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A.I.D. Policy Paper

Private Enterprise Development

Bureau for Program and Policy Coordination
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PRIVATE ENTERPRISE DEVELOPMENT

I. Introduction

A society in which individuals have freedom of economic choice, freedom to own the means of production, freedom to compete in the market place, freedom to take economic risk for profit and freedom to receive and retain the rewards of economic decisions is a fundamental objective of the A.I.D. program in less developed countries. Such a private enterprise economy is held to be the most efficient means of achieving broad-based economic development. 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.

This policy paper builds upon A.I.D.'s experience in assisting private enterprise development. It also draws upon the research conducted for the President's Task Force on International Private Enterprise. The guidance in this document should help A.I.D. strengthen and more fully integrate private enterprise development into the mainstream of Agency activity, as recommended by the Task Force. This policy paper supersedes the A.I.D. policy papers entitled Private Enterprise Development and the Bureau for Private Enterprise Policy Paper (both dated May 1982). However, the goals of A.I.D.'s policy toward private enterprise remain the same. These goals are, in the first instance:

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

Secondly, as a corollary to the above:

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

II. The Importance of The Private Sector in Third World Development

A. Economic Importance

The most efficient allocation of scarce resources occurs when individuals seek to increase their incomes in an environment characterized by open competition in the supply and exchange of goods and services. When complemented by prudent management of necessary government services, the aggregate effect of individual free market behavior is growth and development of the economy at large.

However, many LDCs have not relied on open, competitive markets to determine resource allocations in many sectors of their economies. Rather, LDC governments have attempted to direct essential activity in agricultural and industrial production and trade by administrative determinations. Except for small-scale activities often characterized as informal, the economies of many LDCs are marked by extensive government efforts to determine production levels, prices and consumption patterns.[1] A wide variety of historic, ideological and other reasons explain a particular LDC's mix of public and private sector activities.

Aside from the provision of universally accepted public goods like national defense, public safety, monetary policy and enforcement of contracts, further government involvement in an economy follows from the belief either that a market cannot be established or that the result of market decisions will lead to socially unacceptable outcomes. In certain cases, such as natural monopolies, goods with important externalities, and merit goods (See Annex A for definitions), a government may determine that public involvement in production or distribution is important to achieve social objectives. **But it is clear that LDCs which have overextended the role of the public sector and restricted the operation of the private sector have experienced slow growth, heavy budget deficits and rising debt burdens.**

LDCs that maintain a broad definition of natural monopolies and public goods pay a higher price in overall economic growth. Such countries have typically experienced real per capita growth averaging 3% per year over the last ten years. Many have been at or near zero growth. However, those LDCs which have more narrowly defined the role of the public sector and allowed competitive markets to determine the price and quantity of most goods and services have experienced growth, rates averaging 7% per year.[2]

In terms of equity, countries with a high level of government interference in the market fare no better in the short run than market economies, probably because slow growth reduces employment opportunities.[3] In the long run, government dominated economies may fare worse, because sustaining equity-oriented services becomes difficult when growth, and therefore revenue, lags.

Government is thus in a unique position to establish a favorable climate for private investment. Moreover, that climate is critical to the attainment of both economic growth and equity objectives. The extent and nature of public and private sector roles must be defined and balanced to ensure equal access to opportunities and high economic growth. This is the challenge in A.I.D.'s private enterprise policy.

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[1] Recent efforts at measuring the extent of private sector activity in Sudan and Peru suggest that despite claims to the contrary, private enterprise is thriving. In Sudan a recent A.I.D. funded study identified between 13 and 16 private health care services per commercial block. See A. Bekele, "Briefing Notes on Health Care Financing in the Democratic Republic of Sudan," Draft Report, AID OTR-4121. Peru's "underground economy," which parallels the highly restricted public market in that country, absorbs 60 percent of the workforce, provides 85 percent of internal transportation and has achieved growth rates which exceed those of the formal, legal sector. See C. Rosette, "How Peru Got a Free Market Without Really Trying," *Wall Street Journal*, January 27, 1984.

[2] Agarwala, Ramgopal, "Price Distortions and Growth in Developing Countries," World Bank Staff Working Papers Number 575, 1983.

[3] For a convincing case showing how the expansion of the public sector has stretched the managerial capacity in many countries see The World Bank, *World Development Report 1983*. See also Alvin Rabushka, *Free Markets and Economic Development in Postwar Developing Countries* (December 1983) which shows how most of the countries which have outgrown poverty in the Post-War II period have emphasized free market economic policies.

B. Social Importance and Human Rights

Economic freedom for individuals—an essential condition for viable competitive markets—encompasses the notion of the right of persons to make personal choices in providing for their livelihood and that of their families. Such economic freedom permits individuals to pursue, within the bounds of generally accepted norms of behavior, activities which utilize their comparative advantage in innate capabilities, acquired skills and interests.

The essentially independent decisions of suppliers and consumers in competitive markets result in a diffusion of economic power. The greater the competitiveness of the market and the economy at large, the more dispersed is the power to influence the market and the economy for individual gain. Free markets are the most effective way of mobilizing human energies, assuring responsiveness to consumer demands, and avoiding the exploitation of the poor typical of public or private monopoly or oligarchical enterprise. Given the close association of economic power with political power, a key attribute of a society which permits free competitive markets is a pluralistic body politic. As LDCs remove restrictions on the operation of markets, they are simultaneously encouraging behavior which supports the development of popular representative political institutions. A democratic government is not an automatic outcome of a competitive market environment. However, competitive markets generate greater likelihood of progress towards a form of government which provides for popular representation than towards authoritarian forms of government. Furthermore, a society in which economic power is widely dispersed is more likely to be one in which transfer of political power by election is permitted than in a society where exclusion from political power carries with it exclusion from economic power.

A.I.D. notes that when representative institutions emerge in a free market economy, reciprocal benefits in the form of efficiencies in the provision of public goods and services are likely to occur. In societies which permit open debate, the levels of public goods supplied and the roles of state authorized monopolies are adjusted in the normal political process to the particular level of popular demand. These adjustments attempt to minimize the social and financial costs of these exceptions to competitive markets. However, adjustments in authoritarian societies may not occur until a situation becomes untenable; an abrupt restructuring may then follow civil unrest, a **coup d'etat** or revolution. The society pays an ever increasing price in terms of reduced growth and inequity before the change takes place. Furthermore, the abrupt nature of the change may only produce a different but equally inefficient solution to the supply of goods and services provided or controlled by the public sector.

III. Nature of the Challenge to the Development of Market Economies in LDCs

Greater reliance on competitive markets in LDCs and the growth of indigenous private enterprises are constrained by policy, administrative and developmental impediments. This section focuses on often encountered constraints.

A. Constraints Established by Government Policy

1. The LDCs' Strategy for Economic Development

Government determines the direction of development by establishing the overall development policy environment and a particular strategy. From these government determinations flow the sector policies and regulations which govern the day-to-day activities of the economy. The success of A.I.D. and other donor efforts to support reform of sector policies and government procedures through individual project efforts may not meet expectations if the country's strategy for economic development is not compatible with proposed-reforms.

Many LDCs enunciate their overall strategy in their published development plans. But this is not always the case. In fact, development plans sometimes mask real priorities with rhetoric designed to appeal to donors. Efforts to introduce market pricing and producer competition in an LDC committed to socialism and central economic management will not yield the desired results. However, A.I.D. is more often confronted with less severe strategies which also may involve a strong element of central control of the economy by government. In particular, an LDC with a strategy of general import substitution may be reluctant to expose its domestic market to imports even though this may be a policy reform essential for long run, broad-based economic growth. A country whose fundamental development strategy is to achieve food grain self-sufficiency also may not be receptive to policy changes which stress its comparative advantages in other products and its ability to more cheaply satisfy its food requirements through international trade.

The results of general import substitution policies have largely been contrary to the LDCs' expectations.[4] They have entailed serious resource misallocations, have not reduced the dependency on imports (although they may have changed their composition) and have inhibited export growth. As a consequence, foreign exchange constraints and dependency on external resources have been aggravated, not improved, and growth potential has been adversely affected.[5] In contrast, export oriented strategies have given rise to a variety of LDC success stories.[6] Overall, countries that have adopted measures which have let their private sectors aggressively pursue opportunities to export have done relatively well in terms of growth and improvement in living standards. The exports may have been products of indigenous resources (agriculture surplus, natural resources, etc.), or value added to imports. Export oriented strategies have proven their value in promoting economic growth because LDC domestic demand is usually neither sufficient to support the number or sizes of domestic production units required for healthy competition in many product markets, nor sufficient to achieve full employment. **Consequently, A.I.D. encourages a shift from policies which promote general import substitution to policies which open an economy to international trade.**[7]

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[4] Bela Balassa and Associates, *Development Strategies in Semi-Industrial Economies* (The World Bank 1982).

[5] Anne O. Krueger, *Trade and Employment in Developing Countries Synthesis and Conclusions* (Natural Bureau of Economic Research 1993).

[6] *Ibid.*

[7] This overall objective is not intended to conflict with specific statutory provisions (e.g. FAA Section 620(d)) and existing Agency policies proscribing activities that would result in direct competition with U.S. enterprise.

The transition to an export oriented strategy and A.I.D.'s involvement in it must, however, take cognizance of two basic issues. First, the obstacles to economic liberalization are substantial. Many LDCs have conceptualized their form of import substitution strategy in terms of national security objectives and are reluctant to consider alternatives. In most cases the most sensible (and feasible) approach to assisting an LDC reorient its overall strategy involves the gradual dismantling of controls and price distorting policies first in those areas where success is most likely and change is least threatening to the LDC's perceived national security objectives.

Second, import substitution is not bad **per se**. Efforts that do not run counter to reliance on the price mechanism and which seek to exploit productive activities in which a country has a real competitive potential are sound.

Thus, A.I.D. believes it is critical to focus on the development scheme of the government, to assure that its effects are known and weighed. It is also critical to determine the real motives behind what otherwise appear to be poor economic choices in the management of an LDC economy. Finally, in cases in which an LDC is reluctant to modify its overall strategy, there still may be significant scope for private sector activity and use of market prices. **A key objective of A.I.D.'s strategy is to promote, through the policy dialogue associated with U.S. assistance, a greater reliance on market determined prices and the initiative of the private sector.**

2. Government Policies and Regulations Derived from Its Development Strategy

A country's fundamental strategy gives rise to policies and regulations through which that strategy is implemented. The economies of many LDCs are burdened with diverse policies and regulations which seriously impede enhancement of the private sector's role because, as previously explained, many LDCs have until very recently followed development strategies which involve import substitution and public sector control of the economy. This section describes frequently encountered policies and regulations. In this review, it is important to be aware that there is frequently a lag between a change in an LDC's basic strategy and the subsequent change in sector policies and regulations which were derived from it.

- **Foreign exchange policies and regulations:** Most LDCs do not operate an open market in foreign exchange. As a consequence, their foreign exchange rate often differs from that which would occur under free market conditions. When this difference reflects an undervaluation of foreign exchange the outcome is equivalent to a tax on exports and a subsidy on imports. This distorts factor prices in production.

  In countries that do not rely on the market for foreign exchange operations, government rules regulating banking sector activities prohibit or severely limit the buying and selling of foreign exchange except for specific (sanctioned) purposes as determined by the national planning process. Foreign exchange for essential requirements of the private sector, such as spare parts, fuel or other inputs, becomes unavailable or is rationed on political criteria, rather than priced according to the urgency and economic importance of its use. Consequently, the buying and selling of foreign exchange by private firms requiring non-sanctioned commodities occurs in black markets or through totally offshore transactions. The domestic private sector serving the domestic market usually operates in the black market while foreign investors conduct their foreign exchange transactions offshore. In both cases the regulations impose an extra cost on doing business. While some LDCs have allowed parallel markets to develop, the exchange rates in each market are almost always different from each other. Individuals or firms permitted to deal in the official market have a significant price advantage over those who must deal in the parallel market.

- **Import and export restrictions:** LDCs frequently restrict certain types of imports and exports, severely tax some goods, use non-market mechanisms to allocate other imports and establish a large number of,procedures for import and export transactions. On the import side, most LDCs require businesses to obtain licenses prior to importing needed commodities. The issuance or denial of these licenses is the mechanism by which the government substitutes political control for the economic judgments of the market place. Licenses are also used to help ration undervalued foreign exchange. On the export side, restrictions are imposed to artificially maintain the domestic supply of a particular good so that prices for domestic consumers may be held down. Of course, the result is also to depress the incentives and financial capability to expand supply.

- **Banking restrictions:** LDCs have traditionally controlled the activity of the private sector through a wide array of rules and restrictions imposed on the banking sector. Interest rate regulations frequently set less than market interest rates causing only the most risk-free loans to be made. The low lending interest rate also suppresses the interest rate on savings, which results in little institutionalized mobilization of resources. Institutional capital does not flow to the most productive uses, particularly the more dynamic and labor intensive small and medium enterprises. Rigid controls may substitute for economic considerations in determining the quantity of loanable funds which can be made available for different types of production and investment credit needs. Government imposed or permitted collateral requirements narrow the number of entrepreneurs who are eligible for institutional credit.

- **Market entry restrictions:** Many LDCs have erected a ponderous structure of rules and procedures related to the issuance of business licenses and the establishment of corporations. A firm can be established in a few days in a developed market economy, but it may take months or years to legally establish a firm in an LDC. Not only are a large number of steps formally required; the reality of LDC bureaucracy is that each step may require unofficial payments by the entrepreneur in order to move to the next step. Even without corruption, time is money, and long planning times impose a substantial cost which small-scale entrepreneurs lack the capital reserves to manage. Thus, there are considerable financial as well as administrative barriers to market entry.

- **Limitations on investment:** Many LDCs specify a level of investment which they feel is warranted in a particular industry. In some cases the specification is in the form of a limitation on the maximum size of private sector investment. Any number of entrepreneurs may enter the industry, but none can operate above a certain size. This restriction is usually made to protect a large firm which may be owned by the government and would not be able to compete with a private firm of equal size.

  Other LDCs restrict the number of firms which can operate in a specific industry. While the purpose of these restrictions is to prevent over investment in the industry, the effect is to give the lucky investors excess profits, and government personnel another opportunity to exercise discretionary authority for political or other interests through the rationing of business licenses.

- **Investment promotion programs:** Government may offer a package of investment incentives in order to attract entrepreneurs into activity which the government wishes to promote. This can be done without restricting investment in other industries, but often it is not. However, problems arise when the activities which are promoted follow from administrative determinations which do not reflect the country's comparative advantage in production as might be determined in an open competitive market. Funds invested in promoted industries may be funds denied to other more productive activities which have not been included in the promotion program.

- **Price-fixing:** Countries often set a maximum price to maintain artificially low prices for certain goods. The activity is easiest to enforce when the government operates a price-setting parastatal. However, price-fixing and related enforcement is practiced even without parastatals. The most popular items for price regulation are essential foods and agricultural inputs; however, many countries fix the price of other commodities such as shoes, clothes, batteries and liquor. Price fixing which results in higher than market prices also occurs when the number of private firms in a particular industry is limited so that a suppliers' cartel can be formed.

- **Subsidies:** Closely related to price-fixing are government subsidy programs. Subsidies may be offered to expand consumption or to temporarily protect particularly vulnerable groups from the cost of well advised corrections. However, they are often required to compensate for inefficiencies in production which arise because of policies which restrict private enterprise. Furthermore, perpetuation of subsidies frequently becomes a political necessity for outlasting any temporary justification.

- **Labor Market Laws and Regulations:** Minimum wage legislation that sets excessive levels of wages and fringe benefits, and employment rules that overly restrict hiring and firing processes act to reduce employment opportunities and favor the substitution of capital for labor. Minimum wage laws which set wages above market clearing wage rates do not reflect labor market demand and supply conditions. Either because they are set at unrealistic levels or through their effect on other wages (which change when minimum wages change), they act to push labor costs beyond the capacity of some firms. The impact of fringe benefits, which form a substantial proportion of labor costs in many LDCS, and of regulations covering hiring and separation practices, tends to further dampen demand for labor. Developing countries with a large labor surplus should ask themselves whether the economic and social costs of higher unemployment and economic dislocation are truly compensated for by the perceived political or social benefits of high minimum wage laws.

· **Taxation and User Charges:** LDCs depend more on indirect taxes which are relatively easy to administer (e.g. taxes on exports and imports) than on direct taxes which are more expensive to administer (e.g. income or consumption taxes). Such indirect taxes often impact primarily upon the producers of export commodities, particularly rural producers, and retard export growth. LDCs also tax in an effort to accomplish a specific social purpose, sometimes resulting in very high marginal rates being applied to high income earners and very high duties being levied on "luxury" goods. In these cases, the administration of the tax usually has serious shortcomings and tax amount of evasion is widespread. Also, taxes on income and property usually have high exemption floors. The effect of exemption floors and tax evasion is that the actual number of people or amount of property subject to the tax is very limited and inequitable; administration becomes politicized, and law abiding taxpayers in effect subsidize those who evade taxes. High rates exacerbate inequities and encourage the sheltering of income, including offshore investments. Tax policies should be reviewed, and generally revised to foster development and encourage saving and investment.

User charges, particularly for water, sewers, power and transportation rarely cover costs, and the supply of these services must be financed in part from tax revenues.

3. Policies That Discourage Private Sector Participation In Traditional Government Programs

A variety of policies and regulations similarly discourage private sector participation in the social sectors. For example, the private sector has an important role to play in the delivery of health and family planning services in developing countries. Government resources often cannot support the provision of services for all those individuals who may want them, and some individuals may actually prefer to receive services from sources other than the government.

Governmental policies not only affect their citizens' desire for family planning services, but also this acceptability and availability of the services themselves. Private sector involvement is likely to be more consumer oriented and more likely to offer the range and mixture if product and assistance desired by the public. Moreover, and this is especially important in the family planning area, use of the private sector as a delivery mechanism increases emphasis on personal choice and responsibility and reduces dependency upon the government. The active involvement of the private sector in the delivery of family planning services may depend to some degree on government policies regulating not only the distribution and advertising of particular contraceptive methods, but also on policies which cover the organization and operations of non-governmental organizations.

Many LDC governments sustain policies whereby all government services are provided free of charge, regardless of governments' ability to finance these services and in spite of demonstrated client willingness to pay for some or many of these services. Yet, at the same time, all LDC governments lack the financial resources to provide nationwide access. The result of these policies is the underfunding of basic health services, which are often of extremely poor quality (thinly staffed and deficient in drugs and supplies) or existent more in theory than in fact. Clients are left **de facto** to rely on whatever private health services exist, and these services must compete with "free" (albeit inaccessible) goods.[8] Furthermore, insistence on government provision of services has impeded the private sector from filling the health care gap. Studies in various settings have demonstrated strong consumer demand (as evidenced by willingness to pay) for quality health services provided by government and private sources.

Similarly, there is potential both for involving the private sector more fully in the provision of education and training services and inputs, and for shifting some of the costs of education from the public to the private account.

At the primary or basic schooling level there is potential for private and local organizations to play larger roles in the administration of schools. People in most LDCs are no different from people in our country. Education of one's children is a highly valued objective. In most cases, schooling at this level will continue to require some public subsidy from central revenue sources. However, most strategies of localizing and diversifying school systems require the active encouragement of private and local organizations including community self-help groups, in the provision of basic schooling (see A.I.D. Policy Paper entitled **Basic Education and Technical Training**).

Such organizations are also prominent in the provision of pre-school education and non-formal education or skills training for adolescents and adults. The initiative for starting and sustaining these programs tends to be private, as they tend to be additional to the government's basic education mandate. The most effective form of public support is often some form of technical support services, rather than direct subsidies.

At the secondary, vocational/technical and higher education levels there is an even stronger case for shifting more of the costs of education to the private account, either through tuition and other fees or through reliance on private organizations and employers to provide the training, perhaps supported by partial tax credits. In many countries, half or more of the education at these levels is provided privately, with little or no public subsidy other than essential technical services such as examinations administration. It is essential to keep in mind that at higher levels of education and training, the private benefits tend to equal or exceed social benefits. This is true especially where only a minor fraction of those eligible are able to benefit. Thus, excessive public subsidy of these levels and types of education and training drains resources needed for the provision of basic education and skills training with higher social benefits.

Finally, regardless of how education and training systems are administered and funded, there is great potential for the private provision of education and training inputs. For

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[8] A.I.D. Evaluation Specific Study No. 20, "Prospects For Primary Health Care In Africa: Another Look At The Sine Saloum Rural Health Project In Senegal", April 1984, Abby L. Bloom.

example, private contractors can often build schools and handle the printing and distribution of texts and other instructional materials at less cost, more quickly and with more attention to local demand or design requirements than can central ministries. (And not to be overlooked is the development of managerial and entrepreneurial skills which can have a multiplier effect on a society.) As school systems expand, other opportunities for privately provided services also expand, ranging from housing and transport for students and teachers to commercial media, data processing and telecommunications services.

In the agricultural sector, government policies and programs have restricted the operation of markets and entrepreneurs. Agricultural subsidies and related price controls adopted by many LDC governments in areas such as food marketing and distribution, marketing of agricultural inputs, and agricultural credit have tended to result in substantial reductions in efficiency and productivity with little or no benefit to the disadvantaged groups they are often supposed to help. Moreover, LDC governments often intervene directly in the physical distribution system for both agricultural inputs and outputs in order to enforce such controls.

While there are certain areas in the agricultural sector (such as agricultural research and extension) where government involvement is useful or essential, this involvement should permit parallel or complementary private sector activity. For example, private seed and fertilizer/pesticide companies have been important research centers in the U.S.

Finally, many LDCs maintain policies that discourage the efficient provision and maintenance of infrastructure, both in rural and urban areas. Private road maintenance, urban public transit, water supply and sanitation are examples of other areas where enhanced private participation in the provision of both services and infrastructure can produce significant efficiencies.

Performance contracting for private road maintenance is one such instance. In 1970, for example, in a very large South American country, the highway department began a contracting-out program that by mid-1981 had reduced the size of the public maintenance network by 75% and there were 264 contracts for private maintenance. Similar experience in many other countries for some 19 categories of private road maintenance activities was shown in a recent IBRD study to have resulted in an average 37 cost percent reduction in comparison to public provision of like services. In one large African country, the results were more dramatic because no maintenance had been occurring prior to private contracting.

In urban "public" transport also, the pressure for private provision has grown as a result of shifts in public attitudes and the demonstrable efficiencies that have occurred as the result of the shift from public to private provision. Until rather recently, conventional attitudes were that large public systems operating with fixed routes, large operating units and larger vehicles were more efficient than private systems. These attitudes have changed substantially as the result of careful empirical studies comparing the relative efficiency of public vs. private service in numerous large Asian and South American cities, as well as the experience with large operating deficits and poor service of the existing public systems.

The experience with private vs. public provision in the developed world and the problems of infrastructure provisions in LDCs has also led to renewed interest in private ownership as well as operating and maintenance agreements between ministries and private firms. Careful econometric studies of private water enterprises in the U.S., for example, have shown that private operating expenses were some 25 percent less than those of comparable public operations. Other studies have shown that as the result of existing patterns of public cross-subsidization in many LDCS, existing users of public systems are resistant to extending service to low-income areas even though the prices that low-income water users are currently paying substantially exceed the cost of supplying water from a central system. As a result, through private systems, with fewer cross-subsidies and appropriate pricing, higher quality central system service can often be supplied to low-income residents when it would not have been possible with a public system.

The above examples are particularly interesting in that sole public provision of infrastructure and services often has been based on theoretical justifications (e.g. natural monopoly, externalities, merit goods) set forth in annex A. However, these justifications have often proved erroneous (as is clear in the case of urban transit) and rarely justify a policy of both public finance **and** supply.

These erroneous justifications and rationales for public provision also characterize a wider range of other state-owned and controlled public enterprises discussed in the section to follow.

4. Government Ownership of Enterprises and the Designation of Monopoly Responsibility

The policies, regulations and programs described above are often used to support not only a specific development strategy, but also a set of government owned enterprises (parastatals) or authorized private monopolies. The rationales used to justify these enterprises are many. While the validity of a public enterprise must be judged in the context of the individual country setting, many of the original rationales underlying their establishment—mostly having to do with self-reliance, equity objectives and the assumed inefficiency of the private market—have been found to be erroneous.

Even today, many LDCs operate public enterprises without having to account for the real costs of operation. Revenues are rarely matched against expenses in terms of full cost recovery. Nor are they ever compared in accounting practices. During the 1970s, because markets for primary products remained reasonably buoyant and development was supported by borrowing from the private capital markets and by the introduction of new technologies, the costs of public enterprises were not an issue. However, in a number of LDCs, deceleration of development, declines in prices of primary products, and failures to adjust to the new cost of energy have led to mounting debt and foreign exchange shortages. Governments have been forced to examine the economic efficiency of current resource allocations.

The poor record of state enterprises has become a drain on scarce resources and a liability to economic growth. However, political pressures have slowed the dismantling of these institutions. Thus, the changing attitudes toward parastatals have been accompanied by interest in mechanisms short of sudden divestiture which might be used to correct their poor performance. In general, the performance of state enterprises appears to reflect the degree to which public authorities have relied on market forces to guide the activities of both public and private enterprise. Studies of the market structure in which many LDC public enterprises operate, have revealed an essentially non-competitive environment, including insulation from both foreign and domestic competition. This insulation is buttressed by wide ranging subsidies as well as tax and regulatory preferences.[9] Indeed, where the market has not been

[9] See *World Development Report 1983,* The World Bank.

relied upon to allocate resources, the operation of parastatals and government authorized monopolies has resulted in considerable financial and economic costs.

This problem has been compounded by problems of multiple and unclear objectives for these firms which make it easier for public enterprise managers to excuse inefficient performance by appealing to conflicting objectives. Furthermore, in many cases these firms are subjected to short-term political pressures and interferences in day-to-day operations. If objectives are multiple and unclear or political expediency determines corporate policy, it is inherently difficult to measure and evaluate performance on any objective scale.

B. Constraints Related to Commercial and Country Risk

Certain constraints to private enterprise development can be attributed to risks associated with a country's level of development. Some stem from government action or inaction but others depend upon the resource endowment of the country. These constraints frequently include inadequate infrastructure, lack of access to technology, underdeveloped human resources, inadequate energy supplies, vulnerability to natural disasters, poor communications, rural, urban and regional disparities and other market imperfections. These constraints affect development through the availability and cost of investment funds, including insurance.

The large increases in LDC debt which occurred during the 1960's and early 1970's demonstrated that many LDCs had not faced a situation where capital was lacking. Today many LDCs still can obtain foreign capital; however, the terms have hardened considerably. Large variations exist, but the costs of foreign borrowing to LDCs are substantially higher than the costs to developed countries, and the higher costs reflect a more sober assessment of risks related to the country's level of development. These risks are viewed by lenders to be of two types-investment risks and country risks. Their relative importance depends on the specific country in question.

1. Investment (Commercial) Risks

The first category of risks relates to the quality of the investment. Many LDCs face serious constraints which limit their ability to comprehensively design, analyze and implement public investment proposals. In embracing a significant development agenda, staff resources of LDC ministries become stretched too thin; important data may be unobtainable; and adequate management resources for implementation may not materialize. Despite potential economic gains, public investment proposals often lack the creditability needed to immediately obtain donor or commercial funds. Five year development plans contain many such investment proposals. The consequence is that donors and international lenders discount the LDC's estimated rate of return on public investments and frequently conclude that even a small investment will exceed the LDC's absorptive capacity. If elements of the proposal have merit from a donor's perspective, the donor will become extensively involved in assisting the LDC redesign the proposal before making funds available. Commercial lenders will not expend such an effort but will look elsewhere, usually to more developed countries, for investment lending.

While an LDC's national pride or its sense of urgency for development may in part explain the quality of public investment proposals, an important cause is the scarcity of trained personnel in the LDCS. In many LDCS, particularly those in the lower per capita income range, a mere handful of trained people relative to the population at large can be found to develop the public sector's investment proposals. A similarly small group of people can be found to manage effectively project implementation.

Private sector investment proposals by LDC firms may also tend to lack realism. Particularly, assessments of indigenous firms' capabilities in terms of meeting production targets, delivery schedules and quality standards may be overstated. More importantly, the success of many investments depends upon the personal relations between the local businessman and key government officials. These are subject to sudden change.

2. Country Risks

The second group of risks which have hardened the terms of capital available to LDCs are the risks associated with the political and economic instability of the country. On the political side, wars, revolutions, coups and civil disturbances will influence the cost of commercial capital and availability of donor assistance. On the economic side, fluctuation in the price and supply of LDC primary commodities has raised foreign lenders' risks.

Besides raising the interest rate of commercial capital, the risks of political and economic instability cause the lenders to reduce the repayment period. In fact, one of the most noteworthy behavior characteristics of both foreign and indigenous investors in LDCs is the extremely short time horizon expected for an investment payback.

These two risk effects have dramatically restricted investment opportunities in LDCs since rates of return must be very high to cover investment risk interest and very short payback periods (on the order of six months to one year and a half to hedge the country risk. Given this fact, there is a strong preference among foreign and indigenous investors to finance trade rather than fixed plant and equipment.

IV. A.I.D. Policy to Meet the Challenge

Statement of General Policy

A.I.D. assistance to an LDC should encourage social and economic development that promotes movement toward a democratic, free market society. It is A.I.D.'s view that such societies are most efficient for generating broad based, sustained economic growth and social progress. A.I.D. should program its resources in support of LDC performance towards this objective.

A.I.D.'s private enterprise policy is intimately related to the need to conduct our programs in an environment of policy dialogue with the host country. The essence of this policy dialogue should be to deal with the country's development strategy and related policies as they affect the operation and growth of free markets and private entrepreneurship. However, policy dialogue leading to policy reforms which encourage LDC private enterprise development may not be sufficient to achieve the desired objective. Therefore, A.I.D. should also engage in specific direct program actions to eliminate legal, regulatory and other constraints to private enterprise development, and to assist and promote private enterprises. In this regard, A.I.D. personnel who plan and implement such programs should endeavor to learn as much about the indigenous private sector in their host country as they do about the operation of the ministries and parastatals which are responsible for or involved in the principal sectors of the Country Program Strategy.

The overriding intent of A.I.D.'s private enterprise policy is to promote the establishment of a climate conducive to LDC private sector activity; it is not intended primarily to finance the establishment of individual business entities **per se**. The two-pronged objective, to reach the ultimate goal of growth, is the establishment of viable, competitive markets and the expansion of private enterprise in LDCs. These objectives may not be met by establishment of a particular firm unless the establishment of the firm leads directly towards the development of a competitive market in the LDC or becomes a demonstration project that can readily attract private replication.

A.I.D.'s preference is to build up and rely on the indigenous private sector for the long run economic development of the LDC, rather than to assist continued reliance on parastatals. A.I.D. has a particular interest in exposing productive activities to market forces rather than subjecting them to administrative plans. A.I.D. has a particular interest in reducing and eliminating subsidies. Finally, A.I.D. has an overriding interest in ensuring that activities carried out to develop competitive markets and private entrepreneurship can be shown to benefit A.I.D.'s target group as defined in the FAA.

A.I.D.'s promotion of free markets and the private sector should not be confused with monopoly enterprises, oligarchy or "crony capitalism", which have little to do with the free market. A.I.D.'s effort to encourage competition and entrepreneurial activity is as much a challenge to the limited capitalism extant in some countries as it is to statist economies.

There are no restrictions on the types of funds or modes of assistance applicable to the pursuit of the private enterprise objectives. ESF, DA and PL 480 loans or grants are all appropriate ways to support private enterprise development. Forms of assistance such as studies, short or long term technical advisors, commodities, training or resource transfers can be used either as components of project or non-project assistance in exchange for appropriate policy changes or for support of country performance in areas of significance to private enterprise development. Local currency generated from non-project assistance can also be programmed effectively in support of private enterprise development.

Assistance to promote competitive market conditions and indigenous private enterprises should not be considered as a separate portfolio of activity independent of other sectors of interest to the country assistance strategy, such as agriculture, health, education, etc. The promotion of a democratic, free market economy should underpin and be incorporated in all aspects of A.I.D.'s country programs.

A.I.D.'s private enterprise initiative is directed at the development of the LDC's private sector. A.I.D. will utilize the U.S. private sector to help it achieve this objective. However, the use of U.S. private sector firms to provide technical assistance, commodities and other services does not constitute in and of itself an act which fulfills the intent of this private enterprise policy. In accordance with the F.A.A., the use of U.S. firms on projects to the maximum extent, possible is standard operating procedure for all projects. Skills, commodities and services available in the U.S. private sector are valuable to help solve almost all of the problems confronting development. However, their use on a project does not automatically mean that the outcome of the project will be the direct improvement of the LDC private sector or the furtherance of an open, free market economy. Therefore, the mere use of a U.S. private firm should not be construed to mean that the project is a private enterprise promotion project in the sense of meeting A.I.D.'s policy objectives.

Similarly, the implementation of the private enterprise initiative need not be exclusively through firms in the U.S. private sector. While such firms are often the most appropriate source of expertise, U.S. universities, PVO's and government agencies may also be suitable resources particularly in helping LDCs establish a policy environment conducive to the growth of indigenous private enterprises.

As LDCs develop more market oriented and open economies, U.S. private enterprise should benefit from new markets for inputs to higher levels of LDC economic activity and more opportunities to enter into mutually profitable business relationships with LDC entrepreneurs.

V. Specific Components of the A.I.D. Policy

The following specific policy guidance reflects A.I.D.'s experience in designing, reviewing and implementing project and non-project activities in support of private enterprise development. A specific mission program to carry out this policy will depend on the policy, institutional and legal conditions which prevail in the country. Therefore, this policy paper will not set specific Agency program priorities indicating which A.I.D. supported activity should take precedence. These decisions are to be made at the mission strategy, program and project levels.

A. Agency Target Group

The FAA states in Section 101 and 102 that one of the four principal goals of U.S. foreign economic assistance is "...the alleviation of the worst physical manifestations of poverty among the world's poor majority...". It further declares "...that the principal purpose of the United States bilateral development assistance is to help the poor majority of people in developing countries to participate in a process of equitable growth through productive work and to influence decisions that shape their lives, with the goal of increasing their incomes and their access to public services which will enable them to satisfy their basic needs and lead lives of decency, dignity, and hope." Projects which implement A.I.D.'s private enterprise policy should clearly demonstrate the linkages between the activity which is to occur on the project and progress toward this primary FAA objective.

B. Policy Dialogue

1. Before entering into discussions with the host country representatives on specific project activities, missions should have a firm knowledge of the macroeconomic policy environment including the overall development strategy of the host country and how this affects the emergence or operation of the LDC's private sector. The mission's program should concentrate on macroeconomic or sector policies as appropriate in the specific country circumstance. Efforts to reform policies considered subsidiary to the country's development strategy more likely will be successful when the overall strategy is complementary (or not an impediment) to the reform of these subsidiary policies. However, pursuit of a policy dialogue within a specific sector may be a valuable way to help LDCs overcome political difficulties associated with macroeconomic reforms. "Experimental" reforms within a sector may be more politically palatable to the LDC and may become a model to be applied to other sectors and the economy at large. From our experience, the policies most damaging to the indigenous private sector are those discussed in Section III above.

2. Project and non-project assistance which is primarily aimed at reforming

policy should include complementary actions which institutionalize the reforms in the form of revised laws, regulations, or procedures. In addition, projects should seek to institutionalize the capacity to carry out policy analysis to support continued reforms.

3. Each project which provides assistance to stimulate specific activity within the indigenous private sector must recognize the policy environment and its effects on the outcome of the project. Insofar as the policy environment is not conducive to sustaining the outcome of a proposed project after the A.I.D. resources have been expended, the mission should not proceed with the final design of the project until it can demonstrate that the appropriate policy reform will take place when it is needed. Such reform may be undertaken by the host country as part of the project design or implementation effort (learn-by-doing approach) or it may result from other A.I.D. or other donor activities. However, the project documentation must show that there is a reasonable expectation that the appropriate policy reforms will occur.

4. A.I.D. believes that the operation of the heterogeneous, dynamic and largely unregulated informal economy provides a powerful argument in favor of eliminating uneconomic controls on the formal economy. In countries amenable to policy dialogue and related reforms, direct A.I.D. assistance to enhance the importance of the informal economy is a valuable complementary program to policy dialogue with the LDCs governments. In countries which are reluctant to discuss policy, assistance to productive activities carried out in the informal private sector may be the only effective way to stimulate broad-based growth and development—such assistance is, in any case, highly cost effective in terms of meeting A.I.D.'s mandated target group who are found in great numbers in this labor-intensive, capital-saving sector. A.I.D. has a strong interest in programs which support the informal private sector.

C. Legal and Regulatory Constraints

The expansion and efficiency of the private sector depends upon a supportive legal structure and a positive regulatory environment. The existence of an adequate structure of property rights—including patent and copyright law, contract law and judicial arrangements which facilitate adjudication are essential.

1. Each project which provides assistance to the indigenous private sector must describe and analyze the relevant legal and regulatory structure which affects the outcome of the project. The project must also show how changes in this structure will occur as necessary for the project to achieve its purpose.

2. It may be that individual country circumstances will require a significant institutional development effort to build appropriate legal and regulatory institutions conducive to private enterprise. Specific projects or sub-project activities which provide assistance for studies or advisory services to review or reform legal and regulatory barriers, are encouraged.

D. Assistance to the LDC's Private Sector

A.I.D.'s purpose in these policies covering assistance to the indigenous private sector, is to stress management improvement and technology transfer through advisory services and training. In addition, A.I.D. believes it is essential to avoid creating fictitious (non-market) conditions for the indigenous private sector through the offering of highly concessional terms for A.I.D. financial capital. A.I.D.'s highly concessional terms will not be the cost of capital required by the indigenous private sector to sustain and expand production and services. Consequently, A.I.D. agreement to highly concessional terms postpones the need for the recipient firm to manage its resource's and make its decisions on the basis of market forces. It also relieves pressures to institute essential reforms in financial markets such as the introduction of positive interest rates for savings and lending. Finally, concessionality is, in essence, a grant of capital to the owners of equity of the firm and, therefore, generally an inappropriate use of U.S. funds.

1. A.I.D. resources should be channeled through the private sector rather than the public sector, when host country conditions make this possible. In many cases, it may be feasible to contract with a private sector firm to provide what might have been provided through a government ministry.

2. Recognizing that concessional assistance to a private sector firm is, in essence, a grant of capital to the owners of equity of the firm, its appropriateness 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.).

3. If an indigenous private enterprise is to receive and manage A.I.D. resources to accomplish a specific development objective, and several LDC firms are capable of carrying out the activities, the firm to be used should be selected by an appropriate competitive process or evaluation.

4. A.I.D. may use grants or loans with concessional terms to finance direct training of and technical assistance to LDC private enterprises. Concessional assistance is particularly useful when:

a) Training and technical assistance has as its direct objective the improvement of competition in the industry.

b) New technology is transferred to the country. In this case A.I.D. should take care that its use of concessionary finance is proportionate to the transfer of technology (not the normal commercial risk) and does not hurt the marketing of such new technology by the U.S. private sector through normal commercial channels.

5. A.I.D. will not take an equity position in a private enterprise. However, 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.

6. A.I.D.'s provision of financial capital to an LDC private enterprise will

be subject to the following conditions:

a) **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:** In this case A.I.D.'s resources should be channelled only to development activities which are 1) consistent with A.I.D.'s country development strategy and 2) unable to attract the full amount of required financial capital from commercial sources. A.I.D. is willing to assume the risks associated with a country's political or economic situation, which maybe impairing institutional access to commercial credit.

The on-lending of the financial institution to the A.I.D. target group should be at LDC market determined terms (interest and repayment period). If interest rates or repayment periods are artificially set by the government, the rates agreed to under A.I.D. projects should be part of a planned effort to achieve market terms in the LDC's capital market. As a minimum, it should be at positive rates to prevent decapitalization and economic misallocation of resources.

In situations in which foreign exchange risks make it inappropriate for private borrowers to assume a dollar debt, A.I.D.'s financing may be passed through a host country's government entity (e.g. central bank), the discount rate charged to the financial institution by the government entity should reflect the real cost of capital within the LDC.

A.I.D. funds provided to financial institutions should avoid introducing government ministries or parastatals into the on-lending approval process where such involvement does not now exist. Furthermore, such projects should seek to extract government ministries and parastatals from the process if they are now so involved.

b) **When its purpose is to initiate an entirely new venture or activity in the LDC's private sector to reach a target group previously not served.** In this case, concessionality may be warranted to finance the extraordinary start-up costs associated with introducing the new venture or activity. (Extraordinary costs are costs which would not be incurred by subsequent investors who enter the market on the basis of the success of the initial enterprise.) In this case, the concessionality may be linked to project components such as advisory services and training. Concessionality may also be warranted to finance special costs arising from the newness of the venture or the requirement of direct benefit to a specific AID target group. These special costs could include the need to hedge certain risks and provide for normal profit. In developing such projects, Missions are encouraged to consider alternative methods of providing concessionality in order to avoid distorting sound business management practices which may follow from the offer of up-front concessionality as a hedge against losses.

c) **Detailed guidance on A.I.D. Loan Terms will be provided in a forthcoming Policy Determination.**

E. Private Sector Participation in the Provision of Traditional Government Services

A.I.D. encourages an expanded role for the private sector in delivery of services and supports the development of a multiplicity of channels for services. The private sector is an important factor in allowing consumers to have truly free choice and A.I.D. will continue to support its growth.

1. With regard to population, the flexibility and innovativeness of the private sector, both voluntary and for-profit, are a vital component of an effective system for the distribution of contraceptives. Where supplies are sold through the commercial market, either at full price or at subsidized prices, cost recovery can be maximized and dependence on external sources of support is decreased. In many developing countries, there is not a nationwide government structure for the delivery of services. But in almost all towns there are market outlets through which contraceptives can be sold along with other common commodities. AID support for social marketing of contraceptives has expanded proportionally more than any other type of delivery system over the last few years, and we will continue to support such programs.

2. With regard to improving health care, a variety of opportunities should be pursued to harness private resources. First, private funds (i.e., client fees or payments in other forms) should be encouraged to pay for services for which there is existing demand. Fees-for-service, fees for drugs, and prepaid cooperative or insurance schemes have been implemented successfully in different settings. Second, private channels (radio, advertising media) can be used to stimulate demand for services. Third, private sources can be used to manufacture drugs and medical supplies, and private channels employed for their distribution, thereby eliminating costly and inefficient duplication between public and private sources.

3. In education, A.I.D. encourages the diversification of school providers so that parents have a choice in determining the type and quality of their children’s education. For many LDC’s this implies an expansion of private education and community based schools. A.I.D. supports a shifting of more costs of education to the private account, particularly at the higher levels of education. Finally, A.I.D. assistance should engage the private sector in a wide variety of schooling related services from construction of facilities to the provision of instructional materials.

4. In agriculture, A.I.D. supports a substantial transfer of responsibility to competitive markets and private enterprises. In particular, the market should have primary responsibility for determining the price of agricultural commodities and inputs. Similarly, the private sector should have principal responsibility for the provision of agricultural inputs and credit. For example, irrigation offers opportunities for an expanded private sector role in activities such as on-farm development and systems design. In addition, A.I.D. should seek creative ways to increase the involvement of the private sector in traditional government programs such as agricultural research and extension. In particular, A.I.D. encourages the development of new arrangements between input suppliers, farmers and marketing firms such as "contract" or "satellite" farming.

5. In energy, A.I.D. encourages private sector development of fossil fuel resources where there is a potential for equity investment or for private operation and management. Energy conservation activities should tap private engineering capabilities rather than government owned or controlled organizations. For renewable resource development, especially for applications for rural development, the private sector should be viewed as the primary dissemination mechanism for providing new technologies for cooking, heating,

irrigation, mechanical power and lighting.

6. A.I.D. supports programs to involve the private sector in a wide variety of public service activities through such techniques as contracting for management, operation and maintenance of facilities. This is particularly important in the transportation sector.

F. Parastatals and Government Authorized Monopolies

1. A.I.D. assistance to or through a parastatal should be given in the context of exposing the parastatal to market forces and scheduled divestiture of the government interest. This objective is more likely to be achieved through an evolutionary process rather than as a result of an A.I.D. insistence on the immediate and complete divestiture by sale to the private sector. A.I.D. resources should start a policy dialogue which initiates the process even if there is no initial commitment from the LDC on eventual divestiture. AID resources should assist the process as LDCs indicate interest in reducing the financial and management burden accompanying state ownership of companies. The experience of a number of LDCs which have divested parastatals suggests that measures to improve the management and operational efficiency of a parastatal has helped the divestiture process. A.I.D. projects designed to improve parastatal performance must have identifiable benchmarks upon which substantive progress towards divestiture can be measured. However, the burden of proof rests squarely with Missions proposing such activities to demonstrate that the proposal can achieve meaningful objectives, and that the selected benchmarks represent substantive evolutionary progress in moving the parastatal towards market-based operations and divestiture.

2. A.I.D. encourages the introduction of employee stock ownership plans (ESOPs) as a method of transferring a parastatal to private ownership.

3. In assisting an LDC through the divestiture process, A.I.D. should explicitly consider the consequences to the parastatal's employees of transferring all or part of the parastatal's activities to the private sector. In this regard A.I.D. resources could be used to assist those employees who may be adversely effected by the firm's transition from state to private ownership by job retraining or job placement assistance.

G. Capital Saving Technology

Decisions on what technologies are promoted by A.I.D.'s private sector related activities should be based on a rational assessment of the particular economic and financial circumstances in which the specific private sector effort is taking place. Where appropriate in terms of capital and labor availability, capital saving technology should be encouraged.

Capital saving technologies of interest include tools, production processes and delivery systems. Capital saving technologies should in general have the following characteristics: (1) they should be compatible with the local cultural, economic, environmental, political and social context in which they are imbedded and in which they interact; (2) they should involve the local community or be otherwise physically and financially accessible to the poor; (3) They should be able to be maintained and repaired by relying on locally available labor skills, spare parts and organizational capacity; (4) They should be widely replicable; and (5) they should be economically efficient. Generating employment and increasing income for the poor is a fundamental objective of AID's development efforts. Accordingly, a project which uses more local labor and less capital goods without substantially increasing project costs or entailing a loss in output quality is to be preferred to alternative projects with a more capital intensive nature.

H. Training Activities

A.I.D. should promote and assist in training LDC indigenous entrepreneurs in business related topics. Such training could range from very short training sessions for small, independent entrepreneurs in both the formal and informal private sector, to more substantial efforts utilizing participant training and advisory services. A.I.D. will encourage public and private efforts to develop the human resources of the host country consistent with our policies as stated in the **Basic Education and Training Policy Paper** and the **Participant Training Policy Determination**. This is especially important in countries with low literacy rates.

I. Infrastructure

The infrastructure systems most relevant to improving competitive markets and private enterprise are reliable power, transport and communications.

A.I.D. is willing to assist in the development of these facilities under the following terms:

- A.I.D.'s first priority is the provision of technical assistance and training toward institutional development defined as improved management so that services are reliable, well maintained and managed in a businesslike manner in terms of cost recovery and capital growth.

- A.I.D. is willing to cooperate with other donors in parallel efforts to improve these types of infrastructure. However, where possible, A.I.D.'s involvement should be focused on the institutional development aspects of the project rather than the finance of capital development.

- When budgets permit, A.I.D. is willing to finance capital costs of infrastructure systems when it can be demonstrated that such finance is an essential complement to the institutional development objective and no other funds are available. However, the long-term financing of infrastructure is a matter of critical concern to A.I.D. Where possible, the costs of infrastructure (particularly operation and maintenance) should be covered by user fees. Where infrastructure is provided as a public good such that user fees cannot be introduced, costs must be recovered through some other mechanisms such as the use of community funds, special assessments or general tax revenue. Where charges or other revenue sources do not cover the cost of at least maintaining the infrastructure, A.I.D. will not, in general, support a major investment in infrastructure.

J. Research and Studies

A.I.D. is willing to assist in research and studies which provide a better understanding of the importance of competitive markets and private entrepreneurship to LDC policy makers. Such research and studies should be results oriented in support of policy dialogue. These activities could be carried out with direct A.I.D. sponsorship or by building up the capability of host country institutions to carry out such research and studies.

VI. The Responsibilities of Missions and Regional Bureaus

The principal responsibility within A.I.D. to carry out the private enterprise policy rests with the A.I.D. field missions and their respective regional bureaus. As noted above, the promotion of competitive markets an private enterprise in LDCs is not a sector or an add-on to the project. Rather, it is a fundamental objective of A.I.D.'s assistance to LDCS. It is firmly based in both economic theory and successful development experience.

ANNEX A

Natural Monopolies: Until recently, the concept of a natural monopoly was not controversial. The generation and distribution of electric power, telecommunications and some forms of transportation were assumed to be natural monopolies. However, today's technological advances make it more difficult to define a natural monopoly. Activities which are site-specific and require heavy investments in infrastructure to achieve the least cost in the production and distribution of goods have been considered as natural monopolies. However, applying this definition to specific situations usually provokes debate among different political and economic interests within an LDC and different countries have reached different conclusions in similar situations. However, even when a domestic political consensus exists that a particular activity fits a definition of a natural monopoly, there is considerable room in most LDCs to manage the function in a profitable or at least a cost-minimizing fashion. The implementation, construction and management of the public good can often best be undertaken by the private sector with public oversight, as in the case of regulated public utilities.

Goods With Externalities: An externality is associated with particular goods or services when individuals or groups cannot be excluded from benefiting from (or being harmed by) the provision of the goods or services to another intended group. Furthermore, no pricing mechanism can be established to compensate (or charge) the supplier commensurate with the additional recipients' estimate of the benefits received (or costs incurred). For example, when some children in a village are immunized against an infectious disease, those who are not immunized still receive some benefit because their chances of infection have been reduced. Even in situations in which there is a significant demand for immunization, free riders can take advantage of a competitive market's inability to charge them for the benefits they have received by virtue of the consumption of others. If the prevalence of free riders threatens the existence of the market, the good or service may be declared a public good and non-market procedures introduced to ensure that the supply continues.

Merit Goods: Merit goods are goods which society (often paternalistically) argues are good for the individuals and should be consumed in a greater amount than the individual would purchase in a free market. For example, at a market determined price an individual may not consume an amount of education that society believes he or she should. Consequently, society, acting through government policy, may interfere with the market by lowering the price of education through a subsidy. However, a developing society also benefits in that the general level of competence has risen. Consequently, it is in society's interest to try to expand the supply and consumption of such a merit good for the benefit of all. Many activities in the fields of public health and education provide good illustrations of externalities and merit goods. For such services a government may provide a higher level of service or set a lower price than that which would result from purely competitive market forces. However, many LDCs have identified natural monopoly situations, externalities and merit in a wide variety of other goods and services and have abrogated the market to provide an administratively determined quantity of goods and services at an administratively determined price. In most LDCs the list of public goods or quasi-public goods includes such items as food, clothing, energy, transportation, agricultural inputs, construction materials, and communications equipment.

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