lack of demand constitutes developing economies' principal constraint and argue, accordingly, that trade is essential for broadly based economic growth. Interestingly, though, few apply the same logic to the sectoral and microeconomic sphere. Although “market oriented” and “demand-driven” approaches are now in vogue, few put the demand horse squarely in front of the supply cart. It is one thing to argue for connections with markets; it is quite another to look to -- and accept -- demand as the engine of the process. Development experience is replete with agricultural technology transfer programs that have foundered in the absence of demand. But development experience also points up the opposite side of the coin: small farmers can and will adopt modern practices, but when they know beforehand that someone will buy their product at a price acceptable to them. In short, when demand is present, it furnishes incentives for economic actors to address supply constraints; when it is absent, however, attacking supply constraints is tantamount to pushing on a string.

Exhibit 1 distinguishes graphically between physical and programmatic directionality. Although product moves physically from producer to consumer, programmatically the starting point must be the market, not the supplier. Adopting a market-driven approach does not mean producing what you normally do and then figuring out how to connect to the market afterwards. Such thinking is “*vender lo que se produce*,” when one needs to “*producir lo que se vende*.” A market-driven approach is one that heeds what the market is demanding – quantity-, quality-, and timing-wise -- in the first place. In other words, the challenge is for suppliers not just to “*articular*” with demanders, but to react to demanders.

***If one sees the development process as driven by demand, pitting city against countryside makes little programmatic sense. In fact, urban and rural areas fit naturally together in what can be termed “economic corridors.”***

Development is driven by demand. Demand for rural products is found primarily in cities. Cities drive rural development.

Agricultural production takes place in rural areas, but the income and employment generated as a result extend far beyond the farm. From both demand and supply perspectives, therefore, it is time to break down artificial conceptual barriers between the two supposedly distinct economic domains.

Programmatically, the concept of economic corridors offers a useful way of making the natural alliance between city and countryside operational. Economic corridors are natural economic regions defined by commercial flows between rural areas and cities, and among cities themselves. As one might expect, in practice they correlate closely with the presence of roads and watersheds.

***Outsourcing and subcontracting can be useful mechanisms for connecting micro and small businesses with markets.***

In most countries, government and donors have chosen to support micro- and small enterprises primarily with technical assistance and micro-finance services. Without identified buyers, however, technical assistance can only go so far. And although micro-finance provides an invaluable service in stabilizing incomes and alleviating household insecurity, ultimately it is essentially a safety net, not an economic growth strategy.

What, then, to do? In the end it is only market demand that will furnish adequate incentive for micro- and small enterprises to increase (in size) and multiply (in numbers). In other words, improving the lot of Paraguay's micro- and small entrepreneurs means looking elsewhere – once again, to sources of demand for their goods and services. Doing so is not “trickle-down” economics, but a simple recognition of the demand-driven nature of the development process as well as what the burgeoning literature elsewhere in the world tells us about the potential of outsourcing and subcontracting mechanisms.

A final comment. The bevy of surveys of micro-entrepreneurs worldwide over the last two decades buttresses this whole line of argument. When interviewers ask micro-entrepreneurs what is the most important thing they need to get ahead, the typical response is, “connect me with a buyer.” It is not, “improve my technology” or even “provide me credit.” Again, resolving demand problems comes first. The other constraints, though important, are second-order problems.

***Resolving the problems that impede the growth of specific businesses is an appropriate, focused, and disciplined way to allocate scarce program resources to business development.***

There are so many worthwhile things one can do to promote businesses in Paraguay that one can justify practically any intervention he or she can think of. The difficulty is that the resources available to address problems pale alongside their magnitude. As a consequence, opportunity-cost thinking is essential. A good business development service is not necessarily a high-priority business development service.

Although it is tempting to support products, industries, and sectors across the board, such support often turns out to be diffuse and unmeasurable in its impact. Ultimately a nation's wealth is created business by business. That is where key resource allocation decisions are made, and where business development services can be most effective. But not all types of assistance are of equal value. Experience suggests a useful operational criterion to bring focus and discipline to the technical assistance process: only provide a business development service if it is reasonable to expect an increase in the subject firm's sales five times the cost of the service in question.

***Focus on the sustainability of businesses supported, not on the sustainability of the service provider.***

In projects throughout the world, it is customary to worry about the sustainability of the organizations created to provide development services. At first blush, such a concern would appear to make sense. Further reflection suggests the priority is misplaced. In the end, what counts is not whether the service provider continues to exist, but the commercial relationships established between buyers and sellers. In fact, the sooner a service provider can consolidate such relationships, the sooner it makes sense for it to retreat from the scene. In the final analysis, commercial phenomena must stand on their own two feet. Trying to perpetuate long-term relationships of dependence is counterproductive. Moreover, trying to keep oneself in business typically shifts one's perspective inward. As a result, one's service to one's clientele tends to suffer, thus – ironically -- making one's own sustainability even less likely.

***Focus on results, and keep monitoring and evaluation sweet and simple (KISS).***

Many projects content themselves with measuring only their activities, making the question of the impact of those activities a matter of faith. In effect, such projects choose to manage for inputs, not for results, holding themselves accountable for what they do, not what they achieve. Clearly, raising the bar to measure results not only makes much more sense developmentwise, but is also wise management practice. If people say they shall accomplish something, they should hold themselves accountable for same.

Experience also suggests the wisdom of restricting monitoring and evaluation to essentials and relying on objectively verifiable quantitative indicators. In such instances, monitoring and evaluation systems not only crunch out numbers to satisfy donor financiers, but become a management tool that implementers can use to monitor progress, spot problems, and correct them in mid stream.

## Components of the Strategy

The strategy recommended here would consist of two components, an action program component and a policy dialogue component. Exhibit 2 portrays the relationship between the two and how they would fit in a broader poverty reduction and alleviation framework. As the reader can see, the exhibit distinguishes poverty reduction clearly from poverty alleviation. Poverty reduction means permanent solutions to poverty, which typically result from private sector initiatives that generate incomes and jobs. In contrast, poverty alleviation activities relieve poverty in the immediate term, but since they do not furnish permanent solutions, require recurrent funding. Reducing poverty normally costs much more per capita than alleviating poverty. To meet the needs of all their poor, therefore, countries engage in both kinds of activities.

Conceptually, the generation of incomes and jobs depends on four factors: a policy environment conducive to private sector investment; access to markets in the broadest sense -- that is, the wherewithal to trade; adequate physical capital; and adequate human capital. The strategy outlined here would address the first two of these factors, interacting with government, as appropriate, to address the two latter.

### Action Program Component

The action program component of the strategy would provide technical assistance in the form of business development services in selected economic regions of Paraguay. The assistance in question would link businesses -- and the producers they source from, many of whom are currently poor -- more solidly with markets, especially foreign markets.

### Geographic Siting

For the strategy to have an impact on poverty, it would make sense for its action program component to go where the poor are. To come up with permanent solutions to their poverty, it would make sense to go where economic opportunities are.

Exhibit 3 takes a first cut at determining what areas in Paraguay meet both desired criteria. As discussed above, the intent in the end would be to work in "economic corridors." Given data availability, however, the information in the exhibit is organized by department. Each is ranked by two variables, economic potential and connection with poverty. All other things being equal, the departments most appropriate for interventions are those in the northwest portion of the exhibit. In all, there are ten such departments, Alto Paraná, Amambay, Caaguazú, Caazapá, Canindeyú, Concepción, Guairá, Itapúa, Ñeembucú, and San Pedro. Of these, Caazapá is the focus of GTZ's development program, and Ñeembucú is isolated from other departments of interest. It would therefore make sense to concentrate interventions under the strategy in the remaining eight departments.

Thinking in terms of economic corridors, it would appear that the best way to site the strategy's action programs is as follows:

Eastern Economic Corridor. This corridor would consist of portions of three departments, Itapúa, Alto Paraná, and Canindeyú. Specifically, it would include districts bordering both sides of the paved highway that runs essentially from Encarnación through Ciudad del Este to Salto del Guairá. The criterion for selecting exactly which districts to include would be the degree to which they are linked commercially, or could be linked commercially, with the highway in question.

Central Economic Corridor. This corridor would consist of portions of three departments, Caaguazú, Guairá, and San Pedro. Specifically, it would include districts bordering both sides of the paved highway that runs west-east across Caaguazú, and districts bordering both sides of the paved highway that runs south-north from Villarica through Coronel Oviedo to San Estanislao and beyond into the southern part of San Pedro. This corridor would therefore have the form of a cross. The criterion for selecting exactly which districts to include would be the degree to which they are linked commercially, or could be linked commercially, with the highways in question.

Northern Economic Corridor. This corridor would consist of portions of three departments, Concepción, Amambay, and San Pedro. Specifically, it would include districts bordering both sides of the paved highway that runs west-east from Concepción through Horqueta and Yby Yaú to Pedro Juan Caballero, and districts bordering both sides of the paved highway that runs north-south from Yby Yaú into the northern part of San Pedro. The criterion for selecting exactly which districts to include would be the degree to which they are linked commercially, or could be linked commercially, with the highways in question.

Under the strategy, each economic corridor would house a business promotion center. Possible candidate sites for the centers are:

<u>Eastern Economic Corridor:</u>	Ciudad del Este
<u>Central Economic Corridor:</u>	Coronel Oviedo
<u>Northern Economic Corridor:</u>	Horqueta

#### Functions of Business Promotion Centers

Exhibit 4 suggests how the strategy could translate the demand-driven paradigm presented in Exhibit 1 into action. Depending on the problems identified in each case, the strategy would intervene at one or more of the following levels:

- Identifying final demand in as specific a form as possible. The ideal would be to have a formal purchase order in hand, especially in the case of foreign buyers. This task is the most basic, since it drives the rest of the process.

- Identifying and securing the commitment of large and medium enterprises to engage in the business in question. More often than not, the commitment would include entering into outsourcing agreements with small producers.
- Nurturing the outsourcing relationships established, inserting technical assistance and management expertise into the process.
- Organizing small producers to deliver the product agreed upon in the quantity, quality, and time frame desired. This task could involve entering into alliances with third parties in the area – non-governmental organizations, for example – with on-the-ground capacity to furnish technical assistance, monitor progress, flag supply problems as they occur, and solve them.

A priori, the strategy would not restrict itself to any one sector or to any one size or type of firm. The guiding criterion for selection of business clients would be straightforward: work with those enterprises with the highest potential to expand sales and create jobs. If the strategy can attract IBM to open up a plant with 500 jobs for people in a corridor, fine. If it can boost employment by helping producer associations shift from low-value to high-value export crops, fine, too. In other words, the suggested strategy is not an agricultural or small enterprise strategy, for example, even though it is highly likely that it would have heavy involvement in agriculture and involve substantial numbers of small producers through outsourcing arrangements, typically subcontracts.

Early this year the Mission met with a variety of companies and associations to ground truth the approach recommended. Interestingly, those value chains with the most promise currently rely on outsourcing. More than that, the actors in question -- both buyers and sellers – look to build on the base established.

One key role played by the outsourcing arrangements observed is financial: the medium or large company that buys from individual producers typically finances the bulk of the variable cash costs of the operation – primarily physical inputs and technical assistance, thereby freeing up small producers from cash-flow burdens they would otherwise need to shoulder on their own. As the strategy facilitated the expansion of the scale of these operations, the number of “borrowers” would increase as well. As they grew, it would be important to document what transpires, taking into account the nuances that distinguish the approach of one “lending” company from another.

The same goes for other forms of financial services. Again, the strategy would not limit its support of financial intermediation to any one model. In principle, it would facilitate access of producers to formal banks, savings and loan associations, cooperatives, credit guarantee mechanisms, etc. -- whatever would facilitate the expansion of sales and jobs and nurture the consolidation of value chains for the long term. To the degree possible, it would also promote equity investment in the economic corridors, either directly or through joint ventures. In each case, the strategy would document the number of participants in the scheme in question and describe how the operation works for replication elsewhere.

One final comment. Although technical assistance can take many forms, experience elsewhere suggests the key role that disinterested third parties can play as “honest brokers” between parties – large buyers and small sellers – that often enter the scene with deep-set prejudices against each other. Aside from whatever other services the business promotion centers would provide, building trust could be the most basic and far-reaching contribution of all.

### Functions of Central Office

A central office in Asunción would provide technical guidance and backstopping support to operations in the three economic corridors. Specific functions would include:

- Providing administrative management oversight to assure that all activities conducted under the strategy comply with USAID regulations and Paraguayan law.
- Setting up the three business promotion centers.
- Coordinating the technical activities of the three centers, providing technical guidance and coherence, and assuring that the centers have internalized and made operational the proposed demand-driven approach, and speak with one voice.
- Identifying buyers in Asunción interested in sourcing from the three economic corridors, and attracting new actors to the corridors, both to buy and to invest.
- Identifying and coordinating international technical assistance to resolve specific business problems that the business promotion centers are unable to address from local sources.
- Setting up and managing a results-focused monitoring and evaluation system, establishing baselines and assuring that the sales, employment, and investments attributed to the strategy’s intervention are indeed so.
- Making information on the results of the strategy, and the activities conducted under it, available publicly, both electronically and in print bulletin form.
- Setting up a policy analysis unit (see below).

### Policy Dialogue Component

The policy dialogue component of the strategy would address policy issues – norms, regulations, practices, etc. – identified by the business promotion centers as key systemic constraints to the expansion of business activity in their corridors. By resolving them, this

component would facilitate the growth not only of client businesses, but of others as well, contributing thereby to an improvement in the climate for business generally.

### Functions of Policy Dialogue Unit

The functions of the strategy's policy dialogue unit would include:

- Maintaining contact with the business promotion centers to stay abreast of emerging policy issues.
- Identifying with the centers the issues that call for priority attention, and developing work plans for addressing them.
- Analyzing, either directly or through others, options to address the policy issues identified.
- Dialoguing, either directly or through others, with appropriate levels of government in the pursuit of workable solutions to policy problems.
- Following up with appropriate levels of government to be sure that they take action on the solutions agreed upon.

### Linkages with Other Activities

The success of the strategy would depend on forging effective alliances with others. With support from the central office, the business promotion centers could likely identify and cultivate potential buyers and investors to source from and invest in their corridors. Alone, however, they probably would be unable to organize and provide technical assistance to a sizable number of value chains, especially value chains that source from many small producers. As a result, it would be unwise for the centers to put up walls around themselves. They must work closely with others.

Examples of organizations to collaborate with include:

Peace Corps. Peace Corps volunteers could be invaluable allies in building trust with small producers and organizing supply. Peace Corps management in Paraguay has already expressed a strong interest in their playing this role.

Local non-government organizations. NGOs with bases in the economic corridors typically have the field presence needed to help organize supply. In principle, an alliance between those who identify buyers and organizations whose strength is organizing suppliers is win-win. For the cooperative sector, a similar case could be made for collaboration with ACDI/VOCA.

Sources of finance. Financial organizations are wont to complain that they have few bankable projects to fund in rural areas. As the business promotion centers facilitated the emergence of viable businesses, it would be natural to bring them to the attention of potential sources of funding.

Local governments. Municipalities receiving technical assistance under USAID's Municipal and Rural Finance Program could play a potentially significant role as well. In many rural areas, the critical constraint to expanding market activity is access roads. With more tax revenue in hand as a result of the program, local governments may now be in a position to bring key roads up to par, thereby facilitating a dramatic rise in access of local businesses to market.

### Expected Results Over Time

To be able to nurture and consolidate a critical mass of economically buoyant value chains in the three proposed economic corridors, the business promotion centers would probably need to operate at least four full years. It would likely take about six months to get the centers up and running. The strategy is therefore recommended to have a life of at least four and a half years.

During its life, the strategy would achieve results in line with the objectives posited above. Candidate indicators include:

Purpose-level indicator. Poverty levels would drop in each of the departments in which the business promotion centers are active.

Results-level indicators. The strategy would generate increases in sales, employment, and investment in plant and equipment, which, cumulatively, would rise exponentially over time.

Additional indicators. The success of the strategy would depend heavily on gaining increased entry into external markets and an increase in financial services to small producers. As a consequence, it would be wise to include indicators for these variables as well.