

Business for Development

FOSTERING THE PRIVATE SECTOR

A Development Centre Perspective



2007

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FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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THE DEVELOPMENT CENTRE

The Development Centre of the Organisation for Economic Co-operation and Development was established by decision of the OECD Council on 23 October 1962 and comprises 22 member countries of the OECD: Austria, Belgium, the Czech Republic, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Korea, Luxembourg, Mexico, the Netherlands, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey and the United Kingdom as well as Brazil since March 1994, Chile since November 1998, India since February 2001, Romania since October 2004, Thailand since March 2005 and South Africa since May 2006. The Commission of the European Communities also takes part in the Centre's Governing Board.

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Foreword

The Development Centre has organised its 2007/2008 work programme around strategically selected output areas culminating in the production of regular annual or biannual flagship publications and regional *Outlooks*. These serve as the hubs for associated policy dialogue events organised by the Centre and as instruments for engaging key stakeholders in the Centre's activities. Each thematic output area and its corresponding "flagship" is supported by an *Informal Policy Network* composed of interested principal stakeholders in member-country capitals and delegations, and an *Expert Network* of specialists from the OECD community, other international organisations, the private sector, leading international universities and think tanks. An *Informal Advisory Group* for each output area including the regional *Outlooks* has been formed from these networks.

This volume on *Business for Development* is one of the Centre's thematic flagships. *Financing Development* is the topic of another title in the series, while *Policy Coherence for Development and Human Security* is the focus of the third. The series is completed by the *African Economic Outlook*, *Latin American Economic Outlook* and *Black Sea and Central Asian Economic Outlook*.

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Table of Contents

Preface	9
Introduction and Overview	11
<i>Chapter 1</i> Private Sector Development: Concepts and Practices	21
<i>Focus 1:</i> Private Sector Development in a Pro-Poor Growth Context: The Role of Donors	54
<i>Focus 2:</i> Public-Private Dialogue in Developing Countries	59
<i>Chapter 2</i> Export Diversification and Global Value Chains: Lessons from Selected Case Studies	65
<i>Focus 3:</i> SME Development and Entrepreneurship: Evidence from OECD Countries	88
<i>Focus 4:</i> Financing SME Development in Africa	97
<i>Focus 5:</i> Export Diversification Revisited	101
<i>Chapter 3</i> Agriculture in Africa: Open for Business?	109
<i>Focus 6:</i> Institutional Bottlenecks for Agricultural Development in Africa	139
<i>Focus 7:</i> Transport Infrastructure in Africa	145
<i>Chapter 4</i> Corporate Governance for Economic Development	149
<i>Focus 8:</i> Privatisation and Regulatory Reform in the Southern Mediterranean: Improving the Basis for Long-term Growth	171

Preface

Business for Development is one of three principal thematic areas of the Development Centre's 2007-2008 Programme of Work. The two other areas are *Financing Development* and *Policy Coherence for Development and Human Security*. Drawing on contributions from across the OECD, it presents a wide-ranging review of the role of the private sector in economic development and poverty reduction and how it can best be encouraged.

Sustained development of the private sector is a necessary condition for sustained growth and achieving the Millennium Development Goals. Whilst there are indeed signs of an expansion in business activity in many low-income countries, as evidenced, for example, by the growing range of exports, any such progress must be placed in the context of a rapidly evolving global economic landscape.

Over recent years, competition has been intensifying as a result of the emergence of new important global actors, most notably China and India. The fragmentation of international production, which is expected to continue apace in the coming decades, has already had far-reaching implications for the performance of developing-country firms and their strategies in terms of building productive capacity and enhancing technological capabilities. Furthermore, the expanding set of multilateral, regional and bilateral trade agreements is modifying the regional configuration of trade and is leading, *inter alia*, to important changes in the formation of global value chains.

Governments in both low-income and emerging economies need to take these developments into account. This volume emphasises, furthermore, the importance that they should attach to adopting a *forward-looking* approach as they seek to mobilise private investment — both domestic and foreign — and foster local entrepreneurship. If they identify and tackle specific areas of co-ordination failure concerning investment, such as a lack of innovation and insufficient effort at R&D, they can indeed make a substantial contribution to private sector development.

Louka T. Katseli
Director
OECD Development Centre
April 2007

Introduction and Overview

Private sector development is an essential component of economic growth and poverty reduction in developing countries, as it is a very important source of innovation and employment generation. A vibrant and competitive private sector can also empower poor people by providing them with better goods and services at more affordable prices. In recent years, policy makers in many developing countries, especially in Africa, have paid greater attention to fostering private sector development (PSD) as a key pillar of their national development strategies. Similarly, PSD has become part and parcel of the development assistance strategies of multilateral and regional development banks¹.

Fostering PSD has taken the centre stage in the recent international initiative for African development — known as the *Enhanced Private Sector Assistance* (EPSA) — that was launched on the occasion of the Group of Eight Summit Meetings at Gleneagles in July 2005. The EPSA is an international initiative designed to take a comprehensive approach to support PSD by channelling resources to five major areas of intervention: creating an enabling environment, strengthening financial systems, building competitive economic and social infrastructure, promoting the development of small and medium-sized enterprises (SMEs) and promoting trade and foreign direct investment, including intra-regional trade and investment whose potential has not been fully exploited. In addition to these areas of main concern, the private sector operations of the African Development Bank have assisted its member governments in developing national strategies to enhance corporate governance which is fundamental to attract and protect investors, both domestic and foreign (AfDB, 2006).

The discussion on fostering PSD inevitably places itself into a wider debate on the respective roles of markets and governments for achieving sustainable growth and poverty reduction. For markets to work efficiently and deliver desired outcomes, an effective government is also needed to create an enabling business environment, provide public goods, facilitate adjustment and mitigate negative externalities associated with private action, such as pollution and other harmful environmental effects. A further challenge for developing countries in Africa (and elsewhere) is to enhance transparency and accountability in the design and implementation of policies aimed at fostering PSD so as to ensure that private sector-led growth can benefit the society as a whole.

The 2007 flagship publication on *Business for Development* is dedicated to this theme and more specifically seeks to address the following two questions:

- What is the role of government in fostering private sector development both in theory and in practice?
- How can private enterprises in developing countries and especially in Africa better seize the business opportunities created by their increased participation in global and regional markets?

Before addressing these questions, it is important to explain why the OECD Development Centre has launched this new flagship publication.

Why are we launching this new flagship publication?

Over the past years the Development Centre has made substantive contributions to the OECD's work on PSD in developing and transition economies and more recently in the African context. Three examples may suffice to illustrate this point.

The first is the OECD Regional Workshop on *Trade Capacity Building and Private Sector Development in Asia* which was jointly organised by the Development Co-operation Directorate and the Development Centre in December 2003 in Phnom Penh, in close collaboration with the Cambodian government. One of the key policy messages emerging from this workshop is that fostering PSD calls for a mix of interventions geared towards improving the domestic policy environment and firm-level capabilities: these two goals are mutually reinforcing and need to be tackled in a comprehensive manner (Bonaglia, 2006).

The second example is a series of studies conducted in the context of the *African Economic Outlook* whose annual focal themes over the past five years have included privatisation (2003), energy (2004), financing SME development (2005), transport infrastructure (2006) and access to drinking water (2007). Furthermore, such special studies have been extended to the MEDA region. Three short *Focus* articles based on the results of these studies are included in this volume.

The third example of the Development Centre's contribution to the work of OECD on PSD is two ongoing activities that were initiated as part of the Development Centre's 2005-06 Programme of Work, on the *Impact of the Economic Ascendancy of China and India on Other Developing Countries* and on *Aid for Trade and Agro-based Private Sector Development in Africa*. Regarding the former, Goldstein *et al.* (2006) have demonstrated that the rise of China and India is already affecting the business environment and growth patterns of African countries. They argue that resource-rich Africa will have to balance the need to match the promotion of job-creating sectors (agro-business, textiles, tradable services, etc) with the desire to capitalise on a windfall gain generated by higher commodity prices (*Ibid.*, p. 111)². As for the latter, its aim is to explore the possibility of agro-based PSD at country level and discuss how governments and their development partners can support it effectively. Some preliminary results of this work are included in this volume.

These ongoing activities provide the Development Centre with the opportunity to launch *Business for Development*, a new series of publications dedicated to PSD. A novelty in this flagship publication is that the volume includes the contributions from other substantive directorates working in this area, including the Centre for Entrepreneurship, SMEs and Local Development (CFE), the Directorate for Financial and Enterprise Affairs (DAF) and the Development Co-operation Directorate (DCD). Their written contributions have broadened the scope of analysis and enriched policy discussions.

What do we know about the private sector in developing countries?

It may be useful at the outset to highlight some salient features of the private sector in developing countries. The private sector can be broadly defined as "a basic organising principle of economic activity where private ownership is an important factor, where markets and competition drive production and where private initiative and risk taking set activities

in motion” (OECD, 2004). The term therefore covers all private actors — the poor and the rich, individuals and businesses — engaged in risk-taking activities to earn profits and income through market exchange. It applies to smallholder farmers as well as to very large multinational corporations (MNCs).

The diversity of the private sector across developing countries and regions and its fragility in many poor countries are already well documented in the literature. In the case of many low-income countries, notably in Africa, there is a paucity of reliable data on the size of the SME sector. But available evidence suggests that SMEs and informal enterprises account for over 60 per cent of GDP and 70 per cent of total employment in low-income countries and about 70 per cent of GDP and 95 per cent of total employment in middle-income countries (Ayyagari *et al.*, 2003). The majority of developing-country firms are not just small; they also disproportionately belong to the informal sector.

Taking the case of sub-Saharan Africa, OECD/AfDB (2005) highlights that a small number of large firms co-exists (even within the same sector) with a large number of micro and small enterprises. In this bi-modal distribution of enterprises, there is thus a so-called “missing middle”. It has been argued that the predominance of micro and small enterprises stems from a combination of cumbersome regulations — it never pays to be just large enough to attract legal enforcement — and structural characteristics including low levels of skills and capabilities, underdeveloped product markets, unsophisticated demand and poor business environment.

The 2005 UNIDO Africa Foreign Investor Survey offers some interesting insights regarding the characteristics of the *formal* sector in 15 sub-Saharan countries. Ten per cent of the surveyed companies account for 70 per cent of all reported sales and 65 per cent of employment. Amongst the top 25 firms by sales revenue, 15 operate in the manufacturing sector (mainly in import-substituting sectors such as food and chemicals), nine in the service sectors (transport, storage and communication) and one in plantation agriculture. Of these 25 firms, which bar one are joint ventures, 14 were exclusively domestic-market oriented. The smallest economies in the survey have none of the largest investors who are concentrated in Nigeria, Cameroon and Côte d’Ivoire.

The high transaction costs and the poor business environment are the two major sources of constraints facing African firms. In fact, these factors reduce the competitiveness of all enterprises (regardless of firm size) engaged in transaction-intensive economic activities that require, for instance, supplier credit and other financial contracts often with overseas business partners. The World Bank *Doing Business* report shows that 16 out of the 20 countries characterised by the worst business environment are in sub-Saharan Africa. Lacking formal institutions or facing unsupportive ones, African entrepreneurs often resort to private networks, based on ethnic relationships. The reliance on such informal mechanisms to govern contracting and market exchange has inherent limits, as economic transactions become more complex (Biggs and Shah, 2006).

The low managerial and technical capacity of many African firms is another obstacle to private sector development. Improvements in the regulatory environment are not sufficient to spur entrepreneurial activity. Managerial skills, access to capital and technology, availability of reliable and affordable infrastructure services are among the most severe constraints facing African businesses, especially SMEs, and limiting their ability to serve domestic, regional and international markets.

Access to finance is often considered as the most serious obstacle to SME development in developing countries, notably in Africa. However, the problem of SME access to finance cannot be separated from considerations on the overall business environment in which these firms operate. The institutional characteristics of the financial sector and various factors affecting the volatility of the business environment (information asymmetries, poorly defined property rights, lack of contract enforcement and protection of creditors' rights, high crime rates and so on) negatively affect the ability of firms to access credit. To be sure, these features tend to penalise SMEs disproportionately. An adequate strategy to promote SME development should then tackle both the internal weaknesses of the firms and the external factors that contribute to raising their perceived risk.

Private Sector Development: Theory and Practice

Chapter 1 of this volume presents a useful review of the very large body of literature on private sector development. It has two objectives: the first is to discuss the rationale for justifying public support to PSD following different theoretical approaches and for proposing an approach targeted at remedying so-called “co-ordination failures” that often lead to underinvestment in the economy. Since the actual policies and practices adopted at country level often deviate from what is justifiable on theoretical grounds, the second objective of this chapter is to review and discuss several concrete mechanisms currently used to foster PSD, with special focus on poor countries, notably in Africa.

This chapter concludes by drawing several policy lessons learned from recent experiences of PSD. These can be summarised as follows:

- The starting point for designing and implementing appropriate PSD policies is the firm-level. The analysis of firm-level weaknesses, notably in learning and innovation, should drive policy makers and donor agencies.
- The option to use indirect inducements, instead of direct interventions, should always be considered. This means building well-functioning institutions and appropriate incentive mechanisms supported by official development assistance.
- Open dialogue, transparency, accountability and regular evaluation are always necessary in designing and implementing PSD policies. These principles can help minimise corruption and avoid the risk of private firms capturing the whole benefits of policies.
- Governments need to adopt a dynamic approach to PSD as their policies evolve over time: this is because firms need to adapt to economic, technological and regulatory environments which are constantly changing.

As regards the role of donors, Focus 1 points to the importance of applying a pro-poor lens to PSD. This requires a rethinking of donor agendas and approaches, moving away from narrow direct interventions to broader, market-oriented approaches. In this context, public-private dialogue — the participation of civil society (e.g. consumers, employees, citizens and private sector associations) in the design and implementation of public policy — has been increasingly seen as a way forward to improving its effectiveness. Nonetheless, Focus 2 argues that donors' approach to public-private dialogue should be cautious and pragmatic in encouraging interactions between the government and the private sector in developing countries.

Export Diversification and Global Value Chains

Although a broad range of policy goals are often attached to PSD, export promotion and diversification remain major development objectives associated with PSD in Africa today. This is because many low-income countries in the continent persistently depend on a very limited number of (largely unprocessed) primary commodities (Bonaglia and Fukasaku, 2003). Chapter 2 of this volume takes a close look at the question of export diversification in developing countries from the perspective of global value chains (GVCs). Among a variety of sectors that are considered to be affected by fragmentation of international production, the four sectors — namely household appliances, animation service, tourism and aircraft — were chosen to provide a varied picture of GVCs and draw some broader policy implications.

This chapter shows that the on-going fragmentation of international production has created considerable business opportunities for developing-country producers, not only in traditional labour-intensive manufacturing but also in a more technology-intensive industry and service sectors. Yet, realising such potential would require much more consistent efforts on the part of the private sector and governments. Value chain analysis can help identify the lead firms in the global supply chain with whom local SMEs could interact to promote domestic sourcing, linkage creation and upgrading. Governments can also support such firms' efforts to enhance production and design capabilities, as they seek to move into more profitable segments of value chains and adopt the strategies that allow them to turn their "latercomer status" into a source of competitive advantage.

Based on recent OECD experience on SME development and entrepreneurship, Focus 3 stresses that governments can play an important role in supporting the SME sector, particularly where there is market failure or where incomplete markets inhibit the provision of adequate financing to SMEs. Governments can also help improve awareness among entrepreneurs of the range of financial options available to them. Furthermore, Focus 4 provides a broader picture of SME development in Africa, notably from the point of view of financing. The key policy messages are drawn from the studies undertaken over the last few years in the context of the *African Economic Outlook*; these are still highly relevant for the current policy discussion on PSD in Africa.

Export diversification has been seen as a key strategic policy issue for many developing countries, since it is closely associated with their long-term development. On the basis of empirical work on the determinants of product variety in a country's export profile, Focus 5 presents a healthy reminder to readers that export diversification is closely linked to the stages of development (using per-capita income as a proxy) itself. Beyond that, the lack of human capital and deficiencies in infrastructure are found to be very significant among other factors driving product diversification.

Africa's Agriculture: Open for Business?

The policy issues discussed in Chapter 1 are highly relevant for Africa's agricultural sector. Chapter 3 reviews the current state of agriculture in the continent, discusses its export potential and suggests the ways forward as a critical component of PSD³.

Agriculture is by far the dominant sector in most African countries and plays an essential role in rural and overall economic development. More than 60 per cent of Africa's active labour force earns a livelihood in the agricultural sector. It also contributes 17 per cent of aggregate GDP and 40 per cent of total export earnings. Moreover, this sector is the primary source of employment for the poor, and is characterised by high female labour participation. Hence, an advancement of agriculture has the potential to contribute greatly to the achievement of the Millennium Development Goals (MDGs) by African countries. Stronger agricultural growth can also trigger development in the off-farm sector through production and expenditure linkages associated with higher agricultural income.

The global market for agro-food products is expanding and undergoing profound changes, which open up opportunities for African producers but also pose new challenges. The transformation of Africa's agriculture has been driven by technological advances, changes in food consumption patterns in OECD and more advanced developing countries, as well as stricter quality and health standards imposed by retailers and importing governments. This process is likely to continue at a faster pace, as regional and multilateral trade liberalisation gains (or regains) the momentum. Moreover, the likely increase in domestic demand associated with rapid urbanisation is another important driver of change for African producers. In many African countries, fresh fruits and vegetables are sold on the local market mainly through traditional retail channels. For instance, despite phenomenal growth since the late 1990s, exports remain a small fraction of Kenya's overall horticultural sector, with over 90 per cent of all fruit and vegetable production consumed domestically (Muendo and Tschirley, 2004).

Two country case studies reported in Chapter 3 show that both Tanzania and Zambia have given the highest priority to agricultural development and private sector-led growth through diversification and trade expansion. Development partners also emphasise the need to align their interventions with recipient-country policies and programmes. Nonetheless, more efforts should be devoted to better co-ordination of development co-operation efforts with the view to improving the supply-chain management and enhancing the capacity of local producers to link them up to processors and buyers.

In explaining the lack of dynamism in many segments of African agriculture in the past, Focus 6 argues that much of this problem can be traced back to the prevalence of institutional bottlenecks, such as weaknesses in property rights protection and in contract enforcement mechanism. This poses a huge challenge to policy makers and other stakeholders in pursuing agricultural policy reform which must be designed and implemented in a broader institutional setup. Similarly, insufficient provision of infrastructure services has long been considered a serious bottleneck to agricultural development, and more generally private sector development. Focus 7 gives a succinct review of transport infrastructure in Africa today and its importance to achieve the MDGs. It also points to the role the private sector has increasingly played in the operating segment of transport service provision.

Corporate Governance and Economic Development

The final chapter of this volume, Chapter 4, shifts attention to the question of whether corporate governance is important for developing countries to achieve long-term development. This is the area of research that has attracted greater attention since the East

Asian crisis of 1997-98. This chapter argues that the role of corporate governance for development is likely to become even more important in the coming years, as virtually all developing countries are going through a difficult process of internal transformation, by moving towards more functionally rules-based systems of governance, away from those systems that are heavily relationship-based. This point may be better understood by seeing it from the angle of fostering PSD, because the purpose of corporate governance is to: *i)* facilitate and stimulate the performance of corporations by creating and maintaining proper incentives to motivate corporate insiders; *ii)* limit insiders' abuse of power over corporate resources; and *iii)* provide the means to monitor managers' behaviours to ensure corporate accountability and protect investors' and society's interests against corporate insiders.

The role of corporate governance for development is also better understood when one looks at the mixed results and lessons learned from past privatisation in many developing countries. Based on a new database developed by the Development Centre, Focus 8 provides a brief and insightful review of the privatisation process in the MEDA region. Its impact on PSD has been limited so far. More generally, it highlights the importance of governance — corporate and public — in managing the privatisation process and regulatory reform.

Concluding Remarks

Fostering PSD does not mean the disengagement of government in the development process; it means rethinking the ways it is engaged. Most importantly, it requires adopting a consistent set of policies and a “whole-of-government” approach to designing and implementing PSD programmes. Efforts to alleviate supply-side constraints would be useless if other policies perpetuated an anti-private sector bias and kept the incentives for engaging in new risk-taking activities low. A stable macroeconomic environment, adequate access to competitively priced inputs, protection of property rights and contract enforcement remain key priorities of any PSD strategy. Policies to ease certain supply-side constraints, for instance insufficient training for workers or low innovation activity, should be designed in conjunction with national efforts to identify a country's growth constraints. Concerning innovation, simply providing subsidised credit or incentives for re-investing profits in R&D might have little impact on a firm's actual R&D investment if the firm knows that, as a result of inadequate legal protection, it cannot fully internalise the benefits of its innovation. Again, a well-structured strategic collaboration between government, private sector and civil society can help identify possible areas of incoherence and legitimise government interventions.

Notes

1. See, for example, AfDB (2006), AsDB (2000), IADB (2005) and World Bank (2002). See also UN (2004) and OECD (2006).
2. See also Blázquez *et al.* (2006) and Santiso (2007) for the impact of China on Latin America.
3. De Laiglesia (2006) provides a useful framework to analyse the institutional bottlenecks (ranging from cultural and social norms to legal and political systems) that may have affected agricultural development in sub-Saharan Africa. His analytical focus on fast-moving or slow-moving institutions seems very important to apply to the design and implementation of policies to foster agro-based PSD in Africa. See also Focus 6 in this volume.

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Chapter 1

Private Sector Development: Concepts and Practices

Summary

Private sector development (PSD) has emerged as an increasingly important element in the economic growth of poor countries. But such development has to be carried out in a coherent manner and with regard to local conditions.

Discussion on PSD is also related to the debate on the pros and cons of industrial policy and includes several approaches. One is to compare market failures, such as imperfect competition, with government failures, though caution should be exercised in assuming that government failures are irremediable.

The microeconomic foundations for PSD policies are then reviewed, as are the consequences of system and co-ordination failures, and responsibility for identifying and treating them. This is followed by a brief discussion of a new form of industrial policy, starting from the recognition that both positive and negative aspects may exist.

The chapter also reviews and discusses current practices and lessons learned in PSD, highlighting enterprise clusters and internal and external linkages between firms and support organisations. Business development service and the promotion of entrepreneurial activities are also discussed.

The conclusions emphasise the need for government intervention to be directed at improving the functioning of markets, the need for policies to remove systemic imperfections when innovation and technology systems fail and the importance of taking a coherent approach to policy support. Public-private dialogue and active collaboration are essential if PSD policies are to succeed.

Introduction

Over the years, different paradigms have prevailed in development thinking; emphasis has shifted from basic needs, to capabilities, to structural adjustment programmes and the provision of a market-friendly business environment. Sometimes this has meant real strategic shifts, but in most cases only “cosmetic” changes have prevailed in practice. Nowadays the development of the private sector¹ in developing countries is regarded as essential. The logic behind this statement is simple: poverty reduction is the main objective of development co-operation and a target of development policies. Economic growth is essential for development, and growth is best achieved through the private sector, which in turn needs to be adequately promoted. Thus policies to foster private sector development (PSD) deserve most attention.

This emphasis is confirmed by most recent policy papers of national donors and multilateral organisations. Let us recall the most recent declaration on the *European Union Strategy for Africa* (EC, 2005) which plainly states that “Africa is on the move ... and that today there is real momentum for change” (p. 1). The purpose of this *Strategy for Africa* is to give the EU a comprehensive, integrated and long-term framework for its relations with the African continent. With this aim, the Communication openly sets the target of stimulating PSD. To achieve such an ambitious goal, the report affirms that “... Macroeconomic stability, the creation of regional markets and an *appropriate private investment climate* are preconditions for sustained growth. However, while such a pro-growth framework is crucial for sustainable economic development, it needs to be accompanied by appropriate measures to boost and diversify production and to establish and upgrade the necessary infrastructure and networks” (*ibid.*, emphasis added).

Private sector development is therefore a major concern for the EU, as well as for most donors; fulfilling such priority calls for an explicit strategy with strong intellectual justifications. This is especially needed if, as some observers note, the past donors’ PSD programmes have been based on highly abstract concepts, have lacked intrinsic coherence — often adopting a piecemeal approach rather than an integrated one — and have often underplayed the actual conditions prevailing in developing countries (Schulpen and Gibbon, 2002). Moreover, policies have often focused on the macroeconomic preconditions for private sector development, notwithstanding the reality of concrete micro-level PSD policies.

This chapter has two aims. The first is to discuss the rationale for PSD following different theoretical approaches and to propose an interpretation based on the idea of “remedying failures of co-ordination” in the economy. The second is to review some concrete tools and programmes currently used to promote PSD, with a focus on low-income countries, notably those in Africa. It will also discuss the intrinsic logic — often unexpressed and at best implicit — of such interventions, and conclude by summarising the main points of the discussion.

The Rationale for PSD from Economic and Policy Debates

The debate on the rationale for PSD feeds itself into the wider debate on the role of markets and governments in affecting development outcomes. It is also interestingly related to the debate on “industrial policy”, recently revived by attempts to interpret the remarkable growth experiences of several East Asian countries, and more recently China (Rodrik, 2004 and 2006; Lall, 2005). Here are some of the main approaches.

Market Failures versus Government Failures

If markets worked perfectly, they would, by assumption, be the optimal way of allocating resources, and there would be no need for interventions and public policies. Thus, there would be no economic grounds for PSD policies. Interventions to restore optimality would be justified only if markets were missing or affected by “failures”². A sceptical stand towards government intervention follows, where the only legitimate role for the state is to provide a stable macroeconomic environment with clear rules of the game and essential public goods such as defence, education and infrastructures.

Examples of “market failures” are imperfect competition and market power, public goods and externalities. These restricted cases of failures can, in theory, be corrected by governments, and in the conventional mainstream approach they do not seriously question the theoretical case for efficient markets. A typical example is the failure of the market for research and development (R&D) and knowledge creation. Owing to problems of incomplete appropriability of returns to the investment, externalities and spillovers, social returns tend to be higher than private returns, resulting in under-investments in knowledge creation. In such a case, governments can provide public funding for R&D or modify incentives to promote private investment in R&D (e.g. via patent laws).

Furthermore, as economists such as Stiglitz (1989 and 1996) and Lall (2000) point out, failures in information markets are much more prevalent and diffuse; they threaten the theoretical case of a perfectly functioning competitive market to the point whereby it becomes necessary to question the usefulness of the model as the benchmark for policy choices and government interventions³.

However, the existence of market failures does not, by itself, establish the case for intervention. In fact, most interventions have their own costs and risks; it needs to be assessed whether the benefits outweigh these costs. Appropriate design of certain interventions requires knowledge and information, while their effective implementation requires autonomy, skills and impartiality (Lall, 2000). These conditions are hard to meet especially in developing countries; as a result, governments also “fail”. In sum, the cost of market failures must be weighed against the cost of government failures. This is easy to state in principle, but much harder to apply in practice.

A common and reasonable assumption has often been that developing countries are affected by frequent and costly market failures (and even *missing* markets for several goods and services). This assumption has often been accompanied by the other one, that governments are bound to fail more frequently in developing countries, with consequences that would be costlier than the consequences of market failures. However, this hypothesis needs to be empirically tested; so is the assumption — often implicit in policy papers — that government failures cannot be remedied, and that “governments cannot learn”.

The Microeconomic Foundations for PSD Policies

Analysing the markets for technology and innovation is especially instructive to understand the rationale behind PSD policies⁴. The conventional case against pro-active policies rests on a particular conceptualisation of *technology at the enterprise level*. It assumes that technology is freely available from a known “shelf” on which there is full information. Firms *optimise* by choosing from this shelf according to their own factor and product prices. Any government intervention necessarily distorts resource allocation. The selected technology is absorbed without cost or risk by the enterprise and used at efficient (“best practice”) levels. No learning is required, and the underlying assumption is that any observed industrial inefficiency is due to government interventions. If there is any lag in efficiency, it can only be for a brief period in which scale economies are fully realised or costs fall in an automatic “learning by doing” process. Again, there is no need for public intervention because firms can anticipate the process and finance the learning process in efficient capital markets.

An alternative to the above conventional view of technology is offered by the “technological capabilities” approach⁵. This draws upon the evolutionary approach suggested by Nelson and Winter (1982) and regards learning in markets prone to imperfections and widespread failures. Technological capabilities are then the skills — technical, managerial or organisational — that firms need to master in order to utilise efficiently the hardware (equipment) and software (information) of technology. Capabilities are *firm-specific*, institutional knowledge made up of individual skills and experience accumulated over time.

Technological change is the result of purposeful activities undertaken by firms (so-called “technological efforts”). It is neither exogenous nor automatic. Individual effort is required to make the many tacit elements of technology explicit, and most technological effort does not take place at the frontier of technology at all. It covers a much broader range of effort that every enterprise must undertake to access, implement, absorb and build upon the knowledge required in production.

Technology cannot simply be transferred to a developing country like a physical product. Its effective implantation has to include important elements of capacity-building: simply providing equipment and operating instructions, patents, designs or blueprints does not ensure that the technology will be effectively used.

Learning is a central determinant of PSD, and its success depends on the efficacy with which markets or institutions function, uncertainty is coped with, externalities tapped and co-ordination achieved. If the learning period is long, costs, uncertainties and leakages are very high, co-ordination with other firms in the supply chain is exceptionally difficult or information, labour and capital markets are particularly unresponsive, “difficult” knowledge may not be absorbed — even where it would be efficient to do so. The policy implications of this approach are straightforward and may be drawn in terms of the contribution public policies may give to the building and strengthening of technological capabilities.

When the “System” Fails

An influential new literature focuses on the idea of (national, regional and local) “systems” of innovation that influence the development, diffusion and use of innovation (Edquist, 1997). The rationale for policy design and implementation easily follows this representation: *policies need to address the failures of the system*.

It is well known that the pattern of industrial success in the developing world reflects to a large extent the effectiveness with which countries have undertaken learning and innovation (Lall, 1996; Piore and Sofer, 1998). This “evolutionary school” argues that the pattern of innovation depends on much more than the behaviour of individual firms. Firms do not learn or innovate on their own but in intense interaction with other firms, factor markets, support institutions and governments. They respond to rules pertaining to trade, competition, employment, intellectual property or the environment, and they behave in ways fashioned by their history, culture and environment. While firms are the primary actors in the generation of technological artefacts, their activities are supported by the accumulation of knowledge and skills in a complex *milieu* of other research and training institutions. Public policies must necessarily encompass this wider context.

The interaction of economic, social and political factors provides the system within which firms learn and innovate, and so compete in global markets. This is widely acknowledged for industrial economies, where National Innovation Systems (NIS) now play a major role in the literature on technology policy. The idea that innovation occurs in a

“system” — a set of interacting enterprises, institutions, research bodies and policy makers that engage in technological activity, share in knowledge spillovers and often engage in collective action — is now widely accepted⁶.

In contrast, research on developing country innovation systems is relatively recent⁷. This is surprising, since the need for conscious and purposeful technological effort in developing countries is widely accepted and explains different experiences in many developing countries often described as “forging ahead”, “catching up” or “falling behind” processes.

In most developing countries, the nature of technological effort is quite different from the industrial countries’ focus on R&D and frontier innovation. This does not mean that the effort is not so important to their development nor does it mean that the system within which it takes place is less significant. As noted, the effort is vital — it is only countries that build strong technology systems and develop the necessary capabilities that succeed in developing strong and competitive industrial sectors — and the system is critical to sustaining the effort. It is thus important for development — and PSD — policy to analyse the features and constraints of these technology systems.

The “component institutions” of the system are first of all private firms working individually or in collaboration, but also universities and other educational bodies, professional societies and government laboratories and research institutions, private consultancies and industrial research associations. Technology institutions refer to bodies dealing with quality, standards, metrology, technical extension, R&D and technology training. They may be government-run, started by the government but run autonomously, or started and managed by industry associations or private interests. In most of the developing world the public sector plays a central role in this respect.

Many services provided by these institutions are the essential “public goods” of technological effort, difficult to price in market terms. Public research institutes and universities undertake basic research that does not yield commercial results in the short term, but provides the long-term base of knowledge for enterprise effort. Quality, standards and metrology institutions provide the basic framework for firms to communicate on technology and keep the basic measurement standards to which industry can refer. Extension services help overcome the informational, technical, equipment and other handicaps that small and medium-sized enterprises (SMEs) tend to suffer. The provision of these services faces market failures of the sort that every government, regardless of its level of development, has to remedy.

All this has a dynamic dimension, and the characteristics that the system needs to have are rapidly and constantly reshaped by technological changes, altering the institutional and policy structures needed for competitiveness.

Co-ordination Failures

Production and investment decisions in upstream and downstream segments of industry are often interdependent. Therefore, a firm’s productivity depends not only on its own efforts and abilities and on the macroeconomic and legal context in which it operates, but also on the actions of other firms and organisations influencing infrastructures, regulations, public goods provision. The problem arises as the markets for these (intermediate) goods and services are beset by market failures, and this is due to economies of scale, thick market effects⁸, knowledge spillovers and tacitness and so on. As investments by one firm can have a positive effect on the profitability of investments by other firms (via the increase in aggregate

demand and ensuing economies of scale affecting productivity everywhere else), everybody would be better off if everybody else were also investing (i.e. at the high-investment equilibrium), but market forces cannot take the economy from a low-investment to a high-investment equilibrium. Some kind of co-ordination is needed to move to the good equilibrium. If the economy stays in the bad equilibrium, this is due to a “co-ordination failure”.

Economists such as Dani Rodrik (1996, 2004 and 2006), Andres Rodríguez-Clare (2005a and 2005b) and Karla Hoff (2000) have been exploring these issues in detail. However, this is not a new story. Paul Rosenstein-Rodan (1943) was the earliest author to write of *underdevelopment traps* related to the possibility that the potential offered by the simultaneous industrialisation of many sectors of the economy could not be exploited through market forces alone. In fact, as no sector would be profitable industrialising alone, the lack of an explicit co-ordination would not induce development. In modern terms, economies often experience “co-ordination failures”, where individuals’ inability to co-ordinate their choices leads to a state of affairs (an equilibrium) that is worse for everyone than an alternative equilibrium where many or all sectors were industrialising simultaneously. The obstacle to industrial development is not technological opportunities, knowledge or resources, but the failure to co-ordinate choices⁹. In countries that have reformed their economies and built adequate institutions and an appropriate legal framework, the lack of co-ordination among private and public actors, among firms and workers, among research and technology institutions and the productive sector, among service and infrastructure providers and the enterprise sectors, are all possible determinants of inferior performance and underdevelopment traps. This is equivalent to saying that individual actions that are privately rational, given the environment in which individuals are involved, need not be socially optimal. And market forces alone do not have the capacity to move the economy to the “best” equilibrium¹⁰.

One can think of many examples that are relevant for least-developed countries (LDCs) today (Rodríguez-Clare, 2005b, p. 10). Building an airport in a region that has no hotels would not lead to any traffic, but hotels without a regional airport may not be profitable either; a large scale irrigation project would not be profitable if only a few farms used modern technologies, but using such technologies is profitable only if there is adequate irrigation. A university specialised in fashion design would be useless in the absence of firms demanding such human resources, but the absence of specialised professionals would not allow firms to develop towards fashion design.

As these examples show, although co-ordination failures may occur at the economy-wide level, they also frequently occur at the local level or at the level of a *cluster*, i.e. a collection of related industries and public and private agents. However, geographical agglomeration may make co-ordination easier, and offers the possibility of higher productivity and better performance through some kind of co-ordination. Using a different terminology, this amounts to stating that productive agglomeration alone offers only some (limited) ground for what has been called “collective efficiency” (CE) (Pietrobelli and Rabelotti, 2004 and 2006; Schmitz, 1999). External economies may be exploited also without explicit and purposeful co-ordination, but it is only through joint collaborative actions and better co-ordination (at the local level) that the largest benefits of agglomeration are attained. (The next section deals with this with reference to clusters and value chains.)

As it should be clear from the examples above, the “co-ordination failure” approach has remarkable and comprehensive policy implications, and most current approaches to PSD policies may find their rationale in this conceptualisation.

As a general principle, within this framework the role of government policy is to move the economy out of the bad equilibrium into the good one. In theory, this can be accomplished in many different ways. In his early studies Rosenstein-Rodan argued that there could be co-ordination from “above” with the government planning the process of industrialisation and remedying what we today call co-ordination failures. Thus, in a rather obtrusive way, the government may co-ordinate private sector investment decisions to ensure that the industrial infrastructure of intermediate inputs is put in place (Rodrik, 1996). However, this view was rejected by other authors because government is itself part of the endogenous set of institutions and, as a result, governments fail — even in democracies — just as markets do (Hoff, 2000).

However, even in the event of a government failure, a positive development that has emerged in recent years is to try more limited interventions to harness the spillovers among agents, and to try to design sequences of policies that may make it less likely for underdevelopment traps to occur (Hoff, 2000, p. 4). This may be observed in practice in many of the examples we present in the following section.

Finally, co-ordination failures are often especially damaging for innovation and technology and call for specific interventions (Lall, 2000). Innovation policies may be used in a very specific way, that is to solve specific co-ordination failures in clusters that ultimately lead to low innovation (Rodríguez-Clare, 2005*b*). A different way of phrasing this idea would be to promote “innovation clusters”, or clusters of innovation activity.

The idea of promoting innovation at the cluster level is supported by the evidence that, in spite of globalisation and market integration, knowledge spillovers are weakened by distance; moreover, spillovers are stronger for firms in related sectors of activity (in a sector, or participating in the same value chain, and “speaking the same technological language”). Finally, it is the right kind of innovation that leads to larger and more frequent spillovers that should be supported. In fact, the context and the way innovation is undertaken affect the extent of spillovers. Thus, for example, larger spillovers occur from research carried out in universities rather than in corporations, or where there is a long tradition of collaboration and exchange of information and knowledge, such as in some advanced industrial clusters in Italy and Germany¹¹. Appropriate policies to address such co-ordination failures detrimental to innovation in clusters might include, for example, grants and prizes for innovative projects and firms, joint research efforts involving local research centres and firms, long-term collaboration between local training centres, universities and business associations.

Who Should Identify and Address These Failures?

The previous reasoning has illustrated how the functioning of market economies is affected by remarkable failures, and how these hinder the development of the private sector. In developing countries — but not only there — markets are highly imperfect and bound to fail. In some instances there is not even a market to assign resources to the best alternative use and thereby improve welfare. Moreover, recent authors have elaborated the contributions of classical development economists such as Rosenstein-Rodan and Gerschenkron to argue that markets often suffer from insufficient co-ordination. Individual agents’ performance crucially depends on others’ behaviour, but markets often lack the means to induce adequate behaviour, and this often leads to multiple equilibria, and certainly to allocation of resources that is less than optimal. Finally, innovation theory reminds us of the relevance of the whole “system” of technology and innovation, and of the frequent failures that harm its functioning.

Private sector development needs policies to remedy all these failures and imperfections. But who should be in charge of this pressing and demanding task?

By now the discussion is no longer on whether one should rely on either of the two opposite extremes: the state *versus* the market, or the government *versus* the private sector, and on the advantages and disadvantages of each. In fact these are not real alternatives; the true challenge lies in exploiting the best capacities of both. It is clearly unreasonable to expect governments alone to identify the market, systemic and co-ordination failures hindering the development of the private sector in a developing country. Uncertainty and imperfect knowledge afflict policy makers no less than businessmen. However, policy makers cannot act only as neutral brokers applying taxes or subsidies to keep the system in “equilibrium”. They risk committing errors of omission no less than errors of commission. Therefore, a public policy to promote capabilities and PSD needs to elicit information from the private sector on significant externalities and their remedies, and implement appropriate policies (Rodrik, 2004; UNIDO, 2005). In other words, we face a true paradox, as greater reliance on markets needs a more proactive role for the government. Markets are powerful but they are not perfect, and the institutions needed to make them work are often weak (Lall, 2005).

At the same time the assumption that governments are necessarily less efficient than markets has less to do with economics than with ideology (Lall, 2005, p. 34). In fact governments are endogenous to the economic system and may themselves learn over time. Past policy failure is a reason for improving policy-making capabilities, and this in turn requires explicit investments and a clear and solid commitment.

The overall answer to the huge question posed in this sub-section lies in a clever, dynamic and pragmatic partnership that may be achieved by inducing smart and effective forms of collaboration between the private and the public sector, between the market and the government. Policies to promote industry and the private sector should be seen as a process of economic self-discovery in a broad sense, with an interactive process of strategic co-operation between the public and private sectors which serves to elicit information on business opportunities and constraints and also generates policy initiatives in response (Rodrik, 2004).

This collaboration should occur at the national as well as at the local level, and should also involve organisations such as universities, research and training centres, infrastructure and service providers and clusters. For example, clusters seldom have institutions effectively representing the interests of the whole cluster beyond individual sections or firms. In most instances such institutions simply do not exist, and if they do exist they do not have the vision, capabilities and selflessness to pursue collective aims. This implies that cluster promotion policies should always employ participatory approaches and promote the involvement of all — and most importantly the relevant — stakeholders (Pietrobelli and Maggi, 2005).

Dani Rodrik’s recent effort to appreciate the fundamental underpinnings of China’s export performance and its economic success may offer useful insights to our aims. In his own words:

... much more than comparative advantage and “free markets” have been at play here. China’s pattern of production and exports would have looked very different if the traditional forces of comparative advantage, pushing China to specialise in labour-intensive products “appropriate” to low income economies, were the sole determinant ... Government policies have helped nurture domestic capabilities in

consumer electronics and other advanced areas.... Whatever static inefficiency costs may have been engendered in the process, this has had favourable implications for China's growth. ... [T]he inevitable debate between "market fundamentalists" and "planners" plays itself out in the Chinese context (Rodrik, 2006, p. 23).

Moreover, he reminds us of the usual criticism of industrial policy: governments cannot pick winners, and therefore should not try. But he continues arguing that:

... this is not the right way to think about industrial policy. In environments that are rife with uncertainty and with technological and informational spillovers, markets under-provide investment in non-traditional products. The appropriate role for industrial policy is to fill in this market incompleteness by subsidising investments in new products. ... [T]he appropriate criterion of success for industrial policy is not that "only winners should be picked" (an impossible task) but that "losers should be let go" (a much less demanding and more doable task) (Rodrik, 2006, p.24).

This chapter shows that this has remarkable implications for the rationale behind PSD policies in developing countries, often supported and following the (policy) advice of donors and multilateral organisations.

New Industrial Policy: Search Networks and System Integrators

Somewhat along similar lines is a recent approach labelled the "New Industrial Policy", as it aims at "solving economic development problems without picking winners" (Kuznetsov and Sabel, 2005a; Dahlman and Kuznetsov, 2004; Sabel, 2005), and may provide useful insights to our present aims. This approach starts with the realisation that development resembles what Albert Hirschman called a "jigsaw puzzle" where many good elements (firms, professionals at home and abroad, pockets of vitality) coexist with backward elements, and end up being "stuck": a critical mass of initiatives and resources is therefore slow to emerge, but it is what would be needed. The authors claim that "New Industrial Policy" is a simultaneously humble and ambitious process: it is humble as it aims to accelerate what already exists, assuming that public sector capabilities are weak, but it is also ambitious.

The focus is on bridging private-public organisations, on business networks linking global and local, (e.g. diasporas, innovation clusters and value chains), and on the best performers in public and private sectors (i.e. linking best public sector agencies with best and promising private sector performance). In a nutshell, the focus is about *generating missing connections* — without opening the door to rent-seeking (Kuznetsov and Sabel, 2005a).

This approach somehow represents an evolution of industrial policy that tries to respond to the unresolved issues of vertical and horizontal policies. Vertical policies are indeed based on the idea of rewarding best practice, with subsidies contingent on performance (e.g. such as in South Korea and Japan), but they often run the risk of inducing rent-seeking behaviour. Moreover, they are based on the assumption that the public sector has the information and capabilities to make a choice and "pick winners". This poses a *discovery problem*, as winners are constantly evolving in dynamic industries, and a problem of *entrenched interests* capturing all the rents. Horizontal policies in turn reflect the goal of creating markets, a correct but insufficient and slow process.

The objective of new industrial policy lies in enhancing the diversification of the productive structure through a *process of discovery* of which new activities have low enough cost to be profitable. This also implies a process of discovery of the relevant institutions required. As stressed also by other authors (Hausmann and Rodrik, 2003), such discovery process is not automatic, as entering new market niches involves significant fixed costs and risks, and the private sector alone will not do it without support. Examples such as salmon in Chile, cut flowers in Colombia, footballs in Pakistan, software in India and aircraft in Brazil fall within this conceptualisation, and they all represent examples of a state activism that is behind virtually every successful diversification of productive structure².

The building blocks of this approach are the following: *i) Search networks*, that allow rapid identification of people or institutions that are solving (part of) a problem closely related to the one you are trying to solve. Search networks are thus key to benchmarking (i.e. finding solutions that inform your provision design) and to uprooting faulty strategies, by showing that others in your situation are doing better than your own efforts suggest is possible¹³; *ii) System integration*: reflecting the effort to move from good *programmes* to good *systems* that are often more effective at a sectoral or cluster level. One example of such organisations is provided by Tekes (Box 1.1).

Box 1.1. TEKES, Finland: An Example of System Integrator

Tekes is the Finnish funding agency for technology and innovation. Tekes funds industrial projects as well as projects in research organisations, and especially promotes innovative, risk-intensive projects. In July 1983 it was created to assist Finland in the economic recession of the 1970s, with a workforce of 20, a number that has now increased more than tenfold. The Finnish government identified that improved technology would play a key role in economic resurgence. Tekes' first technology programme was the Semiconductor Technology Programme, followed by the Finnish Programme for Research and Development in Information Technologies. Today, Tekes runs over 40 technology programmes in different fields of technology, has six offices abroad and 320 employees.

In 2004, Tekes granted 409 million euros to 2 242 R&D projects with a total budget of close to 800 million euros. About half of Tekes' funding went to corporate projects, and the rest to universities, research institutes and polytechnics. The public research projects completed in 2004 generated over 2 451 scientific publications, 999 academic theses and nearly 150 patent applications or patents.

More than half of Tekes' funding for corporate projects goes to SMEs, and over three-quarters to companies with fewer than 500 employees. Some 1 000 companies start Tekes-funded R&D projects annually, while 2 000 to 3 000 companies continue existing projects.

Selective project funding is the basis of Tekes' operations. Funding and expert services are channelled to business R&D projects run by companies, research institutes and universities. Tekes encourages co-operation between these, as well as between different fields of technology.

Tekes assists companies in their search for ideas, the finalisation of business plans and their quest to conduct meaningful and valuable research. It adopts an open and proactive approach towards companies' technology planning. Companies are encouraged to contact Tekes' experts in the initial planning stages to formulate their research proposals with the aid of a dedicated Tekes expert. It does not derive any financial profit from its endeavours, nor does it claim any intellectual proprietary rights; these stay strictly with the enterprises. Completed project proposals are then evaluated internally by Tekes business and technology experts and each project is designated a Tekes expert to assist with the project and monitor progress. It constantly strives to investigate promising areas where extended effort could ultimately lead to greater success.

Source: www.tekes.fi.

Donors' and Multilateral Organisations' Approach towards PSD Policies

How are these differing theoretical frameworks being translated into concrete PSD strategies by donors and multilateral institutions?

A consensus is beginning to emerge among several international organisations, including the World Bank, the UNDP and the OECD Development Assistance Committee (DAC), which places emphasis on a small number of market-driven solutions and tends to focus more on the risks of government failure than on those related to market failures¹⁴. Altenburg and von Drachenfels (2006) recently labelled this approach as the “new minimalist approach” (NMA), as it incorporates some innovative elements together with a belief in a minimal role for the state in the economy. This approach is innovative because of its explicit pro-poor reasoning, its emphasis on issues of political economy, its well-founded critique of traditional government-driven and subsidy-based private-sector support programmes, and its optimistic stance with regard to the informal sector. At the same time, it is minimal as the central idea is that the creation of a level playing field would boost faster and equitable economic growth and that this is to be achieved mainly through deregulation and guarantees for property rights.

The shift in emphasis relative to the “consensus” prevailing in the 1990s is remarkable, as the focus is no longer on the internal weaknesses of small firms, but rather on the *need to reform the framework* in which these firms operate¹⁵. A new optimism emphasises the capability of small firms to react to a business environment that allows easy entry and exit for firms, and provides entrepreneurs and financing organisations with certainty that property rights will be respected and contracts enforced. The NMA has been strongly influenced by the work of Hernando de Soto (1989 and 2000), it has been further elaborated in World Bank and UNDP documents, and it is also echoed in the recent OECD-DAC report on PSD and pro-poor growth (OECD, 2006), and in other multilateral policy documents¹⁶.

The assumptions on which such consensus is based are aptly summarised by Altenburg and von Drachenfels (2006) as follows:

- selective public policy interventions in markets tend to hamper the formation, registration and growth of private enterprises and therefore reduce growth and welfare;
- the key role of the state is to guarantee a level playing field for the private sector;
- the exit of inefficient firms is an inevitable and necessary element of structural change that should not be held back;
- entrepreneurial spirits and capabilities are ubiquitous and unfold by themselves once a conducive investment climate is in place; this also holds for the informal sector;
- entrepreneurs are willing to pay for useful business development services and, apart from a very few purely public goods, these should be provided on commercial terms.

However, the approach that is followed in practice often differs from these statements of principle. Thus, we observe a variety of projects and programmes that go much beyond what is stated in principle in official policy papers. Below are presented some concrete tools and programmes currently used to promote PSD, with a focus on poor countries, notably those in Africa, considering the specific constraints that their PSD efforts face. These are especially manifest in agriculture and agro-industry, with farmers suffering from scarce access to credit and technology, remoteness from market, uncertain property and land rights. Among others, Nissanke (2001) rightly notes the dearth of institutions providing finance to the micro, small and medium-sized enterprises in Africa.

Practices and Lessons Learned in PSD

This section describes some concrete experiences of PSD projects and programmes, targeting special and crucial elements such as clusters and value chains, inter-firm linkages and linkages with multinational enterprises (MNEs), innovation policies and policies to promote R&D, incubators, business development service centres and technology centres, and entrepreneurship promotion.

Enterprise Clusters as a Tool for PSD

Several PSD programmes rely on the notion of clusters and seek to enhance the benefits that may be derived from enterprise agglomeration and clustering. It is beyond the aim of this paper to discuss the terminology and the many different definitions of clusters¹⁷. It is enough here to remember that enterprise agglomeration may determine “collective efficiency” that in turn enhances the productivity and overall performance of clustered firms¹⁸. Collective efficiency is itself the result of “external economies” and joint collaborative actions. The former may derive from the local availability of a pool of specialised workers, from the cheap and readily available supply of specialised inputs, from the easier access to specialised trade and technical knowledge and rapid dissemination of information; and from improved market access. Joint actions are consciously pursued and may remedy local co-ordination failures.

This issue has recently been broadened to consider industrial clusters and districts as one specific form of industrial organisation along a continuum of possibilities ranging from “Marshallian” industrial districts to hub-and-spoke districts to satellite platforms and foreign direct investment (FDI)-led networks in developing countries (Guerrieri *et al.*, 2001; Guerrieri and Pietrobelli, 2004 and 2006). This is especially relevant for SMEs in developing countries that often participate in clusters and value chains at the same time, where both the local and the global dimensions operate simultaneously. Both forms of organisation offer opportunities to foster competitiveness via learning and upgrading. But firms also face constraints, such as limitations to upgrading in some forms of value chains, and limited influence on competitiveness for clusters with less developed external economies and joint actions.

The concept of upgrading — making better products, making them more efficiently or moving into more skilled activities — has often been used by the literature on competitiveness (Porter, 1990; Kaplinsky, 2000) and is relevant to our present aims. Here we define upgrading as innovating to increase value added. Enterprises may achieve this in various ways, for example by entering higher unit value market niches, by entering new sectors, or by undertaking new productive (or service) functions.

The concept of upgrading may be effectively described for enterprises working within a value chain, where four types of upgrading are singled out (Humphrey and Schmitz, 2000):

- *process upgrading* is transforming inputs into outputs more efficiently by reorganising the production system or introducing superior technology (e.g. footwear producers in the Sinos Valley, Schmitz, 1999);
- *product upgrading* is moving into more sophisticated product lines in terms of increased unit values (e.g. the apparel commodity chain in Asia upgrading from discount chains to department stores, Gereffi, 1999);

- *functional upgrading* is acquiring new, superior functions in the chain, such as design or marketing or abandoning existing low-value added functions to focus on higher value added activities (e.g. Torreón's blue jeans industry upgrading from maquila to "full-package" manufacturing; Bair and Gereffi, 2001);
- *intersectoral upgrading* is applying the competence acquired in a particular value chain to move into a new sector. For example, in Chinese Taipei, competence in producing TVs was used to make monitors and therefore move into the computer sector (Humphrey and Schmitz, 2002; Guerrieri and Pietrobelli, 2004).

Empirical evidence collected for a large number of clusters in Latin America allows us to explore the hypothesis that enterprise upgrading is simultaneously affected by firm-specific efforts and actions and by the environment in which firms operate (Pietrobelli and Rabellotti, 2004, 2005a, 2005b, 2006; Giuliani *et al.*, 2005). The firm's environment is crucially shaped by three characteristics: *i)* the collective efficiency of the cluster in which SMEs operate; *ii)* the pattern of governance of the value chain in which SMEs participate; and *iii)* the peculiar features that characterise learning and upgrading patterns in specific sectors.

These studies reach several important conclusions. First, whenever collective efficiency is achieved in clusters — through external economies and collaborative actions to remedy co-ordination failures — this makes a difference and affects enterprise upgrading; however, the impact differs and follows different routes in different groups of sectors.

Second, the mode of organisation of inter-firm linkages and the governance of value chains also matter. These have different implications for process, product and functional upgrading in different groups of sectors. Thus, firm-level strategies to pursue upgrading substantially differ by groups of sectors: clustering and collective efficiency play a key role in some sectors but not in others, where the global logic of foreign buyers prevails and firms need to learn how to cope with more competent (and often larger) players.

The approach followed in these studies constantly advocates a context-specific approach to policy design and implementation. Which action (or combination of actions) a cluster should choose depends on its characteristics, its actual degree of collective efficiency, its main sector of specialisation and the characteristics of the value chains in which it operates — most importantly, its mode of governance. Specific recommendations include the following:

- In order to design adequate policies, there is a strong need to develop good tools to map and analyse clusters. The information available is often insufficient, collected for different purposes, and reflects a different logic¹⁹.
- Policies need to be context-specific and — in several regards — cluster-specific and sector-specific: no general recipes are valid and may be applied everywhere, regardless of local history, idiosyncrasies and peculiarities. Table 1.1 offers some examples of how policies may differ depending on sectoral and technological specificities.
- Furthermore, policies need to evolve over time and consider the evolution of clusters and value chains.
- Finally, in spite of the popularity of the concept in governments' and donors' policies in many developing countries, cluster policies are not the panacea to all economic development problems. There is a widespread tendency to label generic initiatives to support SMEs, sectors, regions as "cluster policies", creating confusion, false expectations and much disillusion and reluctance among firms to spend time and efforts on such projects.

As Table 1.1 illustrates, policies to promote clusters in natural resource-based activities may often be very different in different environments and need to reflect the underlying institutional and technological context. Efforts to promote SMEs' competitiveness through cluster development policies have also been made in sub-Saharan Africa in the agricultural sector (Box 1.2).

Table 1.1. A Sectoral Approach to Policy Design

<p>Traditional Manufacturing Clusters</p> <ul style="list-style-type: none"> ▪ ensure consistency between micro support policies and programmes and the overall macroeconomic framework; ▪ promote linkages between firms; ▪ promote access to new additional value chains.
<p>Natural Resource-based clusters</p> <ul style="list-style-type: none"> ▪ promote public-private collaboration in research and disseminate research to SMEs; ▪ improve skills and abilities of producers in the backward stages of the value chain (i.e. agriculture, breeding); ▪ facilitate the entry of SMEs; ▪ promote the adoption of quality and sanitary standards, environmental regulations, and enforce quality inspections and controls; ▪ promote access to foreign markets and overcome non-tariff-barriers (NTB); ▪ Improve the access and availability of good basic infrastructures.
<p>COPS – Complex Product Systems – Clusters</p> <ul style="list-style-type: none"> ▪ promote/support the active and dynamic role of actors working as “network brokers” of the cluster, and notably of the relationships between the large anchor firms and the local small suppliers; ▪ set up an incentive framework aimed at inducing large firms to source their intermediate inputs and services locally, and to support their suppliers' upgrading strategies.
<p>Specialised Suppliers (Software)</p> <ul style="list-style-type: none"> ▪ invest in highly skilled professionals; ▪ intensify industry-research collaboration.

Source: Based on Pietrobelli and Rabellotti, 2004 and 2005a.

Box 1.2. Rice Farmers' Associations and Clusters in Tanzania

The lesson the rice farmers of Tanzania's south-western Mbarali district have learned is that the potential of inter-firm collaboration and clustering is remarkable. Operated in six regions that account for a third of Tanzania's population, the Private Enterprise Support Activities programme (PESA) — supported by USAID (the U.S. Agency for International Development) — focuses primarily on association development, encouraging farmers to form producer associations or to strengthen existing groups that pool resources and improve their sales position. The associations also serve as vehicles for training in marketing, bargaining and financial management skills.

In Mbarali, the programme has reached 17 producer associations and farmer networks representing 7 500 households. To reduce their reliance on moneylenders, association members formed 11 savings and credit co-operative societies. Members contribute small amounts — usually \$3 to \$5 a month — and after six months are allowed to take out loans up to three times their deposits (with guarantees from two other co-op members). They use the money to buy seeds and invest in their farms. The groups are also uniting to improve their bargaining power. Eight associations representing 129 producers have agreed to combine their crop yields and seek a long-term, reliable contract. These farmers have also applied new production techniques that have boosted yields and incomes. The rice farmers of Mbarali, by working together and collectively building their knowledge, have the opportunity to use higher incomes to improve their productivity through capital investment, technical training and innovation.

Source: www.dai.com.

Most importantly, cluster development policies need to adopt a dynamic approach and evolve over time. A remarkable example comes from the Chilean salmon cluster, where policy requirements and realisations have evolved over time with the development of the local system (Andersson *et al.*, 2005; and Maggi, 2006). Initially, pre-competitive investments in R&D and pioneer risky initiatives, both private and public, were favoured, and this produced a remarkable demonstration effect. Later, the imperative was to standardise production quality and increase production scale, and the cluster was helped with better infrastructures and promotion and marketing abroad. Finally, in the current globalisation phase public policies are enhancing technology transfer (foreign missions), biotechnology research and the introduction of environmental controls.

Domestic and International Inter-firm Linkages

The experience of clusters and value chains in different countries teaches us important lessons that all point to the need to develop efficient and effective linkages among firms and institutions, which prove useful to actions to remedy market and co-ordination failures at the local level. It is worth remembering that some important linkages are often with larger firms and with MNEs, traditionally studied in development economics as a possible conduit for access to technology, resources and markets.

To this aim, the recent experience of Chinese Taipei offers useful lessons. In order to explain its extraordinarily dynamic industrial development, several elements have been emphasised, such as the government's capability to "govern the market" (Wade, 1990), its dynamic entrepreneurs, or the networks and clusters of SMEs that characterise this economy (Guerrieri *et al.*, 2001).

In addition to all these dimensions, one central explanation of the success of SMEs competing in globalised high-tech industries is that clustering and networking have taken a peculiar form and generated the co-evolution of domestic and international knowledge linkages. In other words, inter-firm and inter-institution linkages have been built to provide local SMEs with the necessary externalities to cope with the dual challenge of knowledge creation and internationalisation (Guerrieri and Pietrobelli, 2004 and 2006). Let us briefly explore how these networking linkages have developed for SMEs in Chinese Taipei.

When this economy began to enter the computer industry during the late 1970s, domestic linkages did not exist. International linkages were thus of primary importance from the outset, and the domestic linkages gradually developed afterwards. Two main types of international linkages prevailed: inward FDI that played an important catalytic role for knowledge creation during the early phase, and the participation of local firms in global production networks (GPN) established by foreign electronics companies. The latter has represented a remarkable organisational innovation, and its main features have been aptly described by Ernst (2001).

SMEs in Chinese Taipei, often with government support, have pursued a variety of approaches, in parallel to building domestic linkages. The following approaches have been considered especially important (Ernst, 2001: 101-7):

- Informal "peer group" networks, whose focus has shifted from labour, capital and basic market information to technological knowledge and brand name recognition. Originally these networks were restricted to family and kinship relations. Now they have evolved to professional "peer group" networks that are especially required in electronics and high-tech industries.
- Hierarchical centre-satellite systems to encourage closer, interdependent and long-term ties between larger "centre" firms (upstream suppliers, final assemblers, large trading companies) and their "satellites" (especially component suppliers). These links have often been favoured and subsidised through government policies.

- Linkages with large domestic firms, often in the form of cross-sectoral business groups; this has been most pronounced in electronics, because of the critical importance of economies of scale and scope, the necessary linkages with foreign customers via international subcontracting and OEM (original equipment manufacturing) arrangements and with international supply sources for key components.
- Business groups centred around a holding company, and creating a federation of loosely connected companies united by four factors: access to the holding company's core technologies; financial resources; knowledge base; and a common brand name.

Linkages with MNEs may also contribute to stimulate PSD in developing countries through several channels that have been carefully explored in, for example, UNCTAD (2001). Such channels include the effects that foreign direct investments (FDI) by MNEs may have in developing countries on increasing financial resources and investment, increasing demand for intermediate products (local sourcing), enhancing technological capabilities (through better technology generation, transfer and dissemination), providing better access to export markets, creating and strengthening human capital and generating employment.

Of course we need to stress that what has been described reflects a *two-way cumulative causation*, as FDI may be more beneficial to host countries in that host developing countries themselves invest in technological capabilities, infrastructures and a better business environment, thereby attracting more FDI flows of the type that is more likely to generate these effects (Lall, 2001; Lall and Narula, 2004).

MNEs may contribute remarkably to the development of local manpower and technical skills in developing countries, as exemplified by a case of Uganda (Box 1.3).

Box 1.3. Training and Skill Development by MNEs in Developing Countries — Unilever Uganda

Unilever Uganda Ltd. is one of the leading foreign investors in Uganda, specialising in the manufacture and distribution of foods, detergents, soaps and related products. It is part of the global Unilever group, and has strong linkages with Unilever subsidiaries in Kenya, India, the UK and South Africa. The company has a long history in the country, dating back to 1960 as a subsidiary of East African Industries Ltd. based in Kenya. Later it was partly nationalised under the Obote government, and became a distribution outlet for its mother company in Kenya. In February 1996, Unilever bought 100 per cent of the shares and now the company reports independently to London.

The major sources of benefits to Uganda's transfer of technology and skill development depend on the relationship Unilever Uganda has with the parent company. Unilever is a world leader in personnel development. Rigorous reviews for management staff are carried out every year, to identify existing capabilities, their possible lack, and measures to fill these skill gaps. Under the Management Trainee Programme, selected young graduates are sent on a six months' training programme to prepare them for managerial posts within the Group. Within the programme of internationalisation of managers, Ugandan managers and management trainees are seconded for international postings, and overseas managers are sent to the local operations. Through these measures, local managers and staff are exposed to modern management techniques developed by any subsidiary of the global Unilever Group. Technology is sourced from the parent company, and almost no research and technological efforts are carried out locally. Practically no use of local science and technology or training institutions is made and relationships are only occasional. Sourcing of intermediate inputs from local firms still occurs to a limited extent, essentially of packaging materials, calcium carbonate (key material for the detergent), and a few others.

Source: Lall and Pietrobelli (2002).

In sub-Saharan Africa (SSA), a special linkage with foreign firms that may be worth strengthening and improving is with fruit and food importers. The following Box 1.4 shows how a USAID project helped Malian mango exporters develop better commercial relationships with fruit importers in Britain.

Box 1.4. Mango Exports from Mali through Better Commercial Linkages with European Importers

Malian mangoes are of high quality and are well regarded in France, a traditional destination for West African produce. But recently, competitors from Côte d'Ivoire have cut into the Malian share of the French market. This has jeopardised the income of hundreds of fruit farmers and intermediaries who depend on this high-value export. A PSD project has recently helped a group of Malian exporters — who previously worked in isolation and in competition with one another — to pool their resources to compete with their Ivorian neighbours. The exporters developed a commercial relationship with fruit importers in Britain. These new ties, coupled with declining sea freight rates to Northern Europe, have created an opportunity for the exporters to target new markets and develop expertise outside France.

In addition, the project's Agro-Entreprise Centre helps the exporters launch a marketing campaign in Britain and Germany and assists them with quality control, packaging and determining the best financial mix for processing Malian mangoes. The exporters already have a modern, computerised packhouse complete with cold storage and refrigerated trucks. Teams of skilled buyers select the best fruit at the orchards, and an established mango-exporting firm in Sikasso utilises its excess capacity to process the fruit. The project is helping agribusiness operators recognise new opportunities, develop bankable business plans, manage profitable enterprises and compete in the international market.

Source: www.chemonics.com.

Scientific and Technical Support Organisations

In the present context of globalisation and rapid technological changes, countries require new skills to manage technical change and the institutional ability to upgrade them constantly. Therefore, technical support organisations in standards, metrology, quality, testing, R&D, productivity, SME extension are increasingly needed to complete and improve the “technology system” within which firms operate and grow. The same applies to the advanced infrastructures in science and technology and in information and communication technologies (ICT).

In this domain, once again, several actions are needed to address and solve co-ordination failures, and involve the creation and strengthening of public (and private) organisations. Following are descriptions of some insightful experiences of policy support to scientific and technical support organisations in developing countries. The evidence shows that the linkages between firms and technology organisations are especially weak in sub-Saharan Africa (Lall and Pietrobelli, 2002).

One policy tool that is frequently used to promote R&D and linkages among firms and organisations that concern innovation and technology is the creation of Science and Technology (S&T) Parks²⁰. Perhaps the outstanding — and most often quoted — experience is that of the famous Hsinchu Science-based Industrial Park in Chinese Taipei (Saxenian and Hsu, 2001; Lee and Yang, 2000). In a sense, the Hsinchu Park may be viewed as an industrial *cluster*, in which competition and vertical co-operation among local firms account for rising productivity, innovation and new firm formation.

The recent success of India's software exports is also at least partly attributable to the creation of technology parks, with the support of the Indian Ministry of Information Technology. One of the novel features of this approach has been the effort to create a network of parks to exploit the possible complementarities and interactions.

Another powerful policy to promote R&D in developing countries through international collaborative linkages has been the explicit government support to R&D consortia in Chinese Taipei (Mathews, 2002). Several alliances could be counted in Chinese Taipei in the late 1990s, bringing together firms, public sector research institutes, trade associations, with the catalytic financial assistance from the government. The target behind this policy was clearly the promotion of technological learning, upgrading and the creation of a catch-up industry. Although these consortia had varying results, their net contribution to effective network creation and technological upgrading of the industry has been very positive.

Another example of public policies to promote R&D in developing countries is provided by Costa Rica's R&D Matching Grant System, approved in 2000 to finance projects that contribute to innovation and technological change (Rodríguez-Clare, 2005*b*). This system appears to have had substantial success in improving the co-ordination between industry and research organisations in the country, and in focusing collaborative research efforts towards industrial development projects. This is another example of a policy addressing significant co-ordination and market failures that would otherwise have led to research and innovation efforts that would have been both inadequate and inappropriate to the country's economic development.

It could be argued that these examples are not appropriate or relevant to the relatively less developed among developing countries and that the promotion of formal R&D does not target their most pressing needs. However, research has proved that R&D is relevant not only for frontier innovation, but also to facilitate the absorption, adaptation, use and marginal improvements of existing technologies (Lall, 2000). Moreover, R&D organisations already exist in most developing countries, and so what matters is how such organisations may be reformed and become useful and relevant for their country's development. With this aim in mind, an interesting example illustrates how, thanks to its own efforts as well as carefully delivered aid-supported technical assistance, the Kenya Industry Research and Development Institute (KIRDI) was structurally reformed to serve the needs of the local productive sector better (Box 1.5). This in turn served the purpose of improving a central component of the national technology "system" as discussed previously.

Box 1.5. Effective Reforms in Public Research Organisations: KIRDI (Kenya Industry Research and Development Institute)

In 1994, a team from the UK examined the R&D institutions in Kenya and its findings led the government to reorient them to meet industrial needs. KIRDI was placed under a new director, who redefined its work to move from R&D to industrial technology support and thoroughly reorganised the institution. Since then KIRDI has become strongly market oriented, with all its work funded by projects: about 50 per cent contracted by the government and the remainder by aid donors and industry. The reorganisation involved substantial retrenchment, from 700 to 289 workers, with almost all the losses confined to support staff rather than technical personnel. Productivity indicators were put in place, based on impact on industry rather than research publications. These indicators show a tenfold increase in productivity. In general, there are very positive signs in terms of the management of KIRDI and its growing links with industry.

There are six centres in KIRDI. The Engineering Development and Services Centre makes dies, tools, jigs, spares and prototypes for industry. The Leather Development Centre offers training services to industry and demonstration of leather processing techniques. The National Industrial Information Centre offers various types of search and library services. The Laboratory Services Centre provides analytical and quality control laboratory services. The Industrial Plant and Machinery Unit conducts economic feasibility and appraisal studies, and has links with sources of finance for new projects (in 1998 it successfully “sold” 12 industrial projects). The Traditional Food Development Centre promotes traditional food processing technologies.

All divisions offer consultancy services, and are allowed to retain all their earnings except for costs and a 15 per cent overhead. Each staff member is assigned work targets, with salary increases tied to achievement. The average achievement rate was around 60 per cent; staff unable to meet 30 per cent of targets were fired. Advisers were taken on a part-time basis from private industry, apparently a very successful strategy. With this reorganisation, industrial demand for KIRDI services increased significantly. There was a waiting list for its services (28 firms at the time of the visit in October 1999), and KIRDI approached the university to take some of these projects. The main demand was from SMEs but recently large firms have also started to approach KIRDI for help with energy and environmental audits and waste management.

Source: Interview with Dr. Kaane (Director of KIRDI), October 1999, in Lall and Pietrobelli (2002).

However, there are several other public policy instruments that may contribute to enhancing the diffusion and transfer of technologies that are appropriate to micro and small enterprises in less developed SSA countries. For example, the GRATIS experience of creating a network of technology transfer units in Ghana appears to have been very successful, to the point of exporting its services to neighbouring countries (Box 1.6).

**Box 1.6. Technology Transfer to Micro and Small Enterprises:
The Ghana Regional Appropriate Technology Industrial Service (GRATIS)**

The Ghana Regional Appropriate Technology Industrial Service (GRATIS) was created by the government under the Ministry of Industries, Science and Technology in 1987 with the assistance of two donors, the Canadian Agency for International Development (CIDA) and the European Commission. Its mandate is to serve as a vehicle in transferring intermediate technology to the ten regions of the country, and promote “grass-root industrialisation in Ghana.” This was to be achieved by providing consulting services and training to micro and small-scale industrialists. The project initially aimed at reproducing the successful experience of the Technology Consultancy Centre in transferring intermediate technology to the craftsmen in the largest informal sector in Ghana, “Suame Magazine”, in Kumasi. A complementary objective was to reduce migration to towns and cities, and encourage educated and experienced people to set up their enterprises in rural areas.

Apart from its head office, GRATIS has nine Intermediate Technology Transfer Units (ITTU). In addition to providing technical information and training, the units’ main functions include the manufacture of equipment for rural industries and provision of advice on small-scale engineering and manufacturing industries. Demonstration workshops are set up in each ITTU to show potential clients new industrial processes suitable for their workshops. In addition, GRATIS assists clients to obtain machinery under a hire-purchase scheme, and provides subsidised loans for a maximum of seven years at about a 20 per cent interest rate. The GRATIS network employs a total of 287 people. As with other technology institutions, it suffers from high labour turnover as it has to pay low salaries. It claims to have some 16 000 beneficiaries (micro and small entrepreneurs, apprentices and trainees) that amounted to 53 per employee in 1998. Most clients are SMEs to whom the intermediate technologies transferred by GRATIS are well suited.

GRATIS has provided useful technology services to micro enterprises in Ghana. Among its strengths are close contact with enterprises, with monthly clients’ association meetings, its national coverage, its practical and problem-solving orientation, and its ISO 9000 awareness training. A source of weakness is its dependence on government and donor support. In 1997, the percentage of total costs covered by its own earnings was only 46 per cent, reaching 53 per cent in 1998. Its loan recovery ratio is estimated to be only around 52 per cent. An indication of the value of the initiative is manifested by GRATIS’ exports of services to other African countries. For example, it has sold shea-butter machinery to Burkina Faso on three occasions (in 1990, 1992 and 1999), cotton spinning wheels to Uganda to make thread oil extraction, and helped develop fish smokers in Mauritania.

Source: Lall and Pietrobelli (2002).

It is necessary to remember that scientific and technical skills also have a crucial bearing on trade and export development in order to fulfil the many complex technical and sanitary standards increasingly required in international trade²¹.

Among the many PSD programmes, a relevant and perceptive example comes from a trade development programme sponsored by the Swedish International Development Agency (SIDA) and the Norwegian Development Cooperation Agency (NORAD) targeting the promotion of African exports through quality and product safety (NORAD-SIDA, 2004). Since many African countries do not have the means to comply with international quality and health standards, they are affected by technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS) more than advanced countries (Box 1.7).

Legislation in the TBT/SPS area varies greatly among African countries. Although many countries have a reasonably complete set of legislation in the areas of weights and measures, product safety and standardisation, there are still many gaps. In the last two decades standards for management system such as ISO 9000 and ISO 14000 and HACCP (hazard analysis critical control point) have become increasingly used across the world but in Africa very few certificates have been issued. The key areas of the SIDA-NORAD programme are building awareness and developing competitive suppliers in agriculture and industry. Building awareness implies involving all relevant stakeholders that include the private sector (farmers, entrepreneurs, traders and exporters), policy makers in their role of setting the necessary rules and regulations, and specialised institutions that deal with TBT/SPS issues such as testing laboratories, standardisation bodies and metrology institutes. Developing business through improved quality implies promoting what has been called a just-in-time (JIT) targeted export strategy. This requires that countries are endowed with a well-functioning, state of the art, internationally recognised structure of testing laboratories and certification bodies.

Box 1.7. Sanitary and Phytosanitary Requirements for Exports: Prawns from Mozambique

Mozambique is one of the poorest countries in the world with more than 90 per cent of the country's exports in the primary sector. Among the most important export products are, arguably, prawns; in 1994 their export value exceeded that of all agricultural goods. The target market for prawns is mainly Europe. In 1998, the EU fish-import ban due to the outbreak of cholera in some fish-exporting countries — including Mozambique — markedly damaged the economy. The main product exported then became deep frozen prawns, which were not affected by the ban because they were frozen directly on board immediately after they were caught. However, the EU requested a laboratory test and the facilities to perform these tests were lacking.

A number of activities were launched to cope with this situation: the government introduced new bills in line with SPS requirements, HACCP was introduced throughout the fishing industry and firms had to prove that they were working in accordance with the new requirements. Compulsory training courses for workers and inspectors were organised. The Danish and the Icelandic development agencies supported the creation of laboratories in Mozambique's two main harbours. These two laboratories are now preparing for accreditation, but Mozambique has already regained full access to the EU market for fish products including prawns.

Sources: UNDP (2005) and NORAD-SIDA (2004).

Business Development Services

The notion of “Business Development Service” (BDS) is quickly gaining popularity among policy makers and scholars of management, industrial organisation and development. Several expressions are frequently found in the English-language literature to designate similar concepts, including industrial extension services, support services, advisory services, or business services. Among all these labels, the notion that most vividly portrays their actual nature and function is that of *real services* to indicate their impact on structural features of company behaviour and notably on their competitiveness. Thus, “real” should not be interpreted as the opposite of “financial”²². In a developing country context, however, this emphasis on new knowledge and innovation should be toned down. Notwithstanding the central role of learning at all levels of industrial development, BDS in developing countries may target the promotion of a wide range of business skills and capabilities, even of a simple and routine kind, with varying degrees of innovativeness.

Along similar lines, Altenburg and Meyer-Stamer (1999) note that “... to meet the demands of globalised competition, intra-firm efforts are not sufficient. The business sector has to be able to organise collective action for self-help, and it must be able to articulate its demands *vis-à-vis* political actors. This places great demands on business associations,” as well as on BDS Centres.

A recent study and assessment of BDS experiences in three of the most industrialised regions in Italy (Pietrobelli and Rabellotti, 2002 and 2007) allows us to draw some general implications for developing countries about the contribution of BDS centres to PSD²³. Moreover, given that most developing countries are facing increasingly stringent budget constraints, and that financial resources are fungible and could find alternative uses, it is really crucial for all countries to learn how to provide assistance to SMEs in the most effective, efficient and self-sustainable way. The first essential finding of this study is that there are no easy recipes to copy, and that no “ideal” best practice BDS centre exists in the real world. Nevertheless, many useful lessons may be derived.

- 1) BDS centres clearly have a role in supporting the development of a supply of services whenever this is inadequate, either through direct provisions, or supporting other existing institutions²⁴.
- 2) However, the market may do much without public subsidies which should rather focus on specialised areas and functions and take into account the specific features and the historical background of each region. For example, the Italian experience shows that BDS that deserved public subsidies at an initial stage (e.g. quality management and certification in the early 1980s) later became self-sufficient, and their public support lost its justification.
- 3) The capability of BDS centres to provide services demanded by firms depends on their embeddedness in the local business environment. The three following conditions appear to have been necessary in the Italian case: *i*) a deep involvement of the private sector in both the creation and operation of the centre; *ii*) a specific sector specialisation; and *iii*) a location close to potential customers. Providing the “right” services demanded by local enterprises in turn has a positive impact on the centres’ financial sustainability;
- 4) Managerial and technical skills and capabilities, entrepreneurial attitudes and, in general, human capital are crucial for the success of BDS centres.
- 5) Notwithstanding individual BDS centres’ efficiency and effectiveness, sometimes questionable also in the highly reputed Italian experience, the density of their presence in most industrialised Italian regions is itself crucial. The presence of a variety of agents and institutions and their dynamics of entry, exit and restructuring in response to markets and the needs of enterprises is a crucial determinant of industrial (and SME) performance. Sometimes staying below a given threshold of local institutions, as in poorer countries, inevitably hinders PSD. However, continuous and durable commitment to promoting local development is likely to bring results in due course, provided that the strategy — and the centres’ role, mandate and operations — are constantly monitored, evaluated and revised accordingly.
- 6) It is important for the centre to be situated close to its customers, but the advantages from acting at a local level do not imply that everything may be available locally. This is the apparent paradox of globalisation: enterprises’ local interaction with BDS centres needs to go together with linking up and reaching out to distant (foreign) service providers. Thus, for example, virtual electronic networks, although essential, and

increasingly widespread, do not eliminate the need for local interactions. Some relatively standardised services, such as laboratory testing, may be provided by remote (foreign) centres. But this does not apply to other services more tailored to the characteristics of the client and of a more innovative nature, which requires intense interactions between service providers and the client.

- 7) BDS centres also have a role in stimulating the demand for new services from firms. This requires anticipating tacit, unexpressed needs and convincing firms of their relevance for future competitiveness. This is especially true in less developed regions, where firms have not yet fully recognised their needs, and lag behind in adopting a “strategic” and “forward-looking” business attitude. Some of these needs may be perceived by enterprises in a relatively short time, under the pressure of competitive markets (e.g. laboratory testing and quality certification services). But in other cases, such as innovative services, R&D projects, development of new technological solutions, they may need to be subsidised for a long period.
- 8) An alternative and more “market-neutral” way to provide innovative services to firms is to create BDS centres acting more as “network-facilitators” than as service providers. Nevertheless, this model requires the existence of institutions, such as universities, research centres, laboratories and training centres to set up the network. This is often a feasible alternative in more industrially advanced developing countries, but not elsewhere.
- 9) In poorer countries, where industry is still incipient, a BDS centre is often bound to operate on its own, in the absence of other agents and institutions supporting local industrial development. This requires a different strategy. In such cases,, a centre should first improve its management and technical skills and the quality of the services provided. In turn, this would improve its reputation and raise enterprises’ demands for its services. Once it has established its presence in the local economy, the centre should also aim to create linkages with existing firms and institutions and convince firms that close collaboration is to their mutual advantage.
- 10) Evaluation of a BDS centre’s activities is a difficult but necessary task. It is worth making efforts in order to quantify benefits, costs and impacts, and evaluations should be repeated on a regular basis.

Entrepreneurship Promotion

According to a well-established definition, the role of the entrepreneur is: “...to recognise an opportunity to use resources that yield a low return and shift them into a function that yields a higher return from which they personally gain” (Casson, 1982). If there are few or no entrepreneurs, resources are not used effectively as they are concentrated in areas which are less rewarding (Schumpeter, 1942). Entrepreneurial development policies aim to foster such venturing, both by supporting existing entrepreneurs and, perhaps more significantly in a development context, by encouraging nascent entrepreneurs. In most studies there is wide agreement on the impact that entrepreneurship and new enterprise creation has on dislodging the inefficient, in spurring the firms that survive and in sending signals to other potential entrants (Acs and Storey, 2004, p. 874), thereby supporting development. University and public research lab spin-offs, incubator programmes and other forms of clustering, managerial and entrepreneurial training and venture capital support are some of the tools of entrepreneurship development policy.

In a recent comprehensive analysis of the policies to develop entrepreneurship in Latin America and worldwide (Kantis, ed., 2005), one remarkable finding is that firms where the entrepreneur has previously worked provide the best setting for enhancing new enterprise creation. This has important repercussions for policy design, and should induce us to consider the policies to strengthen and improve linkages with large (foreign) firms in a different light.

The features in common with most successful policy approaches are the following (Kantis, ed., 2005, Chapter 12):

- there is no single prescription for success, and strategies are always dependent on the context;
- knowledge of the initial conditions is essential for strategy development;
- in the absence of an integrated strategic framework, *ex post* linkages between initiatives must be established;
- there are significant differences in the strategic, geographic and budgetary reach of the various initiatives;
- it is common to combine generic strategies (those that are national and sectoral) and niche-based strategies (those concerning local and social groups);
- weak institutional frameworks must be strengthened;
- sustainability crucially depends on involvement of the private sector and of civil society;
- the style of interventions must itself be “entrepreneurial”;
- a flexible strategy requires efficient monitoring and evaluation systems.

Box 1.8 describes an interesting experience from a comprehensive nationwide programme in Peru.

Box 1.8. Peru's Entrepreneurship Programme

In 2003, the Peruvian Ministry of Labour and Employment Promotion (MTPE), with financial support from the European Union, launched a programme named *Peru Emprendedor*, to foster entrepreneurship in the country. It had five components: *i*) a credit programme for existing micro and small firms, through essentially microfinance institutions; *ii*) business development services, channelled through a bond mechanism (*BonoPyme*) — 30 per cent of which was self-financed by firms; *iii*) support to young Peruvians aged 18 to 35 years for new enterprise creation; *iv*) support to business associations of micro and small firms, nationwide; *v*) support for unemployed or underemployed adults wishing to create new firms. The two components dealing with new firm creation are similar and consist of four distinct phases:

- 1) **Assessment:** entrepreneurial personal skills are evaluated free of charge.
- 2) **Business Plan:** selected participants are trained to elaborate a business plan. This stage lasts two months and the programme finances 90 per cent of costs.
- 3) **Implementation:** this third step provides support for participants starting their new business, mainly by close accompaniment and advice. The programme subsidises 85 per cent of costs.
- 4) **Consolidation:** during the new firm's first three months (or in some cases up to six months) the entrepreneur can use technical assistance and advisory services from local consulting firms and specialised NGOs, in such business activities as sales, marketing, productivity, financing. In this stage, the subsidy is 80 per cent of total costs.

In the two years 2003 and 2004 results are reported to have been significant, with 2 600 youngsters trained, 84 new businesses operating and 2 500 adults who received specialised services for firm creation.

Source: *Ministerio de Trabajo y Promoción Social*, Lima, Peru, 2005, quoted in Villaran and Hnyilicza, 2005.

Several actions needed to address and solve co-ordination failures involve the creation and strengthening of public and private institutions, and their methods of co-ordination. Developing countries have much to do in this area. While these institutions often exist, they are ineffective, inefficient and lack a clear mandate, and their co-ordination with other organisations and firms is at best uncertain.

However, several examples of good — or best — practices are emerging, and these offer useful insights for policy design and implementation. From the evidence briefly surveyed here (and elsewhere), principles include:

- The financing of interventions and subsidies, to individual firms as well as to support institutions, needs to be based on their actual performance and results. This would create competition among centres and firms, without guaranteeing unconditional funding. Support and incentives therefore need to be temporary and reversible.
- Monitoring and evaluations need to be continuous, with credible penalties attached in the event of underperformance. Feedback from operations should be used to improve future policy design and delivery. Learning is also essential in this domain, and organisations, governments and international donors constantly need to learn how to design and implement policies.

Conclusions

Before summarising policy implications, one question needs to be asked: Under the new World Trade Organization (WTO) regime of international trade relations, to what extent are active policies allowed and feasible? Some authors argue that the “policy space” was there for those now-developed countries which are themselves purposefully shrinking it for countries that are currently underdeveloped (Chang, 2005). However, others show that the space is still there, although restricted (Amsden, 2005; Lall, 2005). We will not go into the details of this debate, but rather pragmatically focus on some criteria for the design and implementation of the policies that are currently carried out with the loans, grants and technical assistance of national donors and multilateral organisations.

In terms of the rationale behind PSD policy actions, we should remember that:

- The rationale of government interventions — and of donors’ actions supporting and advising governments — needs to be aimed at improving the functioning of markets. As we have discussed at length, markets are sometimes missing, often failing and always imperfect. Individual agents and organisations fail to co-ordinate their efforts in a way that induces behaviour beneficial to everyone. Policies to promote PSD have to address these market and co-ordination failures.
- When systems of innovation and technology fail, policies need to remove these “systemic imperfections”. In practice, they need to address the weaknesses of the components of the system, of their relationships and their dynamics. The poor links between industry and the knowledge infrastructure are the most frequent weaknesses in developing countries and should be explicitly targeted.
- A narrow focus on horizontal policies and policies to improve the business environment alone will have mild effects. Policies need to be specific to every system (context-specific).

- The coherence of the whole system of policy support is a primary target. It is urgently needed to move beyond good “projects” to good “systems” of consistent and integrated programmes and interventions. A differently functioning set of public policies affecting innovation and PSD (enterprise, competition, trade, regional development, R&D, public procurement, consumer protection policies) needs to be integrated systematically.
- It is critically important to improve capabilities for strategic policy design, formulation and implementation, and to exploit potential for private-public collaboration. This chapter has repeatedly stressed that public-private dialogue and active collaboration are essential for effective PSD policies.

As for concrete practices to improve the effectiveness of policy interventions and of their design and delivery, several tools have been effectively used and should be considered.

- Benchmarking to compare with other experiences may represent a useful exercise and provide firms and organisations with the incentives to act and improve their performance (<http://www.ecipar.it>; <http://www.benchmarking.it>). Benchmarking is all the more necessary as in most instances there is no such thing as an optimal state in relation to which failures and imperfections may be defined. It follows that it is necessary to compare organisations, systems and clusters in a detailed manner and learn from the comparisons. The same logic applies to the analysis of best practices in specific issues.
- In several cases, the starting point for the design and implementation of appropriate PSD policies is at the firm-level. The analysis of firm-level weaknesses — notably in innovation and learning — should drive policy makers and donor agencies.
- The option to use indirect inducements instead of direct interventions should always be considered. This means building the right institutions and the appropriate incentive mechanisms, and in some cases it has been shown that this may be applied also to official development assistance (Pietrobelli and Scarpa, 1992).
- Open dialogue, transparency, accountability and constant evaluation in the design and implementation of policies are always necessary. These principles should contribute to minimising corruption and the capturing by private individuals (and firms) of all the benefits resulting from policies — thereby preventing spillovers and overall welfare improvements.
- Policies need to adopt a dynamic approach and evolve over time. This is especially necessary for PSD, as the final beneficiaries of these policies are firms which are constantly facing economic, technological and regulatory changes.

Notes

1. In an early report, the private sector was defined by the OECD Development Assistance Committee (DAC) as “*a basic organising principle for economic activity where private ownership is an important factor, where markets and competition drive production, and where private initiative and risk-taking set activities in motion*” (OECD, 1994, p. 4).
2. This argument is based on static models of perfect competition, where failures are defined as deviations from so-called Pareto optimality.
3. In his analysis of the East Asian success Stiglitz writes that: “... whenever information was imperfect or markets were incomplete, government could devise interventions that filled in for these interventions and that could make everyone better off. Because information was never perfect and markets never complete, these results completely undermined the standard theoretical basis for relying on the market mechanism. Similarly the standard model ignored changes in technology; for a variety of reasons markets may under-invest in R&D.... Because developing economies have underdeveloped (missing) markets and imperfect information and because the development process is associated with acquiring new technology (new information), these reservations about the adequacy of market mechanisms may be particularly relevant to developing countries.” (Stiglitz, 1996, p. 156, emphasis added, as quoted in Lall, 2005).
4. This section is based on Lall (2000), and Pietrobelli (1997).
5. Bell and Pavitt (1993), Dahlman *et al.* (1987), Katz (1987), Lall (1992, 2001) and Pietrobelli (1997, 1998).
6. Among the many authors see Lundvall (1992), Nelson (1993), and Edquist (1997).
7. See, for instance, Lall and Pietrobelli (2003, 2005), Cassiolato *et al.* (2003), and papers presented at *Globelics* meetings (www.globelics.org).
8. “Market thickness” is closely related to a globalising economy. Opening domestic market to international trade raises the number of sellers and buyers, broadens the scope of customers and improves search efficiency, thereby raising the thickness or the effective number of participants of every market. It has been argued that market thickness can have non-trivial effects on incentives and organisations and thus on economic outcomes, independently of the resource allocation effect of trade. For example, thickening the market may weaken long-term contractual relationships between upstream and downstream manufacturers and make vertical integration less attractive, thereby leading to more informal and co-operative relationships. While this may eventually promote a more efficient organisational form, it can also have at times adverse consequences, by leading to low-level equilibrium traps. See McLaren (2003) for a further discussion of market thickness.
9. Hoff (2000) explores in detail the possible source of low-level equilibrium traps related to co-ordination failures, and argues for an “ecological” perspective on development, where the influence from others in one’s environment critically determines outcomes.
10. However, Rodríguez-Clare (2005b) clearly shows that co-ordination failures may prevail also in the absence of multiple equilibria, for example with activities that are never profitably provided by private firms (e.g. public goods with non-excludability, where the government should deliver such goods).

11. Hausmann and Rodrik (2003) suggest that the goal of policy should be to promote the discovery of activities where the economy has comparative advantage. However, Rodrik, in his recent analysis of what is so special about China's exports, also notes that: "... lack of co-ordination can be an advantage ... as it allows different things to be tried and for successes in one region to be copied elsewhere." (Rodrik, 2006, p. 21).
12. "In the case of Brazil, the steel, aircraft, and (to an important extent) shoe industries are all the creation of import substitution policies of the past. High levels of protection (steel and shoes) and public ownership, public R&D and subsidised credit (aircraft) were deliberately used to generate rents for entrepreneurs investing in new areas and to build up industrial clusters. In the case of Chile, industrial policies played a huge role in grapes, forestry and salmon. ... In grapes, there was significant public R&D in the 1960s that transformed an industry that was primarily oriented to the local market into a global powerhouse And in forestry, there is a history of at least 60 years of subsidising plantations ... as well as a big push since 1974 to turn the wood, pulp and paper and furniture cluster into a major export industry. ... In Mexico, the motor vehicles and computer industries are the creation of import-substitution policies (initially), followed by preferential tariff policies under NAFTA. None of these are the result of hands-off policies or of level playing fields and unadulterated market forces." (Rodrik, 2004, p. 15).
13. See the fascinating example of the creation of venture capital industry in Chinese Taipei as a result of a search network involving California-educated Chinese and high government officials in Chinese Taipei (Kuznetsov and Sabel, 2005b).
14. See Focus 1 in this volume for the main features of the OECD-DAC consensus on pro-poor PSD.
15. See the detailed analysis in Schulpen and Gibbon (2002).
16. World Bank (2004, 2005a, 2005b), UNDP Commission on the Private Sector & Development (2004); OECD-DAC (2004); Committee of Donor Agencies for Small Enterprise Development (2001). For a more academic discussion along similar lines, see Hoekman and Javorcik (2004).
17. See Pietrobelli and Rabellotti (2006), for a detailed analysis of the concepts.
18. Recent literature also argues that clustering may foster poverty reduction (UNIDO, 2004).
19. Some techniques could be usefully employed, as for example in Pietrobelli and Maggi (2005), SEBRAE (2004), and PACA — Participatory Appraisal of Competitive Advantage. <http://www.paca-online.de>.
20. The variety of forms and institutional arrangements is almost infinite in this regard. For our present aims we do not enter into this debate here, but rather focus on institutions that generally aim at improving inter-firm and inter-organisation linkages to promote innovation and technological capabilities. The terminology used is therefore deliberately loose here to reflect the extreme variety of models and experiences.
21. On the need of technological capability building for food safety it has been estimated that Argentina loses on average up to \$1 billion every year owing to sanitary problems that force exporters to accept lower prices for their products. This handicap could be overcome by investing \$10 to \$25 million a year over five years into building the necessary state-of-the-art capabilities in its food safety agency to respond to the emerging sanitary and phytosanitary requirements (UNIDO, 2005).
22. The expression appears to be derived from the Italian "servizi reali", often employed in policy documents as well as in academic papers by several Italian scholars (see references in Pietrobelli and Rabellotti, 2002, 2007).
23. Few detailed analyses exist on BDS Centres in developing countries. An interesting exception is Oyelaran-Oyeyinka (2006) and Oyelaran-Oyeyinka and Lal, eds., (2006) on Africa.
24. This is the approach using tools such as matching grants and training.

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Focus 1

Private Sector Development in a Pro-Poor Growth Context: The Role of Donors

For donors, the pro-poor growth agenda is not business as usual and more of the same will not be sufficient¹.

The poor know that self-employment or wage income is the most promising path out of poverty². As the private sector is the main driver of economic growth and job creation, developing countries have a strong interest in ensuring that their business environment encourages and rewards entrepreneurship and innovation and enables firms of all sizes to expand and to forge international trade and investment linkages. Donors should regard private sector development as a major theme for their development co-operation strategy and programme, at agency and field levels.

But the way the private sector develops is also important, because it has a strong bearing on the pattern of growth. It influences whether growth has a broad or narrow base and whether it is more or less inclusive of the many poor men and women, informal firms and workers, micro-entrepreneurs and small-scale farmers who make up the lion's share of the private sector in developing countries. Growth is likely to be faster, sustained for longer and more effective in reducing poverty if the poor participate in, contribute to and benefit from growth³. At present, most developing countries are unable to create sufficient formal jobs to cope with the increase in the non-agricultural workforce. This obliges the poor to earn their livings in the informal economy, frequently in "survival businesses" which contribute little to growth, provide fragile livelihoods and exclude people from basic protection. Informality also distorts markets and reduces the revenues available to governments for social and other expenditures.

Factors that limit participation of the poor in the growth process include: *i*) imperfections in labour, land and financial markets, as well as in commodity markets from which the poor earn their livelihoods; *ii*) inadequate access to affordable and reliable transport, energy, water and ICT infrastructure; and *iii*) capacity constraints caused by low levels of human capital. Policy and institutional reforms to improve the administrative, legal and regulatory environment can help the poor participate in markets on more equal terms and reduce opportunities for corruption. But such reforms often require political will, drive and leadership to take on entrenched interests and inertia. Infrastructure development can help connect the poor to markets, but needs to address key bottlenecks and meet the requirements of different groups through appropriate services and tariffs. Building up human and institutional capacities is essential to ensure that reforms are implemented and that the constraints holding back investment and productivity improvements are addressed.

This *Focus* explains how donors have been supporting private sector development, suggests how donors can promote private sector development in a pro-poor growth context and, finally, presents some implications for donors themselves. It draws on policy guidance recently agreed by the OECD's Development Assistance Committee (DAC)⁴.

How Donors have been Supporting Private Sector Development

Providing technical and financial support to firms, either directly or through developing country governments, has been one of the most common ways that donors have been promoting private sector development, especially to industries or firms that involve the poor (e.g. agribusiness and small enterprises). The paradigm is that the poor rely on these businesses for their livelihoods, these businesses are disadvantaged, and this justifies subsidising their access to knowledge and finance. Another common intervention, sometimes referred to as public-private partnerships or business linkages, has been to encourage alliances between firms in developed and developing countries. But experience has shown shortcomings in such use of concessional finance to end users in the private sector, which typically creates market distortions and may often be unsustainable. In addition, there has often been little co-ordination among donors.

Thus, the focus of private sector development programmes has often been on firms, rather than on market outcomes or the pattern of economic growth that results from them. Neglect of institutional change has perhaps been the most glaring deficiency with donors' approaches (OECD, 2004). And even when institutions started receiving the attention they deserved, development agencies attempted to drive change through, based on the technical merits of interventions in such areas as developing new regulations or strengthening regulatory or facilitating organisations. Inevitably, these initiatives ran into resistance from vested interests and change was blocked. The DAC recently highlighted that not enough thought has been given to the broader political and social context within which capacity development efforts take place (OECD, 2006*a*).

Promoting Private Sector Development in a Pro-Poor Growth Context

Recent DAC work emphasises that pursuing a pro-poor agenda for private sector development requires a rethinking of donor programmes and approaches (OECD, 2007). The emerging agenda is broader and more complex than previously thought and brings in issues that may be considered unrelated, such as governance, the political economy of change, capacity building, gender and the environment.

This emerging agenda acknowledges the importance of policy and institutional reforms that change the formal and informal "rules of the game". It recognises that the poor can benefit from growth both directly in their livelihoods, as workers, farmers and entrepreneurs, and indirectly, as consumers and recipients of tax-funded social services. Moreover, it is market outcomes that count, because these determine the pattern of growth and affect the poor in different ways. Investments in infrastructure, human development and social protection are also needed to help foster private sector development.

The role of donors in this pro-poor context can be illustrated in relation to business development services. The approach donors have often adopted is to provide services to help small enterprises survive and grow as an end in itself, because this should result in higher outputs and more jobs. The emerging agenda has a different focus, recognising that business development service providers are themselves business-oriented and market-led and emphasising the importance of making these service markets work better and become more sustainable. The merit of providing these services is they help develop value chains and sub-sectors important for the livelihoods of the poor and expand market access, including for poor men and women. But, to be effective, these services need to be provided in tandem with improving infrastructure, deepening financial markets and reducing unnecessary regulatory and administrative barriers. Encouraging the expansion of larger firms may also form part of a pro-poor agenda for private sector development, because larger firms can create jobs, increase demand for the goods produced and services provided by poor entrepreneurs, and extend business development services to their suppliers.

Implications for Development Agencies

There is now a consensus among donors on the need to move towards more market-oriented approaches to private sector development. What needs to be done, and an indication of the appropriate sequencing, will emerge from an analysis of the country and sector-specific constraints to private sector development and from an assessment of the country's competitive advantage. To achieve sustainable results, donors need to engage with developing countries on a long-term basis and be ready to provide their aid flexibly, so they can respond to changes in the level of development, the policy environment and the extent to which there is a functioning state accountable to the interests of the poor. Donors' interventions should be co-ordinated and provided in support of partner country-led development strategies.

Donors should aim to play a facilitating and enabling role, such as through supporting and building up capacities in developing countries of governments and representative private sector and civil society organisations to identify the binding constraints that are holding the private sector back. Donors can provide analytical support in the use of diagnostic tools to examine the pattern of growth and help identify the institutional and policy weaknesses that are limiting the ability of poor men and women to participate in, contribute to and benefit from growth⁵. They can use their influence and resources to support processes of stakeholder engagement, at national and local levels, ensuring that representatives of the poor can influence policy making and that participatory monitoring and evaluation form part of the process. Donors can also support and help build up the capacity of private sector associations to provide services previously supplied by the state.

As far as possible, the approach to providing assistance should help to deepen the markets for goods and services in which firms and entrepreneurs, including the poor, need to be able to invest and innovate. It recognises, though, that market development approaches may not be applicable in some circumstances in the short term, such as those following conflict or natural disasters. If direct support is given to firms, initiatives driven by demand should be

preferred and firms receiving support should be selected according to their performance and their expected capacity to create jobs, innovate and provide services at local market conditions. In parallel, donors should also help to strengthen institutions important for supporting private sector development.

The emerging pro-poor agenda for private sector development has implications for the way development agencies function, especially in developing countries. Private sector development should not be considered a stand-alone or separate activity. Rather, it should form the basis, ideally under a common strategic framework, for bringing together staff and programmes focused on enterprise development, agriculture, infrastructure, governance, capacity development, gender and environment. As few development agencies can have staff with all these skills stationed in each priority country for their development co-operation programme, donors need to provide appropriate support and incentives to staff to take part in multi-donor and multidisciplinary teams at field level and empower these staff to negotiate, co-ordinate and implement programmes. Development agencies should ensure that their internal incentive and evaluation systems do not discourage staff from taking on difficult, time-consuming and riskier initiatives with potentially high, long-term impact. Finally, donors and other members of the international community in developing countries can help develop the local private sector by sourcing locally, on competitive terms, more of the goods and services they consume, and encouraging their suppliers and contractors to adopt responsible business practices.

Notes

1. Source: "Policy Statement on Pro-Poor Growth", welcomed and endorsed at the DAC High-Level Meeting on 5 April 2006.
2. A sample of over 60 000 poor men and women most frequently cited self-employment or wage income as providing the best prospects for escaping poverty (Narayan *et al.*, 2000).
3. The DAC describes pro-poor growth as a pace and pattern of growth that enhances the ability of poor women and men to participate in, contribute to and benefit from growth (OECD, 2007).
4. Most notably, *Promoting Private Investment for Development: The Role of ODA* (OECD, 2006b) and *Promoting Pro-Poor Growth: Policy Guidance for Donors* (OECD, 2007).
5. Five interlinked factors provide an analytic framework for assessing whether the conditions are in place for the private sector to deliver growth and identifying those changes to institutions and policies that would help make growth pro-poor. These factors are: *i*) providing incentives for entrepreneurship and investment; *ii*) increasing productivity through increased competition and innovation; *iii*) harnessing international economic linkages of trade and investment; *iv*) improving market access and functioning; and *v*) reducing risk and vulnerability (see OECD, 2004, Chapter 2).

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Focus 2

Public-Private Dialogue in Developing Countries

The participation of civil society — consumers, private entrepreneurs, employees, citizens, associations, etc. — in the design of public policies echoes the need of the state to establish their legitimacy by improving the *transparency, quality* and *effectiveness* of their policies. Private firms and the business community in particular tend to be increasingly involved in a *policy dialogue* with the state aimed at discussing economic policies and business regulations.

In the following, *public-private dialogue* (PPD) is defined in a broad sense to include all forms of interaction between the state and the private sector that relate to the design of public policies — improving the business climate, short-term macroeconomic policy, medium and long-term development strategy, sector regulation, and so on. This interaction can be more or less institutionalised (investment councils advising the government, forums bringing together civil servants and business people, and informal social networks that include senior government officials, political decision makers and leading business figures)¹.

Public-Private Dialogue: Working for Better Governance

PPD has been increasingly advocated as a way to improve the effectiveness of public policy in developing countries. Research at the beginning of the 1990s on the conditions and the success factors of certain Southeast Asian economies (Korea, Chinese Taipei and Malaysia) and Japan pointed to the role of the state in the economy and to the positive role of interactions between political elites, bureaucracy and the private sector, in particular. The influence of increasingly important civil-society actors in industrialised countries as well as some emerging and less-developed economies has strengthened this approach: it is clear that the state — bureaucrats and elected officials alike — cannot design public policies if it is cut off from citizens and social actors, and in particular the business sector with which economic policies are concerned. A forthcoming OECD Development Centre Study (Pinaud, 2007) highlights the benefits that can be expected from a fruitful PPD in developing countries:

- *PPD is a tool that the state can use to change the private sector's perception of government policy, gain credibility and establish a reputation for favouring private-sector development.* In many developing countries, much more than in industrialised countries, the state lacks credibility *vis-à-vis* local and foreign private sectors, especially where it concerns policy commitments to be made over time. The problem of “time

inconsistency” in policy decision making involves high transaction costs in the interaction between the state and the private sector and may reduce the impact of government policies when they are not sufficiently predictable. To address this problem, for example, in Mexico consultative bodies linked to the Economic Solidarity Pact (a stabilisation programme in the late 1980s) helped in the 1990s to move from a situation of mutual suspicion to one of “greater understanding, trust and networking” between government and top business leaders (World Bank, 2001, p. 8).

- *PPD can help the state share information with the private sector and tap into the expertise of firms, a potentially valuable resource for designing public policies.* The effectiveness of economic policies would be significantly enhanced, if the private sector could provide necessary information that allows policy makers and bureaucracies to anticipate the likely impact of economic policy changes. During Mexico’s negotiation of the North American Free Trade Agreement (NAFTA) with the United States and Canada, data provided by local exporters were extremely valuable for the Mexican negotiators, who had little experience in international trade talks (Schneider, 1997). In turn, information supplied by the government proved equally valuable to the private sector for the sake of business forecasting, investment planning and strategy development.
- *PPD can help ensure local ownership of public policies by encouraging private sector involvement in policy implementation.* Policies to develop energy infrastructure, water supply and transport networks are among the best examples of PPD where public and private investments are complementary. This public-private collaboration, known as public-private partnership (PPP), has however been only partially successful, indicating that public-private contracts of this kind require prior in-depth dialogue between the government and private operators, which goes beyond purely legal aspects; the underlying economic, social and regulatory issues must be thoroughly discussed, and particularly how such collaboration fits into overall national strategies for growth, infrastructure development and poverty reduction.
- *PPD can be used to influence the rules of the game and foster state reform.* Dialogue is a way for the private sector to press the government to improve its performance, introduce reforms, create a better and more transparent business climate and intervene in areas of serious market failure. Despite globalisation, the state remains in the seat of authority — codifying laws, making regulations — and, for companies, creating the legal environment that governs economic activity within the national boundary. Companies have therefore obvious reasons for influencing the legislative and regulatory processes. The private sector can also use dialogue to ask for more transparency and accountability from the government. Kraus (2002) describes how Nigeria’s major professional associations helped liberalise foreign exchange and credit policies in the 1990s under the dictatorship of General Sani Abacha, when they were allowed to sit with government officials on the committee that allotted foreign exchange quotas. More broadly, PPD can provide a suitable platform for discussion and analysis so as to determine the comparative advantages of public and private sectors in the attribution of economic prerogatives. In this way, it can help establish a more efficient division of labour between the public and private sectors. PPD is likely to lead to a vision of a state whose role (especially in developing countries) is defined by its *capacities* (World Bank, 1997). In practice, this concept of the state advocates an entrepreneurial and arbiter state, one that provides a forward-looking vision by setting up appropriate institutions and co-ordinating externalities (such as research, training and the environment).

Private-Public Dialogue: From Theory to Practice

Because PPD is usually considered poorly developed or badly structured, a growing share of ODA is earmarked for it. The abundance of serious efforts to achieve these objectives is evidence of the growing interest of multilateral and bilateral aid donors in encouraging interaction between government and private sector in developing countries.

Identifying good practices in PPD was the focus of an international workshop on public-private dialogue organised by the World Bank, the UK Department for International Development (DfID), the International Finance Corporation and the OECD Development Centre in Paris on 1 and 2 February 2006. During this workshop a broad range of speakers — from business, civil society, developing-country governments and development partners — laid the foundation for a “Charter of Good Practice in using Public-Private Dialogue for Private Sector Development” and a “PPD Handbook: A Toolkit for Business Environment Reformers”². The current enthusiasm for PPD lies at the heart of three current priorities of aid donors and recipients — private-sector growth, participation and good governance.

Should PPD therefore be the new “recipe for success” in the least-developed countries (LDCs)? The charter and toolkit ideas actually show that engineering such a dialogue is far from straightforward. Also, as often happens with a new and fairly original approach, the benefits of PPD are sometimes overestimated and the risks played down. The high willingness to use and promote this instrument in a context where governance and private sector development are priorities has sometimes led to mistaken assumptions about the conditions for a healthy and fruitful public-private dialogue that actually improves the business environment.

In developing countries, the state is often simultaneously weak and bloated, whilst the private sector is fragmented, largely disorganised, and often allows for the emergence of powerful rent-seeking lobbies which exert strong pressure on the state. In countries where the rule of law and separation of powers are fairly recent, barely formalised and often non-existent, this leads to collusion and predatory behaviour between public and private sectors. The interaction between both sectors, which may formally take the format of a “dialogue”, is thus highly likely to constitute nothing more than a cloak for rent-seeking activities, the opposite of what might be expected from a fruitful public-private dialogue: the production of public goods such as economic policies fostering the growth of national wealth.

Pinaud (2007) underlines the extent to which the quality of the dialogue depends on the structure of participating institutions, be they from the public or private sector. Fulfilling the conditions for a fruitful dialogue is indeed a highly complex challenge. It is particularly difficult to strike a delicate balance between, on the one hand, preserving the respective autonomy of the public and private sectors and, on the other, fostering a level of interaction which is sufficient to constitute true dialogue — i.e. allowing the private sector access to the public administration and government, and allowing the state to bring itself into the national economic fabric and develop its networks there.

Nevertheless, the disconnect — particularly in most LDCs — between the local institutional and economic situation and the conditions for an “optimal” public-private dialogue should not lead to scepticism regarding this tool for the elaboration of public policy. Rather, it implies taking an informed, voluntary and modest approach to its use. Merely assembling government representatives, high-level civil-servants and private sector institutions around a table will not suffice to create an atmosphere of trust in which the broad direction of economic policy can be jointly expounded. It is of the utmost importance

that the participating actors — notably also donors supporting these initiatives — bear in mind the constraints that are likely to impede public-private dialogue. It is equally important to analyse in advance the institutional and economic dimensions of the dialogue, in other words its “political economy”, in order to determine whether a dialogue is both feasible and timely. Launching a dialogue prematurely (e.g. the Private Sector Round Table in Ghana in 1993-94) will not only lead to negligible results, but may end up reinforcing the distrust between actors over a long period of time.

Donors’ approach to the PPD instrument should therefore be cautious and pragmatic; in particular, they should refrain from substituting for local participants in the dialogue and instead take on the role of go-between and honest broker: they may for instance help spot “policy champions” and “pockets of efficiencies” both within the local administration and the private sector. They could also support the latter by providing analytical and material support, as well as contributing to their organisation. This contribution, modest though it may appear, can prove critical. The organisational and process dimensions of the dialogue can indeed turn out to be key to its success.

Pinaud (2007) also argues that private-public dialogue is a “complex transaction” characterised by asymmetries of information and transactions costs. Put differently, mutual distrust, fuelled by the impossibility to coerce the partners into sticking to its commitments, if not simply to monitor them, may bring about a non-cooperative equilibrium, i.e. a vicious circle of misunderstanding, distrust and, in due course, of mutually disadvantageous hostile decisions. Breaking this vicious circle of distrust, eliciting a momentum of dialogue which, in the end, would lead to a co-operative equilibrium between the state and the private sector, may require external resources and the intervention of a third party. Donors may be able to take on this role, being the broker who analytically informs the process, share its knowledge derived from best practices and success stories, and come forward as the guarantor of the commitments and sincerity of participants.

Whatever the role of donors however, their intervention must be undertaken with modesty. Some of the constraints which are driving the interaction between the state and the private sector, not least the dysfunctional working of local bureaucracies or the lack of a structured private sector, are both difficult to overcome and to work out in the short term: they are institutional features which take generations to be changed (Jutting, 2003). A proper understanding of this set of constraints should pave the way for a realistic and pragmatic approach to public-private dialogue and to what may be expected from it.

Notes

1. Therefore, *Private Public Dialogue* must be distinguished from *Private Public Partnership*: while the latter usually refers to a specific transaction (concession and franchise for instance) whereby the state delegates the provision of public services to a private sector entity, the former is much broader, encompassing various forms of consultation and dialogue between the state and the private sector. PPP can be regarded as a specific sub-category of PPD.
2. See <http://rru.worldbank.org/Toolkits/PublicPrivatedialogue/> and <http://www.publicprivatedialogue.org/>

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Chapter 2

Export Diversification and Global Value Chains: Lessons from Selected Case Studies

Summary

Developing countries face the imperative of diversifying their economic activities from a narrow base of primary commodities into a broader range of manufacturing goods, chiefly of parts and components.

But the experience has not been uniformly positive as greater integration of countries into global value chains (GVCs) carries risks as well as opportunities.

A number of specific instances are examined in depth. These are white goods, or large household appliances, in China, Mexico and Turkey; tourism in Mozambique; film animation in the Philippines; and aircraft in China.

The international fragmentation of production creates opportunities in developing countries for producers to access markets, acquire knowledge and upgrade processes and products. Freer international trade and technological innovation provide opportunities in high-tech industries and services as well as the older labour-intensive industries, with domestic demand being a key element. At the same time, both firms and governments have to make deliberate efforts to avoid falling to the bottom end of the value chains.

Companies are more likely to succeed when they use global competition as an opportunity to build capabilities, move into more profitable areas of industry and use their late arrival on the scene as a source of competitive advantage.

Export Diversification in a Changing International Environment

Many developing countries, especially the least developed ones, are characterised by a production structure that concentrates in a narrow base of commodities (WTO, 2006; Bonaglia and Fukasaku, 2003)¹. Promoting economic diversification towards non-traditional, higher-value products is hence a primary goal of national development strategies. Policy makers are concerned by the economic and political risk associated with heavy dependence on commodity exports. The concern stems from a widely held view that such a high concentration can increase vulnerability to demand shocks (e.g. price fluctuations) and, in the specific case of natural resources, the risk of the so-called “resource-curse”².

Devising policies to promote diversification and internationalisation requires a clear understanding of how the private sector functions and what factors — internal to the firm or present in its business environment, in the domestic economy or abroad — impact on

competitiveness. A large body of literature discusses obstacles to export diversification, highlighting both domestic factors (e.g. non-conducive investment climate and supply-side constraints) and external factors (e.g. tariff escalation, non-tariff barriers and complex rules of origin built into preferential market access agreements).

The relative importance of these constraints must be assessed in light of the changing structure of international trade and investment. The vertical fragmentation of manufacturing production into separate activities that can be performed in different locations by different firms is possibly the most distinctive feature of the contemporary global economy (Feenstra, 1998). Improvements in information and communication technologies (ICT), combined with the search for lower cost locations, better logistics, preferential market access and ways to circumvent trade barriers (“tariff hopping”) brought about such geographical fragmentation of the production process and multiplied developing countries’ links with global production networks for a wide range of products. The growing share of parts and components in global trade is evidence of this phenomenon. Athukorala and Yamashita (2005) estimate that world trade in parts and components increased from \$400 billion in 1992 to over \$1 000 billion in 2003 (equal to 23 per cent of total world manufacturing trade), recording an annual average growth rate of 3.4 per cent.

The progressive insertion of developing country firms — be they domestic companies or subsidiaries of multinational enterprises (MNEs) — into international production networks or global value chains (GVCs) has resulted in a phenomenal build-up of manufacturing capabilities as well as export growth in these countries. Although industrialised countries still account for most trade in parts and components, the share of developing countries has constantly increased, to 35 per cent of exports and 44 per cent of imports (Athukorala and Yamashita, 2005)³. In this sense, the unprecedented international scope of markets and distribution systems for goods and services, capital, labour and technology that characterise globalisation opens new trade opportunities to developing-country producers (Gereffi, 2005). As shown by the experience of several Asian “tigers” and a few countries in Latin America and Eastern Europe, international trade and investment have been formidable vehicles of knowledge diffusion and development.

However, greater integration also exposes many developing countries to greater risks, as outcomes of expanded trade and investment have not been uniform across countries or industries. The economic ascendancy of China and India, and their strong impact on international commodities demand and prices, might further exacerbate developing countries’ dependence on exports of raw materials and further raise the bar for competing in labour-intensive industries (Goldstein *et al.*, 2006).

Against this dismal picture of “a narrow range of products, a lack of diversification of export markets and low technology content” (WTO, 2006, p. 26), there are a few promising examples of companies from developing countries that upgraded their production and export profiles, and even established themselves as true MNEs (Goldstein, 2007). Understanding what drove their successful diversification and internationalisation may then provide important policy lessons.

What explains the different positioning of countries and companies in GVCs? To what extent does the structure of the chain influence the possible rewards for the firms involved? Which margins do governments (and their development partners) have to promote private sectors and improve their international competitiveness?

This chapter aims at contributing to this debate by looking at specific and concrete examples of productive and export diversification around the developing world. First, it sketches a general framework for analysing developing countries’ participation and upgrading

into GVCs. Second, the chapter summarises four case studies produced in 2005-06 as part of the Development Centre's programme of work. A variety of industries is considered which are all characterised by ongoing fragmentation of production, increasingly involving developing country producers. The sectors — household appliances, animation, tourism and aircraft — were chosen to provide a varied picture of GVCs⁴. The sampling may not be scientifically robust, but it allows for significant insights. The final section compares the key results and distils some broader policy implications.

Participation and Upgrading in Global Value Chains

The GVC phenomenon is a new form of international production sharing that stretches across many countries, with each country specialising in particular stages of an item's production sequence. It has been widely documented (e.g. Gereffi and Korzeniewicz, 1994; Feenstra, 1998; Hummels *et al.*, 2001; Yusuf *et al.*, 2004; Memedovic 2005). Several approaches have been proposed, often complementing each other, to explain the ability of a firm or cluster of firms to enter into new products and markets, innovate and upgrade.

A firm's ability to produce and sell goods and services hinges upon the competitive endowment of the country, its business climate and the internal resources of the firm. The country's competitive endowment includes the physical, human, "institutional" and social capital that combine to determine productivity and the structure of comparative advantages. The business climate refers to the set of regulations and procedures that determine the ease of doing business, the rule of law, the protection of property rights and the willingness to invest to augment the existing endowment. These external factors shape the environment in which firms compete, and promote or impede the creation of the firm's competitive advantages, i.e. its ability to produce consistently at lower cost, higher quality, or greater customisation than its competitors.

As discussed in Altenburg (2006), the concept of value chain and production network is particularly useful for understanding the factors affecting enterprise competitiveness, identifying the binding constraints and tackling them. This concept builds on a variety of approaches, from management science to sociology and political economy (see Box 2.1). Porter (1990) suggested that the competitive advantage of an enterprise stems from its proprietary assets and is influenced by four country characteristics, the so-called "diamond". The proprietary assets include location (proximity to markets, suppliers and competitors), technology, human resources, organisational capabilities, relationships with suppliers, to name a few. The diamond comprises the availability and quality of factors of production, the size and nature of demand, the presence and quality of suppliers and supporting industries, and the nature and rules of competition. Porter's framework emphasises the critical role that local conditions and linkages play in shaping the ability of the firm (and its supply chain) to exploit its internal capabilities profitably. These interrelationships are summarised in the concept of value chain or *filière*⁵ (Box 2.1). As barriers to international trade and investment become less important, firms can source not only parts and components but also whole stages of the production process to firms (or cluster of firms) located abroad. As a consequence, value chains can span over national borders — into GVCs or production networks. A value chain describes the full range of activities and actors involved in bringing a product/service from conception to consumption. Virtually all consumer products sold by developed country retailers today are made at least partly in offshore factories located in developing countries. Even products that require precision manufacturing, like hard disk drives and many kinds of semiconductors, are becoming "high-tech commodities" made in capital-intensive facilities in Southeast Asia and elsewhere.

Box 2.1. Value Chains and Global Value Chains

In the business literature, a supply chain is defined as a system of suppliers, manufacturers, distributors, retailers and customers where material, financial and information flows connect participants in both directions. Porter (1980, 1985) introduced the “value chain” as a more systematic approach to examining the creation of value and the development of competitive advantage of an organisation such as a firm. In this framework, the chain consists of a series of value-adding activities that build the overall value delivered by the firm. A firm’s value chain includes “primary activities” (e.g. logistics, production, marketing and sales, after-sales services) and “support activities” (e.g. human resource management and R&D). A profit-seeking organisation manages these activities in such a way to maximise value creation while minimising costs.

The final good delivered to a consumer is in fact a bundle of products and services, whose production and value involve several firms (e.g. suppliers, wholesalers, distributors), each one managing its own value chain. Therefore, value maximisation requires extending the framework beyond the individual firm to the whole supply chain linking the economic actors involved in the production, delivery, disposal and recycling of a final good. Porter terms this larger, interconnected system of value chains the “value system”. The international fragmentation of production allows the value network to involve actors from different locations, spanning many countries, and resulting in a global value chain or global production network. In a nutshell, we can distinguish between:

- value chain: interrelation of economic activities within a firm, where value is added at each stage;
- value or production network: a network of several interrelated value chains, spanning upstream suppliers and downstream customers across sectors, providing services and other inputs;
- global value chain (GVC) or global production network (GPN): a network of value chains that involves several actors in different locations, spanning over many countries.

A GVC describes the full range of activities and actors involved in bringing a product from conception to consumption. Dicken (1994) defines GVC as a “transactionally linked sequence of functions in which each stage in the sequence adds value to the process of production, whether of goods or services.” The GVC for a particular product stretches across firms and national boundaries and links up — backwards, forwards or horizontally — to other value chains. For instance, the GVC for apparel spreads out over various value chains, such as raw materials (e.g. natural fibres), components (such as textile yarn), apparel manufacturers, exporters and retailers, and involves internationally dispersed actors.

The GVC and GPN approaches provide a unified theoretical framework for analysing the political economy of global production and trade. They have been developed independently, but are increasingly considered as part of a common analytical framework. Various terms have been created to name analyses of global production and trade that look at the entire chain of productive activities — value chain, *filière*, commodity chain, value network, activities chain, production network. The range of terms reflects the specific, yet sometimes complementary, perspectives peculiar to each analysis. Traditionally, GPN analysis has focused more on how MNEs contribute to industrial upgrading of developing countries through knowledge transfer and local capacity formation (Ernst and Kim, 2002). The GVC has focused more on the governance aspects, in particular the power relationship within the chain and how value-added is distributed amongst participants (Gereffi *et al.*, 2005). Although proponents of each approach defend the peculiarities of their own framework (Altenburg, 2006), boundaries between the GVC and the GPN have blurred in recent years, and both analyses have increasingly looked at the implications of global production sharing on development.

Source: Raikes *et al.* (2000), Bonaglia (2006) and Altenburg (2006).

International production sharing *per se* is not new — what is new is its scope and governance structure. In one of its earliest forms it involved the shipment of primary commodities from developing countries to industrial nations for further processing, and then the re-exportation of part of the processed product back to the primary commodity producing country (Yeats, 2001). A different form of production sharing between developing and industrial countries emerged in the mid-1960s when large, vertically integrated MNEs established subsidiaries in developing countries and transferred their labour-intensive production activities (e.g. electronics and semi-conductors, apparel and leather goods). The reduction in trade and transport barriers in the late 1980s, as well as the improvement of suppliers' capabilities in developing countries and the development of new organisational practices (flexible manufacturing, modular product architecture and lean retailing), contributed to a further transformation from “vertical integration” to “vertical specialisation”⁶. The continuing improvement in ICT has enabled firms in industrialised countries to outsource to their affiliated companies abroad or to foreign suppliers not only the provision of intermediary inputs and materials, but also, and increasingly, of services, allowing a further specialisation in higher value-added business functions and activities (OECD, 2005; Amiti and Wei, 2005).

Participation in GVCs can be a powerful tool for enabling developing country firms to access foreign markets and upgrade their technological and managerial skills. By linking up with the most significant players in the chain, firms in developing countries can overcome the limits imposed by less demanding domestic markets and upgrade their products and processes. Meanwhile, by manufacturing for others, they can capitalise on their cheap labour while avoiding the expense and risk of marketing, distribution and research and development (R&D).

Nonetheless, expectations of a fast upgrading of such firms, partly due to the “death of distance”, have proved naïve (Goldstein and O'Connor, 2004). Firms based in industrial countries control key proprietary assets such as technological, organisational and marketing skills, as well as brand-name and design, and move only non-core activities offshore⁷. GVC leadership is still exercised by MNEs, buyers or global retailers that only transfer to their suppliers in developing-country locations the necessary know-how to perform simple assembly work, adding little value. Moreover, while buyers concentrated (and thus acquired stronger bargaining power), the pool of potential suppliers has enlarged. Hence depressed export prices and profit margins for these suppliers, causing so-called “immiserising growth” (Kaplinsky *et al.*, 2002).

What explains the differential success of firms to access GVC and upgrade? The capabilities of the firm clearly play a critical role (Teece, 2001). Equally important are two exogenous factors that affect the ability of firms to exploit those capabilities fully and build their competitive advantage. These factors are the business environment in which the firm operates — Porter's diamond — and the governance structure of the GVC which the firm tries to integrate.

Chain Governance and Supplier's Upgrading

GVC analysis aims to explain why different forms of global production and distribution networks arise, how they are co-ordinated and what the implications are for different participants. This analytical framework takes into account the “intricate links — horizontal, diagonal, as well as vertical — forming multi-dimensional, multi-layered lattices of economic activity” (Henderson *et al.*, 2002, p. 442). It has been applied to many different industries and has gained considerable attention within academia and international organisations⁸.

One of the key insights of GVC analysis is that in many industries, co-ordination and control of complex system co-ordination does not require direct ownership. Thanks to its control over key assets, a lead firm shapes the organisational structure of the chain, sets the parameters that govern the activities along the chain (standards, delivery times and so on) and largely determines the room for capacity improvement of lower-tier suppliers. The emergence of a system of chain co-ordination mainly reflects the key competitive assets within the industry, the nature of the product traded and the regulatory environment in which firms operate (Box 2.2).

Box 2.2. The Governance Structure of Global Value Chains

Different industries have different forms of governance. In his seminal work on US retailers, Gereffi (1994) distinguished between buyer-driven (BD) and supplier-driven (SD) chains. BD chains have arm's-length market relations among participants and are usually found in labour-intensive industries, such as textiles and clothing, footwear, toys, consumer electronics and, to some extent, food products. Control over research, design, sales, marketing and financial services allows the buyer to co-ordinate tiered networks of overseas sub-contractors and traders with the main consumer markets. In contrast, SD chains are vertically integrated and the lead firm is a large, usually multinational producer or designer that co-ordinates the whole network through its control over technology. SD chains are found in capital intensive and technology intensive industries such as consumer durables (automobiles) and capital goods. This BD-SD taxonomy is by no means exhaustive. Emergence of a system of chain co-ordination also reflects the nature of the product traded. In the case of tropical beverages (e.g. coffee, cocoa), what provides the leeway to co-ordinate the chain is the ability to procure continuously specific volumes and quality mixes for a number of processors (Gibbon, 2001).

Gereffi *et al.* (2005) argue that the emergence of a specific governance structure would depend on: *i*) the complexity of the transactions involved; *ii*) the codifiability of the information to be transmitted; and *iii*) the capability of the suppliers to fulfil the tasks set by the lead firm. According to this argument, market relationships would emerge when product specifications were simple and information easily codified, so that explicit (and costly) co-ordination was not needed. At the other extreme, vertically integrated firms would emerge when transactions were highly complex, information hard to codify and the capability of the suppliers low. Between these two extremes, they identify, in order of increasing explicit co-ordination, “modular value chains” (turnkey suppliers provide a full range of services to the lead firm, often serving different chains at the same time), “relational value chains” (a high level of interdependence between buyers and sellers based on trust and reputation) and “captive value chains” (small suppliers are at the beck and call of large buyers).

The governance structure of a chain is not static; rather it co-evolves with technological and institutional changes within the chain or in related ones. For example, advancements in ICT and enhanced suppliers' capabilities contributed to the evolution of the computer industry from an SD chain, with a direct involvement of branded manufacturers in production, into a modular form. Lead firms concentrate now on design and branding and outsource production to first-tier, full-package suppliers.

Source: Gereffi *et al.* (2005) and Gibbon (2001).

For lead firms, the crucial trade-off is between access to low-cost inputs in developing countries and the risks of suppliers' failure in meeting quality standards, which could also have negative effects on the brand reputation. Therefore, these firms might decide to set up

and co-ordinate complex supply-chains, instead of relying on arm's-length relationships, and invest in upgrading their suppliers' capabilities⁹. Closer relationships also allow better monitoring, limit the risks inherent in decentralised decision-making and foster new product development (Sobrero and Roberts, 2002; Gereffi *et al.*, 2005).

Competitive upgrading — i.e. the improvement of a firm's ability to undertake more profitable or technologically sophisticated activities — can take various forms. A widely adopted categorisation distinguishes four stages: “process upgrading” (making production processes more efficient), “product upgrading” (developing new or improved products), “functional upgrading” (undertaking more complex and value-adding activities) and “value chain upgrading” (using the skills developed in one chain to move to a different, more rewarding one). The framework is associated with the experience of East Asian firms that learned the technology of electronics through their gradual insertion in Japanese and US production networks and have gradually evolved from mere low-cost assemblers of imported components to original equipment manufacturers (OEM), producing finished products to the precise specification of the buyer. OEM arrangements then allowed the most advanced sub-contractors to learn, achieve economies of scale in production and justify investment in automation technology and design capabilities. Building on these new capabilities and thanks to the licensing and technology transfer from lead firms, some OEMs evolved to original design manufacturer (ODM) status, carrying out some or all of the product design and producing the finished products according to a general design layout supplied by the buyer¹⁰. This upgrading path can eventually lead suppliers to develop their own brand of the product, becoming original brand manufacturers (OBM) and/or employ the capabilities developed to enter into a new, related, value chain.

Different factors are at play in determining the position of each player along value chains and different firm-specific resources must be accumulated in order to climb them and remain competitive over the long run. The economic environment in which firms operate and their relationships with lead firms co-ordinating international production networks (i.e. the chain's governance structure) critically influence the upgrading trajectories. Networks of firms of similar power and complementary competencies seem to be more conducive to functional upgrading, i.e. taking on more rewarding functions, and chain upgrading, i.e. using the competencies developed in one chain to enter into a new one. The electronics and automobile industries that best epitomise globalisation, on the other hand, maintain a hierarchical governance structure, where suppliers' upgrading remains limited to production and accuracy of delivery.

Still, while ensuring compliance with standards may motivate buyers to invest in enhancing their suppliers' capabilities, they are less likely to provide support in terms of design, branding and marketing (Humphrey and Schmitz, 2004). In electronics, very few ODM suppliers have managed to set up their own marketing channels and develop their own brand. Indeed, there are even some cases of downgrading from OBM to less risky ODM (Yusuf *et al.*, 2004). The experience of the Costa Rica electronics and medical instruments cluster further confirms the limits of suppliers-oriented upgrading (Ciravegna and Giuliani, 2006)¹¹.

There is no determinism here, however. Even where the room for functional upgrading seems to be limited, corporate strategic choices are crucial to exploit favourable conditions. Several companies from emerging and developing economies have built their successful internationalisation on the ability to learn from strategic partners and leverage on their resources (Mathews, 2006; Tokatli and Kizilgün, 2004). Experiences in the household appliance sector documented below confirm these findings¹².

Insights From Case Studies

There has been relatively little work carried out to understand the nature of outsourcing, particularly in cross-country and industry-specific situations, i.e. where, when, and how it occurs. In 2005-06, the Development Centre carried out a number of industry case studies to analyse the contribution of various factors to the upgrading process. A major objective was to move beyond the limited number of sectors, such as consumer electronics, motor vehicles, software and apparel, which have received most attention so far.

The focus is on cases where globalisation from the periphery has led to successful upgrading. While any selection is open to criticism for the bias that is inherent in the process, all cases point to the crucial importance of firms' capabilities for accessing GVC and of corporate strategising for upgrading. This does not detract from the importance of government actions, both in terms of improving the business environment and through specific policies.

*Appliances in China, Mexico and Turkey*¹³

The household appliances or “white goods” sector is a mature industry¹⁴. Products are relatively similar and simple to produce (although environmental and energy-saving concerns are leading to important regulatory changes) and production is being delocalised to developing countries where not only input costs are lower, but demand growth rates are higher as ownership of major home appliances is strongly correlated to economic development. The industry is hence a testbed for the emergence of firms capable of transforming themselves from OEM to OBM — in fact a story that explains the upgrading trajectory of industrial countries' MNEs such as Merloni (now Indesit) of Italy (Sori, 2005).

Mabe, Arçelik and Haier (from Mexico, Turkey and China, respectively), are successful examples of latecomer firms that managed to upgrade their operations, evolving from the production of simple goods, generally as OEM subcontractors, into new product lines developed through their own design, branding and marketing capabilities¹⁵. These firms did not delay their internationalisation until they were large, as did most of their predecessor MNEs from North America, Europe or Japan. Instead, many of the enterprises from developing countries grow large as they internationalise; conversely, they internationalise in order to grow large. This is a striking pattern which, if confirmed in other studies, indicates that enterprises from developing countries, both those that are still small and those that are growing large, have pursued distinctive approaches to internationalisation.

Mabe, Arçelik and Haier fit pretty well into the framework of “second wave” or latecomer MNEs, characterised by accelerated internationalisation, strategic and organisational innovation and building global brands (Mathews, 2002). Since the mid-1990s, these three companies have internationalised through exports, built their own resource capabilities and rapidly expanded internationally through acquisitions of brands and production operations, as well as greenfield investments. They have also benefited from the great dynamism of their domestic market, although in a context of trade liberalisation and decreasing margins. They have succeeded in seizing opportunities available in the global economy to generate linkages with existing players, initially through OEM contracts, and built rapidly on them to establish their own brands and production facilities around the world. All three firms have invested heavily in R&D and innovation. These moves triggered continuous and substantial process and product upgrading, as witnessed by numerous awards received over the last years.

To varying degrees, the three firms have used participation in GVCs and OEM arrangements to overcome problems of market intelligence and uncertainty regarding the quality of knowledge potentially available. These linkages have provided initial involvement in the global economy. The earliest founded firm under study, Mabe, took the longest to establish internationally. Starting with the joint venture with General Electric (GE) in 1986, it took Mabe 12 years to expand to seven countries in Central and South America — but it has not expanded as yet beyond its “natural market”. It is a good example of what Rugman and Verbeke (2001) call “regional MNEs” as compared with global MNEs. Arçelik embarked on its globalisation quest later than Mabe, beginning its OEM phase in 1988 and its full-blown globalisation in 2002 with a series of targeted acquisitions in Europe and greenfield investment in Russia to expand its geographical, product and brand range. In 2006, it sold in 101 countries, increasing its share of foreign sales from 16 to 39 per cent (between 1999 and 2005), and being the third largest appliance company in Europe. The last established firm, Haier, has been the fastest to internationalise. It leapfrogged beyond OEM stage through acquisitions and greenfield investments in all regions, starting in Asia in 1995, in the US in 1999 and in Europe in 2001. Within five years of its internationalisation being launched, it was active in five countries (including the US); within ten years, it was actively producing in 22 countries.

The critical starting point for the latecomer is that it is focused on the advantages that can be acquired externally. The three latecomer MNEs have all used innovative resource-leveraging strategies to secure access to technologies that would otherwise have been unavailable. Mabe leveraged its knowledge of GE corporate culture to behave like a turnaround specialist at its South American subsidiaries, which in most cases it bought either from GE or from the founding family. Arçelik has obtained several technological licence agreements and strategic partnerships to develop smart appliances and networking software enabling device-to-device communication. Exposure to more developed markets, combined with a long-standing focus on skills training and engineering, led to leading-edge products winning the European Energy+ Award for outstanding energy-efficient products. Haier too is entering into numerous parallel alliances in order to secure maximum leverage from advanced technologies and co-develop network-enabled digital appliances.

In terms of organisational capabilities, the three case firms adopted numerous innovations that have helped to accelerate their globalisation. Arçelik, for example, because of the small size and limited capabilities of many local suppliers, displays a higher degree of vertical integration than might be typical in the appliance industry, manufacturing more of its components in-house. Mabe too is utilising the most advanced management techniques to boost its latecomer advantages. It characterises itself as a “low profile, but pragmatic firm”, which implemented a “learning by doing” strategy in searching and chasing opportunities for growth, through rapid organisational changes to adapt to evolving market conditions. Instead of following an incremental pattern, moving from pure trading to distribution and finally to direct investment, Mabe decided to form a group of managers capable of identifying appropriate targets and then buying and managing them.

Likewise Haier has engaged in global consolidation of its operations, employing a strong and unifying geocentric perspective that has enabled it to capture advantages from its global reach and co-ordination, such as in logistics. The company developed so-called “accountability chains” from the market directly into those corporate services. Haier has an extensive distribution and service network throughout China and uses this to gather data on customers. The company’s repairmen, for example, discovered that customers in rural areas used their washing machines not only to launder clothes, but to clean vegetables as well.

The repairmen relayed this information to the product managers, who asked engineers to make tweaks to existing products, such as installing wider drain pipes that would not clog with vegetable peels. Haier then affixed large stickers on the modified washers, with instructions on how to wash vegetables safely using the machine. This innovation and others (including a washing machine optimised to make goats' milk cheese) helped Haier to win market leadership in China's rural provinces, while avoiding the cut-throat price wars that plagued the country's appliance industry.

As argued before, the governance of the white goods industry presents opportunities and challenges to emerging-market MNEs. If mature technology, supply-chain fragmentation and differences in the growth rates of domestic markets all sustain the internationalisation of developing-country firms, they may still find it hard to acquire and/or develop brand reputation and consumers' loyalty. Moreover, despite ongoing M&As (mergers and acquisitions) and consolidation, the big players have been in the business for more than 50 years. It is possible to identify three mechanisms to overcome these obstacles to upgrading. First, acquisitions of Western brands, such as was the case of Arcelik with Blomberg and Grundig (and would have been the case with Maytag had Haier managed to buy it). Such moves can probably work only when the buyers know how to manage a brand identity. Second, the three companies have supported this brand-building endeavour through long-term relationships with OECD-based industrial design specialists. Third, at least one of the firms (Haier) has chosen sports as the focus of its global marketing effort, a strategy that also characterises other emerging MNEs. Success in bidding for international sponsorship contracts signals competence, availability of resources and market power. Sponsorship offers a quick and easy way to raise brand awareness and benefit from "image transfer" (i.e. acquiring the values of the commercial partners).

Tourism in Mozambique¹⁶

Since the 1980s, Mozambique has implemented many "first generation" structural reforms such as adopting sound fiscal and monetary policies, privatising public enterprises and liberalising trade. The reforms have helped stabilise macroeconomic balances and supported the remarkable growth performance since 1992. The poverty reduction pass-through of growth, however, has been relatively modest and in 2000, the government adopted the Action Plan for Reduction of Absolute Poverty (PARPA) as a medium-term rolling instrument incorporated into the public planning system. Tourism is seen as a priority area in which additional investment may create the jobs that are necessary to meet the PARPA objectives.

This expectation is sensible and reasonable, as most developing countries have increased market shares in international tourism. Sub-Saharan Africa, in particular, has experienced very strong growth in tourism within the last two decades — increasing its market share of global arrivals from 1.5 per cent in 1970 to 4.5 per cent by 2003. In Mozambique, the tourism sector was once a significant part of the economy, but 19 years of armed conflict starting in 1972 put a stop to international arrivals. In a way, this has set Mozambique back to square one. Despite a quite impressive growth rate of 13 per cent per annum (1999-2003), the average of two tourists per 100 inhabitants for Mozambique is half of that of Africa, and well below the world average of 11 per 100 inhabitants. The share of GDP is relatively small — 2.5 per cent in 2003 according to the World Tourism Organisation. In comparison, tourism's share of GDP is about 6.9 per cent on average in sub-Saharan Africa, 8 per cent in South Africa and 10.2 per cent worldwide.

Mozambique's comparative advantage — its marine and terrestrial wildlife resource base and historical and cultural heritage — is still valid, although there are no big game viewing facilities and wildlife was decimated during the armed conflict. Images of armed conflict, landmines and floods, on the other hand, still linger in the minds of tourists. The poor state of physical infrastructure, transport in particular, is a further hindrance. Yet the future for the development of tourism in Mozambique is bright, and the prospects for growth are real. Already, tourism contributes about 12 per cent of the country's exports.

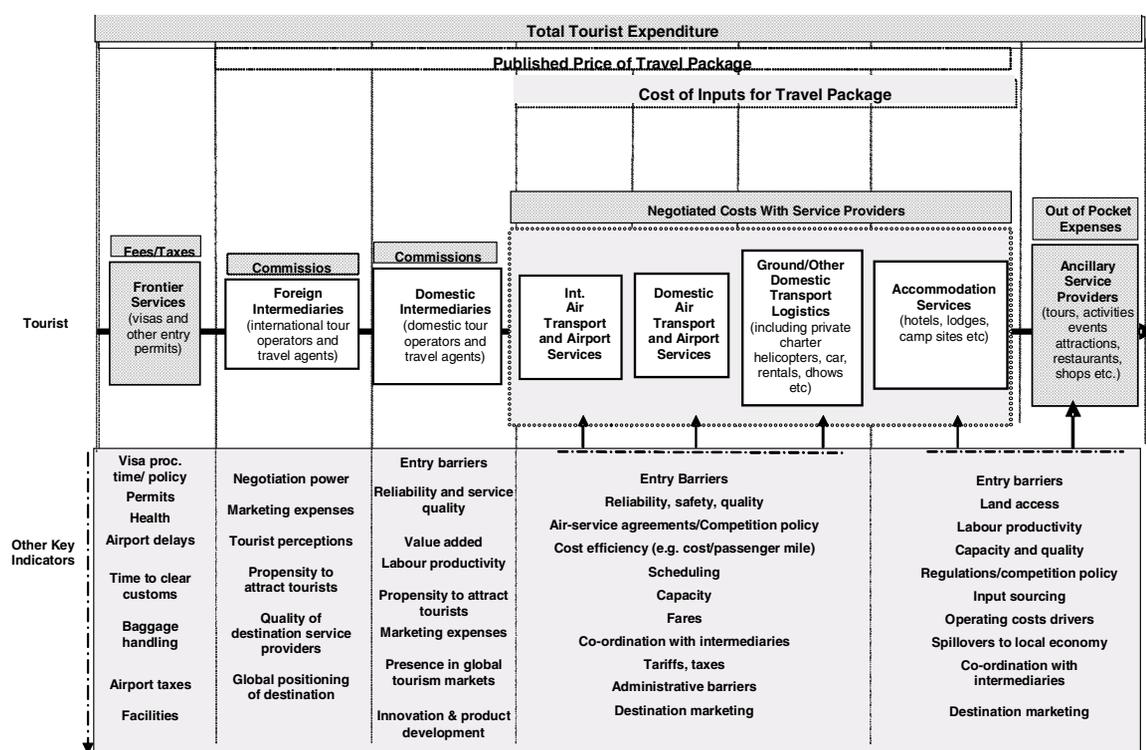
For Mozambique to make up for the time it lost during the years of armed conflict, catch up with neighbouring countries and participate fully in international and regional growth of tourism, the country's overall image must be improved, product variety enlarged and quality of tourists' experiences enhanced. Realising this potential depends substantially on the ability of all players in the Mozambique tourism value chain — from providers of final goods and services, to other suppliers and government officials — to create and deliver high-quality tourism experiences that can transform the country into a “must see” destination in Africa. The joint FIAS-OECD Development Centre study (Abiola *et al.*, 2006) provides the analytic input for policy dialogue with government and relevant parts of the private sector by examining the constraints and challenges that undermine growth of tourism in Mozambique. It outlines actionable measures that can help to catalyse tourism growth in the country, and presents recommendations for removing investment climate constraints that undermine the competitiveness of firms in the travel and hospitality industries. By focusing on constraints for each activity within the value chain of a tourism product, the study provides comprehensive insights that complement previous and ongoing work for tourism development in Mozambique (such as trans-frontier conservation areas, investment climate assessment and studies of institutional marketing).

The study's main objectives were to:

- 1) enhance public and private awareness and forge consensus on the scope, importance and impact of investment climate constraints on the tourism industry;
- 2) identify and prioritise the challenges and opportunities for increasing Mozambique's access to, and share of, global and regional tourism markets;
- 3) assess the performance of tourism industries (e.g. hotels, airlines, transport) along the value chain in responding to these challenges and opportunities confronting the travel and tourism sector in the country;
- 4) identify potential measures to address these constraints; and
- 5) increase Mozambique's share in the value added in the tourism industry.

The value-chain analytic framework applied in the study uses five selected travel itineraries representing diverse source markets (Portugal, South Africa, Europe), itineraries (air-based and road-based), destinations (Maputo, Vilanculos-Bazaruto and Pemba-Quirimbas), tourism products (beach, Meetings-Incentives-Conventions-Exhibitions, adventure), and customers. The framework provides a step-by-step mapping and assessment of the chain of activities involved in the production and delivery of a tourism experience. Mozambique's competitiveness at the industry level, as well as the economy level more broadly, is analysed using a number of metrics and indicators.

Figure 2.1. Tourism Value Chain in Mozambique



Source: Abiola et al. (2006).

The value chain approach to tourism covers all stakeholders involved in delivering a tourism experience (see Figure 2.1). This enables a strategic way of identifying and prioritising critical issues along the chain, and developing targeted solution interventions to achieve maximum impact. The disaggregated approach allows drilling down at an itinerary-specific level while also capturing economy-wide policy issues. Thus the scope could include issues associated with specific bureaucratic constraints that affect ease of entry of small enterprises; taxes and duties that increase input costs of hotels; land use issues that constrain expansion of the hotel industry; protective government policies in the airline industry that affect price and supply of flights.

The project highlighted the severity of industry-specific issues, such as poor accessibility and positioning in the international marketplace, absence from the international distribution networks, and thin product line dispersed across locations. Difficulty and cost of access are limiting growth of tourism in Mozambique. The combination of visa restrictions, delays and cancellations of flights, pilferage and poor baggage handling, harassment of visitors at border entry points, a heavily regulated and protected airline industry that limits availability and quality of flights, substandard road infrastructure and ground transportation services — all create enormous obstacles for tourism. More generally, a poor climate for investment increases finance and inputs costs, drains resources from the private sector, creates an uneven playing field and entry barriers for innovative entrepreneurship. Hotels, lodges and resorts face a difficult business environment that includes lengthy procedures for securing land for development and expansion, high costs and low quality of utilities, cumbersome import

procedures, high duties and taxes on imported inputs and so on. In addition, the lack of reliable ancillary services (e.g. local service providers for ground handling, laundry services, landscaping, transportation to islands, and so on) places additional burden on hotels to provide these services themselves — mostly at higher costs because they cannot take advantage of economies of scale in sourcing, production and distribution.

Animation in the Philippines¹⁷

While R&D, legal work, medical care and animation are examples of services that have continuing, and great further potential for, outsourcing, it is complexity, codifiability and supplier capabilities that determine the actual scope of the outsourcing process. The animation industry is largely computerised nowadays. Computers originally enabled the pioneering of digital animation by allowing images to be represented as computer-generated imagery, a form of animation that allows artists to draw three-dimensional (3D) animation images. In traditional animation, computers have also allowed artists to produce two-dimensional (2D) images much faster, instead of having repeatedly to outline, ink and paint every frame by hand. While in this, as in any other industries, value-added or labour arbitrage are clearly among the driving factors behind outsourcing, in creative sectors such dynamics may find its limit in other factors. For instance, research on the production of creative goods such as video games has highlighted the relevance of the cultural milieu and of creator-user interactions (Aoyama and Izushi, 2003). More generally, in a process that involves creative or presumably non-rational (in the logical sense of the term) elements, the rules for partitioning and outsourcing work are likely to differ from those applying in standardised sectors.

Business and technological paradigms influence the international geography of outsourcing in the contemporary global economy. The specific example of animation is exemplary to understand how and why, despite labour being a significant factor of production costs, certain works are outsourced, and some are not. While countries in Asia and Central Europe present themselves as destinations of choice for animation outsourcing, the most innovative firms in the industry, such as Pixar in California, have chosen not to. In fact, the core of Pixar's work is not just the creative pre-production and post-production ends, which can be done at a distance, but rather the creative production stage, which requires co-location and generates agglomeration economies.

Conventional 2D animation has been produced in the Philippines since the late 1940s. Western and Japanese studios started outsourcing there in the early 1980s, when the country stood almost alone at the frontier of that line of work. Various studios developed in the 1990s doing 2D cartoon animation as contractors, only to find themselves at the mercy of shifts in client needs when market projects changed. While it could be argued that animators in the Philippines and other developing countries were at the same level of sophistication as their US counterparts, in reality the contractors were relying on a limited subset of skills and knowledge, including artistic techniques that were readily available and learnable. These can be considered the mechanistic parts of the knowledge base, or, to put it another way, the codifiable knowledge. The Philippine studios were effectively doing mechanical rather than creative work and this made it easy to make them redundant and transfer contracts to other locations.

In animation, as with software, it has been much harder to upgrade into the high-value ends of the work: conceptualisation and pre-production. According to the standard evolution of industry paradigm, the 3D animation industry could eventually become mature, and

production could well be standardised so it will be easy, and indeed cost-effective, to partition the work into different segments and transfer more of it to developing countries. This will rest on whether the production stage becomes “non-core” to the whole project, whether there continue to be complex and tacit interactions in the work, and whether the co-ordination and specification mechanisms will become sophisticated enough to overcome the barriers caused by the other factors. To some degree, this is also dependent on whether certain forms of knowledge can overcome cultural barriers. Consumers are too fickle, and audience responses too unpredictable, for them to take these risks.

In the Philippines, the average studios in the past have had trouble surviving many difficult environmental conditions, including technological change and business “cycles” (or adverse business conditions). In partial response to the problems in the global animation market, and perhaps in recognition that they are being consigned to mechanistic work while the foreign studios will continue to keep control of the more creative work (i.e. conceptualisation and pre-production), the Philippines industry has been seeking new ways to improve its situation. One solution was to work on co-productions with developed-country clients. Another has been to try to develop local content for schools and TV. At least a couple of local attempts have occurred, but the lack of capital and institutional support may constrain these efforts.

All this can be addressed by building domestic firms with stronger organisational capability which are resilient to market vagaries, but also adaptive to change. At the same time, in an industry where hits and misses cannot be predicted, even up to the point when the product is released, Pixar’s model will come under increasing pressure as other animation companies develop the technology and creative processes to compete. When labour-intensive production processes mature, along with substantial mechanisms for co-ordination and specifications, there is the hope that more front-end work is outsourced and that the Philippines can find its own niche. Compared with India, where studios are cross-financed by the earnings from software activities and technical talent is widely available, the Philippines, with its close ties to the Western mindset, is seemingly ahead in 2D production and artistic quality, where a “feel” for drawing may be more important. However, as other countries succeed in managing the cultural differences, and as the industry as a whole moves into 3D animation, the computerisation of much of the work requires less in the way of feel as it does in the way of plotting points and attaining photo-realistic scenes. This, however, takes financial resources, fairly significant domestic market power, and the right blend of creativity and appreciation for what markets want (i.e. a high degree of contextual knowledge) — conditions which are unlikely to be met in the short term.

Aircraft in China¹⁸

For economic, technological and political reasons, many developing countries have tried to build a competitive aircraft manufacturing industry, but very few have succeeded (Goldstein 2002). The weight of history goes heavily against wholly new aircraft market entrants, in all segments. Success depends on design and manufacturing strength, the price and operational costs of the aircraft, and after-sales services provided to customers that are relatively reduced in number but are spread around the world. Launch and R&D costs, as well as survival risk, are high, while cost reductions over time from learning by doing are unusually large.

Over the past decade or so, China has emerged as the main location for low-end, labour-intensive manufacturing in many global production networks. As the country's income and salary levels increase, one of the crucial questions facing policy makers, scholars, managers and competitors is whether the same successful experience can be replicated climbing up the value chain (Doner *et al.*, 2004; Nolan, 2005; Sturgeon and Florida, 2004). Aerospace was included in the 863 Programme launched in March 1986, a national strategic development programme to promote China's high-tech development. Results, however, were rather meagre, as were those of some ambitious joint ventures launched in the 1990s with Western aircraft manufacturers. Moreover, the rationalisation of the state-owned aerospace industry is still pending. Nonetheless, the government considers this a strategic industry, although not an official "pillar" one, and sees Chinese companies becoming world-class producers by 2012, in part via close co-operation with major international aerospace firms and enhanced supplier relationships with non-Chinese primes.

The strategy builds on two factors. On one hand, it is trying to leverage the interest that foreign manufacturers have in accessing the domestic market in order to negotiate favourable terms for partnerships of various kinds. On the other hand, it attempts to exploit the ongoing transformation of the global aircraft industry from vertical integration to a more complex setting in which assembly and system integration are key competencies for successful primes, as supply chain management and associated risks are pushed down on Tier 1 and 2 suppliers¹⁹. Regional jets are seen as the most appropriate entry points into world-class aircraft production, especially in view of the likely explosion in the demand for this class of plane once the liberalisation of civil aviation is completed and carriers are free to adopt the hub-and-spokes network structure.

In the first half of the 1990s the potential of Chinese industry to mount a competitive challenge to Western aircraft builders was largely discounted. Nowadays, as China strives to bear the ARJ-21 project to execution and even considers entering the market for wide-bodies, the threat is taken more seriously. The growth in the Chinese air transport market has reinforced the bargaining power of national aircraft producers in signing informal offset programmes with Western majors, and authorities are giving priority to building the science and technology capacity in this area. The seeds of "techno-nationalism" — i.e. the desire to demonstrate or acquire the status of being a technologically advanced country — are seemingly planted.

Nonetheless, industrial policy has far from proved its effectiveness. Progress in creating military/civilian synergies has proved modest — especially when compared with the shipbuilding industry. Government involvement in air transport remains significant despite the gradual shift to a more hands-off approach. To place orders, airlines still need approval from the state council and from China Aircraft Supply Corp., a government-owned company that decides on the country's aircraft purchases. Decisions on where to buy planes are also intertwined with policy makers' concerns that China's trade surpluses with the United States and, increasingly, Europe give rise to protectionism. Other policies, however, act at cross-purpose with the goal of developing manufacturing excellence in regional jets. China still charges flat landing and cabin cleaning charges for all planes and the Air Traffic Management Bureau lets big planes fly at the level where fuel can be used economically, while the feeder planes are often guided to lower levels where more fuel is consumed. The prospects of setting landing fees and taxes according to the size of aircraft, which would reduce the cost of operating regional jets, remain uncertain.

Possibly the most fundamental issue concerns the decision to launch two competing projects. China's policy for the aircraft industry combines judicious opening to foreign investors and support for local firms. This may make sense insofar as it allows Chinese firms to build different skills, but the risk is that none of them reaches the level of excellence which is required to become a global competitor. As other authors have observed, China will have difficulty following the "Asian model" of state-guided industrial growth, given its heavy and particularistic concern for firms in trouble — a tendency to support losers rather than winners (Moore, 2002; Steinfeld, 2004). Stovepiping and bureaucratic rivalries in state-owned industry make it particularly problematic to obtain design and subsequent production from researchers and R&D facilities.

As for the contribution of foreign investment, two years of such change and flow are obviously far too short a period to assess an investment as complex as the one that Embraer has embarked upon in China. Without any guarantees for minimum orders, Embraer was confident that, with the right business sense, a product with the appropriate characteristics would easily find a place in the market. Nonetheless, the number of deals so far has failed to live up to the Brazilians' expectations and the suspicion lingers that China is leveraging big buying and gate-keeping its economy to promote its own manufacturer²⁰.

That being said, the prospects of HEAI (Harbin Embraer Aircraft Industry) are necessarily intertwined with those of Chinese aerospace more generally. In the market for regional jets, the current competitive position of Embraer is stronger than McDonnell's when it co-operated with the Chinese. At the same time, it is difficult to foresee the Sino-Brazilian joint venture succeeding if other, state-owned firms fail in their current plans and authorities are tempted to push the ARJ21 project ahead of HEAI.

There is no doubt that the emergence of China's aircraft manufacturing would dramatically reshape global aerospace. However, it will take clear strategic thinking, determination, commitment and lots of money before the aerospace industry may eventually achieve credibility for more and more aircraft parts and even larger aircraft to be built in China. The industry is not immune from the various problems that plague high-end manufacturing in China — in particular, regulatory inconsistency and opacity that push managers into pursuing short-term returns and excessive diversification rather than developing strong corporate competencies and building inter-firm relationships.

Conclusions

The international fragmentation of production creates considerable opportunities for producers in developing countries to access markets, acquire knowledge and upgrade their processes and products. Seizing these opportunities, however, demands deliberate efforts by firms and governments. For most producers, the reality in fact is of finding themselves confined at the bottom-end of the GVC, performing simple tasks, yielding low rewards and remaining at the constant mercy of clients in industrial countries. The changing competitive landscape, characterised by a complex web of public and private standards and the enlargement of the pool of potential suppliers, raises the bar for entry for developing-country producers and puts a downward pressure on their profit margins. This situation poses a tremendous challenge for firms and decision makers in developing countries. How can

producers in poor countries both enter a GVC and participate in ways that lead to upgrading and sustainable income growth? How can governments promote private sectors and improve their international competitiveness?

The main point emerging from the various experiences considered in the case studies is that liberalisation in international trade and technological innovations creates new opportunities, not only in traditional labour-intensive manufacturing, but also in more high-tech industries and in services. Trade integration drove the dramatic expansion of white goods exports from Mexico to the US and from Turkey to Europe. The prospects of liberalisation of civil aviation boosted production of regional jets in Brazil and now in China. Improvements in ICT and computer graphics are likely to lead to further outsourcing/off-shoring of animation services.

Domestic demand plays a key role for firms to strengthen their productive capacities and build a solid basis for their internationalisation strategy. The three white-goods producers could achieve scale economies and strengthen their international competitiveness on the basis of their being market leaders at home. The prospect of expanding domestic and regional traffic is a major incentive for investment in developing a national aircraft industry in China. On the other hand, low domestic demand and regional arrivals contribute to hold back the international development of tourism in Mozambique. It is important to note, however, that these producers face intense competition on their domestic market — both domestic rivals and MNEs — which result in strong pressure on prices and margins. Shrinking profits in the Chinese white-goods market are leading to consolidation and market diversification, both towards export and less price-sensitive products.

Improving the domestic business climate remains of paramount importance. Barriers to acquiring intermediary inputs and bureaucratic hurdles remain a major problem for upgrading. For instance, deep-seated investment climate constraints undermine the competitiveness of firms in the travel and hospitality industries in Mozambique, hampering the realisation of its full tourism potential. Inadequate institutional support in “branding” and inadequate complementary investments partly explain the meagre success of Mozambique’s tourism industry. An active industrial policy was also observed in the Chinese aircraft industry. However, the combination of judicious opening to foreign investors and support for local firms has not yet delivered the expected results.

There is extensive evidence that governments do play a role in supporting private sector development through various pro-active interventions, although the debate on the “do’s and don’ts” is not settled yet. The existence of market failures is generally used to justify government interventions. On the other hand, critics of pro-active policies point to the many “government errors of commission”. As discussed in Rodrik (2004), government failures often reflect a combination of poor information, lack of administrative capacity, flaws in incentive design and state capture by vested interests. Designing effective industrial policies requires then collecting information — often dispersed amongst many actors — and using it efficiently, which demands technical capacity, experimentation and transparency. Government interventions, rather than try to pick up winners, should focus as much as possible on strengthening and expanding the range of firms’ capabilities to produce more efficiently and engage in non-traditional activities.

In this respect, the GVC analytical framework discussed here can prove extremely useful. Intervention design requires a careful understanding of the functioning of the international value chain and of the potential for domestic producers for integrating in it. The GVC

framework can serve as a diagnostic tool to identify critical bottlenecks that hamper integration and tackle them. As the Mozambican tourism industry shows, the binding constraints might fall outside the realm of intervention of the industry stakeholders (e.g. in transport or financial services). In this case, value chain analysis allows the discovery of such strategic complementarities²¹. In a similar vein, participation in GVCs can be a powerful tool for learning, and supplier-oriented upgrading continues to be a primary source of capacity building in most industries (Bonaglia, 2006). However, the incentives for lead firms to transfer knowledge to their suppliers, and the extent of such transfer, greatly depend on the characteristics of the suppliers themselves. Value chain analysis can help to identify the lead actors in the GVC with whom government and the local private sector should interact to promote domestic sourcing, linkage creation and upgrading.

Mere availability of opportunities for internationalisation and upgrading does not suffice to reap them. Investing in production and design capabilities remains crucial. Firm strategy and government support significantly explain the success (or lack) of the firms reviewed. Design and branding in white goods is a good example of careful corporate strategy. Mabe, Arçelik and Haier are latecomer firms which have established themselves as key regional players, in one case with global ambitions. On the other hand, despite its long-established relationships with Western and Japanese studios, the Philippines animation industry, which had specialised in mechanical work rather than developing creative skills, was made redundant when the market changed and now risks missing the boat of further off-shoring in 3D animation. As in the successful cases documented by Bartlett and Ghoshal (2000), companies succeed when they treat global competition as an opportunity to build capabilities, move into more profitable industry segments, and adopt strategies that turn latecomer status into a source of competitive advantage.

Notes

1. In 2000-03, primary commodities constituted almost two thirds of the merchandise exports of the LDCs as a group. Although export growth for LDCs as a group in 2004 was significantly higher than world exports growth (34 per cent against 21 per cent), a small number of oil-exporting countries drove such performance (WTO, 2006).
2. The negative association between higher concentration in primary exports and economic growth (so-called “resource curse”) could stem from declining terms of trade, the risk of excessive real exchange-rate overvaluation (Dutch disease) and the possibility of inducing higher than normal rent-seeking activities. While there is some truth in these arguments, the “resource curse” view should be taken with a pinch of salt. For one thing, the historical experience of several resource-rich OECD countries suggests that resource-based activities can sustain growth over long periods. For another, export diversification has in practice taken different forms in different countries, though some have been more successful than others. See Bonaglia and Fukasaku (2003) for a discussion.
3. These figures probably underestimate the real size of international production fragmentation, owing to limitations in the SITC data classification system. SITC Revision 3 introduced a more detailed commodity classification for manufacturing trade (categories 7 and 8), allowing separation of parts and components from final goods. However, it still lacks such a fine distinction for other areas of trade that have seen increased fragmentation, such as pharmaceutical and chemical products and machine tools. See Athukorala and Yamashita (2005) for a discussion.
4. Chapter 3 in this study considers opportunities for diversification in agriculture and agribusiness.
5. See Raikes *et al.* (2000) for a thorough discussion of these concepts and their origin.
6. This phenomenon has been variously called “fragmentation,” “international production-sharing,” “outsourcing,” “disintegration of production”, “multistage production” and “vertical specialisation.” The meaning of “outsourcing” has changed since the 1980s, when it meant firms expanding their purchases of manufactured physical inputs. Nowadays it means a specific segment of the growing international trade in services, involving arm’s-length supply of services, with the supplier and buyer remaining in their respective locations (so-called Mode 1 in the WTO terminology). When the buyer and the provider of the service are located in different countries — as is the case in international production-sharing — the term “international outsourcing” or “offshoring” is preferable.
7. Lead firms in the production network concentrate on the creation, penetration, and defence of markets for end products — and increasingly the provision of services to go with them — while manufacturing capacity is shifted out-of-house to globally operating turn-key suppliers. The electronics industry best epitomises this phenomenon (Sturgeon, 2002). In the early days of mainframe computers, lead companies such as IBM produced their own semiconductors, operating systems, computers and software applications, and even marketed and distributed them. In the era of personal computers, the industry has structured itself into increasingly specialised layers (microprocessors, operating systems, computer assembly, marketing and distribution, software applications), each of which is dominated by different specialised companies.

8. See, in particular, the Global Value Chains Initiative <http://www.globalvaluechains.org/index.html> and the Linkages and value chains Working Group of the Donor Committee for Enterprise Development <http://www.sedonors.org/groups/group.asp?groupid=4>.
9. The enhancement of suppliers' capabilities allows lead firms progressively to outsource activities previously performed in-house or by foreign affiliates. Major US electronics MNEs have sold their production facilities to contract manufacturers. A significant recent example involves the sale of IBM production activities to Lenovo of China.
10. These suppliers have expanded their operations and taken under their responsibility a growing set of related functions (e.g. sales and customer support) becoming "turn-key suppliers", i.e. service providers with a high degree of autonomy offering a full package of services to the lead firm. In the most advanced form, these suppliers are able to manage the entire manufacturing network for a customer with minimal support and input.
11. The study finds that linkages from MNE to domestic suppliers are very limited and characterised by low technological content. MNE affiliates largely source from approved suppliers located elsewhere, especially for the higher value parts and components. Moreover, local firms often suffer a technological gap to qualify as MNE suppliers, which the limited availability of venture capital makes it difficult to close.
12. Another example is Erak, a Turkish OEM that has built its own brand name as a global retailer by exploiting the knowledge and information acquired through its long-standing relationship with major EU branded-trouser manufacturers and hired an international team of designers to develop its product line (Tokatli and Kizilgün, 2004).
13. This section is based on Bonaglia *et al.* (2007).
14. "White goods" include washing machines, fridges, dishwashers, ovens and cookers. Major household appliances used outside the kitchen, such as video and audio systems, are known as "brown goods".
15. We define as "latecomer" a firm that does not possess its own resources (both in terms of technology and market access) and seeks to acquire them by connecting with the technological and business mainstream (Mathews, 2002).
16. This section is based on Abiola *et al.* (2006).
17. This section is based on Goldstein and Tschang (2005).
18. This section is based on Goldstein (2006).
19. A second-tier supplier is one that supports a primary supplier in the delivery of goods and services to a customer.
20. Two of the world's largest financial services groups (AIG and GE), which want to expand their business ever deeper into China, run huge aircraft leasing subsidiaries, ILFC and GECAS. Government may quietly pressure them to acquire ARJ21s in exchange for opening market gates to the mother firms.
21. The returns to investing in non-traditional activities are uncertain and often depend on complementary upstream or downstream investments. Because of lack of co-ordination, these interdependent investments may not be made, further reducing the incentives to undertake the project. See Rodrik (2004) for a discussion.

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Focus 3

SME Development and Entrepreneurship: Evidence from OECD Countries

Introduction

Small and medium-sized enterprises (SMEs) and entrepreneurship are recognised worldwide as a significant source of dynamism, flexibility and innovation in advanced industrialised countries, as well as in emerging and developing economies. Today SMEs represent over 96 per cent (and even more than 99 per cent in some cases) of enterprises in OECD economies; they account for a large and growing share of employment in many countries (between 40 per cent and 70 per cent); they generate a substantial share of manufacturing output and over 50 per cent of value added for a number of OECD countries; they are responsible for most net job creation in OECD countries; and they make important contributions to economic growth and productivity.

New challenges confront SMEs in a globalised, technology-driven environment and knowledge-based economy which are changing and expanding the rationale for government policies. In order to maximise SMEs' contribution to growth, governments must fashion more co-ordinated approaches to take into account the small firm specificities in all policy areas. This chapter will highlight recent work undertaken by the OECD Working Party on SMEs and Entrepreneurship (WPSME) that seeks to address the issues of financing and access to international markets.

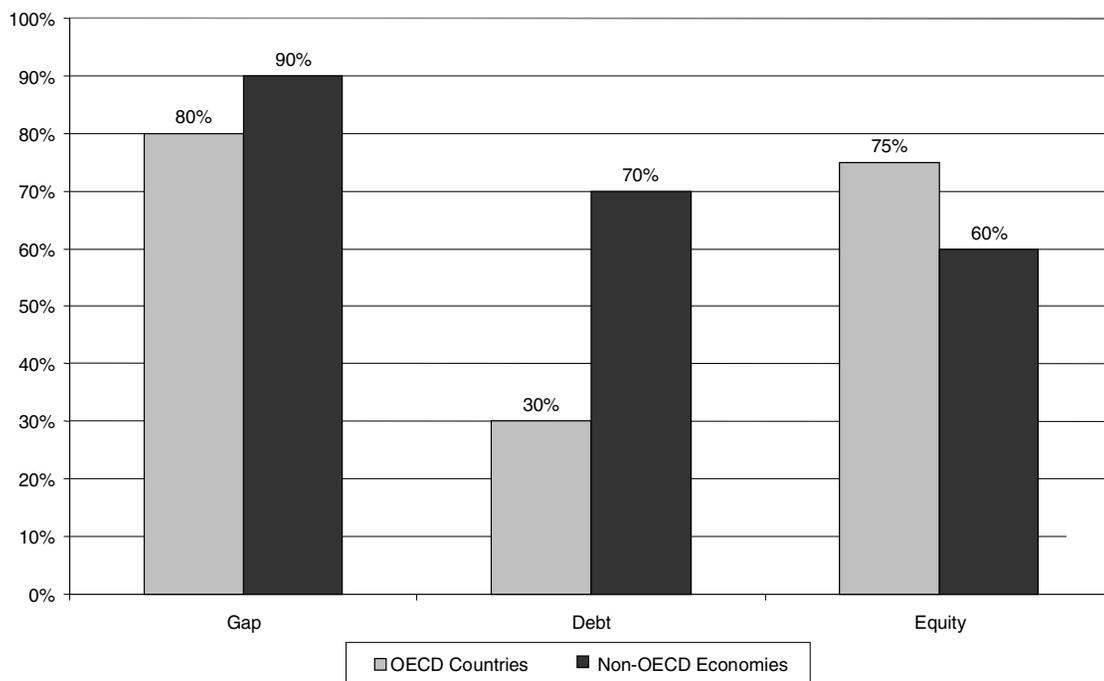
SME Financing

Lack of access to financing continues to be one of the most significant impediments to the creation, survival and growth of SMEs, including innovative ones, especially at a time when enterprises operate in environments of high complexity and rapid change. SMEs form a broad spectrum as far as their relative size, sector of activity, seniority, location and performance are concerned. They can be innovative and growth-oriented or basically subsistence-driven. Depending on the characteristics of the enterprise, its stage of business creation and development, the financing needs and sources (e.g. family, banks, equity) are likely to differ.

Many commentators have postulated a “financing gap” for SMEs, meaning that there are many of these enterprises which could use funds productively if they were available, but which cannot obtain finance from the formal financial system. Financing gaps may arise as a result of agency problems¹, asymmetric information and other market and policy imperfections that can give rise to incomplete financial markets and constrain SMEs’ access to financing. Analysis reveals not one, but several kinds of financing gaps. Many OECD countries have partial gaps, which tend to be severe especially in the early-stage firms. However, financial gaps are more pervasive in emerging, transition and developing economies (see Figure 2.2).

Access to appropriate types of financing structures and facilities are especially required to allow SMEs and entrepreneurs to take advantage of the opportunities provided by innovation, notably through the diffusion of information and communications technology (ICT). They are also needed for SMEs with new business models and high growth prospects, as they make a very important contribution to economic growth accompanied by job creation and social cohesion.

Figure 2.2. Is There a Financing Gap? Where is the Gap?



Note: In many cases of debt in OECD countries, this problem is limited to a sub set of SMEs, mostly start-ups and very young firms. Data are based on the responses of 20 OECD and 10 non-OECD economies.

Source: OECD SME & Entrepreneurship Financing Survey, 2006.

Obstacles to SME Access to Financing

SMEs, in particular young and innovative ones, tend generally to have a high risk profile for a number of reasons: e.g. absence of track records, informational asymmetries, shortage of assets and collateral, insufficient management skills. Additionally, the disproportionately high administrative costs in relation to the financial amounts involved, as well as uncertainties

about future performance, generally make SME financing unattractive to potential funding sources. When SMEs are able to raise capital, they may still encounter higher interest rates as well as credit rationing due to shortage of collateral. Consequently, SMEs experience difficulty in accessing long-term credit and risk capital, which are necessary for starting up, expanding or upgrading a business.

The difficulties that SMEs encounter when trying to obtain finance can also be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework. Financing issues vary at different stages of business development, as well as country development. But overall, the greater variability in the perceived prospects for profitability, survival and growth of SMEs, compared with larger firms, accounts to a large extent for their specific problems with regard to financing.

How Easy is it for SMEs to Borrow from Banks?

In most jurisdictions, commercial banks as a group are the main source of external finance for SMEs. Therefore, it is essential that the banking system be prepared to extend credit to the SME sector. However, there are a number of rigidities of a macroeconomic, institutional and regulatory nature that may bias the entire banking system against lending to SMEs. Macroeconomic policies may lead to excess demand for available domestic savings, while government policy may favour industrialisation and/or import substitution which effectively gives large domestic firms privileged access to finance. The legal system may not provide adequate protection for rights of creditors and be relatively inefficient in resolving cases of delinquent payments and bankruptcy. Additionally, the tax and regulatory framework may encourage firms to operate opaquely.

The characteristics of the banking system in emerging markets frequently inhibit SME lending. Many banks are state-owned, and their credit may be allocated on the basis of government guarantees or in line with government targeting to develop specific sectors. Often banks are subject to ceilings on the interest rates they can charge, which makes it difficult to price credit in a way that reflects the risk of lending to SMEs. Many banks may have ownership and other ties to industrial interests and will tend to favour affiliated companies. In a market where banks can earn acceptable returns on other lending, it will not develop the skills needed to deal with SMEs.

Market-based banking, where banks are accountable for achieving high returns to shareholders and maintaining high prudential standards, is gaining acceptance on a global level. This model creates a competitive market where there is more incentive for banks to lend to SMEs, but many emerging markets have been comparatively slow in implementing this model.

The fact that SMEs in many emerging markets do not have access to bank financing is especially worrisome because SMEs typically employ a large share of the labour force and account for a large part of national income. If the SME sector does not have access to external funds for investment, the capacity to raise investment per worker and thereby improve productivity and wages is seriously impaired.

By contrast, banks in the most advanced countries are adopting strategies to cope with reducing the risk of lending to SMEs. They are investing considerable resources in seeking to overcome information asymmetry problems by using credit-scoring models and other sophisticated techniques to discriminate between high and low risk borrowers. These lending

mechanisms enable banks to identify businesses likely to survive and expand, and with whom it is worthwhile to develop a long-term relationship. Banks are also altering the nature of their products. An increasing proportion of bank revenue now comes from fees for services, rather than interest on loans, which favours lending to entities such as SMEs.

Governments of OECD countries are convinced that there are still enough instances of market failure in SME finance to justify government intervention. Thus, countries have launched a number of programmes to utilise public funds in order to facilitate SME lending. Efforts of banks to develop the SME market supported by a moderate amount of government guarantees have resulted in a situation in which most SMEs are able to access bank finance in most OECD countries. It is worth mentioning that in most cases the volume of funds supplied under official programmes is modest in comparison to that supplied by banks at their own risk.

Where Can Innovative SMEs Find Funding?

A lack of appropriate financing notably represents a hindrance to the creation and expansion of innovative SMEs, putting a drag on job creation and hurting economy-wide competitiveness. Finance of innovative SMEs is a challenge in a broad variety of countries. Traditional bank finance is of limited relevance to innovative SMEs, which usually have negative cash flows, untried business models and high risk. Instead, investors provide risk capital through equity and quasi-equity products (e.g. “mezzanine finance” and “hybrid products”). The investor can assume high risk, but may also reap large rewards. Unlike traditional listed equity investments, innovative SMEs will usually progress through several stages of private equity (i.e. not listed on stock exchanges or subject to full formal regulation) finance adapted to their special needs.

“Business angels”, individuals who commit business experience as well as their own capital, often play key roles in formative stages in the life of the firm. The role of business angels in early stage finance appears to be growing and is increasingly recognised as a vital link in the financing chain. It is also an area where government technical support may have a very high payoff.

Venture capitalists, who often enter the firm in the middle to later stages of its life cycle, provide a link between the innovative SME and institutional sources of capital. Funds are usually obtained from institutional investors, especially pension funds, but financial intermediaries and the corporate sector, as well as the official sector, are also major investors.

Geographic proximity is a factor in innovative SME development. Investors need ongoing communication with technical innovation, innovative entrepreneurs and the marketing plans of competitors. Therefore, these investors, like the entrepreneurs they support, tend to locate near “technology clusters”, in areas close to universities and other research facilities. The trend towards concentration is often reinforced by policies to locate “science parks” and “business incubators” near research facilities. Some of these facilities are supported only by private funds but most use public funds as well. The risk capital industry has become increasingly global in scope, with the sector reaching large scale in several non-OECD countries, such as China, India and Israel.

The sharply varying levels of development of risk capital among OECD countries and worldwide makes it imperative for those countries where the industry is lagging to review and reform their entire frameworks for entrepreneurial finance.

How to Bridge the SME Financing Gap?

Governments can play an important role in supporting the SME sector, particularly where there is market failure or where incomplete markets inhibit the provision of adequate financing on terms suitable for the SME's stage of development. Government measures to promote SMEs should be carefully focused, aimed at making markets work efficiently and at providing incentives for the private sector to assume an active role in SME finance. Where necessary, banking systems should be reformed in line with market-based principles. Action should be taken to enhance guarantee funds and make better use of related public funds, as guarantee schemes are among the most effective instruments governments can use to ease SMEs' access to credit financing. However, measures have to be taken to promote appropriate risk sharing with private lenders and SMEs themselves.

Governments should also act to improve awareness among entrepreneurs of the range of financing options available to them from officials, private investors and banks. Micro-credit and micro-finance schemes play an important role in developing countries and efforts should be made to boost their effectiveness and diffusion. Any provision of official funding should respect the principle of risk sharing, so official funds should only be committed in partnership with funds from entrepreneurs, banks, businesses or universities.

In the area of risk capital, there is a need to promote awareness among SMEs of the value of equity finance and facilitate the channelling of further funding by institutional investors. Governments should also look at whether government technical support can be used to generate the emergence of business angels and to make the existing business angel systems operate more efficiently.

Policy makers need to ensure that the tax system does not inadvertently place SMEs at a disadvantage. They should also review the legal, tax and regulatory framework to ensure that it encourages the development of venture capital. Efforts should also be made to reduce obstacles to the creation of cross-border markets for private equity and venture capital.

In order to assess the success of such actions, governments need to be able to measure the size of the SME financing gap and evaluate the impact of government actions. OECD and non-OECD governments have asked the OECD² to take the lead in establishing international benchmarks to facilitate comparisons of the relative performance of markets in providing finance to SMEs and entrepreneurs, and to shed light on outstanding financing gaps and issues.

SME Internationalisation

Globalisation offers both opportunities and challenges for businesses. Increasingly, SMEs are seeing participation in international markets as critical to their survival, job creation and growth. Already SMEs³ are significant contributors to the global economy accounting for approximately 50 per cent of local and national GDP, 30 per cent of export and 10 per cent of FDI⁴. While it is not possible to quantify accurately the number of SMEs currently involved in international markets, it appears to be increasing, particularly in the service sector. The opportunities for international business dealings⁵ have grown dramatically as the traditional barriers associated with distance and cross-border transactions have been reduced through new technology and trade negotiations. But the development of a fast-changing and increasingly complex global market place has also placed considerable pressures on firms, particularly SMEs.

Operating successfully in international markets requires, among other things, learning to manage at a distance using a variety of informal and formal contractual business relationships, gaining familiarity with different business regulations, customs, cultures and languages, and developing appropriate solutions for all the markets in which the firm operates.

This poses challenges for the managers of those firms and requires them to use, or develop, a much larger range of managerial competencies than if they operated solely in their domestic market. It involves aligning the financial, human, marketing, technological and innovative capacity resources of the firm with the decision to internationalise. It also poses challenges for governments (and business associations and others who assist SMEs) in providing the right, targeted support programmes and other incentives to encourage SMEs to internationalise and to help them overcome the internal and external barriers they face in doing so.

Barriers to Internationalisation

The OECD has undertaken a *Survey of SMEs' Perceptions of Barriers to Access to International Markets*⁶. When asked to rank the ten barriers⁷ considered to have the most detrimental impact on their ability to access international markets, the responding SMEs identified those concerned with internal capabilities and access to markets to be the most important, with barriers in the business environment of less importance. However, SMEs appear to go through a learning process when they engage in international activities. This process can be shaped by the size and the industrial sector of the firm. Each step of this learning process presents special challenges for SMEs. Those firms which are not yet active exporters often underestimate the barriers present in the external business environment, such as those associated with financial matters and access to markets. They may also lack awareness of how their capabilities match the challenges of operating in international markets, as well as the knowledge of how to evaluate their capabilities in this respect. However, when these firms become engaged in international trading activity, there is increased awareness that the key barriers relate to the business environment and their own management capabilities rather than financing and access to markets.

Through a parallel survey, SME policy makers in OECD countries and APEC economies considered the main barriers facing SMEs to be internal to the firms and not connected to barriers created by government policies. The top ten barriers⁸ related almost exclusively to a lack of knowledge and internal resources, both financial and human. External barriers, especially those imposed by governments, scored relatively low.

Removing Barriers to SME Access to International Markets: Towards Implementing an Action Plan⁹

Governments can play an important role in helping SMEs internationalise because of the positive overall effects for economic growth. However in doing this, governments must recognise that the needs of internationalising SMEs differ according to the age and experience of each firm, and their sector, and should focus their assistance accordingly. To open up greater opportunities for international trade and investment, governments should consider actions such as: concluding outstanding trade negotiations leading to open markets; reducing trade barriers and contributing to a stable and transparent business environment; actively removing non-tariff barriers to international trade (e.g. through mutual recognition of product

standards and business and occupational licensing, efficient legal systems, improved customs procedures, facilitating business travel); and promoting clear and accessible public consultation mechanisms to facilitate SME participation in the trade policy process.

There is also a need for better support and facilitation for SMEs that are intent on entering international markets (for example, informed and up-to-date advice on market opportunities; and specific training and advisory support, such as funding for the development of marketing plans, for access to market experts, etc.), as well as better, and better targeted, support for SMEs already operating abroad. This includes in-market facilitation and also facilitation by the government and government agencies of the SME's home economy, such as support for attending trade fairs, and provision of skilled and informed foreign representatives.

A number of policies and programmes have been utilised successfully by governments wishing to assist SMEs to enter new international markets more effectively, from encouraging the formation of clusters of SMEs and appropriate co-operation between SMEs and larger firms to providing programmes to assist SMEs to access the finance needed to fund potentially successful entries into new markets and, where necessary, develop or create additional financial instruments, such as innovation funds, for financing the internationalisation of SMEs. It remains crucial to utilise and communicate more effectively the full range of government and non-government support that is available for SMEs seeking to access international markets and ensure that the activities of the various government agencies supporting SMEs are fully integrated. Also, governments should establish evaluation frameworks for their programmes and keep constantly under review the support schemes they provide for SMEs about to be or already engaged in internationalisation.

Finally, OECD and APEC have been called upon to continue their co-operation (in partnership with other international institutions), in order further to develop work on removing barriers to SME access to international markets and assist policy makers to promote SME internationalisation and competitiveness.

Notes

1. There is no precise, generally accepted definition of a financing gap, but the term implies that a sizable share of economically significant SMEs are unable to obtain adequate finance. Agency problems arise because it is impossible to write complete contracts and the interests of the contracting parties may not coincide. See OECD (2006*a*).
2. At the invitation of the Brazilian government, the OECD Global Conference on Better Financing for Entrepreneurship and SME Growth took place in Brasilia on 27-30 March 2006. Convened within the framework of the OECD Bologna Process on SME and Entrepreneurship Policies, the meeting brought together the key stakeholders — small and medium-sized enterprises, the financial community, and government participants at senior levels — from OECD member countries, as well as from non-member economies. Participants recommended: “The OECD Brasilia Action Statement for SME and Entrepreneurship Financing”.
3. There is no single agreed definition of an SME. A variety of definitions are applied among OECD and APEC economies, and employee number is not the sole defining criterion. SMEs are considered to be non-subsidiary, independent firms which employ fewer than a given number of employees.
4. This refers to firms in the formal sector only.
5. In this Action Plan the international activities of SMEs include all forms of transferring goods and services across borders such as export activity, joint ventures, non-equity strategic alliances, licensing, establishment of subsidiaries or branches and franchising. Importing is also a form of internationalisation.
6. SME Survey carried out between January and July 2006. Usable responses were received from a total of 978 SMEs worldwide, with a high degree of concentration within just seven OECD member countries: Canada, Greece, Switzerland, Turkey, Japan, Spain and New Zealand. Barriers are ranked using the Likert-Scale ranking method, from 5 (very significant) to 1 (not significant).
7. The top ten barriers as identified by SMEs: *i*) shortage of working capital to finance exports; *ii*) identifying foreign business opportunities; *iii*) limited information to locate/analyse markets; *iv*) inability to contact potential overseas customers; *v*) obtaining reliable foreign representation; *vi*) lack of managerial time to deal with internationalisation; *vii*) inadequate quantity of and/or untrained personnel for internationalisation; *viii*) difficulty in matching competitors’ prices; *ix*) lack of home government assistance/incentives; *x*) excessive transportation/insurance costs.
8. The top ten barriers as identified by the *Member Economy Policy Maker Survey*: *i*) inadequate quantity of and/or untrained personnel for internationalisation; *ii*) shortage of working capital to finance exports; *iii*) limited information to locate/analyse markets; *iv*) identifying foreign business opportunities; *v*) lack of managerial time to deal with internationalisation; *vi*) inability to contact potential overseas customers; *vii*) developing new products for foreign markets; *viii*) unfamiliar foreign business practices; *ix*) unfamiliar exporting procedures/paperwork; *x*) meeting export product quality/standards/specifications.
9. At the invitation of the Greek government, the OECD-APEC Global Conference on Removing Barriers to SME Access to International Markets took place in Athens on 6-8 November 2006. Convened within the framework of the OECD Bologna Process on SME and Entrepreneurship Policies, the meeting brought together members of the international business community (including SMEs), organisations involved in the facilitation of world trade, and senior government representatives from members of the OECD and APEC as well as non-member economies. Participants adopted the Athens Action Plan on 8 November 2006. See OECD (2006*b*).

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Focus 4

Financing SME Development in Africa

The development of the private sector varies greatly throughout Africa. Small and medium-sized enterprises (SMEs) are flourishing in South Africa, Mauritius and North Africa, thanks to fairly modern financial systems and clear government policies in favour of private enterprise. Elsewhere, the rise of a small-business class has been constrained by political instability or strong dependence on a few raw materials. In the Democratic Republic of Congo, for example, most SMEs went bankrupt in the 1990s as a result of looting and civil war. In Congo, Equatorial Guinea, Gabon and Chad, the dominance of oil has slowed the emergence of non-traditional businesses. Between these two extremes, Senegal and Kenya have created conditions for private-sector growth but are still held back by an inadequate financial system. In Nigeria, SMEs (about 95 per cent of formal manufacturing activity) are key to the economy but insecurity, corruption and poor infrastructure prevent them from becoming the motor of growth.

SMEs in Africa: The “Missing Middle”

Africa's private sector consists of mostly informal micro-enterprises, operating alongside large firms. Most companies are small, partly because the private sector is new and facing legal and financial obstacles to capital accumulation. Between these large and micro firms, SMEs are very scarce and constitute a “missing middle”. Even in South Africa, with its robust private sector, micro and small enterprises provided more than 55 per cent of all jobs and 22 per cent of GDP in 2003, while big firms accounted for 64 per cent of GDP.

SMEs are weak in Africa because of small local markets, shallow regional integration and very difficult business conditions which include cumbersome official procedures, poor infrastructure, weak legal systems, underdeveloped financial systems and unattractive tax regimes. Many firms stay small and informal and use simple technology that does not require a great use of national infrastructure. Their small size also protects them from legal proceedings (since they have few assets to seize on bankruptcy) so they can be more flexible in uncertain business conditions. On the other hand, large firms have the negotiating power and good contacts to overcome legal and financial obstacles. They also depend less on the local economy because they have access to foreign finance, technology and markets and can more easily make up for inadequate public services.

A Four-pronged Approach to Financing SME Development

A major bottleneck to the emergence and development of SMEs in Africa is limited or no access to finance. Their main sources of capital are retained earnings, informal savings and loan associations (tontines) which are unpredictable, insecure and have little scope for risk sharing because of their regional or sectoral focus. Access to formal finance is very limited, partly because of the high risk of default among SMEs and partly owing to inadequate financial facilities. Therefore, improving business conditions, helping SMEs meet the requirements of formal financing, making the financial system more accessible to SMEs and fostering business links between firms are all prerequisites to substantially increasing SMEs' access to finance.

Improving Business Conditions

Access to proper information is a key to deciding whether to make a loan. This can be facilitated by adopting clear accounting standards, setting up independent, competent and reputable accounting firms and creating more credit-rating firms supplying data on the solvency of firms. Furthermore, an impartial legal system that can help settle contract disputes, commercial law reform and drafting and clarifying land titles, as well as effective bankruptcy procedures and proper tax laws, are vital for the growth of the business sector.

Helping SMEs Meet Formal Financing Requirements

Even in a difficult business environment, some financial instruments can help provide missing information or reduce the risk stemming from some SMEs' lack of transparency. Franchising, for instance, is very popular in Southern and East Africa. It allows use of a brand name or know-how that reduces the risk of failure. Warehouse-receipt financing (in South Africa, Kenya and Zambia) guarantees loans with agricultural stocks. Leasing and factoring can also reduce risk effectively for financial institutions but are still little used in Africa. More widespread, credit associations help reduce risk by sharing it. But their growth is limited by the lack of organisation among SMEs in Africa and by their focus on certain sectors and geographical areas.

Lack of funding for SMEs has partly been compensated for by microfinance. While adapted to local needs, microfinance institutions remain fragile and modest in size. They are facing a limited scope of expansion because of the sheer size of their funds and trained staff. That their finance is mainly of a short-term nature means that they cannot easily turn the savings they collect into medium or long-term loans. They are also up against the cost of refinancing through the formal banking sector and have no access to refinancing either by the central bank or by venture capital. Microfinance institutions could be put on a firmer financial footing by developing long-term products for savings that exist elsewhere, such as life insurance and home-saving plans, and encouraging their links with the formal banking sector (See Box 2.3 below).

Box 2.3. The Role of Microfinance Institutions

Microfinance, i.e. loans and other financial products targeted at low-income clients, has proved very successful in expanding these people's access to credit. Microfinance institutions (MFIs) include a broad range of financial sector organisations, such as banks, non-bank financial institutions, financial co-operatives and credit unions, finance companies and NGOs specialising in serving people who lack access to traditional financial services. The UN Commission on the Private Sector (2004)* suggests that micro-credit schemes and MFIs are serving 41 million poor people in over 65 countries. MFIs are potentially useful to fill a gap in short-term financing and avoid resorting to informal moneylenders and could also become a source of financing for micro-enterprises and SMEs. They also contribute to the development of financial intermediation and insurance instruments and markets (especially in rural areas and among the "unbankable"). Against this background, the United Nations declared 2005 the Year of Microcredit, with a call to "build inclusive financial sectors and strengthen the powerful, but often untapped, entrepreneurial spirit existing in impoverished communities".

MFIs have proved efficient to a certain extent in filling the gap of SME finance. Over the years, MFIs have developed beyond being purely a poverty-alleviation tool to financing economic development through their proximity to local entrepreneurs. Their successful uptake is due to a flexible formula offered to small entrepreneurs, bypassing stringent regulatory and collateral requirements. For example, Novobanco, active in Africa and Latin America, provides credit to SMEs, based on no-fees account with no minimum balance, informal guarantees (house assets and a guarantor) and continued relationships with loan officers.

Despite their adequacy to local needs, however, MFIs remain small and fragile. They often lack the skills to assess project proposals and develop or adopt innovative financial tools. MFIs struggle to follow their clients as they grow, because they suffer from the lack of medium to long-term tools to transform the savings they collect into long-term lending. Furthermore, the refinancing of MFIs through the formal banking sector is limited by a lack of collateral and the cost of financing. Unlike commercial banks, MFIs have no access to central bank refinancing at low cost and do not qualify for refinancing through venture capital, as they are not formally financial institutions.

Promoting agreements between MFIs and providers of non-financial services can ease MFIs' capacity constraint. Business development services (BDS) institutions can carry out the first selection of the project proposals on a purely technical point of view and this is relayed by MFIs to assess the financial viability. In turn, BDS may provide moral guarantees for its members seeking funds to MFIs, based on a technical assessment of the project proposals.

Financial sustainability of MFIs can be ensured by closer collaboration with formal banks. The transfer of clients to the banks as their financing needs increase is a good example of co-sharing of finance for SMEs between MFIs and commercial banks. Associating informal financial organisations and formal institutions can help the former grow towards formality. A major drawback, however, is a potential loss of growth-oriented clients for MFIs. Specific regulatory frameworks may help them extend their lending activities to SMEs, mainly by increasing the maximum loan amount and extending the maximum loan maturity. In this way, MFIs will be able to develop into fully-fledged rural banks and finance larger enterprises.

* UNECA (2004), *Report on the Roundtable Discussion on Promoting Domestic Private Sector in Africa* United Nations, New York, NY.

Making the Financial System More Accessible to SMEs

Some African countries have dealt with the lack of funding by supporting the growth of smaller commercial banks (in Kenya) or of rural banks (in Ghana), so as to bring traditional banks and SMEs closer geographically and business-wise. South Africa passed two laws in early 2005 to expand the banking system to include savings and loan institutions (second-tier banks) and co-operative banks (third-tier banks) while easing banking regulations so the newcomers could still be flexible in providing loans. In many countries, commercial banks are also setting up their own micro-credit services. Experience shows that removing the obstacles to access to finance for SMEs requires that commercial banks, microfinance institutions, community groups and business development services (BDS) work closely together. It helps make up for lack of capacity and reduce costs by more efficient division of labour. It also allows them to reduce and share the risk of lending to SMEs.

Fostering Business Links

Financial institutions are not the only source of credit for SMEs. The interdependence between SMEs, large firms and sectoral “clusters” is a major potential source of finance, as shown in Asia and Latin America. Big firms can do a lot to help SMEs’ access to finance easier by transferring resources (money and factors of production) and guaranteeing SME solvency with financial institutions. Links with major companies can also help SMEs obtain export credits. Similarly, clusters of SMEs enable member firms to seek finance together, provide collective guarantees or even set up their own financial body. Working together also means that firms can obtain supplier credits and can borrow from each other when necessary, which reduces general costs.

Subcontracting and clusters, however, are at an early stage of development in Africa. To be sure, subcontracting has grown rapidly in South Africa since 1998, though some claim that SMEs are confined to low-skill informal activities. Clusters are concentrated in South Africa, Kenya, Nigeria, Tanzania and Zimbabwe.

Focus 5

Export Diversification Revisited

Many low-income, commodity-dependent countries, especially the least-developed countries (LDCs), have expressed concerns about the lack of export diversification as a key development issue that needs to be tackled in earnest under the current WTO (World Trade Organization) round of multilateral trade negotiations, known as the Doha Development Agenda (DDA). The DDA states that “the integration of the LDCs into the multilateral trading system requires meaningful market access, support for the diversification of their production and export base, and trade-related technical assistance and capacity building” (paragraph 42). This Focus revisits issues related to export diversification and discusses their policy implications.

Trade Patterns and Export Diversification

According to the standard Heckscher-Ohlin trade theory, a country’s trade structure reflects its comparative advantage, which is in turn determined by the relative endowment of production factors, such as land, labour, skill and capital. The relative abundance of land (per worker) and scarcity of skill (per worker) would explain why African countries have failed to specialise in exports of manufactured products, in contrast to land-scarce, skill-abundant East Asian economies. This is not a mere intellectual curiosity. Since some endowments are almost fixed, while others can be altered only very slowly (e.g. the stock of human capital), a country’s relative factor endowment and hence comparative advantage are unlikely to change over the short run.

The pattern of changes in the export structure of 93 developing countries has been analysed in detail by Bonaglia and Fukasaku (2003), using the OECD “mirror” trade data between 1966-70 and 1996-2000. High export dependence on primary products was a widespread phenomenon in all developing regions at the end of the 1960s. The average share of broad primary products (including both processed and unprocessed products) was roughly 90 per cent of total merchandise exports from these regions. Thirty years later, broad primary products still constituted the majority of total merchandise exports in all developing regions except Asia. Moreover, Asia is the only region where export diversification was accompanied by a corresponding rise in its market share in the high-income OECD countries: all the other regions lost shares between the 1960s and the end of the century. As a result, the aggregate market share of all 93 developing countries increased only moderately to 22 per cent in 1996-2000, 5 percentage points higher than the 1966-70 level.

The overall picture described above, however, masks large differences across countries even in a given region. In Africa, for example, export diversification has yet to occur for the majority of sub-Saharan countries (see Table 2.1). As several African countries demonstrate, diversification opportunities do exist and new areas of competitive advantage can be developed. At the same time, export diversification can be seen as a slow process and still remains a major challenge for the continent. In fact, Africa's average of diversification index declined between 2001 and 2005, reflecting more export concentration in resource-based sectors. Table 2.1 also shows that diversification does not necessarily deliver "export successes" in terms of higher export growth rates.

Given such export perspectives of least-developed and other low-income countries, increasing trade opportunities continues to be the most important contribution that the WTO can make to development. It should be recalled, however, that many developing countries have already been granted non-reciprocal preferential treatment in a variety of GSP (Generalised System of Preferences) schemes. In this regard, the outcome of the WTO negotiations at the Hong Kong, China Ministerial Conference in December 2005 took an important step forwards in the right direction but fell short of the specific request of LDCs under the DDA. While the LDC Group asked for 100 per cent access, the Hong Kong Ministerial Declaration was to provide them with duty-free, quota-free market access for 97 per cent of tariff lines. The devil is often in the detail, however. The remaining 3 per cent would amount to some 330 tariff lines, which could be large enough for LDCs to be denied *meaningful* market access.

Apart from market access issues, there are many other reasons for marginalisation of least-developed and other low-income countries, particularly in Africa. They include the difficulty of tackling comprehensively the inter-linkages of multiple trade challenges, such as the need to import essential materials at world prices to expand exports, the need to enhance the ability of domestic firms to meet the price and quality requirements of global supply chains, the need to build the legal and physical infrastructures conducive to international business development, and so on. Limited access to finance by local firms, notably small and medium-sized enterprises (SMEs), can be seen as a serious obstacle as well¹. Thus the DDA has emphasised the role of aid-for-trade activities to help developing countries achieve effective participation in the WTO negotiations on the one hand and build productive capacity and trade-related infrastructure on the other.

The greater focus on "behind the border" measures in multilateral trade negotiations, such as sanitary and phytosanitary (SPS) regulations and other technical barriers to trade, presents another challenge for poor countries. Rather than simply having to lower tariffs, the new requirements have potentially far-reaching implications for domestic institutions and policy reforms.

Table 2. 1.Export Diversification: Africa

	Diversification Index*		Annual Export Growth (%)
	2001	2005	2001-2005
Morocco	35.3	34.7	12.4
Tunisia	28.5	30.6	11.7
South Africa	33.2	23.1	11.2
Egypt	26.3	22.6	24.7
Swaziland	8.8	18.9	28.4
Tanzania	19.0	18.7	21.1
Eritrea	14.4	15.4	11.0
Kenya	11.3	15.2	9.7
Djibouti	49.0	14.8	-19.5
Zimbabwe	9.8	13.9	0.1
Madagascar	9.2	12.2	0.1
Mauritius	12.6	9.9	1.4
Togo	9.3	7.6	1.7
Uganda	6.2	5.8	13.0
Senegal	12.8	5.7	1.4
Lesotho	5.2	5.6	25.5
Somalia	11.6	5.6	3.1
Côte d'Ivoire	6.8	5.6	8.6
Namibia	7.1	5.2	56.5
Gambia	5.8	4.6	0.1
Ghana	8.2	4.3	9.9
Congo Democratic Republic	2.4	4.1	3.5
<i>Africa (Average)</i>	8.1	4.1	21.4
Ethiopia	5.3	3.6	27.7
Cameroon	4.5	3.6	10.7
Central African Republic	2.4	3.5	-7.7
Seychelles	2.6	3.5	17.4
Guinea	3.4	3.3	6.7
Rwanda	2.6	3.1	4.9
Zambia	4.2	3.1	32.7
Sao Tome and Principe	7.0	3.0	-3.7
Mauritania	3.8	2.9	13.8
Benin	1.8	2.9	-5.2
Malawi	2.9	2.8	5.7
Comoros	1.3	2.6	-8.7
Cape Verde	8.6	2.6	8.1
Sierra Leone	6.8	2.5	35.2
Algeria	5.3	2.1	27.6
Mozambique	2.9	1.8	28.9
Liberia	2.1	1.8	2.6
Gabon	1.7	1.7	13.9
Niger	4.6	1.6	-4.7
Mali	3.2	1.5	1.7
Burkina Faso	4.4	1.4	9.0
Burundi	1.9	1.3	35.2
Botswana	7.5	1.3	369.7
Congo	1.5	1.3	35.7
Sudan	1.7	1.3	45.1
Nigeria	1.3	1.2	27.3
Equatorial Guinea	1.3	1.2	61.4
Guinea Bissau	1.6	1.1	6.0
Chad	1.5	1.1	477.6
Libya	1.4	1.1	29.8
Angola	1.3	1.1	51.0

Notes: * The diversification index is defined as the inverse of a Herfindahl index, using disaggregated exports at 4 digit level (SITC 3). A higher index indicates more export diversification. Countries in bold experienced more diversification between 2001 and 2005.

Source: OECD/AfDB *African Economic Outlook* Statistical Database.

Export Diversification and Long-term Growth

More generally, export diversification can be seen as a strategic policy issue for many developing countries, since it is closely associated with a country's long-term growth. The link between product variety and productivity is central to the so-called endogenous growth models considered by Romer (1990) and Grossman and Helpman (1991). This literature suggests the potential for deepening the growth-enhancing division of labour by increasing product variety available in a country through international trade, innovation and imitation. For instance, Funke and Ruhwedel (2005) investigate the nature of the transition process in Eastern Europe and test the validity of a Ventura (1997) export-led growth model: growth is driven by accumulation of physical capital and countries specialise according to their comparative advantages. The process of structural change is the driver of export-led growth, because countries have to fight the tendency of the rate of return to capital to fall over time, by continuously shifting to productive activities with higher capital-labour ratios; such an option is only possible to the extent that countries are open to international trade. This interpretation can also be applied to the East Asian growth experiences, characterised by the key role of exporting manufactured goods (see, for example, Fukasaku *et al.* 2005).

There is growing recognition that product variety on both export *and* import sides may represent a critical channel through which trade impacts on productivity. For instance, Feenstra and Kee (2004) provide empirical evidence on the correlation between export variety by sector and a country's productivity, covering a sample of 34 countries from 1982 to 1997. They estimated the impact of differences in export variety across countries on their respective productivities, and found that setting aside country-fixed effects, export variety can explain 60 per cent of residual differences in TFP. Similarly, Broda and Weinstein (2004) investigated the impact of import variety on productivity in the United States, and found that import variety contributes to 1.2 per cent per year fall in the "true" import price index, which is reflected as a productivity improvement in importing industries.

The link between export diversification (or sophistication) and long-term growth has been further examined empirically by Hausmann *et al.* (2005) and Rodrik (2006) using a new indicator that measures the income level associated with a country's export basket². The result is that low-income countries produce too few high-productivity products that they can sell in the world market. Viewing from this angle, what stands out for China is that the country's export basket is much more sophisticated than what would be normally anticipated for a country at its income level. This "productivity jump" in China's export basket is most notable in the country's export success in consumer electronics in which foreign investors have played a key role.

Determinants of Export Diversification

While the link between product variety and productivity has drawn increased attention in the endogenous growth literature, there is a paucity of empirical analysis of what determines product variety in a country's export profile. Causa and Fukasaku (2007) have sought to fill this gap by investigating key drivers of export diversity across countries, using the index of product variety following the work of Feenstra and his associates³. The results of their quantitative analysis point to the very nature of the "two-way" relationship between

export variety and productivity, in which much of differences in product variety across countries can be explained by differences in levels of per capita income. Beyond that, other factors are also found to impact on export variety to varying degrees. For instance, an insufficient level of human capital (measured by the level of education per worker) has emerged as one of the most critical factors across the whole spectrum of developing regions, notably sub-Saharan Africa. The same observation applies to MENA countries, a result that corresponds to the conclusions reached by Causa and Cohen (2004 and 2006) on the analysis of regional bottlenecks to productivity growth in developing countries.

Among major developing countries, Southeast Asian countries display relatively high levels of export variety, but nevertheless appear to suffer from infrastructure deficiencies, potentially impeding a rise in product variety. Manufacturing labour productivity and technical efficiency could equally be improved through innovation and imitation to attain higher levels of product variety. On the other hand, the policy priority for Latin American countries seems to lie in the area of transport costs. It may be argued that transport costs are indeed a proxy for different types of trade barriers, including information or transaction costs, and that those factors are not well explained by geography or remoteness. It may also be argued that the content of Latin American exports, largely natural resource-based, makes the region's average transport cost higher than otherwise. Further empirical work is required to shed more light on the regional characteristics of the relationship between product variety and productivity⁴.

Strategies for Export Diversification

Existing empirical work on the determinants of export diversification reminds us that the level of export variety is closely linked to the stages of development itself (using per capita income as a proxy). Beyond that, the levels of education and infrastructure development are found to be very significant among other factors driving a country's export mix. It also confirms that export diversification remains a major challenge for developing countries, particularly those in sub-Saharan Africa. Despite more than a decade of policy reform and structural adjustment, the supply response has been weak in many countries of the region.

Policies to foster export diversification thus need to be re-considered. First, the traditional view of export promotion, often taken by public agencies dealing only with the overseas marketing of existing products, is no longer appropriate for this task. They are not able to tackle in a comprehensive manner the inter-linkages of multiple trade challenges as described earlier. There is now an urgent need for taking an integrated approach to trade promotion and export diversification which considers the reduction of risk and transaction costs as a key element in achieving higher investment and productivity growth⁵. Any serious "business plan" for trade promotion and export diversification must be based on a realistic assessment of a country's position in the global and regional markets. This cannot be done without an assessment of:

- External opportunities and constraints: how is world demand evolving? What are the most dynamic products? What are the entry conditions for these products in international markets? How are these products to be placed into global commodity chains? What is the governance structure of the commodity chain?

- Internal opportunities and constraints: what are the strengths and the weaknesses of the private sector? Is the private sector ready to absorb technological change? How are government policies affecting the private sector's ability to trade? How is the country placed in terms of producing the most dynamic export products and meeting the market entry conditions? Which interest groups are likely to consider themselves affected by a specific policy?

Second, processing of primary products has traditionally been considered an important avenue to diversification for many commodity-dependent low-income countries. However, many constraints, external and internal, still prevent local producers from fully exploiting existing business opportunities. External constraints include tariff escalation, strict SPS and technical barriers to trade, as well as vertical integration of retailers that acts as a strategic barrier to entry. Internal constraints are related to weaknesses of private firms and inadequacy of government policies, which reinforce external ones. Successful experiences of agricultural export diversification, however, suggest that diversification often follows the development of domestic markets. Many low-income countries are indeed already engaged in food processing for their domestic markets. Admittedly, breaking into the international market is much more demanding than serving domestic consumers, especially in terms of meeting stringent entry conditions and satisfying final buyers' demand in a timely fashion. It certainly requires a significant investment in supply-chain management and in quality control, marketing and branding. In many cases, this is beyond the capabilities of individual producers. Fragmentation of producers and a low degree of reliability in terms of product supply are major obstacles to realising the untapped potential in exports of high-value food products⁶. International assistance can play an important role in helping developing countries meet these challenges.

Notes

1. See Focuses 3 and 4 in this volume. See also OECD (2006) for further discussion.
2. In a similar vein, Lall *et al.* (2006) also provide an index of product sophistication based on the income levels of exporting countries.
3. The Feenstra index of export variety was calculated by using the OECD trade data disaggregated at the 5-digit level (some 2 800 products) covering 51 developing and developed countries in the years 1990, 1995 and 1999.
4. Bebczuk and Berrettoni (2006) find that most Latin American countries diversified their export structure between the mid-1960s and the late 1990s but that they were unable to achieve considerable levels of GDP growth.
5. Eifert and Ramachandran (2004) present a useful synthesis of cross-country evidence on Africa based on the World Bank's Investment Climate Data.
6. See Bonaglia and Fukasaku (2002), as well as Chapter 3 in this volume, for further discussion.

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Chapter 3

Agriculture in Africa: Open for Business?

Summary

Agriculture offers African countries substantial opportunities for promoting growth and poverty reduction which would be even more pronounced if subsidies in the developing and developed countries world were to be cut.

But formidable obstacles stand in the way of the exploitation of this opening. There is little between very small undertakings and large, often foreign-owned, businesses and Africa's presence on the world agro-food market is very small.

Among the factors working against the development of agro-based private sector are weak productive capacities and insufficient knowledge of markets, resulting in low productivity, high losses in the production process and inability to meet quality standards. Additional problems stem from a difficult access to input, including credit, and poorly developed local markets.

The experiences of Tanzania and Zambia are reviewed. Problems to agricultural export development are identified, ranging from inefficient production methods, through lack of investment and credit to over-taxation, a lack of water and weak contract enforcement. Promising examples are identified, including contract farming schemes that have brought small-scale farmers into the production of export crops.

The study points to three major conclusions: *i)* Commercial and large-scale agriculture needs to be promoted. Farmers and agro-business firms' productive capacities should be strengthened. Meanwhile, actions are needed to reduce the vulnerability and support the transformation of smallholder farming, which will continue to dominate African agriculture in the near future. *ii)* Retailers and processors can work more closely in linking farmers to markets and upgrading capacities to enable entry into the agro-food value chain where standards are continually rising. *iii)* Agriculture cannot be seen in isolation. The overall business environment needs to be improved while macroeconomic stability is essential.

Introduction

Agriculture is the dominant sector in most African countries and plays an essential role for their economic development. It is widely recognised that agricultural growth has a strong impact on poverty reduction both directly, in terms of higher income and employment and improved food security, and indirectly, through the development of backward and forward linkages with other economic sectors. For example, Thritle and Piesse (2005) find that a 1 per cent increase in agricultural yields would lift 2 million people out of extreme poverty in Africa.

Changing consumption patterns in industrialised countries, rapid income growth in large emerging economies and the prospects of population growth and urbanisation in Africa itself translate into higher demand for agricultural and food products and open up sizeable opportunities for African producers. If tariff rates and domestic subsidies on agricultural products were cut in both OECD and developing countries, welfare gains would be considerable and benefit a large group of developing countries, including in Africa.

However, the ability of African farmers and agribusiness firms to seize these opportunities is uncertain. Persistent shortcomings hamper the emergence of a competitive agricultural sector in the continent and weaken the potential contribution of this sector to growth and poverty reduction. Moreover, the changing governance structure of agro-food global value chains, characterised by more stringent product and process standards, is drastically raising the bar for entry for developing country producers, especially the smaller ones.

Against this background, this chapter examines the prospects for enhancing the competitiveness of the agricultural sector and improving the participation of African producers in domestic, regional and international markets. After considering the current state of agriculture in the continent, it reviews the main changes in agro-food markets that are likely to affect African producers. The opportunities and risks that such transformations induce are assessed against the main obstacles to private sector development (PSD) in agriculture. Two specific country experiences, Tanzania and Zambia, are then presented. The last section concludes with some recommendations for policy and future research.

The Role of Agriculture in African Development

Agriculture Plays an Essential Role for African Economic Development

Agriculture is by far the dominant sector in Africa and plays an essential role in rural and overall economic development in most countries. More than 60 per cent of Africa's active labour force earns a livelihood in the sector, contributing 17 per cent of the region's aggregate GDP and accounting for 40 per cent of its export earnings. In some sub-regions, the contribution of agriculture to the economy is even higher. For instance, in most West African countries the sector contributes between 30 and 50 per cent of GDP and is the major source of income and livelihoods for between 70 and 80 per cent of the population (Toulmin and Guèye, 2003). Moreover, this sector is the primary source of employment for the poor, and is characterised by high participation of women in the labour force.

Hence, agriculture can be an effective driver for pro-poor economic growth and greatly contribute to the achievement of the Millennium Development Goals (MDGs) by African countries through employment generation, higher incomes and improved food security (OECD, 2006a). Moreover, more efficient agriculture and stronger agricultural growth can also trigger development in the rural non-farm economy (RNFE), including "agribusiness", through production linkages as well as expenditure linkages associated with higher agricultural income¹. Agricultural diversification and the modernisation of agro-food industries played a key role in the development process of several developing countries, especially in Southeast and East Asian economies (Hazell and Rosegrant, 2000). Such a virtuous cycle has not yet started in Africa. Although performance has remained positive, with the value of aggregate agricultural output increasing by 2.5 per cent per year since the 1960s, Africa has lagged behind both Latin America (where output growth was 2.9 per cent)

and developing Asia (3.5 percent) (Haggblade *et al.*, 2004). In fact, Africa is the only developing region where per capita agricultural production and food insecurity have substantially worsened since 1970².

Although Africa is endowed with vast land, its agricultural productivity is beset by soil degradation, tropical climate and disease³. Institutional and structural constraints, discussed later in this chapter, reduce the incentive to invest in this sector, further aggravating the situation. About one third of total land is of medium to low potential, requiring considerable use of irrigation and fertilisers to reach an acceptable level of output. Only a quarter of Africa's potentially arable land is actually under cultivation. Despite steady increases in the region's agricultural production over the past three decades, agricultural productivity remains low or stagnant, and the majority of production continues to be targeted at subsistence farming (Table 3.1). In fact, area expansion, rather than increases in yields, accounted for the biggest increase in agricultural production. The sustainability of this process is questionable since the new land brought under cultivation is often fragile and because population growth in rural areas is faster than the expansion of the land area under cultivation.

Increased agricultural sector productivity and improved access to land and markets are key ingredients of a successful pro-poor growth strategy led by agriculture (OECD, 2006*a*). Several empirical studies have identified a strong impact of improved productivity on average incomes and poverty. Thritle and Piesse (2005) find that a 10 per cent increase in agricultural yields would reduce the number of people living below the \$1 per day poverty line by about 7 per cent. The effect would be particularly strong in Africa, where poverty could decline by as much as 9 per cent⁴. Improvements in productivity growth would mainly stem from investment in research and development (R&D) and increased use of fertilisers which are extremely low in Africa⁵.

Table 3.1. **Agricultural Value Added per Agricultural Worker**
(constant 1995 \$)

Region	1988-1990	2000-2002	Change %
Latin America & Caribbean	2 770	3 591	30
South Asia	343	412	20
Sub-Saharan Africa	382	360	-6

Note: "Agriculture" comprises forestry, hunting and fishing, as well as cultivation of crops and livestock production (ISIC 01-05). "Value added" is the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources.

Source: Author's own calculations based on the data from the World Development Indicators 2005.

Private Sector Development in Agriculture and Agribusiness

The development of a vibrant and modern agricultural sector can have a powerful impact on poverty, given the predominance of poor households in rural areas. African agriculture is still largely dominated by traditional, rain-fed, smallholder production systems, with very little acreage and limited intensification⁶. The average acreage of land per agricultural worker is not only very small, but it has also shrunk in 18 of the 31 African least developed countries (LDCs) between 1980 and 2000 (UNCTAD, 2006).

Smallholder farmers have shown a high degree of flexibility and adaptability to changing economic conditions (Toulmin and Guèye, 2003; SWAC, 2005). However, the viability of smallholder farming and its capacity to provide sustainable livelihood opportunities is increasingly called into question (Jayne *et al.*, 2006; Ashley and Maxwell, 2001; UNCTAD, 2006).

Demographic pressure, a more complex market environment, inadequate access to land and other inputs are amongst the main constraints smallholders face. The development of the RNFE is an opportunity to expand the options and opportunities of the rural poor and favour the structural transformation of the economy (Start, 2001). Household surveys suggest that off-farm sources account for a growing share of rural household income in most developing countries. Reardon *et al.* (1998) show that rural non-farm activities account for about 42 per cent of the income of rural households in Africa, 40 per cent in Latin America and 32 per cent in Asia.

As the interface between markets and rural households, agribusiness enterprises are key actors in the process of agricultural modernisation and industrialisation, and create synergies between agriculture and industry⁷. They provide inputs, expertise and services needed for farm production and access to markets for output, while creating employment and entrepreneurial opportunities in both rural and urban areas. Through the establishment of market linkages, the agribusiness sector can also contribute to the growth of micro and small enterprises. The development of an efficient processing industry could help to absorb a rapidly growing rural labour force and offer to producers enough incentives to scale up production, providing them with a market for their surplus. Nevertheless, agency problems related to information asymmetries and imperfect monitoring, weak contract enforcement (e.g. side-selling in contract farming) and size-invariant transactions costs (costs which remain the same irrespective of the farm's size) can induce buyers and processors to engage with larger farm enterprises rather than individual producers (Poulton *et al.*, 2006).

Despite its strategic importance, relatively little is known about the characteristics of agribusiness in Africa⁸. Most analyses concur that the sector is small. It is estimated that Africa's total agribusiness contribution to GDP is just under \$70 billion, representing approximately 1 to 2 per cent of the world agribusiness GDP share, or about the same as that of Thailand and one quarter of that of Brazil (Table 3.2)

Table 3.2. Share and Size of Agribusiness in GDP

	Sub-Saharan Africa	Thailand	Brazil
Agriculture's share of GDP	32	11	8
Agribusiness's share of GDP ^{a)}	21	43	30
Agribusiness GDP (\$ billion) ^{b)}	67	68	236

Notes:

a) Combines the value added for agro-related industries and that of agricultural trade and distribution services.

b) Agribusiness only – does not include the GDP of primary agriculture.

Source: Jaffee *et al.* (2003).

The structure of agribusiness mirrors that of the African private sector at large, which is polarised around two extremes and characterised by a “missing middle” of small and medium-sized enterprises (OECD-AfDB, 2005). At one extreme, micro and small enterprises, often informal and serving local markets, constitute the backbone of the private sector. Examples of such micro enterprises are often found in sectors such as grain milling or oilseed processing. At the other extreme are a small number of relatively large firms, often foreign-owned, and generally engaged in export activities. Most of these firms are active in food and beverages, cotton and tobacco processing.

The African food and beverage industry developed under import substitution industrialisation strategies. Large food-processing companies were often state-owned or controlled by parastatals and operated at high levels of inefficiency. High protection allowed offsetting inefficiencies within the food industry itself and in related industries such as

packaging and transport. Despite their inefficiencies, these companies could survive thanks to exclusive contracts with institutional customers such as the army or hospitals. The implementation of market reforms and privatisation triggered adjustment and led to the collapse of many formerly dominant players, which could not compete with cheaper imports. Although there are some cases of successful restructuring, the response to liberalisation has not been uniform across the continent (Jaffee *et al.*, 2003).

Structure and Patterns of Agricultural Trade

In 2005, agricultural exports from Africa stood at about \$48 billion, about the same level of the previous year. As Table 3.3 shows, agricultural products represented some 13 per cent of African total exports (16 per cent for sub-Saharan Africa, SSA), but the share of Africa in world agricultural trade remains minor, around 5.2 per cent (4.2 per cent for SSA). Moreover, although agricultural products have a considerable weight in many countries' exports — in some cases representing the largest foreign exchange earner — they are mostly exported either unprocessed or at a low level of value-addition (Bonaglia and Fukasaku, 2003). Apart from a few exceptions, African countries have not yet been able to exploit the opportunities associated with strong world demand for agricultural and food products. For instance, they only play a marginal role in the booming fresh fruit and vegetable trade (SOMO, 2006).

Table 3.3. Africa's Participation in International Agricultural Trade

Region	Year	Agricultural exports (a) \$ billion	Food exports \$ billion	Total exports (b) \$ billion	Share of agriculture in total exports (a)/(b) \$ billion	Share of world agricultural exports (%)
World	1990	378	279	3 049	12.4	100
	1995	580	433	4 904	11.8	100
	2000	650	497	7 334	8.9	100
	2005	930	738	11 544	8.1	100
Africa	1990	15	11	84	18.5	4.1
	1995	22	16	97	23.0	3.9
	2000	34	26	203	16.8	5.2
	2005	48	37	372	12.9	5.2
Sub-Saharan Africa (SSA)	1990	13	9	58	22.8	3.5
	1995	19	13	68	28.1	3.3
	2000	29	21	139	21.0	4.5
	2005	39	29	244	16.0	4.2

Note: Mirror data based on SITC Rev. 3. Because of lack of reliable national data for many countries, export figures are obtained from world imports. Agricultural exports are defined as SITC categories 0, 1, 2 (excluding 2.27 and 2.28) and 4. Food exports are defined as SITC categories 0, 1, 2.22 and 4.

Source: UN COMTRADE data, extracted from <http://wits.worldbank.org> (accessed in February 2007). The most recent year for which data are available for the whole continent is 2005.

The weak performance of African agriculture on the international market mirrors that of African exports more generally. Africa's participation in world trade has been constantly deteriorating since the 1970s. Despite a wide range of preferential market arrangements granted by OECD countries, sub-Saharan Africa's share of world exports has halved between 1970 and 2005, falling from 3.4 to 1.8 per cent. This decline is even more worrying, when considering that it took place against a dramatic rise of developing countries' exports in world trade.

Primary commodities, notably oil and mineral products, play a dominant role in the continent's exports. Historically declining terms-of-trade led to a substantial reduction in purchasing power of African exports, with particularly worrying consequences for the affordability of food imports and the food security of the many net food-importing countries. Volatility and persistence of commodity price shocks appear to be of even greater concern than this long-term downward trend. In fact, international commodity prices have been slowly regaining over the last four to five years, in what has been dubbed a "commodity super-cycle". The volatility of export prices for primary commodities results in great instability of export revenues, which increases vulnerability and could jeopardise any medium-term stabilisation and development strategy⁹.

Promoting export diversification is therefore necessary to hedge against international price swings and associated risks of boom-and-bust cycles. Most analyses suggest that, given the relative land-abundance (per worker) characterising African countries, they are likely to remain, at least for the foreseeable future, net exporters of primary products, rather than manufactures (Wood and Mayer, 2001)¹⁰. Diversification is a medium to long-term goal, which cannot elude a country's endowments. Hence, African countries need to learn to live better with commodity dependence, improving revenue management and devising instruments to cushion price shocks. If developing the manufacturing sector seems a more long-term scenario, then agro-industrialisation and diversification into higher-value products — such as fruit, vegetables, oils, fishery and livestock products, cut flowers, specialty coffees, processed and pre-cooked foods — would appear to be a more promising opportunity for many African countries.

Changes in the Agro-food Market

Globalisation of Food Systems: Opportunities and Challenges

The global market for agro-food products is rapidly expanding and undergoing profound changes, which open up opportunities for developing countries but also pose new challenges. These transformations are driven by technological advances and changes in food consumption patterns (OECD, 2004a), stricter quality and health standards enforced by public agencies as well as retailers (World Bank 2005a; OECD, 2004b) and the globalisation and increasing concentration of the retailing sector (Box 3.2). Changing consumption patterns, in particular greater health consciousness and a stronger demand for ready-to-cook or ready-to-eat products, as well as off-season and "world food" products, represents a considerable opportunity to develop non-traditional agricultural exports.

The globalisation of food sourcing can easily be observed in most supermarkets. Food and other agricultural products are today as globally sourced as manufactured products. This transformation has spurred rapid growth of agribusiness in many developing countries and provided impetus for agribusiness firms to diversify into higher-value products. The share of developing countries in world exports of high-value food products (aquatic products, fresh and processed fruit and vegetables, meat and spices) rose from 30 to 50 per cent between 1980 and 2000 (World Bank, 2005a). Exports of "non-traditional" tropical fruits such as mangoes, papayas or pineapples have more than doubled in value over the last decade, while fresh vegetable exports increased 62 per cent in value. Real prices for horticultural commodities have shown a decline over the decade but much less so than for agricultural commodities in general (SOMO, 2006).

Liberalisation of agricultural trade and foreign investment have accompanied and in some cases boosted such transformation. In particular, the liberalisation of developing countries' domestic markets and the breakdown of most international commodity cartels have brought about a substantial change in the organisation and governance of the agro-food supply chain (Gilbert, 1996). Meanwhile, persistent distortions and trade barriers in developed and developing countries alike continue to affect market outcomes and the ability of agricultural producers in developing countries to exploit their comparative advantage to the fullest extent.

The OECD-FAO Agricultural Outlook forecast that over 2005-14 world agricultural production will increase at a slower pace than in the previous decade, but global consumption will continue to expand, in particular because of economic performance and population growth in developing countries (OECD-FAO, 2005). Developing countries will account for the strongest growth of production and become leading world exporters for most agricultural commodities¹¹.

The likely increase in domestic demand, associated with population growth and rapid urbanisation, is another important driver of change for African producers. In fact, in many African countries fresh fruit and vegetables are sold mainly on the local market, through traditional retail channels. Muendo and Tschirley (2004) show that, despite a phenomenal growth since the late 1990s, exports remain a small fraction of Kenya's overall horticultural sector, with over 90 per cent of all fruit and vegetable production consumed domestically. Urbanisation is progressing fast in the continent. The United Nations estimates that, by 2030, 87 per cent of population growth in Africa will take place in urban areas and more than half of the population will be urban.

Liberalisation of Agricultural Trade

Agriculture is one of most distorted sectors internationally and a contested issue of multilateral trade negotiations. Given the current high level of protection¹², agriculture would be the sector to benefit the most from further multilateral trade liberalisation. Anderson and Martin (2005) show that if WTO members were to make very substantial cuts to bound tariff rates and domestic farm subsidy commitments, welfare gains would be considerable and benefit a large group of developing countries, including low-income ones¹³.

The net impact of multilateral agricultural trade liberalisation on the African continent would largely depend on the supply-side response to the new competitive environment in both agricultural exporters and net food-importing countries. The removal of domestic agricultural subsidies in OECD countries is likely to prompt an increase in prices for many food commodities such as grain and meat, which could negatively affect those countries that depend on imports to secure their food needs. Today over 70 per cent of African countries are net food importers¹⁴. At the same time, as competition in global commodity markets intensifies and productivity improves, real prices for agricultural commodities are likely to decrease.

The persistence of domestic policy-induced and structural constraints, which raise transaction costs and dampen competitiveness, will significantly influence the ability of African farmers and agro-enterprises to adjust to this new environment¹⁵.

Governance of the Agro-food Global Value Chain

A major change affecting agricultural markets is the increasing degree of vertical co-ordination exercised by buyers and retailers. Agricultural trade is increasingly taking place along global value chains (GVCs), which replace anonymous spot market transactions (Box 3.1). Several studies have analysed the governance structure of the agro-food GVC¹⁶. Most found that the degree of explicit co-ordination was often associated to the specific characteristics of the traded product (Gibbon, 2003). In the case of agricultural commodities that are anonymously traded (e.g. tropical beverages), co-ordination is looser, resembling more the buyer-driven type described by Gereffi's seminal work on global commodity chains (Gereffi, 1994). In the case of higher value products, which often require certification and where the cost of suppliers' failure to meet the buyer's requirements is greater (e.g. on the buyer's brand image) co-ordination is tighter.

Box 3.1. Agricultural Global Value Chains

An agro-food supply chain is a flow of agro-based products, linking upstream farm production to downstream distribution and to consumers ("from farm to fork"). Consumers are increasingly sophisticated and demanding and their preferences have a large impact on decisions about what should be cultivated and marketed, to the extent that experts talk about a "supply-chain reversal" to describe the shift from a product-oriented business model (farmers determine what to produce) to a demand-driven business model (consumers drive production decisions).

The value chain concept refers to the existence of some form of co-ordination (governance) of the relationships and linkages between the many actors involved in the creation of value, rather than arm's-length market transactions. The value chain consists of an interdependent network of enterprises, institutions and activities, involving different actors such as growers, pickers, packers, processors, storage and transport facilitators, marketers, exporters, importers, distributors, wholesalers and retailers in different countries (van Roekel *et al.*, 2002). These actors deliberately enter the chain to undertake jointly activities they could not undertake or do not find profitable to undertake by themselves.

Humphrey (2006) discusses in detail the governance structure of the agro-food GVC against the five-fold categorisation of value-chain governance, originally proposed by Gereffi *et al.* (2005). The five categories include, in order of decreasing explicit co-ordination: "vertical-integration" (supply-driven GVC); "relational linkages"; "captive linkages"; "modular linkages"; and "arm's-length transactions" (buyer-driven GVC). According to this framework, the specific form of co-ordination within the chain would depend on the interplay of three key factors, namely: *i*) the complexity of the information that needs to be transferred between participants in order for the transaction to be successfully completed; *ii*) the extent to which this information can be codified and transferred between actors; *iii*) the competence of the supplier in undertaking the required tasks.

Although product-specific features influence the organisation of the chain, so that it is not entirely appropriate to speak of a single global value chain (GVC) for all agro-food products, there remain some common factors to this sector that allow making some generalisations. In fact, the GVC for most agricultural goods has evolved from a quite simple "trader-driven" supply chain, with international trading companies in end markets acting as intermediary between exporters in developing countries and importers and wholesalers, to a more buyer-driven one, where supermarkets ensure vertical co-ordination and set the standards governing the whole chain, all the way up to producers.

Source: Humphrey (2006); Gereffi *et al.* (2005); and van Roekel *et al.* (2002).

The emergence of supermarkets as a major buying force has markedly changed the governance structure of the agro-food GVC, with repercussions all along the chain, up to the producers (Humphrey, 2006; Reardon *et al.*, 2003). The process of concentration in retailing has resulted in the emergence of a small number of powerful supermarket groups, with global sourcing strategies, that increasingly set the product and process standards governing the whole agribusiness chain (Box 3.2)¹⁷. Control over marketing and branding and strong market power gives buyers and retailers a significant leverage over production, distribution and trade, even without ownership or direct control over upstream producers.

Box 3.2. Retail Concentration

Sourcing of food commodities has become as global as that of manufactured goods, and there is progressive agro-food market integration through the rise of medium and long-distance trade and the establishment of specialised production areas. Agricultural commodity chains, particularly those of high-value crops and processed products, are increasingly dominated by large retailers and a few vertically integrated, multinational enterprises that have a strong advantage in marketing, transport and distribution.

Consolidation of the retail sector via the rise of supermarket chains widely took off in the 1990s in both developed and developing countries. This had repercussions all along the agro-food supply chain, up to farmers. For example, imported horticultural produce was previously channelled primarily through wholesale markets in the United Kingdom. But the country's large retailers now control 70 to 90 per cent of fresh fruit and vegetable imports from Africa. Today the five largest international food retailers control between 30 and 96 per cent of food retailing in the European Union and the United States. Worldwide, the top 30 supermarket chains now control almost one-third of grocery sales.

Reflecting the varied demand of consumers, these large retailers seek to maintain diversity, year-round supply and products with assured quality and safety levels. Supermarket supply chains distinguish themselves from traditional market chains by developing sophisticated procurement and logistic systems (e.g. centralised procurement and distribution centres) parallel to the traditional wholesale systems, which entail significant efficiency gains.

Source: Reardon *et al.* (2003); Dolan and Humphrey (2000); Vorley (2003); SOMO (2006).

What are the implications of the changing governance structure for African producers? The African horticultural industry has been one of the success stories of African development during the past decade. Dolan and Humphrey (2000) point out that the growing competition between supermarkets in OECD countries for fresh produce was decisive for the rapid development of the African horticultural trade. The market for fresh vegetables imported from Africa has increased in volume and product variety, moving from off-season supply towards an increasing year-round supply.

Although there is a general perception that participation in these supply chains contributes to enhancing suppliers' capabilities, there is not yet a systematic empirical assessment of the net benefits of participation for small farmers. On one hand, participation in the agro-food GVC represents an opportunity for developing-country producers to access markets, upgrade their production processes and improve the quality of their products. Often, buyers help their suppliers to organise production better and meet the quality and safety standards they require. At the same time, the "power asymmetry" between buyers and

suppliers may put a downward pressure on prices and reduce the profit margin accruing to suppliers. Moreover, buyers might prefer to have the smallest number of suppliers, to reduce transaction costs, and look for producers that already have the potential to comply with their standards. This situation can adversely affect small farmers and processors, because of their lower capacity to meet the demands for high quality and volume at low prices. Therefore, there is a risk for smallholders to be excluded from the buyers' sourcing network and being further marginalised.

Obstacles to Agro-based Private Sector Development

The data on trade figures previously illustrated suggest that, while some developing countries are benefiting from the changing patterns in global agricultural and food markets, African countries have not been able to expand and diversify their export range.

The marginalisation of African producers in agricultural trade is symptomatic of the sorry state of this sector in the continent. If the removal of distortions in international agricultural trade and import protection in high and middle-income countries is a necessary condition to sustain export growth and diversification of Africa's agriculture, the contrasting experiences of various low-income countries, including within Africa, suggest that these market access factors *per se* are only part of the explanation for poor export performance¹⁸.

Low agricultural productivity, reflecting several shortcomings plaguing the production process or "supply-side" constraints, seems a more fundamental explanation¹⁹. Shortcomings in the business climate contribute to making the situation worse, since they discourage the investment needed to remove those constraints. Poor contract enforcement, loose definition and protection of property rights, and weak implementing capacity within ministries and public agencies in charge of agricultural and private sector development policies all contribute to raising the cost of doing business and reducing investment incentives.

Sustainable agricultural intensification, through better access to and use of fertilisers and irrigation, as well as improved seed varieties, would permit large increases in agricultural productivity and expansion of output. In this respect, the current situation is quite worrying. Reardon *et al.* (1999) suggest that African agriculture is severely undercapitalised, which makes current intensification efforts largely unsustainable. For instance, at 10 kg per hectare, inorganic fertiliser use in sub-Saharan Africa is much lower than the average 100 kg in developing countries, and has also been on a decreasing trend until very recently (Camara and Heinemann, 2006). Investment in agricultural research and development is also insufficient. Pardey and Beintema (2001) estimate that sub-Saharan Africa is the only region in the developing world where public research expenditure as a share of agricultural GDP decreased between the 1970s and the 1990s. Moreover, private sector funding of research remains minimal.

Structural reforms implemented over the late 1980s and 1990s have removed some major policy distortions hampering the further development of the sector²⁰. Yet they failed to stimulate an adequate supply-side response, both in terms of domestic and foreign investment and emergence of a more vibrant private sector. The dismantling of inefficient parastatals in charge of input provision and marketing has created a vacuum that has not been adequately filled by private actors. In fairness, reforms have often not been fully implemented or have even been reversed (Kherallah *et al.*, 2000).

Three obstacles seem of particular concern in the development of a vibrant agro-based private sector in Africa: difficulties in accessing financial markets; lack of or underdeveloped markets for agricultural inputs and products; and insufficient capacity to meet quality and sanitary standards set by exports markets.

Access to Credit

Smallholder farmers, who dominate Africa's agricultural sector, suffer from serious undercapitalisation. The limited availability of formal credit weakens their ability to insure against risks and to engage in a more intensive use of irrigation, fertilisers and technical inputs. This situation reduces land and labour productivity and locks them into a vicious cycle of low savings and investment, volatile income and persistent poverty. For their part, the smaller agro-enterprises face considerable difficulties in financing the investment in technology and supply-chain management which is needed to access global agro-food chains and upgrade products and processes in a sustainable fashion.

Credit rationing reflects weaknesses on both borrower and lender sides and is often amplified by shortcomings in the regulatory framework. On one hand, credit institutions find it too costly to serve rural enterprises, as they are widely scattered and disconnected from major centres. The inability of farmers to provide a credit history and present bankable projects, and a poor capacity on the side of credit institutions to deal with small enterprises in a volatile and risky business environment, characterised by inadequate contract enforcement and protection of creditor's rights, aggravates the situation²¹.

Underdevelopment of Markets

The underdevelopment of domestic and regional markets for agro-food products is another major hindrance to the further expansion of this sector. Fragmented domestic markets and low purchasing power, especially outside main urban areas, depress demand, limit firms' ability to achieve economies of scale and further dissuade risk-taking activities and investment. At the country level, a better integration of rural and urban areas is vital, as rapid urbanisation will lead to a strong rise in food demand. Unfortunately, producers are often disconnected from major urban markets. The collapse of agricultural marketing boards, which have not been adequately replaced by private sector distribution channels, has also resulted in the elimination of the sole channel for villagers to bring their products to the market. The strong development of retailing in Africa may provide a better chance. However, as discussed above, cost consideration may lead supermarkets to opt for sourcing strategies that do not include remote and smaller producers.

Inadequate transport and communications infrastructure contributes to prevention of market integration²². Transport networks were developed in the colonial era in response to the need to ship commodities out of a country, rather than connecting rural and urban areas and integrating domestic and regional markets. Out of a total road network equal to 1.5 million km, only 19 per cent is paved, compared with 27 per cent in Latin America and 43 per cent in South Asia. The quality of paved roads has been severely affected by systematic axle overloading of trucks and poor water drainage, resulting in widespread potholes and increasing road accidents. Similar weaknesses are found in other modes of transport, such as air transport and port services (OECD-AfDB, 2006). Transport costs amount on average to twice those for comparable services in South Asia and up to four times higher than in OECD countries (Commission for Africa, 2005; Jaffee *et al.*, 2003).

The lack of efficient logistics systems should not be overlooked²³. In fact, the improvement of trade facilitation, logistics and supply-chain management is crucial for realising the gain associated with tariff liberalisation. Administrative barriers and lack of competition in provision of transport and communications services, cumbersome procedures at customs and lack of harmonisation at the regional level are additional costs that exporters have to bear. Africa's own trade barriers hinder the development of regional markets and stifle the ability of exporters to access larger markets, achieve economies of scale and, eventually, improve their competitive position²⁴.

Insufficient Capacity to Meet Quality Standards

The ability to procure continuously specific volumes and quality mixes for buyers and processors and to comply with the standards set by retailers and public agencies in importing countries are a critical factor for success in entering the GVC for agro-food products. Hence, the competitiveness of African agricultural production and trade hinges upon the efficiency of the whole supply chain, from input providers to packaging and logistics.

The prominence of product and process attributes is increasing with respect to mere considerations of price. As discussed above, buyers of food and agricultural products are very demanding in terms of reliability of supply, quality specifications and sanitary and phytosanitary (SPS) requirements (Box 3.3). SPS concern for instance, the use of antibiotics and the quality of feed ingredients for animal farming, which could potentially affect human health.

This situation is of particular concern for African agro-enterprises, given the high costs of compliance with standards and the lack of capacity to implement testing and certification in most countries (World Bank, 2005a; Cato and Lima dos Santos, 2000). Otsuki *et al.* (2001) estimate that the implementation of a specific, more restrictive SPS measure by the European Union could reduce African exports of cereals, dried fruits and nuts to this market by 64 per cent, equivalent to \$670 million²⁵. Downstream processors of agricultural products can only exert a weak monitoring over the upstream segment of the agro-value chain. Farmers and traders often lack adequate storage and transport equipments to preserve the quality of perishable goods and are not able or willing to make necessary investments to make conditions more hygienic. Inadequate sanitation infrastructure and widespread use of pesticides and antibiotics in animal farming further exacerbate the risk of rejection by export markets. The myopic behaviour of upstream actors can generate costly negative externalities for the whole sector, which are difficult to solve given the generally high number of decentralised households and middlemen involved in farming and trading. Moreover, sanitary authorities are unable to enforce more stringent controls, owing to their limited technical and financial capacity. The numerous import bans for aquatic and vegetable products from developing countries — including several African ones — demonstrates these difficulties. African fish exporters, especially from East Africa, suffered several export bans owing to their inability to meet sanitary standards: outbreaks of cholera (1996), presence of salmonella (1997) and use of dangerous fishing methods, such as use of poison (1999). The three Lake Victoria countries suffered a tremendous loss. Ugandan fish exports halved in value between 1996 and 2000. Similar losses were registered in Tanzania. Upgrading processing plants to meet the HACCP (hazard analysis and critical control point) or other quality code standards would require an investment which exceeds the financial capacity of most private enterprises.

Box 3.3. Barriers to Market Entry for Agricultural and Food Products

Although import tariffs remain a barrier to entry for exporters of agricultural products (Anderson and Martin, 2005), exporters of fresh produce often quote non-tariff barriers (NTBs) as a more serious concern. Amongst NTBs, sanitary and phyto-sanitary (SPS) measures imposed by destination countries and buyers play a significant role. In their analysis of NTBs of concern to developing countries, based on notifications made to the WTO Negotiating Group on Market Access for Non-Agricultural Products (NAMA), Fliess and Lejarraga (2005) find that, for the sample of 21 developing countries considered, the product groups most frequently notified as being hampered by NTBs were “live animals and products” and that SPS measures were the third most frequently reported barrier to export. Most African countries do not have the human and infrastructural capacity, especially in terms of laboratory services, to ensure that their exports meet the required standards. There is a large element of fixed costs in implementing and maintaining high levels of compliance and certification. High capital investment costs needed to meet quality standards make it difficult for small firms and farms to participate in the export market. Hence, this further accelerates the process of concentration from the buyer end. More recently, the ability to finance investment in information and communication technologies has given large firms an additional competitive edge.

The dominance of the supermarkets and greater competition among exporters of fresh produce are leading to a general rise of quality and safety standards for food products. Statutory health and safety requirements are also being overtaken by a large number of private standards imposed by international retailers and processors — see, for example, EUREP-GAP (www.eurepgap.org) and the British Retail Consortium (www.brc.org.uk). The respect of labour, environmental and product safety standards are becoming a crucial competitive factor in the global retail business.

These standards function as instruments to reinforce supply chain governance and as a competitive factor, by assuring superior product quality. However, as noted by Dolan and Humphrey (2000), they may act as a barrier to entry for small growers and processors who lack the investment capabilities to ensure a consistent, quality product that complies with all regulatory requirements.

Source: Fliess and Lejarraga (2005). FAO (2004b; 2004c); Dolan and Humphrey (2000); Reardon *et al.* (2003).

Agricultural Diversification: Evidence from Tanzania and Zambia

Tanzania and Zambia both have great potential for agricultural and agribusiness development, though their economies are still heavily dependent on a few unprocessed primary commodities such as gold and copper. Agricultural productivity is low in both countries and producers encounter significant problems to deliver quality goods at competitive prices²⁶.

The predominance of traditional smallholder production systems and the inadequate use of fertilisers and extension services are often indicated as major hindrances to enhance productivity. This partly reflects a legacy of past development strategies. The market-oriented reforms of the 1990s removed several obstacles and triggered necessary adjustments, though structural obstacles and institutional weaknesses still linger on, contributing to limiting the development of commercial farming.

Governments in both countries give the highest priority to agricultural development and private sector-led growth, given its large potential impact on poverty alleviation and the potential for raising export earnings. They have launched ambitious agricultural development strategies, which incorporate export diversification and growth as key objectives alongside food security.

Tanzania's Agricultural Potential and Performance

Agriculture is the backbone of the Tanzanian economy and plays a pivotal role for the achievement of the country's objectives in terms of sustained growth and poverty reduction. Over 80 per cent of the population depends on agriculture, which is the largest source of employment, especially for women. Hence, promoting production and value-addition of agricultural products could have a significant impact on poverty eradication, particularly in rural areas where 39 per cent of the population lives in poverty (2001 data). The transformation and improvement of agricultural production capacity is recognised as a fundamental goal within Vision 2025, the country's development strategy.

Although the share of agricultural commodities in total exports is decreasing, the sector's overall contribution to total production and exports remains dominant, accounting for 45 per cent of the national income. On the other hand, the contribution of industry to GDP remains modest, accounting on average for only 16 per cent over 2000-03. Over the same period, agriculture and food exports averaged about 60 per cent of total merchandise exports, while manufactured goods contributed only 13 per cent. Between 1996 and 2003, the primary sector (crops, livestock, forestry and fisheries) and agribusiness contributed to about 60 per cent of the country's GDP growth over the period.

Despite such importance, the sector's performance over the years has not been impressive. Between 2000 and 2004, agricultural value-added grew on an average by 4.4 per cent per year, against a 6.2 per cent growth for the country's GDP. Agricultural production levels (including crops, food and livestock) have been stable over the last five years, even showing a gradual rise. Still, agricultural productivity (agricultural value-added per worker), which rose by 7 per cent between 1988-90 and 2000-02, remains low relative to those of sub-Saharan Africa and other major agricultural regions. The failure to promote commercial farming, in particular the development of medium to large-scale commercial farms, largely explains the low productivity growth of the country's rural sector (Temu, 2006).

Following a decade of transition from a socialist to a market-oriented economy that began in the 1980s, the Tanzanian government has been pursuing a number of reforms to liberalise and open up the economy since the mid-1990s. Annual GDP per capita growth has increased from 1.6 per cent during 1996-2000 to 4.5 per cent over 2001-04, and poverty is estimated to have declined by nearly 28 per cent between 1994 and 2002 (Temu, 2006). The exporting sector is in large part responsible for this recent growth recovery, accounting on average for over half of GDP growth during 1990-2003. Gold exports, which rose from \$27 million in 1990 to \$400 million in 2003, have been responsible for much of the 84 per cent export growth during 2000-03. However, Tanzania's share of world trade remains minimal, representing less than 0.02 per cent of world exports in 2004 (a sixth of that in 1960).

Most reforms directly impinged on agriculture, whose performance had been poor during the previous three decades and only started to recover in the late 1990s. At an annual average rate of 3.5 per cent over 1996-2003, agriculture has made a substantial contribution to overall growth. However, with a population growth rate of 2.9 per cent, it was insufficient to boost per capita incomes (World Bank, 2005*b*). Tanzania's agriculture is still a primitive, traditional, smallholder production system. Only a quarter of the 44 million hectares of land classified as suitable for agricultural production is under cultivation, predominantly by smallholder farmers operating between 0.2 to 2.5 hectares. A small fraction of the abundant land that is suitable for irrigation development is currently being irrigated. Reliance on hand-hoe and traditional crop husbandry practices is also widespread, while use of agricultural inputs is low. It is currently estimated that only 15 per cent of all farmers use fertiliser.

Production: food crops, traditional and non-traditional export crops

The main food crops are maize, rice, wheat, sorghum/millet, cassava and beans, representing nearly 85 per cent of the cultivated area. Since 1993, there has been a continuous reduction of state control over crop marketing and inputs supply. The immediate consequence of liberalisation was an increase in the proportion of the market prices received by producers. This stabilised production regardless of the fall in world prices²⁷.

Four main traditional export crops — coffee, cotton, tea and cashew nuts — make up over 15 per cent of Tanzania's merchandise exports, and are the main sources of income for over 1.2 million rural households, or about 4 per cent of total population (United Republic of Tanzania, 2005). Other traditional crops having relatively similar forms of marketing and export processes include tobacco and sisal. Producers of these crops are predominantly traditional smallholders and have very limited influence on marketing, and no influence in the export process. Up to the mid-1990s, they sold raw material to co-operatives. Thereafter, market liberalisation policies allowed private marketing companies' activities in the export crops sub-sector.

Despite liberalisation, crop boards still play a major role in all export crops. These regulatory bodies, funded from a tax levied on producers, also perform some private sector roles, including production, marketing, transportation, storage, processing and input supply activities. The boards have come under increasing criticism and pressure to limit themselves to regulatory responsibilities. A review of the coffee, cotton, tea and cashew crop boards has been undertaken and a strategy for reforming them was adopted in mid-2005. New legislation on crop boards is expected to be submitted soon to parliament.

A recent study (World Bank 2005*b*) highlights that a shift of production towards non-traditional products, mainly catering for exports, and import-competing commodities might be underway. Major non-traditional exports include maize (a regional export), horticultural products and cut flowers, fish and pulses. According to customs data, those exports amounted to \$12 million in 2003, or 1.1 per cent of total exports. Although still small, they have constantly increased during the last ten years. It is also likely that official statistics underestimate the actual volume of trade.

The need to ensure greater efficiency all along the domestic agricultural value chain has prompted the emergence of some form of vertical co-ordination in the sector. Vertically integrated firms that purchase, process and export crops have emerged, following market liberalisation. The challenge in this case has been regulations that bar single firms from acquiring licences for more than one market node of operations. These firms, as well as vertically co-ordinated producer organisations, seem better placed than individual, small producers to manage risks, optimise procurement, access capital and engage with foreign buyers.

National priorities

The 1998 "Development Vision 2025" specifies the country's long-term development goals. Vision 2025 seeks to transform the country from a predominantly rural, least-developed economy to a semi-industrialised middle-income country. The associated Poverty Reduction Strategy Paper (PRSP), implemented over 2000/01-2003/04, mainly targeted the social sectors as the main strategic component for development and poverty reduction. When the first PRSP came to an end, the government decided to emphasise and promote private-sector development and trade in the poverty-reduction strategy. The new, five-year PRSP, the

National Strategy for Growth and Reduction of Poverty (locally known as MKUKUTA) was finalised in June 2005 and put economic growth at the centre of the development agenda, alongside trade policy and trade development concerns.

The main policy vehicle for implementing the agricultural component of the country's Vision 2025 and PRSP are the 2001 Agricultural Sector Development Strategy (ASDS) and the associated implementation framework, the Agricultural Sector Development Programme, whose estimated total cost is about \$600 million. The ASDS aims to create a policy environment favourable for increasing private investment in agriculture and agribusiness, and raising productivity and competitiveness. Other relevant policies for agriculture and agribusiness development include the Rural Development Strategy (RDS), which provides a framework for integrating and co-ordinating rural-based initiatives covering on/off-farm activities, social services and economic infrastructure.

Despite the stated goal of promoting agricultural exports, there is currently no particular documented sector export strategy. This is supposedly included in the national trade policy and ensuing strategies. The Diagnostic Trade Integration Study (DTIS), conducted jointly by the government and the donor community within the Integrated Framework, provides the basis for addressing the main obstacles to trade and private sector development, including in agriculture (Box 3.4)²⁸.

Box 3.4. Diagnosis of Bottlenecks to Agricultural Export Development in Tanzania

Major bottlenecks to agricultural export development identified by various analyses include:

- predominance of traditional smallholder agriculture and over-reliance on production of and trading in primary agricultural commodities with little post-harvest processing, quality enhancement, and underdeveloped packaging technologies;
- inadequate efforts to attract innovative commercial agricultural investments: out-grower schemes, contract farming and other vertically integrated (production-processing) value chains;
- serious economic and business environment constraints that prevent financial institutions from extending credit to agriculture;
- lack of land titles, poor linkages with manufacturing sector and inadequately educated population employed in agriculture;
- underdeveloped transport infrastructure and high costs of public utilities;
- underdeveloped market information systems;
- high levels and multiplicity of taxes at local and national government levels;
- wrongly prioritised and irrelevant research, over-emphasis on smallholder agriculture primary production; weak agricultural extension services, focused on the traditional system;
- declining availability of water for agricultural irrigation, especially fresh water needed for specialised production systems, e.g. horticulture.

Source: Review of several diagnostic studies in Temu (2006).

Zambia's Agricultural Potential and Performance

Zambia is experiencing strong growth, thanks to a booming mining sector (OECD-AfDB, 2006). But it is agricultural performance that has been the fundamental determinant of poverty for the majority of households over the last decade (Thurlow and Wobst, 2004). The

country has huge agricultural potential, which is still largely untapped. It has three different agro-ecological zones, whose diversity in terms of rainfall, temperature, soil characteristics and vegetation allows it to produce a wide range of crops. It has one of the best land and water endowments in Africa, but only 15 per cent of total arable land is cultivated; a similar share of irrigable land is actually irrigated and production is based mainly on rainfall.

Primary agricultural production contributed on average 16 per cent of GDP between 1994 and 2005. Value added from agro-processing industries contributed another 8 per cent. The agricultural sector absorbs about 70 per cent of the labour force and is thus the main source of income and employment for the majority of Zambians. It is estimated that in 2005 agriculture destined for export provided employment to 320 000 smallholders and 143 000 commercial farm workers (Fynn and Haggblade, 2006). Agro-processing industries produce 75 per cent of manufacturing value added. Agriculture is therefore very important to urban employment as well. In addition, because of the substantial rise in agricultural exports since the early 2000s, agriculture is making an increasing contribution to the country's balance of payments.

Compared with its potential, agriculture has clearly under-performed according to variables such as agricultural GDP growth, area cultivated and yields. A combination of policy distortions, the country's land-locked situation and vulnerability to drought has hindered further development and diversification of this sector and its potential for eradicating poverty. During years of booming copper prices the country's strong dependence on mining has led to neglect of agricultural development. The sector is characterised by a dualistic agrarian structure, where a small number of large commercial farms, concentrated near main markets, co-exist with scattered subsistence smallholders and a few small commercial farmers. Development of smallholdings, which could have a considerable impact on eradicating poverty, faces, however, tight constraints regarding access to input and output markets.

The government has implemented substantial reforms since 1992, liberalising prices, curbing subsidies and disengaging from agricultural input provision and crop marketing. These reforms, together with a more stable exchange rate and increased foreign investment, have accelerated agricultural growth, averaging 4.5 per cent per annum during the 1990s, and an expansion in cultivated land area and crop production.

Production: food crops, traditional and non-traditional export crops

Zambia's agriculture is dominated by maize, the nation's staple food, which before the early 1990s accounted for over 60 per cent of total agricultural production. This dominance was due to a series of state interventions that supported the growing of maize over other crops. The liberalisation of agriculture in the early 1990s removed some of these interventions and a more diversified agriculture developed. By the end of the 1990s, maize accounted for 44 per cent of total production while more traditional crops, particularly cassava and other tubers, took an increased share.

Agriculture mainly consists of small-scale farmers, who often engage only in subsistence production. The Ministry of Agriculture's post-harvest survey in 2000 estimated that some 830 000 households were dependent on agriculture. Of these, some 200 000 were classified as very poor, with no food security and not commercially viable. Of the remaining 630 000, about half were potentially viable and some were able to sell some of their produce in years when rainfall was good; the other half were formal, small-scale farmers, usually growing for the domestic market or participating in out-grower schemes (Pinder and Wood, 2003).

Although copper remains the largest foreign exchange earner, agriculture has proved the most dynamic component of Zambia's export economy over the past decade and the main driver of export diversification (Fynn and Haggblade, 2006). Its share of total export rose from less than 5 per cent in the 1970s to about 20 per cent in the early 2000s. The sector has witnessed a significant expansion in production of cotton, tobacco, spices, coffee, dairy products, honey, fruit and vegetables and cut flowers. Agricultural exports amounted to \$277 million in 2005 — almost double their 2000 level — making up the bulk of non-traditional exports.

The expansion of export crops was at first driven by foreign-exchange scarcity under the exchange control system in existence before 1990. The foreign-exchange retention scheme whereby exporters could keep 50 per cent of the foreign exchange they earned provided an incentive for farmers who wanted to access foreign exchange to start growing export crops. After the reforms of the early 1990s, the rise in the production of these crops continued, as policies became more supportive for exports. Contract farming has been the most important way for small-scale farmers to participate in this growth (Box 3.5). In the case of cotton alone, there are an estimated 200 000 small farmers who are farming under contract to the three main ginneries in the Eastern, Southern and Central provinces. This is equivalent to 25 per cent of the estimated number of small-scale farmers.

Box 3.5. Contract Farming Schemes in Zambia

Faced with credit shortages and insufficient expertise, farmers have few incentives to engage in cash crop production and commercial farming. On their side, providers of commercial services refrain from engaging with smallholders, given the high transaction costs involved and the risks of opportunistic behaviour. Agribusiness companies have developed their own schemes to provide credit, inputs and extension services in order to ensure a reliable supply of produce for processing, such as out-grower schemes.

It is estimated that some 250 000 Zambian small farmers are currently engaged in out-grower/contract farming schemes. Such interlocking arrangements have been developed mainly in the cotton sector, where two large players provide inputs and services on credit to farmers and guarantee to buy their output. Given the large investments undertaken in processing plants, these companies need to achieve high utilisation capacity. Similar schemes have been developed, though on a much smaller scale, in the spice (paprika), horticulture and tobacco sectors. While in the cotton sector the two foreign-owned processors entirely finance their schemes using their own resources and bank credit, the smaller schemes rely heavily on government or donor funding and on NGOs, such as the Co-operative League of the United States (CLUSA), for implementation.

Interlocking arrangements in developing countries have experienced mixed results, mainly because of weak contract enforcement and high loan default rates (Kirsten and Sartorius, 2002; Poulton *et al.*, 2006). The Zambian experience confirms these findings but also shows that effective schemes can be devised. Problems with side-selling and credit defaults with contracted growers led Lonhro, the major cotton firm in Zambia, to sell its business to Dunavant. Under the new company, the rate of loan recovery improved significantly, mainly following the introduction of the so-called Distributors System. Distributors are cotton growers themselves, living close to the contracted farmers, and not company employees. The company provides them with training and inputs, and they make their own decisions regarding which and how many farmers to work with (generally about 80). They supply inputs to farmers, collect the crop and store it on behalf of Dunavant. The distributor does not have a fixed salary. Remuneration is tied to the level of cotton collected and credit recovery and the commission increases if the loan recovery rate exceeds 90 per cent.

Other out-grower schemes have been less successful. In the paprika sector, for instance, the recovery rate on seed advances is slightly higher than 50 per cent, owing to widespread opportunistic side-selling.

Source: IFAD (2003), Kirsten and Sartorius (2002) and Chiwele (2006).

Following privatisation and an initial phase of adjustment, cotton production has grown by about 15 per cent each year since 1999. The sector has benefited from the establishment of foreign companies having downstream linkages to clothing producers in South Africa, that in turn benefit from preferential market access to the United States under AGOA (Tschirley *et al.*, 2003). Tobacco production and exports have also expanded, mainly thanks to a large influx of Zimbabwean farmers, who have brought with them expertise, capital and contacts with buyers. Vegetable producers have benefited from the close relationship with large agro-processing exporters, but also from the advent of modern retailing. Livestock and dairy products have also emerged as important sectors, both benefiting from South Africa's foreign direct investment (FDI) and close relationship with supermarkets. The South African supermarket chain Shoprite Checkers has offered a market for vegetables, meat and dairy products and contributed to raising the quality standards and continuity of supply. As a result of these collaborative efforts, quality has improved and even obtained export grade. Since 2006, Zambeef, the largest agribusiness company in Zambia, has been exporting meat to Nigeria²⁹.

The horticulture and cut flower sector experienced remarkable export growth, although it remains small when compared to other African competitors such as Kenya and Ethiopia. The sector has mainly developed through contract farming schemes. Producers, grouped in the Zambia Export Growers Association (ZEGA), are located in the area around Lusaka airport, to exploit nearby storage and transport facilities. Following the bankruptcy in 2004 of the major exporter, Agriflora Zambia, which had set up a modern logistic chain and contracted numerous out-growers for production of vegetables and cut flowers, producers face increasing difficulties in meeting the sufficient volume required for profitable cargo flight shipment. Two main actors now dominate the sector: York Farms and Chalimbana Fresh Produce, whose primary customers are UK importers³⁰. The two companies have recently obtained permission from the US administration to export baby corn and baby carrots into the United States.

Despite considerable progress, the agricultural sector remains vulnerable, growth is volatile and a large majority of rural households have only marginally taken part in it. Commercial agriculture is limited, while food security continues to be a problem. It is estimated that about 40 per cent of rural households are engaged *solely* in subsistence agriculture, characterised by low labour and land productivity.

Structural obstacles increase farmers' vulnerability and retard agricultural intensification, maintaining overall agricultural growth below its potential. These obstacles include the inadequate reach of infrastructure and irrigation, the high incidence of disease among livestock, which reduces farmers' endowments and productivity, and the lack of credit and extension services. Low educational attainments and high HIV/AIDS infection rates diminish labour productivity. Insufficient research on new seed varieties that are better suited to local conditions is also a major constraint.

Governance and contract enforcement are additional serious problems. First, government provision of subsidised fertilisers to smallholders does not seem to improve the viability of the targeted group, while it creates distortions in the market. Second, because of a high perceived risk and high rates of non-repayment of loans, private providers refrain from extending inputs on credit terms to farmers. High credit defaults and poor contract enforcement reduce debtors' discipline and undermine the viability of out-growers' schemes, since contracted farmers often engage in side-selling with "pirate buyers".

National priorities

The Zambian government attaches high priority to the diversification of the economy, and the development of agriculture and agribusiness in particular. The cost of dependence on mining became dramatically evident when copper prices and export earnings started to decline in the 1990s, reducing overall real GDP growth to negative in 1998. The Fifth National Development Plan (2006-10), the country's second-generation PRSP, considers agriculture as "critical in poverty reduction and economic development of the Zambian economy and [...] the engine of growth for the next decade and beyond."

The 1996-2001 Agricultural Sector Investment Programme (ASIP) represented the first attempt to co-ordinate government and donors around a wide-ranging agricultural development programme. A major objective of this \$350 million programme was to improve the domestic input supply and marketing of products and promote a greater involvement of the private sector. ASIP fell short of original expectations and has been considered largely unsuccessful. The programme's overall objective was "too broad, ambitious, and complex for a four-year program[me]", while the macroeconomic and institutional context was inappropriate for implementing a sector-wide approach, and resources and capacity constraints within the Ministry of Agriculture had not been properly taken into account (Chiwele, 2006).

The Agriculture Commercialisation Programme (ACP) 2002-05 replaced ASIP and aimed to mobilise domestic investment and attract FDI to large-scale commercial farming and agro-processing to foster exports, while developing backward linkages to smallholders through out-grower and other contract farming schemes. In contrast to the ASIP, the ACP had a much lighter structure, outlining objectives and broad areas of intervention, but without specifying detailed programmes and activities. The Programme came to an end in 2005, but, according to local stakeholders, it never really took off. Market participants complained that no consultations took place in the design phase. The recently approved Agricultural Market Development Plan and the Private Sector Development Action Plan should provide a new coherent framework for developing a functioning private sector-led agricultural market system in Zambia.

Conclusions

Agriculture plays a key role in Africa's development. The rapid growth of domestic and external demand, the globalisation of food markets and the likely liberalisation of world trade open up new opportunities for expanding agricultural production and exports, but major obstacles remain.

In Africa, the sheer numbers of the poor living in rural areas imply that improving agricultural productivity and promoting private sector development are key to the region's overall growth performance and meeting the Millennium Development Goals (MDGs). Many African countries have a significant, unexploited agricultural potential. The agribusiness sector, although still at an early stage of development, is often cited as one of the few African success stories. Strong demographic growth and urbanisation will significantly increase the domestic and regional demand for agro-food products. Moreover, the rapidly expanding markets of China, India and other middle-income countries, and the prospects of further multilateral trade liberalisation create a notable opportunity for agricultural exporters from

developing countries, including in Africa. Tapping these new opportunities would require a sustained expansion and diversification of the African production base and dramatic improvements in the whole agricultural value chain.

However, major supply-side constraints contribute to a sluggish productivity growth and hold back the transformation of African agriculture into a more productive, diversified and internationally competitive sector. External factors, such as persisting trade distortions, complex rules and standards and heightened competition, aggravate the domestic constraints that lower the competitiveness of the export-oriented sector.

If African countries, especially the least developed ones, are to exploit fully the emerging opportunities, including those arising from further trade liberalisation, then their national policy response will have to include the modernisation of agriculture and the strengthening of productive and trade capacities. More concretely, these countries will have to tackle, in a comprehensive manner, several trade and development objectives. The evidence reviewed in this chapter points to three major conclusions:

1) The viability of traditional smallholder farming is problematic. A change in perspective is needed to promote commercial and larger-scale agriculture and the development of rural non-farm activities. To this end, governments and their development partners should put more emphasis on strengthening firms' productive capacities and filling the institutional vacuum left by the dismantling of marketing boards and parastatals, through measures including innovative public-private partnerships.

Despite its capacity to adjust, traditional smallholder farming is coming under strong pressure and its capacity to provide sustainable livelihood opportunities is increasingly called into question. Productivity growth is inadequate and the sector cannot absorb in a sustainable fashion a rapidly growing labour force. The experiences of Tanzania and Zambia confirm that their agricultural potential is held back by the prevalence of traditional, subsistence agriculture and the small size of producers, which expose them to greater vulnerability and reduce the scope for connecting to the agricultural value chain and achieving economies of scale. Farmers and agro-enterprises suffer from severe weaknesses in terms of capitalisation, technology, logistics, quality control and management of production and markets risks.

African governments, often with donor support, have implemented a wide range of reforms affecting the agricultural sector and increasingly emphasise the need to promote private sector development, including in agriculture and agribusiness. Reforms implemented in the last 15 years have contributed to removing some of the major distortions, but the supply side response, both in food and cash crops, has been unsatisfactory. Reforms have not induced strong investment towards the sector, nor spurred the emergence of private sector suppliers to fill the vacuum left by marketing boards and parastatals. Factor and products markets remain underdeveloped or do not work efficiently. The predominance of very small and scattered farming implies high unit transaction costs and risks for input suppliers and for buyers and processors. Meanwhile, smallholder farming will remain an important reality in many, if not most, African countries (Toulmin and Guèye, 2003). Actions are therefore needed to reduce the vulnerability of family farms and promote their access to extension services and training, fertilisers and credit. Interlocking arrangements with larger farms and processors can be instrumental to sustain their transformation and growth, so as to fill the "missing middle" between micro and larger farms. Networking of producers' associations, agribusiness firms and public actors, both at the central and local level, is important to promote exchanges, capitalise on results and favour the circulation of promising experiences (SWAC, 2005).

2) Public and privately enacted standards are raising the bar for entry into the agro-food value chain, putting an additional burden on the weak capacities of public agencies and firms in implementing quality control. Meanwhile, retailers and processors can be instrumental in linking up small farmers to markets and upgrading their capacities. Creating alliances in the country will help to identify and tackle bottlenecks along the value chain, and allow experimentation.

The changing governance structure of agro-food markets imposes more stringent entry conditions for producers. The situation is of particular concern for Africa, since in most countries quality control and testing are underdeveloped. The difficulties encountered by many African exporters in obtaining certification for exporting to the EU and US markets under the EBA (Everything-But-Arms) and AGOA (African Growth and Opportunity Act) initiatives bear testimony to this fact.

There are several examples of successful African producers that have managed to enter into the fresh fruit and vegetable or the cut flower value chains, including in Tanzania and Zambia. Retailers and processors have often played an important supportive role. For instance, interlocking arrangements such as the out-growers schemes adopted by large horticulture exporters have proved successful in integrating small producers into the export-oriented agro-food chain. The case of the Zambia meat industry highlighted how close relationships between producers and retailers can be instrumental to upgrading and even internationalisation. Engaging lead firms in the value chain in the design of PSD policies can significantly improve their effectiveness.

Promising as they might be, these examples are still quite an exception. In fact, interlocking arrangements in developing countries have experienced mixed results, yielding some successes and many failures (Kirsten and Sartorius, 2002). Co-ordination and free-riding problems can severely undermine the success of these schemes, which seem to work better in commodity chains characterised by high downstream investments. This is because they provide an incentive for buyers and processors to assist suppliers, as a limited number of buyers facilitate horizontal co-ordination and reduce the scope for side-selling/side-buying. As the Distributors System in Zambia shows, appropriate mechanisms to improve monitoring and co-ordination and reduce the incentives to deviate must then be devised.

3) Promoting agricultural diversification, processing and export growth requires action beyond agriculture. There are serious shortcomings in the overall business environment that must be tackled, while macroeconomic stability remains a fundamental precondition for conducting business and promoting diversification into non-traditional activities. Value chain analysis can be a useful tool for identifying those problems and devise corrective measures.

As argued by De Laiglesia (2006), the lack of dynamism of many agricultural markets in Africa “can be traced to institutional causes, especially the failure of the formal contract enforcement edifice and of governance structures”. The design of agricultural reforms must then take into account these fundamental institutional bottlenecks, including social institutions or culture, which — although difficult to measure — might “distort incentives and constrain the choice set of individuals”. As the two countries’ experiences show, obstacles to agro-base private sector development often lie outside the agricultural sector itself and cut across several policy domains. Investment into non-traditional activities is risky and entrepreneurs need a transparent legal framework and a stable economic environment to plan their investment. Weak contract enforcement and a culture of loan non-repayment are major hindrances to the development of contract farming in Tanzania and Zambia and reduce

the incentives for financial institutions, buyers and processors to engage with small farmers³¹. Excessive government borrowing may crowd out lending to the private sector and raise the cost of capital. High exchange rate volatility can discourage investment in the tradable sector, especially when sunk costs are involved. The rapid real exchange-rate appreciation of the Zambian currency in late 2005 reduced the Kwacha value of agricultural exports by 30 per cent, forcing reductions in farm-gate prices and eroding exporter profit margins (Fynn and Haggblade, 2006)³². Although the appreciation turned out to be only transitory, and agricultural exports performed well in the first part of 2006, there remain fears that the gains made in raising non-traditional agricultural exports may be jeopardised by swings in the exchange rate, especially for products that have a high domestic input content paid in local currency.

Achieving these objectives is a tall order, especially in light of the already limited institutional and financial resources available to most governments. It therefore becomes important to mobilise efficiently additional resources, including those coming from donor financing and the domestic and international private sector, and achieve regional synergies.

Donors already fund a wide array of projects in agriculture and agri-business and increasingly put emphasis on the need to promote private sector development. The international aid effectiveness agenda highlights the importance of aligning donor activities to the recipient country's priorities and of improving co-ordination among donors, to minimise duplications and reduce the administrative burden on the local administration. In this respect, various aid modalities have been devised, including sector-wide programmes. Their implementation with respect to agriculture, trade and private sector development remains quite challenging. Competencies are dispersed amongst several ministries and interventions necessarily cut across several sectors and areas of donor interventions (i.e. rural development, private sector development and trade) where areas' synergies can be realised. Therefore, value chain analysis and consultation with private sector stakeholders can be a useful instrument to improve effectiveness and sustainability of interventions (Chiwele, 2006; Temu, 2006).

Regional markets already represent an important outlet for many agricultural producers in Africa. Many analysts suggest that intra-regional trade is below potential, as a result of infrastructure bottlenecks and regulatory differences. As shown in Abdulai *et al.* (2005), regional co-operation in agricultural R&D, harmonisation of regulatory standards and liberalisation of trade systems in both input and output markets, could play a crucial role in expanding opportunities for farmers and firms across the continent and potentially generate large growth spillovers and enhance regional take-off. More attention should then be given by African policy makers and their development partners to removing obstacles and promoting cross-border co-operation and investment, including through the reinforcement of regional institutions.

Notes

1. Agricultural activity refers to all primary production of food (crops and crop products, animals and animal products), flowers and fibres. Forestry and fishing are generally treated separately in the national accounts. The RNFE includes all those income-generating activities that are not agricultural but are located in rural areas, including other non-agricultural primary sectors (e.g. mining or quarrying) and secondary and tertiary activities located in rural areas, including food processing and agricultural services (Davis and Bezemer, 2004). Agribusiness refers to a wide spectrum of enterprises and activities, ranging from post-harvest handling, processing, transportation, marketing, distribution and other agro-based commercial activities. Although they entertain close relationships with farmers and often provide material inputs to the farming sector, agro-enterprises seldom directly engage in primary production.
2. According to the FAO, food insecurity is a situation that exists when people do not have adequate physical, social and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life.
3. Africa has a total land mass of about 30.7 million square km. Prime land accounts for about 9.6 per cent of the total and land with high potential for about 6.7 per cent. The medium and low potential lands, which together occupy 28.3 per cent of the area, present major constraints for low-input agriculture. The remaining 55 per cent of the land consists of deserts or other terrains which are considered to be fragile, highly erodible and in general are not productive, since they would require very high investments for any kind of agriculture. Problems with land tenure rights, lack of access to credit and farmers' myopic behaviour can in fact reduce the incentive for producers to improve soil management and invest in soil preservation (Eswaran, *et al.*, 1997).
4. These authors find that every 1 per cent increase in agricultural yields would reduce the number of people living under \$1 per day by over 6 million, with 95 per cent of this reduction taking place in Africa and Asia. As they put it: "Africa's potential for agriculture-led poverty reduction is far greater than in Latin America, where inequality in the distribution of incomes and land is likely to prevent poverty reduction by means of agricultural productivity growth" (p. 16).
5. It is important to stress that the impact of productivity growth on poverty crucially depends on other factors such as education and land distribution. First, improved literacy is needed for R&D investments and new production techniques to translate into higher agricultural productivity. Second, enhanced productivity alone may not be sufficient to make a dent in poverty if it worsens income inequality. Therefore, access to education and land resources plays a key role in determining the poverty impact of (agricultural) growth.
6. "Agricultural intensification" refers to practices that increase productivity per unit land area. It takes many specific forms, such as irrigation, fertilisation, use of draught animals or machinery to till soil.
7. Reardon and Barrett (2000) identify three related sets of changes in the process of agro-industrialisation: *i*) the development of "agro-industrial firms" undertaking agro-processing, distribution and farm-input provision activities "off-farm"; *ii*) institutional and organisational changes in the relationships between these firms and farms, such as increasing vertical co-ordination; and *iii*) changes in product composition, technology and market structures in the farm sector itself.
8. Jaffee (1999) provides a thorough analysis of the agribusiness sector in Southern Africa based on the findings of a survey of companies in South Africa, Zimbabwe, Malawi, Zambia, Mozambique and Swaziland. The majority of surveyed firms are medium to large in size, with more than 100 employees. FAO (2004a) reviews some successful African agro-enterprises in Ghana, Nigeria, Kenya, Uganda and South Africa.

9. The phenomenal boost given by the economic ascendancy of China and India to world demand and prices for primary commodities, although providing African countries with an export bonanza, may induce further specialisation in raw materials and push back these countries into the “commodity corner” (see Goldstein *et al.*, 2006). See Focus 5 in this volume on the determinants of export diversification, including the role of factor endowments and policies, and Bonaglia and Fukasaku (2003) for a critical assessment of Africa’s export structure.
10. Although relative endowments are crucial in developing a country’s comparative advantage and export structure, the latter should not be considered as destiny. First, the relative composition of production factor can change — at least in the medium to long term — reflecting investments (e.g. in education and R&D). Moreover, systematic evidence suggests that a country’s export structure and long-term development are influenced also by other factors such as the quality of institutions and policies (Lederman and Maloney, 2002). By improving the latter, especially to minimise the potentially negative consequences of commodity dependence, government can promote diversification.
11. Various factors explain the emergence of developing countries as leading agricultural producers. On the supply side, they include sustained productivity gains and the expansion of area under cultivation. On the demand side, population and income growth, coupled with urbanisation and dietary diversification, are the key drivers.
12. Anderson and Martin (2005) estimate that, even after considering preferences, developing-country exporters face an average tariff of 16 per cent for agriculture and food products, compared with 9 per cent for textiles and clothing and 3 per cent for other manufactured products.
13. The global annual welfare gains from further multilateral trade liberalisation, involving both tariff reduction and trade facilitation, would be substantial. Recent OECD estimates suggest that, depending on the precise scenario, they would range between \$126 billion and \$162 billion (OECD, 2006*b*). The largest gain would come from agricultural liberalisation.
14. Currently 42 African countries are eligible for special treatment for their food vulnerability. They include the 34 African LDCs and eight non-LDCs included in the WTO list of Net Food-Importing Developing Countries.
15. When reduction in domestic transaction costs are factored into the simulation model (e.g. reduction in transport costs and better trade facilitation), gains from liberalisation increase substantially (see OECD, 2006*b*).
16. Among others: Gibbon (2003) on coffee and cotton; Ponte (2002) on tropical beverages; Kaplan and Kaplinsky (1998) on canned deciduous fruits; Dolan and Humphrey (2000) on fresh fruit and vegetables; Guillotreau and Le Grel (2001) on aquatic products.
17. Standards address a wide range of issues, such as labour conditions, health and safety norms, quality management procedures, environmental and social concerns.
18. For instance, Nouve and Staatz (2003) find inconclusive results regarding the impact of AGOA (African Growth and Opportunity Act) on African agricultural trade.
19. Supply-side constraints refer to shortcomings plaguing the production process which reduce overall efficiency and a firm’s ability to adjust to changing market conditions and incentives, as well as to cope with climatic and economic shocks. They primarily concern factors internal to the firm, such as capital, managerial and production skills and technology. Other elements external to the firm can add to these firm-specific problems. These external elements refer to infrastructure bottlenecks, elements of the business climate and market supporting institutions (e.g. export promotion or SME development agencies), whose role is to promote enterprise competitiveness by facilitating access to information, inputs, testing, certification and technology. On the low capacity of market support institutions in the African see Bonaglia and Fukasaku (2002).
20. See Bates (1981) for a discussion of the agricultural policies in Africa before structural adjustment, with particular reference to the marketing board system. Friis-Hansen (2000) questions the impact of structural adjustment on agriculture in Africa, pointing to its inability to resolve fundamental institutional shortcomings, namely the absence of well functioning markets, and to the failure of the private sector to take over a number of productive services and functions from the abandoned state

organisations. Reardon *et al.* (1999) discuss the limitations of reforms in stimulating farmers' incentives and capacity to pursue sustainable agriculture intensification. Kherallah *et al.* (2000) discuss the pace and extent of agricultural market reforms in sub-Saharan Africa and show that, for the most part, reforms were not fully implemented.

21. Microfinance institutions could in principle try to meet the untapped demand for credit of cottage and micro-enterprises, which are cut off from formal financial markets. However, regulatory restrictions on the scope of their operations and capacity constraints prevent them from closing the financing gap.
22. See Causa and Cohen (2006) for a statistical analysis of the crippling effect of infrastructure bottlenecks on private sector development.
23. Logistics is the process for efficient planning, operation and control of the movement and the storage of raw materials, intermediate goods and finished products as well as related information.
24. See Longo and Sekkat (2004) on the obstacles to expanding intra-African trade. Abdulai *et al.* (2005) also discuss how trade barriers and infrastructure bottlenecks reduce the potential for regional spillovers in African agriculture.
25. Similar exercises on the impact of non-tariff barriers and SPS on intra-developing country trade are severely constrained by the dearth of information. See Fliess and Lejarraga (2005) for a review.
26. This section draws on two case studies prepared for an OECD Development Centre project on aid for trade and agro-base private sector development. Chiwele (2006) and Temu (2006) review the main obstacles to further developing commercial agriculture and agribusiness in Zambia and Tanzania respectively, and discuss ways in which donor-supported programmes for agro-based private sector development can help and be improved.
27. Since agriculture is still, to a large extent, dependent on unpaid family labour, particularly that of women and children who perform about 70 per cent of all labour in the agricultural sector, the fall in traditional export crops prices impacted on farming-gender dynamics. With the fall in prices of export crops, men are now attracted to and are engaging fiercely in commercial food crops business, trading in crops such as maize and beans, which were traditionally a women's domain.
28. The Integrated Framework for Trade-Related Technical Assistance (www.integratedframework.org) is a multi-agency, multi-donor programme that assists the least developed countries to expand their participation in the global economy.
29. In 1996, Shoprite entered into a partnership agreement with Zambeef for procuring meat, milk and poultry products and assisted the company in improving its sanitary standards. As a result, Zambeef managed to upgrade the quality of its meat, receiving international certification. In December 2005, Shoprite expanded into the Nigerian market and asked Zambeef to join in this venture by taking the franchise on their butcheries. Zambeef set up a 90 per cent subsidiary in Nigeria called Master Meats & Agro Production Company of Nigeria and started exporting meat from Zambia.
30. The UK Plantation & General Investments PLC bought agricultural properties and related assets from Agriflora Ltd, and created Chalimbana Fresh Produce to grow, process and pack vegetables for export to leading UK food retailers. Agriflora rose production assets were transferred to the group's Zambian subsidiary, Khal Amazi Ltd, which already exported cut roses to Europe.
31. In a review of contract farming in Africa, IFAD (2003) documents a unique case of input provided on credit terms without interlocking agreements. Although the company selected farmers with a 100 per cent repayment history within the government fertiliser scheme, it suffered from severe credit losses, owing to a deeply rooted non-repayment attitude nurtured by years of receiving no sanctions from the government in the event of default. See also Poulton *et al.* (2006).
32. A major reversal in the exchange-rate market took place in 2005, which was due to sizeable inflows of foreign currency associated with booming copper exports and substantial scale-up of foreign aid. Cotton ginneries threatened to close their operations since they had signed contracts with growers at the beginning of the season on the basis of much weaker Kwacha rates. Agricultural exporters complained that they would not benefit from the parallel reduction in import prices since they mainly employed locally sourced inputs (labour).

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Focus 6

Institutional Bottlenecks for Agricultural Development in Africa

The poor performance of African agriculture can be attributed not only to a difficult natural endowment and a history of extractive policies, but also to fundamental institutional bottlenecks. In fact, Africa's difficult natural endowment, while crucial, is not a sufficient explanation for performance. Indeed it fails to explain many intra-regional differences in agricultural development. It is also true that African agriculture has been subjected to centuries of extraction and taxation policies. However, it is important to concentrate on what has determined those policies, as well as the response (or lack thereof) of private agents to such policies. Bottlenecks created by the institutions that govern or impact upon sub-Saharan Africa's agricultural development play an important role, but are often overlooked.

Institutions are the rules and constraints that shape economic interaction (North, 1990). They determine, along with scarcity and technology, the opportunity set of an individual or an organisation as well as the incentives they face. They include formal laws and rules and their enforcement mechanisms, but also customs, informal norms and traditions.

It is widely acknowledged that “institutions matter” for economic development. Indeed, structural adjustment policies entailed substantial institutional change, but they concentrated too narrowly on market mechanisms. Market reforms suffered from the absence of market-specific rules, such as established grades and quality standards. But institutional frameworks conducive to the creation of dynamic agricultural markets also require deeper reforms that provide an accessible, trustworthy means of property protection and contract enforcement — to enable farmers and traders to go beyond the cash-in-hand “flea-market economy”— and political institutions which allow farmers to organise themselves to address local problems collectively and which give them a voice in the policy formulation process.

Institutional Outcomes Affecting Agricultural Development

DeLaiglesia (2006) carries out an analysis of the institutional determinants of agricultural development. The focus is on drawing a picture of institutional characteristics and outcomes in order to determine which institutions act as bottlenecks in the process of agricultural development in sub-Saharan Africa today. The institutional outcomes of interest include the enforcement of property rights and entitlement, the organisation and contractual governance of production, the accumulation and dissemination of technological knowledge and the organisation of exchange and allocation of output.

Effective property and contracting rights determine the opportunity set of the individual in terms of access to inputs — land, finance and knowledge. Property rights institutions govern the security of land tenure as well as the transferability of assets and the access to communal assets and natural resources. Institutional outcomes in the form of effective property rights are therefore not only crucial for the efficient use of productive assets but also for the dynamic efficiency of their allocation. Contracting rights and contract enforcement determine the modes of interaction that are available to agents. Effective means to enforce contracts, be they formal, written contracts or oral agreements, is a necessary condition for individuals to engage in such relationships. The definition of those rights is fundamentally the result of a set of slow-moving institutions, including social use and transfer rights allocation rules, as well as the formal legal property definition and administration edifice. However, their effective enforcement relies on legal and judicial rules over which governments are expected to have authoritative power. Without formal rule of law, enforcement happens via social coercion or social pressure.

Contractual and organisational governance determines the distribution of decision power in economic relations. Hence, they alter individual incentives for producers, politicians and bureaucrats. When contracts and norms are incomplete, governance structures are necessary to allocate decision power. Specifically, governance determines the means farmers have of accessing both markets and public organisations, including for example extension services. It also determines their participation and weight in political processes that determine agricultural policy and the availability of key public good inputs, such as infrastructure and research.

Two other institutional outcomes are of interest. Technological progress and dissemination determine the available technology and the amount of information the farmer has about each method of production. They are the result of various institutions that allow communication, including organised research and extension systems. Finally, the prevalent organisation of exchange and allocation of goods determines marketing opportunities and prices or terms of trade faced by farmers.

Specific institutions can impede development in three different ways. First, institutions that are ineffective in generating a specific outcome will result in negative institutional outcomes that can lead to adverse incentives or reduced opportunity sets. Second, institutions that are not adapted to the overall institutional framework can fail to generate the desired outcome despite not being inherently perverse. For example, regulations or laws that go against social norms may not be accepted by the population and thereby not only fail to be enforced but also decrease the confidence of the population in the regulatory or legal body. Finally, some institutions create dynamic inefficiency by preventing the emergence of potentially more efficient arrangements. This includes situations where norms create specific vested interests but also situations where externalities or the concentration of power make collective action more difficult by decreasing its perceived benefits or by increasing its perceived costs respectively.

Contract Enforcement: Courts and Alternative Enforcement Mechanisms

A weak contracting environment is often referred to, along with weak and blurred property rights, as one of the most constraining institutional bottlenecks to agricultural development in Africa (Jayne *et al.*, 1997; Kherallah *et al.*, 2002; Fafchamps, 2004). Farmers' and traders' responses to the weak contracting environment are two-fold: they rely on

marketing practices that limit their exposure to contract risk and they rely on alternative forms of contracting and contract enforcement. The bottom line is that the lack of contract enforcement makes farmers and traders less likely to trade in the anonymous market and limits gains from trade.

Reliance on relationship contracting and lending leads to cash-in-hand exchanges that reduce incentives to invest in specialised production (Jayne *et al.*, 1997). The uncertainty about contract compliance also limits vertical co-ordination. In a context where input and credit supply formerly carried out by the state has disappeared or is being taken up by private traders, the lack of security given by thin markets and the possibility of opportunistic behaviour limit the amount of co-ordination that can be achieved through contracts. This situation severely undermines the development of interlinked input-output contracts, such as contract farming, that could be instrumental in reducing market uncertainty, favouring technology diffusion and the deepening of input markets.

The available evidence points not only to little use of courts by smaller agricultural traders but also, more surprisingly, to the fact that owing to cultural norms, courts are seldom used even as a threat to avoid opportunistic behaviour. The existing literature finds African legal institutions to be largely inefficient. This is due not only to the specific arrangements and procedures within the judiciary, but also to the public having little knowledge and confidence in the legal system (Fafchamps, 2004). Moreover, the absence of instances of recourse to formal judiciary in cases of contractual breach is in marked contrast with the recourse to the police in cases of theft. Hence it is not only a matter of distrust or lack of capacity of the state. Fafchamps (2004, Chapter 6) interprets that “contractual obligations are largely seen as outside the purview of the law — with the possible exception of non-payment”. Within a legal culture deeply influenced by social norms, the judiciary is seen as too antagonistic an institution and recourse to courts would harm or destroy the relationship, the possibility of which is seen as too costly.

In the face of failing or otherwise irrelevant formal contract enforcement mechanisms, agents limit their exposure to contract risk and seek alternative forms of contract enforcement. In a study of agricultural traders in Malawi, Benin and Madagascar, Fafchamps (2004) finds that traders engage in marketing practices that limit their exposure to contractual breach: they operate in a cash-based society, inspect personally the quality of deliveries and are reluctant to hire employees owing to lack of trust. Such practices generate substantial transaction costs.

Contractual relationships nevertheless exist. The ineffective formal contract enforcement edifice leaves contracts to be enforced via social or business networks through long-term relationships. Farmers and traders seek other forms of contract enforcement, especially repeated interaction — or “relationship contracting” — via social networks, where the value of long-term relationships and social or business networks prevent opportunistic behaviour. Relationship-based mechanisms are effective, but may not be efficient, especially in the absence of sufficient information transmission, because they limit the set of potential trading partners, incur significant transactions costs and create hold-up situations. Producers and traders alternatively can rely on traditional authority to resolve contract disputes. Such approaches have the major drawback of offering very unequal levels of protection to different sectors of society, and are especially unfavourable to women and non-“indigenous” people (Francis, 2002), hence limiting their access to contract-based livelihood strategies (such as contract farming). More importantly, both alternatives limit the size of the potential pool of trading partners, hence limiting the scope for specialisation and the realisation of economies of scale.

Enforcing contracts through relationships not only limits the scope of trading, it also generates important transaction costs and curtails economic relationships. First of all, it limits the size of contracts, especially in an initial phase while the relationship is being built up and information is collected. Secondly, it can limit the type of contracts that are signed, favouring mutual exchange over forward contracts for example. Similarly to social networks, once the relationship has been built up and has acquired value for the parties, enforcement via termination may not be credible and contracts are *de facto* renegotiable. This gives rise to greater contract flexibility, which, while desirable in a high-risk environment, also reduces what can be contracted upon.

The conjunction of imperfect property rights and insufficient contract enforcement also limits severely the scope for financial services to be taken on by private actors (Kherallah *et al.*, 2002). Indeed, the contractual characteristics that emerge from our analysis — social enforcement, spot markets, relatively limited information transmission — do not appear to be conducive to financial intermediation.

Conclusions and Options for Reform

Slow-moving institutions, such as social institutions or culture, permeate and influence most economic transactions, sometimes distorting incentives and often constraining the choice set of individuals. The lack of dynamism of many agricultural markets and private sectors in African agriculture can be traced to institutional causes, especially the failings of property rights protection, of the formal contract enforcement edifice and of governance structures.

The prevalence of institutional bottlenecks presents two challenges for policy making. First, to design policy that can take advantage of the existing institutional environment to achieve its aims while avoiding the identified pitfalls. Second, to undertake institutional reform that not only creates effective institutions but also institutions that are a good fit to the overall environment. Moreover, agricultural reform must take into account the broad institutional setup that constrains individual and organisation's choice and how these institutions, formal and informal, affect those outcomes that can trigger or hamper agricultural development. It must also acknowledge that market institutions evolve gradually and determine which must be in place before reform is attempted and which can be expected to develop with agricultural change. Sequencing is therefore particularly important in this context.

Contract uncertainty generates major transaction costs. Therefore, contract enforcement institutions are crucial in determining the organisational and governance structures that emerge in an economy. A recurrent theme in the literature is the failure of the system of formal contract and property entitlement enforcement to secure the rights of all citizens. The failure to use courts not only explicitly for dispute settlement but also as threats to prevent opportunistic behaviour can be explained at least in part by the divergence between the institutions of formal law enforcement and social norms, above and beyond the lack of capacity of the judicial system itself.

Contract enforcement reform need not aim at perfect contract enforcement and must recognise that, whatever the state of the judiciary and the law, many firms will continue contracting on a relationship basis. The objective of policy is to add “new” — or previously unused — enforcement mechanisms in order to allow farmers, traders and firms to interact with agents of whom they have no prior knowledge. To the extent that culture is driving the lack of use of courts, the use of mediation and arbitration mechanisms can foster confidence in the formal system. Nevertheless, alternative dispute resolution will have much greater potential when they are backed by a judiciary that is perceived to be just and impartial.

A second policy option is to encourage information transmission, via referral or credit bureaux for example, when private agents do not engage in such arrangements. There is a clear public good component to such institutions that warrants intervention, thereby extending trade and business networks beyond their social origin.

Insufficient provision of infrastructure and other public goods generates major transaction costs and hence limits the benefits of reform policies, as well as the extent of their effects. Insufficient market infrastructure, in the form of grades and standards, the availability of market information and communication infrastructure, tends to segment markets and reduce their allocative efficiency. Such problems can, to some degree, be addressed by farmers themselves, but typically present collective action problems that are difficult to solve in the absence of established institutions, especially political institutions, whether local or national.

Finally, it is important to stress that reform policies that attempt to change a wide set of institutional characteristics and especially reforms that expect the private sector to fill a void left by the withdrawal of the state are inevitably faced with resistance. In many ways this resistance reflects the same institutional constraints that reform aims to overcome. Lack of political responsiveness, lack of formal contract enforcement and insufficient property protection all hinder private sector response.

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Focus 7

Transport Infrastructure in Africa

Although it is key to progress towards the Millennium Development Goals (MDGs), Africa's transport infrastructure today is strikingly weak compared with those in the rest of the world (see Figure 3.1 below). Sub-Saharan Africa accounts for 17 per cent of the population and 7 per cent of the GDP of developing countries, but for only 3 per cent of their rail transport (see Table 3.4). Less than a fifth of its road network is paved, compared to over a quarter in Latin America and over two-fifths in South Asia. The quality of the infrastructure and of its treatment is also of great concern, with paved roads severely affected by systematic axle overloading of trucks and poor drainage or seaport facilities working beyond their capacity limits.

Figure 3.1. Transport Infrastructure and the MDGs

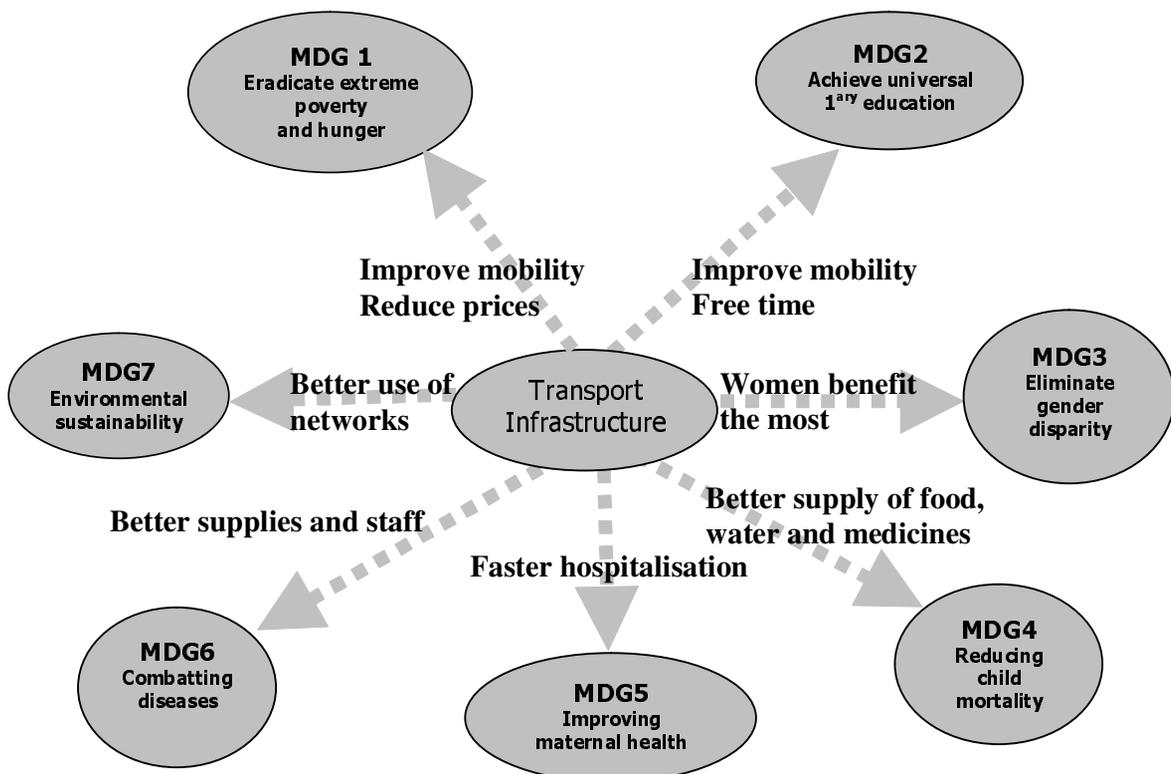


Table 3.4. **Transport in Africa and the Rest of the World**

	Africa	North Africa		Sub-Saharan Africa	
	Developing countries %	World %	Developing countries %	World %	Developing countries %
Population, 2004	20.2	2.3	3.3	11.7	16.9
GDP, 2004	19.7	2	12.4	1.2	7.3
Trade, 2004	6.4	0.9	2.4	1.4	4
Air transport (freight), 2004	1.8	n.a.	n.a.	n.a.	n.a.
Air transport (passengers), 2004	1.9	n.a.	n.a.	n.a.	n.a.
Rail transport, 2003	3.5	0.2	0.3	1.7	3.2
Road transport, 2002	>24.0	n.a.	n.a.	7.6	24
Sea transport, 2004	43.9	10.4	25.5	7.5	18.4

Source: *African Economic Outlook 2005/2006*.

The costs, both human and economic, are huge for African countries. Sub-Saharan Africa reported about 10 per cent of global road deaths in 1999, with only 4 per cent of the registered vehicles. Africa's share of plane accidents accounted for 25 per cent in 2004 for only 4.5 per cent of global air traffic. The few countries that have undertaken estimates of the economic losses due to poor infrastructure, such as Egypt, find striking results: traffic accidents cost up to LE 2 billion (\$365 million) every year in the Greater Cairo region, compared with LE 55 million (\$10 million) allocated yearly to the Cairo traffic authorities. More generally, landlocked sub-Saharan countries have to pay 20 per cent of their trade in transport costs.

Impediments to Transport Development

Geography, demography and lack of resources are all major impediments to transport development in Africa. Fifteen of the continent's 53 countries are landlocked and population densities in the interior are very low, making infrastructure investments and maintenance very expensive. The World Bank estimates that African countries would need to spend the equivalent of 4 per cent of GDP every year for the coming decade, just on roads.

Yet, most African countries largely lack the funds — and also the information and feasibility analysis — to rehabilitate and extend their infrastructure networks. With oil prices at an all-time high level, exporters today have an opportunity to make a difference by investing in this key sector. Algeria, for instance, has planned to invest \$10 billion in transport infrastructure projects between 2005 and 2009. But not all African countries enjoy such an opportunity. And for countries dependent on aid, recent history has not been very supportive of investments in infrastructure.

Throughout the 1990s, official development assistance to Africa mainly overlooked infrastructure in favour of the social sectors. It is only recently that it has regained momentum in the international community, instigated by the September 2005 UN Millennium Plus 5 Summit, the report of the Commission for Africa and the focus put by the NEPAD (New Partnership for Africa's Development) on infrastructure. Meanwhile, though, non-DAC donors, notably China and Arab countries, have greatly increased their involvement in the sector.

Short of money and burdened with inefficient state-owned monopolies, African countries are largely seeking private-sector participation. Investors' perceptions of high risk have generally made full privatisation impractical, leading most private participation towards leases or concessions. Most experiences have been led in the air, sea and rail sectors, rather than roads. However, the results have been mixed.

Private Sector Participation is Becoming Important in Service Provision

The private sector is increasingly important in service provision. This "operating" part is potentially the most profitable and as such can be "unbundled" and easily divested. In the air transport sector, for instance, private involvement is increasing in the management of airfield, gates, jetways, or in the facilities associated with the movement of aircraft, and in "landside" services. In maritime transport, cargo-handling costs have fallen where competition among service providers has been introduced: charges are between \$60-75 per 20ft container in Dakar, Abidjan and Douala, compared with \$200 in Lagos.

In some specific cases where private business stakes are high, the private sector has proved willing to share the risk of investing in the hard infrastructure. This is the case for the toll road built and operated by the private consortium TRAC in the Maputo corridor linking Mozambique and South Africa for the transportation of aluminium. In most cases, however, fixed infrastructure requires large-scale investment that private investors more than often fail to deliver. Several railway concessions have been cancelled owing to wars and natural disasters. But, even in less dramatic cases, the upgrading and extension of networks have continued to be largely funded by multilateral and bilateral loans on concessional terms. In such an example, Cameroon railway was franchised in 1999 to Bolloré and generated a major rehabilitation process, involving 65 billion CFA francs (\$130 million) over 1999-2007, largely supported by the donor community.

Regulatory Reform is a Key to Success

The cases of success and failure all highlight the importance of an efficient regulation to help derive the maximum benefits from private sector participation. An appropriate regulatory environment is crucial to avoid excessive prices and inadequate service, while ensuring optimal access, maintenance and investment. Giving it high priority, some countries, such as Zambia in the road sector, have embarked on extensive reshuffling of their institutional framework. The key factors of success include strong government commitment to ensure the credibility of the reform process; proper sequencing; and the creation of an independent, well-enforced and well-focused regulatory body before divestiture.

The role of government is crucial for setting the appropriate regulatory environment, but also for carrying out infrastructure planning and ensuring coherence with national pro-poor growth strategies and medium-term expenditure frameworks. Only by undertaking thorough, up-front planning, can the authorities maximise the benefits from infrastructure projects while minimising their environmental and social costs. In that respect, attention needs to be paid to the complementarities of different means of transport; the importance of transport hubs and markets; and the development of secondary roads.

In such an initiative, Egypt has undertaken to develop a transport master plan of the Greater Cairo region, looking at all transport means, with the aim of facilitating the mobility of all people (as opposed to vehicles).

Of course, government is not alone in that task. Community participation at all stages has proved helpful in identifying priorities, creating employment and ensuring long-term maintenance. Involving women — who account for two-thirds of the rural transport effort — is also key to aligning transport development with poverty reduction goals.

Finally, careful co-ordination with regional and continental authorities (such as the NEPAD) will enable states to rationalise action on cross-border projects and help raise and pool resources, while offering the countries involved the benefits from larger markets.

Chapter 4

Corporate Governance for Economic Development

Summary

This chapter challenges expressed doubts about whether improving corporate governance should be a priority for countries whose main development priority is to lift large segments of their populations out of poverty — countries where large corporations are often predominantly state-owned, foreign-owned and/or closed family-owned businesses, and large segments of the population often work outside the formal enterprise sector. In fact, the evidence shows that corporate governance is of critical importance, in both low and middle-income developing countries, as the bases of local economic and political power in those countries evolve from the relatively closed and personalised to the more open and democratic.

This chapter seeks to clarify the meaning of corporate governance and identify the people and institutions concerned. It explains why corporate governance matters for a nation's development, not only because it helps raise finance more cheaply but because its absence may hinder productivity growth and restrain long-term development.

The shift from governance based on personalised relationships to one based on rules is examined as are the problems presented by clientelism, weak government and dominant shareholders. The influence of pyramidal structures and vested interests is discussed.

The authors point out that the need on the part of local businesses to attract new funding sources, combined with the pressures of liberalisation and deregulated markets, mean that funding from traditional sources has declined at a time when the need for financing has risen.

The obstacles to improved corporate governance are examined, as are their damaging effects, and the implications for action analysed. The decisive role of an impartial judiciary is underlined.

Does Corporate Governance Matter to Developing Countries?

Corporate governance was long ignored as a development challenge. It remained virtually invisible as a development policy issue until the 1997-98 Asian financial crisis, followed closely by those in Russia and Brazil, drew attention to the problems of “crony capitalism” and poor local corporate governance practices in several emerging-market economies. Moreover, since the perceived threat to global financial markets generated by

those crises has receded and the international pressures it created to strengthen corporate governance in emerging markets has diminished, local efforts to improve corporate governance in many developing countries have flagged significantly.

The more recent corporate governance scandals in OECD countries, widely associated with the names of Enron, Parmalat, WorldCom, Vivendi and others, nevertheless remind us that corporate governance failures can severely affect the lives of thousands, even millions of people — including employees, retired workers, savers, creditors, customers and suppliers, as well as shareholders.

The question addressed here is whether corporate governance is important for non-OECD countries, i.e. for countries whose overriding policy challenge remains that of achieving long-term development? Because the corporate landscape in these countries tends overwhelmingly to be dominated by large family-owned, state-owned and/or foreign-owned companies that do not have shares widely traded on local stock markets — with a multitude of small, non-corporate forms of enterprise often accounting for the bulk of employment and output — even specialists in corporate governance sometimes think the answer is “no”.

The answer, in fact, is “yes”. OECD Development Centre research on the importance of local corporate governance for sustained productivity growth in the developing and emerging-market economies (Oman, ed., 2003; Oman *et al.*, 2003), and the Regional Corporate Governance Roundtables organised by the OECD Corporate Affairs Division in Asia, Latin America, Eurasia, Southeast Europe and Russia (OECD, 2003a), all show that the quality of local corporate governance is critically important for the success of long-term development efforts throughout the developing world today.

The reason, in a nutshell, is that virtually all developing countries (including the so-called transition and emerging-market economies) are going through a difficult process of internal transformation in which corporate governance plays (more than is commonly perceived) a central role. This transformation involves deep change in both the economic and political spheres of national governance. Economically, the transformation is from relatively closed or inwardly oriented and market-unfriendly systems to more open and market-friendly systems. Politically, it is from relatively undemocratic to more democratic systems. In both spheres, the move is towards more functionally *rules*-based systems of governance, away from systems that were relatively non-transparent and unaccountable and often heavily *relationship*-based. In both spheres, the quality of corporate governance is critically important for achieving a successful transformation.

What is Corporate Governance?

“Corporate governance” comprises a country’s private and public institutions, both formal and informal, which together govern the relationship between the people who manage corporations (“corporate insiders”) and all others who invest resources in corporations in the country¹. These institutions notably include the country’s corporate laws, securities laws, accounting rules, generally accepted business practices and prevailing business ethics. To illustrate, Box 4.1 provides an indicative list of key corporate governance institutions, and core corporate governance actors, found in many countries.

Box 4.1. Corporate Governance Institutions and Actors — An Indicative List

A country's corporate governance institutions comprise both formal and informal rules ("informal" rules notably include a country's generally accepted business practices and ethical standards, though these are normally unwritten) that are established among private actors as well as by the state or other public authorities. An indicative list of formal corporate governance institutions and key actors includes:

- *corporate law*, in particular legislation that: *i*) gives corporations juridical personality, i.e. recognises their existence as legal "persons" separate from their shareholders; *ii*) determines corporate chartering requirements; and *iii*) limits the liability of shareholders to the value of their equity;
- *securities laws* which authorise and regulate the issuing and trading of corporate equity and debt securities (including laws on the responsibilities and liabilities of both securities *issuers* and market *intermediaries* such as brokers and brokerage firms, accounting firms and investment advisers);
- a government body (*securities commission*) that has the legal authority and the material and human resources to regulate the issuing and trading of corporate securities, including the means needed to monitor and enforce compliance with securities laws;
- *stock-exchange listing requirements*, i.e. the conditions corporations must fulfil to be able to list and trade their shares on a given exchange (often a privately owned and managed organisation regulated by the securities commission), conditions whose fulfilment may be monitored and enforced (notably via the threat of de-listing) primarily by the exchange itself or jointly with the securities commission;
- a *judiciary system* with sufficient political independence and the investigative as well as judicial powers and the resources required to make and enforce, without excessive delay, informed and impartial judgements;
- *professional associations* or "guilds" (such as those of accountants, auditors, stockbrokers, institutes of directors) that contribute — e.g. through membership licensing, information-sharing, peer pressure — to the definition and maintenance of standards of professional conduct in their field;
- *business associations* and chambers of commerce that, in a similar fashion, use formal and informal means to influence members' thinking on and behaviour with respect to acceptable business practices;
- other *private and public monitors* of corporate and securities-market participants' behaviour (notably pension funds and other institutional investors, ratings agencies, financial media).

In addition to these corporate governance institutions and actors (including the body or bodies that enact relevant legislation), two broad categories of laws, regulations, other formal and informal rules and generally accepted practices are important: those that concern corporate oversight and control; and those that concern information disclosure and corporate transparency.

Box 4.1 (contd.)

Oversight and Control

- *shareholder voting* rights and procedures (including those that are especially important for the protection of minority shareholder rights *vis-à-vis* dominant shareholders as well as *vis-à-vis* management, such as cumulative voting rights and other so-called anti-director rights (see, for example, La Porta *et al.*, 1998a);
- the *duties, powers* and *liabilities of corporate directors* (boards and individual directors, including definition of what constitutes an “independent” director and requirements on board composition and on the constitution of board committees on audit, the nomination of directors and the remuneration of directors and top executives);
- *proscription of self-dealing* by corporate insiders (whether self-dealing occurs via related-party transactions or “tunnelling” (c.f. Johnson *et al.*, 2000) or takes the form of insider trading);
- *stock-tendering requirements* (notably to protect small shareholders in the context of a corporate merger, acquisition or privatisation); particularly important are pre-emptive rights to new stock issues (also called “tag along rights” in Brazil for example);
- *judicial recourse* for shareholders *vis-à-vis* managers and directors (derivative suits, class-action suits);
- the functioning of *markets for corporate control* (take-over markets);
- the functioning of *markets for professional managers*, and of *labour markets*.

Disclosure and Transparency

- *financial accounting standards*, and how those standards are set;
- *public disclosure*, in a clear and timely manner, of such information as financial accounts (including both segment and consolidated accounts, the level and means of remuneration of directors and top executives); related-party transactions undertaken by corporate insiders; compliance, or the reasons for non-compliance, with specific provisions in corporate-governance codes, other relevant codes, laws, regulations and self-declared corporate values or objectives;
- *external audit* (including how the auditor is chosen);
- independent or “*third-party*” *analysis* and assessment of corporate prospects (e.g. by stockbrokers, risk-assessment specialists).

Perhaps more fundamental to understanding the meaning of corporate governance than any list of actors and institutions, however, is to understand the purpose of corporate governance. That purpose, in any country, is threefold:

- facilitate and stimulate the performance of corporations by creating and maintaining incentives that motivate corporate insiders to maximise firms’ operational efficiency, return on assets and long-term productivity growth;
- limit insiders’ abuse of power over corporate resources — whether such abuse takes the form of insiders’ asset stripping or otherwise siphoning off corporate resources for their private use, and/or their causing significant wastage of corporate-controlled resources (the so-called “agency problems”) — which are otherwise likely to result from insiders’ self-serving behaviour;

- provide the means to monitor managers' behaviour to ensure corporate accountability and provide for reasonably cost-effective protection of investors' and society's interests *vis-à-vis* corporate insiders.

The institutions of corporate governance serve, in short, both to determine what society considers to be the acceptable standards of corporate behaviour, and to ensure that corporations comply with those standards. At the same time, these institutions are critically important to creating the conditions necessary for investment and economic growth, as discussed below at greater length.

Why Corporate Governance Matters for Development

Corporate governance is often thought to be important mainly for companies with publicly traded shares that seek to raise capital from outside equity investors. Well-governed companies, it is thought (and the evidence suggests²), should be able to raise such finance at significantly lower cost to the company than poorly governed companies because of the added risk-premium potential investors can be expected to demand for investing in the latter — if they accept to invest in such companies at all.

Yet perceptions that corporate governance is of little importance for countries that do not have many companies with widely traded shares are mistaken. Such perceptions are wrong because the institutions of corporate governance lie at the heart of one of the greatest challenges that virtually all developing countries now face: how to move successfully from institutions of economic and political governance that tend to be heavily relationship-based to institutions that are more effectively rules-based.

This move is particularly important, and difficult, both *i*) because of corporate insiders' widespread ability in developing countries to exploit other investors and generate corporate-control rents (the "expropriation problem"); and *ii*) because of the widely damaging effects in those countries of negative-sum-game rivalry among powerful interest groups entrenched in local structures of political and economic power — groups whose members often include insiders in large state-owned and/or privately owned corporations. The combined effects of the expropriation problem and vested-interest-groups' "negative-sum-game" behaviour seriously hinder long-term productivity growth, and restrain long-term development, in many developing countries — including many with small or non-existent local stock markets.

The importance of corporate governance thus extends well beyond the corporate sector in developing countries. Corporate governance matters for development not only because of the potential benefits for local companies in terms of increased availability and lower cost of finance, or even because the economic performance of a country's corporate sector matters greatly for the country's entire economy, including its non-corporate enterprise sector. Corporate governance matters, more fundamentally, because the quality of a country's institutions of governance — of which those of corporate governance now constitute an integral part — matters greatly for the success of any country's efforts to strengthen rules-based governance. The ability to transform local systems of economic and political governance, including those of corporate governance, from systems that tend to be highly personalised, and thus strongly relationship-based, into systems that are more effectively rules-based, is central to the success of the long-term development process in all countries.

It is worth noting that in many of today's OECD countries the transformation from relationship-based to rules-based systems of economic and political governance took place largely *before* the spectacular rise and rapid global spread, late in the 19th century, of the giant manufacturing corporation and the displacement of proprietary capitalism (in which unincorporated individually owned businesses and partnerships that did not benefit from limited liability were dominant) by corporate capitalism on a global scale. Today's developing countries must therefore face a challenge unknown to many OECD countries: how to move from heavily relationship-based to effectively rules-based systems of corporate and public governance at a time when large private and state-owned corporations play a significant, often dominant, role in the local economy (whether or not their shares trade actively in a local stock market) and, therefore, tend strongly to influence national systems of governance as a whole.

Moving from Relationship-based to Rules-based Governance

The speed and the sequence of steps in the transformation of a nation's system of economic and political governance vary among countries, as do the degree and nature of overt and/or covert resistance within countries to the transformation (see, for example, the country chapters in Oman, ed., 2003). Yet despite these and other conspicuous differences — in culture, history (including legal heritage) and regional location — among today's developing and emerging-market economies, virtually all are in the midst of a dual, often difficult, transition to more transparent, accountable, rules-based and market-friendly systems of economic and political governance.

In many countries, under the system that prevailed until recently — whether it was called import-substituting industrialisation, socialist, or apartheid — large private as well as state-owned corporations obtained long-term investment finance from state-directed or state-owned sources, such as the national development bank. Some of these systems achieved significant output growth through massive factor mobilisation (often involving forced saving along with major investment in human capital), yet few achieved sustained productivity growth in their corporate sector — a key to long-term national development³.

The weakening or collapse of the previous system and the moves underway to achieve more transparent and accountable systems of co-operation and competition among the key economic and political actors may or may not be irreversible. What is clear is that they constitute an important opportunity for needed change in local governance structures.

The Expropriation Problem

Much of the recent corporate governance debate has focused on the “principal-agent” problem that tends to plague the relationship between shareholders (the principals) and managers (the agents) owing to the separation of ownership and management (or control) in corporations with widely dispersed “public” ownership of shares — companies in which no single shareholder owns more than a small fraction of the firm's stock — as prevailed in the United States and the United Kingdom for much of the 20th century. Based largely on the experience of these two countries, many authors have come to argue that the purpose of corporate governance is to protect the interests of shareholders, because the interests of

other investors can be protected through contractual relations with the company, leaving shareholders as the “residual” claimants whose interests can adequately be protected only through the institutions of corporate governance (e.g. Shleifer and Vishny, 1997).

Yet in many developing and emerging-market economies pervasive clientelism (“cronyism”) and/or weak judicial systems, and often poorly defined property rights, tend greatly to weaken effective contract enforcement. Poor contract enforcement in turn renders the distinction between “residual” and non-residual claimants of doubtful applicability in practice. Even authors who firmly adhere to the logic of this distinction tend to argue, for example, that weak bankruptcy procedures create a need for corporate governance to include protection of creditors’ interests in most of those countries⁴.

The existence of institutional infrastructure that is crucial for any country’s system of corporate governance, and which can largely be taken for granted in OECD countries (e.g. widely recognised and enforceable property rights, reasonably well-functioning legal, judicial and public regulatory systems), cannot, in sum, be taken for granted in many developing and emerging-market economies.

Equally crucial is the fact that outside the United States and the United Kingdom, widely dispersed corporate ownership is not the rule but the exception. What prevails in most developing and emerging-market economies (as in many OECD countries) is the corporation with concentrated ownership, i.e. dominant shareholders — “blockholders” — who directly control managers⁵.

Perhaps even more important (though less widely discussed) than the concentration of corporate ownership *per se*, moreover, is the prevalence in many developing and emerging-market economies of pyramidal corporate ownership structures, combined in many cases with the issuance of multiple classes of shares with different voting rights in a given company and/or widespread cross-shareholdings among companies⁶. These are all means used by dominant owner-managers (corporate insiders) to control corporate assets considerably greater, even, than their direct stock ownership rights would justify⁷.

The key potential conflict of interest in developing countries therefore tends to arise, not between managers and shareholders as such (as it does in the United States and the United Kingdom, and which is referred to in the literature as the “agency” problem), but between controlling shareholders on one hand and minority shareholders — domestic and foreign — and other investors on the other.

This conflict of interest is known as the expropriation problem because of the tendency for dominant owner-managers to take advantage of their effective control over corporate resources to expropriate or divert resources from the corporation in ways that deprive minority shareholders, and often other investors, of their fair share of income from those resources. The expropriation problem, as distinct from the “agency” problem, tends to prevail, worldwide, in countries with highly concentrated structures of corporate ownership. It tends to be amplified and aggravated by controlling shareholders’ widespread use of pyramidal corporate ownership structures, often reinforced through the use of multiple classes of shares and/or cross-shareholdings. These techniques not only allow a relatively small number of dominant shareholders to control corporate assets worth considerably, sometimes vastly, more than their own wealth would justify (i.e. vastly greater than their “cash-flow rights”). They widely serve also to provide corporate insiders with access to significant financial resources, including those expropriated from other investors.

A further consequence of the widespread use of pyramidal corporate ownership structures, cross-shareholdings and multiple share-classes has thus been to reduce or eliminate the financial pressure on corporate insiders significantly to improve corporate governance⁸. Whether or not they give lip service to the need for such improvement, the extent to which corporate insiders benefit from corporate control-rents helps explain why they commonly resist it in practice.

Table 4.1 provides an indication of such rents in the amounts reportedly paid for controlling shares in corporations in 29 developing, emerging-market and OECD countries, during the years 1990-2000.

Table 4.1. Value of Corporate Control
(premia paid for control blocs of companies' shares as % of open-market value of companies' equity)

Developing and Emerging-Market Countries											
Latin America	mean	(no. obs.)	Asia	mean	(no. obs.)	Transition	mean	(no. obs.)	Africa	mean	(no. obs.)
Argentina	27	(5)	Hong Kong, China	1	(9)	Czech Republic	58	(6)	South Africa	2	(4)
Brazil	65	(11)	Korea (Rep.)	16	(6)	Poland	11	(5)			
Chile	15	(9)	Malaysia	7	(41)						
Colombia	27	(5)	Philippines	13	(15)						
Mexico	34	(5)	Singapore	3	(4)						
Venezuela	27	(4)	Thailand	12	(12)						
Total (Latin America)	33*	(39)	Total (Asia)	9*	(87)	Total (Transition)	35*	(11)			
Total for developing and emerging-market countries				21*	(141)						

OECD Countries (other than listed above)					
Continental Europe	mean	(no. obs.)	Other OECD	mean	(no. obs.)
Denmark	8	(5)	Australia	2	(13)
Finland	2	(14)	Canada	1	(4)
France	2	(5)	New Zealand	3	(19)
Italy	37	(8)	United Kingdom	2	(43)
Netherlands	2	(5)	United States	2	(47)
Norway	1	(14)			
Spain	4	(5)			
Sweden	6	(13)			
Switzerland	6	(8)			
Total (Continental Europe)	8*	(77)	Total (other OECD)	2*	(126)
Total for OECD countries	6*	(203)			
Total for all countries	14*	(344)			

Notes:

mean = arithmetic mean of control-bloc premia that were calculated in a country;

no. obs = number of control transactions for which premia were calculated.

* = unweighted average of national mean values.

The value of a control-bloc premium is calculated for an individual company (at the time of the control transaction) by calculating the difference between the price per share reportedly paid for the control bloc and the open-market exchange price of the company's shares observed two days after the announcement of the control transaction (dividing that difference by the exchange price and multiplying the ratio by the proportion of cash flow rights represented in the controlling bloc). All transactions occurred between 1990 and 2000.

Source: Adapted from Table II in Dyck and Zingales (2002).

Vested Interests

In many developing and emerging-market economies the effects of the expropriation problem are severely exacerbated, moreover, by the destructive, often acutely negative-sum-game behaviour of powerful vested interest groups that are entrenched in highly concentrated oligopolistic structures of local political as well as economic power⁹. Particularly damaging is often the considerable extent to which the behaviour of such powerful local groups (closely tied to foreign investors in some countries, less so in others) serves to weaken or undermine healthy price competition and the proper functioning of markets — which are indispensable for a country to achieve reasonably sustained productivity growth — as well as to weaken or undermine the development and consolidation of democratic political institutions.

The significant moves in many developing and emerging-market economies since the 1990s to privatise formerly state-owned corporations, to reduce anti-competitive market regulations, to liberalise trade and investment policies, and to attract foreign investors are having a major positive impact. But those moves are often insufficient to create on their own the kind of dynamic and interactive processes of long-term productivity growth and political as well as economic policy reforms which these countries need to achieve, and sustain, in order to carry forward successfully their struggles against poverty and corruption, and for the strengthening of political democracy and modernisation of the state. For these countries, even more than for OECD countries, institutions of corporate governance that work effectively to complement and reinforce the (still weak) competitive market mechanism and (fledgling) democratic political institutions are becoming increasingly necessary.

They are crucial, first, because in all market-based economies the business enterprise (and, over the last century, the corporate form of business enterprise) has become society's dominant agent of economic activity and development — in developing and emerging-market economies as much as in OECD countries. The institutions of corporate governance, combined with those of market competition and government regulation, are society's principal means of motivating corporations collectively to behave in ways that are good for society as a whole. These institutions embody a principal-agent relationship between society (the principal) and corporations as a group (the agents): Society provides corporations with the incentive to act (notably the right to earn profits) and the means to do so (notably the right to exist and to act as “legal persons” separate from their shareholders, and to benefit from limited shareholder liability), and seeks, in return, through the institutions of corporate governance (along with those of market competition and government regulation), to ensure that corporations collectively serve its best interests¹⁰.

Today, as globalisation enhances the strength of market forces relative to that of regulation by national and sub-national governments, corporate governance has become even more important than during the post-war period. In many developing countries two additional phenomena amplify this increased importance of corporate governance even further. One (a positive phenomenon) is the sea change many of these countries have undertaken in recent years to move to more market-friendly policy regimes. The other (a negative phenomenon) is the continued pervasiveness of concentrated oligopolistic local power structures¹¹ — structures that are highly conducive to self-dealing¹² and other such rent-seeking behaviour by corporate insiders who widely exercise power in both the private and public sectors.

The widespread consequences of that behaviour (discussed again below) are huge wastage of corporate-controlled resources and highly inefficient economy-wide use of capital (i.e. major dynamic inefficiencies, including forgone innovation and investment in new capabilities, on top of static misallocation) along with a perpetuation or exacerbation of local inequalities. A further widespread consequence is both excessive resistance to needed change, reflected in excessive rigidity, and simultaneously (paradoxical though it may seem), excessive volatility, in both the political and economic spheres of power and decision making. The combined result is to constitute a very serious hindrance to a country's long-term development (Oman, ed., 2003; OECD, 2003*a*; CIPE, 2002).

While the potential contribution of improved corporate governance to increasing the flow and lowering the cost of domestic and foreign financial resources to corporations is significant, equally if not more important, therefore, is its potential contribution to reducing the considerable wastage and misallocation of real investment resources — human and physical — and to overcoming perpetuation of the often highly negative-sum games of strategic rivalry among distributional cartels. Such wastage and misallocation, and perpetuation of the status quo, can constitute a major constraint on sustained productivity growth, and thus on a country's long-term development.

Forces Working For and Against Improved Corporate Governance

Strong forces have built up in recent years that work both for and against significant improvements in corporate governance in developing countries. Particularly important among those working in favour of improvements are both the rapid growth of institutional investors, in OECD countries and in a growing number of developing countries, and a combination of factors that have greatly increased corporate demands in developing countries for investment funds from non-traditional extra-firm sources (i.e. sources from outside the enterprise). Particularly important among the forces resisting improved corporate governance are entrenched interest groups that benefit from corporate-control rents.

Institutional Investors

In OECD countries, the growing interest in corporate governance preceded the recent corporate scandals associated with the names of Enron, etc. An important reason for the interest already existing before the scandals was the spectacular growth in the 1990s of portfolio investments in corporate equities both at home and abroad, including “emerging markets”¹³, by rapidly growing pension funds and other major institutional investors.

The rapid growth of international portfolio investment by OECD-based (particularly US-based and UK-based) institutional investors is in turn reflected in, and largely responsible for, the significant growth of international portfolio investment during the 1990s. Portfolio equity investment flows to non-OECD countries rose from insignificant levels before the late 1980s to an annual average of \$2.7 billion in 1989-90 and then surged in 1993-96 to an annual average of well over \$40 billion (an amount almost equivalent to global official development assistance). Dropping to about \$17 billion in conjunction with the Asian, Brazilian and Russian “emerging-markets financial crisis” in 1998, they climbed back to some \$40 billion in 2000 before dipping again mainly owing to the sharp decline in OECD stock

markets and a general flight from equities by OECD investors. OECD-based portfolio investors, in particular the major institutional investors, have thus been and continue to be an important force working in favour of improved corporate governance in emerging-market economies, and are likely to continue to be so in the future.

Also important, though perhaps less widely perceived, has been the establishment and growth of domestic pension funds in developing countries. Chile's 1981 creation of a fully funded, privately managed pension system with individualised mandatory savings accounts was followed in the 1990s by the creation or significant development of such "funded" (as opposed to "pay as you go") pension funds in close to 30 countries outside the OECD region (see also Queisser, 1999). While these funds remain small compared with the largest OECD-based institutional investors, many have been important purchasers (along with foreign investors in some countries) of domestic corporate equity issues, notably in conjunction with local moves to privatise state-owned enterprises. These domestic funds constitute a significant current or potential force — arguably the single most important one in the long run¹⁴ — for improved corporate governance in developing and emerging-market economies.

Demand for Funds

If foreign and, in a growing number of countries, domestic institutional investors (pension funds in particular) have become an important force for improved corporate governance as potential suppliers of funds, equally important is the fact that numerous corporations in developing countries have increased their demand for funds in recent years.

One reason for this demand growth — notwithstanding the ubiquitous use of pyramids, cross-shareholdings and multiple share-classes noted earlier — is the considerable increase in the needs of corporations, in all countries, for extra-firm sources of finance to be able adequately to respond to the growing competitive pressures engendered by globalisation. The acceleration of change (in technology, but also in the dominant business model¹⁵) has required most firms, worldwide, to undertake major investments — and often continues to require large investments — in tangible and intangible assets (including human capital and technology), for which finance must be found, in order to remain or become competitive. In many countries it has also been an important factor behind the drive to privatise poorly performing state-owned enterprises.

The significant moves to liberalise trade and investment policies and deregulate markets — a sea change for many developing and emerging-market economies — have added greatly to these competitive pressures, as has the significant privatisation of state-owned enterprises in some. Deeper international integration has further increased competitive pressures on firms, and thus increased their demands for extra-firm sources of finance capital, as well.

A further, crucial reason why the extra-firm financial needs of corporations in developing and emerging-market economies in particular have increased is that, in many, the bulk of those needs used to be supplied (especially for large private companies as well as for state-owned firms) by national development banks and other largely state-controlled sources of investment finance (often through various forms of forced saving). Many of these countries have witnessed the relative collapse or even the disappearance of the relationship-based and politically directed financial systems, thus greatly reducing their ability to supply long-term finance to local corporations — often in the name of "industrial policy" — as they did previously (see also Loriaux, 1997).

The combined result, in the 1990s, was thus a marked decrease in the supply of extra-firm investment finance from traditional domestic sources precisely at a time when corporate extra-firm financial needs in those countries rose substantially. The result has thus also been to increase domestic pressures, within governments as well as among corporate insiders, in favour of improved corporate governance in order to facilitate the flow of investment finance to local corporations.

It was in this context and with a view to promoting improved corporate governance that in 1999 the OECD agreed its Principles of Corporate Governance (Box 4.2) and launched the first Regional Roundtables in collaboration with the World Bank (OECD, 2003*a*), and the Development Centre began its in-depth examination of the importance for developing countries of the quality of local corporate governance (Oman, ed., 2003; Oman *et al.*, 2003).

Box 4.2. OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance were first agreed in 1999 and updated in 2004 on the basis of a consensus among all OECD member governments and after extensive dialogue with representatives of non-OECD countries and a wide range of stakeholders. The Principles set out a framework for good policy and practice designed to assist governments and regulatory bodies in both OECD countries and elsewhere in drawing up and enforcing effective rules, regulations and codes of corporate governance. In parallel, they provide guidance for stock exchanges, investors, companies and others that have a role in the process of developing good corporate governance.

The Principles cover six core issues: *i*) ensuring an effective institutional and legal framework, including for enforcement; *ii*) protecting and facilitating the exercise of shareholders' rights; *iii*) equitable treatment of shareholders, including minority and foreign shareholders; *iv*) the role of stakeholders, including employees and creditors among others; *v*) promoting timely, accurate and transparent information disclosure; and *vi*) board structures, responsibilities and procedures.

The Financial Stability Forum uses the Principles as one of its 12 key standards, and consequently the IMF and the World Bank use them as part of the review of standards and codes (ROSC). The Emerging Markets Committee of the International Organisation for Governmental Securities Commissions (IOSCO) has also endorsed the Principles.

The Principles have provided a conceptual framework for five Regional Corporate Governance Roundtables jointly organised since 1999 with the World Bank Group, comprising national policy makers, regulators and market participants in Asia, Russia, Latin America, Eurasia and Southeast Europe (and more recently a Working Group on Improving Corporate Governance in the Middle East and North Africa). With the exception of Eurasia, each Roundtable has produced a White Paper setting out policy priorities, as summarised in OECD (2003*a*). The Roundtables have supported significant legal and institutional change in a number of countries, a process that is continuing as the participants strive to implement the key policy recommendations.

See: <http://www.oecd.org/DAF/corporate-affairs/>

Obstacles to Improved Corporate Governance

Resistance to the changes required to improve corporate governance significantly is nevertheless widespread. Vested-interest groups that benefit from corporate control rents — at the expense of minority shareholders and other corporate stakeholders, both local and foreign, as discussed earlier¹⁶ — are a major source of resistance to needed change.

In seeking to maintain or increase their share of a country's wealth, these groups — “distributional cartels” as Mancur Olson called them¹⁷ — often invest significant corporate-controlled and/or government-controlled resources, not in the creation of new wealth, or in the provision of public goods needed by business enterprises for the creation of new wealth, but in actions of strategic rivalry among themselves. Those actions — both to manipulate the role of the state for their private economic advantage, and to use corporate resources to increase their share of political and economic power — tend not only to stifle healthy inter-firm price competition and to siphon off significant resources for the oligopolistic rivals' private benefit. They tend also to *consume, waste* and *destroy* significant resources in their actions of strategic rivalry. The result can be huge wastage and misallocation of a country's resources — real (physical and human) and financial — which in turn reduces aggregate wealth and constitutes, for the economy as a whole, a highly negative-sum-game set of dynamics that greatly hinders long-term productivity growth.

Even more harmful than the widespread *monopoly* powers of such groups, which tend to be reflected in forgone investment and innovation compared with what one would find in a more price-competitive context, in other words, is often the socially wasteful and destructive strategic behaviour of rival distributional cartels that operate simultaneously in the economy, notably as corporate insiders, and in government in a context of concentrated oligopolistic local power structures.

Two “paradoxes” found in many developing countries illustrate well the kind of effects that such wasteful, often destructive oligopolistic rivalry among distributional cartels (as distinct from health price competition, as well as from pure monopoly) typically produces. One is a propensity for large private and state-owned corporations alike to undertake major, often highly capital-intensive, investments in production capabilities which then remain significantly under-used (i.e. a propensity to undertake costly investments in over-capacity¹⁸) in countries that, virtually by definition, suffer from relatively acute capital scarcity. The other common “paradox” is a tendency for large corporations operating in oligopolistic local market structures to resist needed change (notably in response to new conditions created by the availability of a new technology, changing consumer preferences and/or the advent of a more competitive business model) yet also to create excessive volatility in markets, and often in politics as well¹⁹ — volatility that can even lead, in more extreme cases, to armed violence.

Put simply, the reason for this wasteful and destructive behaviour — of which one could cite many more examples — is that in their games of strategic oligopolistic rivalry distributional cartels tend, on the one hand, to resist inter-firm price competition and any (socially needed) change that might upset the balance of power within their oligopoly. Yet, on the other hand, they are prone to provoking (socially unneeded) change whenever a member of the cartel (or coalition of members within the cartel) believes it can increase its share of power — e.g. product-market share, share of corporate-control rents, etc. — *vis-à-vis* other members of the cartel.

The combined result of such wasteful and destructive behaviour for the country as a whole thus tends to be:

- very significant wastage of capital resources, both material and human;
- forgone investment in capabilities needed to compete in global markets;
- a building-up over time of bureaucracy and resistance to change in corporations and government alike; and
- instability or volatility and thus fragility in both the economy and local political institutions.

A further result in many countries is a tendency to reproduce clientelistic relationship-based forms of both corporate and political governance that are insufficiently transparent and accountable (Oman, ed., 2003; OECD, 2003*a*).

The overall result is thus often a vicious circle in which heavily clientelistic relationship-based governance systems breed — and make it particularly difficult to overcome — harmful forms of strategic oligopolistic rivalry among distributional cartels whose effects constitute a tremendous drag on economic growth and national development. That behaviour also makes it very difficult to bring about the changes needed to improve both corporate and public governance, and thus successfully to make the move from predominantly relationship-based to more effective rules-based systems of governance. Such a move is nevertheless crucial to reducing corporate-control rents and limiting or overcoming the most damaging effects of the strategic rivalry among distributional cartels that constitute such a hindrance to sustained growth and development.

Powerful distributional cartels operate in all countries, of course, including OECD countries. Yet it is arguably the greater pervasiveness of their rent-seeking and negative-sum-game behaviour in many developing countries — to a point where it can easily overwhelm the benefits of healthy price competition in the economy as a whole — that constitutes the greatest obstacle to long-term productivity growth, and sustained economic development, in these countries.

Pyramidal corporate ownership structures, often used in combination with multiple share-classes and/or cross-shareholdings among companies, widely constitute an instrument of choice for such distributional cartels to operate in developing countries. Corporate insiders' use of these devices thus goes far to explain their observed tendency to resist pressures to improve corporate governance (notwithstanding their frequent lip-service to the contrary) in many developing countries. It also goes far to explain the severe wastage, market distortions and often massive misallocation of resources, human and material as well as financial, associated with corruption and “crony capitalism” in too many countries.

From a long-term development and public policy perspective, the driving imperative for better corporate governance in most developing and emerging-market economies today thus tends less to be any shortage of corporate finance as such than corporate insiders' ubiquitous use of devices (especially pyramidal corporate ownership structures) to separate corporate ownership rights from effective control of their assets. This separation serves widely to facilitate, and camouflage, self-dealing and related rent-seeking behaviour — and the negative-sum-game dynamics reflected in such behaviour — by corporate insiders who operate at the core of powerful distributional cartels in oligopolistic economic and political power structures in many developing and emerging-market economies.

Implications for Action

The challenge for many developing countries is thus to break out of a vicious circle in which the forces working for needed change may be weaker than those resisting it.

To break out of the vicious circle requires first and foremost better, and broader, local understanding of the importance of corporate governance for long-term economic growth and development. The OECD has been working to foster this understanding through its Development Centre's research and informal policy dialogue on this importance, and through

the policy-dialogue programmes organised by its Corporate Affairs Division in Asia, Latin America, Southeast Europe, Eurasia, the Middle East and North Africa (MENA), Russia and China. By bringing together public sector decision makers, regulators, companies, investors and other stakeholders in each region, these Roundtables help build coalitions for reform. Policy discussions have revolved around the OECD Principles of Corporate Governance (Box 4.2) with each region developing recommendations adapted to local conditions, issued in the form of Regional White Papers (OECD, 2003a). More recently, Roundtable efforts have focused on promoting implementation of specific priorities, as well as addressing related issues such as corporate governance of state-owned enterprises, based on the new OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) (see Box 4.3), and corporate governance of non-listed companies (see Box 4.4). The Asia and Eurasia Roundtables and MENA Working Group on Corporate Governance have begun to examine issues related to corporate governance of banks as well.

Box 4.3. Corporate Governance of State-owned Enterprises

The OECD Guidelines on Corporate Governance of State-Owned Enterprises represent the first international benchmark to assist governments in improving corporate governance of SOEs, and how they evaluate and improve the way they perform their ownership function. They are intended to be complementary to the OECD Principles of Corporate Governance, which also apply to SOEs, particularly those that are listed. The OECD Guidelines address the state as an owner, and represent what OECD governments agree are the core elements of a good corporate governance regime for SOEs. They provide standards and good practices, as well as guidance on implementation, and address six main areas: *i*) ensuring an effective legal and regulatory framework for SOEs; *ii*) the role of the state as an owner; *iii*) equitable treatment of shareholders; *iv*) relations with stakeholders; *v*) transparency and disclosure; and *vi*) the responsibilities of SOE boards.

The Guidelines have been developed because of a number of specific challenges associated with the state's role in governing SOEs. SOEs indeed often suffer from passive ownership by the state, or on the contrary, from undue political interference. In this context, an important challenge is to ensure a level playing field in markets where private sector companies can compete with state-owned enterprises and that governments do not distort competition in the way they use their regulatory or supervisory powers. SOEs in many cases are also notorious for having a soft budget constraint, being largely protected from the takeover and bankruptcy threats that are essential tools for monitoring management in private sector corporations. More fundamentally, SOEs have a complex chain of agents (management, board, ownership entities, ministries, the government), without clearly and easily identifiable principals. Structuring this complex web of accountabilities in order to ensure efficient decisions and good corporate governance is a challenge.

After almost two years of far-reaching consultations with SOE managers and owners, state audit bodies, parliamentarians and civil society representatives from both OECD and non OECD countries, the OECD Guidelines on Corporate Governance of State-Owned Enterprises were adopted by the OECD Council in April 2005. These Guidelines are also based on a comparative survey of SOE corporate governance practice and recent reform initiatives in OECD countries.

Given the important role that state-owned enterprises continue to play in many developing and emerging market economies, strong interest has been expressed in making use of the Guidelines and OECD experience in non-OECD countries. The OECD has responded by supporting the launch of regional networks for governance of state-owned enterprises in Asia and Latin America, and using the existing Regional Corporate Governance Roundtables and other forums to build awareness of and understanding of the Guidelines more broadly.

Box 4.4. Corporate Governance of Non-listed Companies

While the OECD Principles of Corporate Governance focus particularly on publicly traded companies, there is a growing interest in understanding their relevance to non-listed companies, which constitute the large majority of companies in any economy, but especially in economies with less developed equity markets. Recent work initiated by the OECD has focused on closely held companies whose shares are not freely traded but which nevertheless have made use of private equity or may be interested in tapping into private capital markets. For such companies, often family-owned or founder-owned, corporate governance issues remain highly relevant, for example the need for financial transparency, effective board oversight and/or other management and control systems, and corporate governance strategies for succession planning and conflict resolution, to name just a few.

To begin studying these issues, the OECD launched a global network for corporate governance of non-listed companies with an initial international experts' meeting held in Istanbul in April 2005. The network brings together policy makers and practitioners from around the world to understand better global corporate governance challenges for non-listed companies. The objective is to gather global experience on policies and practices related to corporate governance of non-listed companies, including the pitfalls of over-regulation.

Participants in OECD's global corporate governance dialogue have started to address the different aspects of corporate governance in these companies, leading to a publication, *Corporate Governance of Non-Listed Companies in Emerging Markets*, issued in 2006. Contributors to this work include policy makers, regulators and practitioners, mostly from emerging markets and developing countries. Drawing on their varied experiences, the contributors address key corporate governance issues such as the role of professional managers; the implications of specific control and ownership structures; the unique characteristics of corporate governance of non-listed companies; transparency requirements in non-listed companies; and how policy makers should inform themselves in order to facilitate better corporate governance and business performance in non-listed companies. Participants in the Regional Roundtables on Corporate Governance have contributed to the development of this work, as well as made use of its conclusions.

High on the list of priorities for reform in many developing countries must be enhanced capacity to address the problem of insiders' abusive use of multiple share classes, cross-shareholding and, especially, pyramidal corporate control structures. In many countries it will require significantly greater public disclosure of effective share ownership, together with stronger measures to ensure the basic property rights of share ownership for domestic and foreign minority shareholders.

The key challenge in many countries today is not so much how to design better corporate-governance laws and regulations — many now have good ones on the books — but how effectively to enforce them. Actually, many developing countries have too much, and sometimes conflicting, regulation that proves to be too difficult to enforce. Adequate enforcement, which lies at the heart of the challenge of moving from relationship-based to rules-based systems of corporate governance, in turn raises the issues of voluntary versus mandatory approaches, and the need for both strengthened regulatory and judicial institutions to enforce them.

Voluntary v. Mandatory: Disclosure is Key

Many OECD countries favour an approach to regulation and enforcement that combines relatively high disclosure standards with considerable reliance on voluntary governance mechanisms. Debate is ongoing in OECD countries as to the appropriate balance between regulatory and voluntary initiatives.

For developing countries, further questions can be raised as to the effectiveness of voluntary mechanisms, given their relatively weak institutions of rules-based governance in general, and weak third-party monitoring capabilities in particular. The large information gap from which corporate insiders benefit at the expense of public shareholders, especially in countries with concentrated ownership structures and poor protection of minority shareholders' rights, means that governments will continue to have an important role to play.

However, there can be no one-size-fits-all answer as to the appropriate balance between voluntary and mandatory mechanisms. Given the existence of entrenched special interests in many developing economies, it can be difficult to achieve the legal and institutional reforms necessary effectively to regulate and oversee company compliance with corporate governance-related requirements. In such an environment, voluntary efforts to promote corporate governance codes and raise awareness of the importance of corporate governance constitute an important step in contributing to the market conditions and political environment necessary to achieve further progress. Institutional investors, including pension funds, can play a key role in influencing the market by taking corporate governance into account in their investment decisions, motivating companies to improve their governance in order to attract increased investment.

Brazil's recent experience with corporate governance reforms provides an interesting example of the inter-relationship between voluntary and mandatory approaches. The Bovespa Stock Exchange established the Novo Mercado in 2000, creating three listing segments on its market with higher standards of corporate governance than legally required (for example, strengthened shareholder rights, improved disclosure and a commitment to resolve any disputes through arbitration rather than lengthier court processes). Although there was some scepticism and a slow market reaction initially, as pioneering companies that voluntarily committed to higher standards saw positive results in their share values, other companies began following suit. Bovespa celebrated the arrival of its 100th company on the corporate governance listing segment in early 2007, and these companies have transformed the Brazilian market, constituting 58 per cent of Bovespa's total trading value and market capitalisation at the end of 2006²⁰. At the same time, the Brazilian regulator has continued to play a prominent and essential role in enforcing company law and issuing advisory opinions on compliance requirements that can serve as a guide not only to companies but also to the judiciary. This experience has shown that, even in emerging markets, voluntary commitments can have a significant positive impact on corporate governance behaviour under the right conditions, when complemented by a credible regulatory and enforcement framework.

While well-functioning regulatory and judicial institutions are important in any country, these institutions may take on even greater importance in developing economies where market incentives for good corporate governance, including institutional investors that take corporate governance into account, are failing to function effectively. Recent experience notably highlights the potential value for these countries of having a strong and politically independent yet fully accountable securities regulatory commission that is both well-funded and endowed

with adequate investigative and regulatory powers. True for all countries, this experience is especially relevant for countries that have weak judicial systems — not least because of the considerable time it can take to strengthen effectively a country's judiciary system.

Importance of the Judiciary

Policy makers should not, however, perceive the choice between regulatory and judicial means of enforcement as an either/or choice; they should see those means as complementary and mutually reinforcing. Moreover, from a long-term development perspective, few institutions are more important for sound rules-based governance and long-term growth in a country than a well-functioning judiciary. This is true not only because a country's corporate-governance system comprises considerably more than its securities laws and their enforcement (it notably includes the credibility of contract enforcement as a whole) but because of the danger that those with responsibility to regulate (e.g. the securities commission) may be corrupted or unduly influenced by those whose actions they are intended to monitor and regulate. And it is precisely in countries most burdened by the behaviour of powerful distributional coalitions — whose entrenchment is often also reflected in the very lack of independence and accountability of their country's judiciary — that the risk of corruption or excessive influence tends to be greatest.

Developing a competent, politically independent and well-funded judiciary is thus vitally important for enhancing the contribution of corporate governance to corporate performance and long-term national development.

Public and Private Governance: A Symbiotic Relationship

The strong resistance to many of the changes needed to enhance corporate governance often asserts itself as well through relationship-based systems of public government²¹. The relative weakening or collapse of those systems in many countries in recent years may constitute a window of opportunity for countries to overcome resistance to changes that are needed as much in their systems of public governance as in those of corporate governance.

The broader point is not only that sound corporate governance requires sound public governance, but also that sound government today requires sound corporate governance. The power of corporate insiders and their close relationship with those who exercise political power at the highest levels mean that development requires moving from the rule of persons to the rule of law in the institutions of corporate and public governance together.

Notes

1. Investors may include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow.
2. See OECD (2003*b*) for a review of the evidence in OECD countries. See also Fremond and Capaul (2002).
3. See Chapter 1 in Oman (2003) for further discussion of the importance of productivity growth for sustained development.
4. These concerns have also been taken up in the Regional White Papers (see OECD, 2003*a*).
5. See for example, La Porta *et al.* (1998*a*), for evidence on corporate ownership patterns around the world. Note also that while the lack, or underdevelopment, of institutional infrastructure required for better corporate governance may well go far to explain why many controlling shareholders do not diversify their equity holdings (thereby reducing their overall exposure to risk) and thus be an important cause of concentrated corporate ownership structures in many of these countries (see for example, Shleifer and Vishny, 1997), one should not underestimate the possibility that a strong reverse causal relationship is also at work.
6. A “pyramid” exists when one corporation (at the top of the pyramid) holds a dominant equity share (say, 51 per cent, though less may suffice) in and thereby controls one or more other companies (the second “layer” in the pyramid) each of which may in turn have a dominant equity share in one or more additional companies (the third layer), and so on. Corporate insiders who effectively control the corporation at the top of the pyramid — often a holding company — can thus control entire groups of corporations, and massive corporate assets, with very little direct equity ownership in corporations lower down in the pyramid (see also Morck *et al.*, 2005).
7. This phenomenon is known in the literature as effective “control rights” that exceed nominal “cash-flow rights”. Bebchuk *et al.* (1999) demonstrate why, when pyramids, multiple-class shares and/or cross-shareholdings are used by corporate insiders to increase their control rights beyond their cash-flow rights, the result tends to be expropriation costs that are “very large...an order of magnitude larger [even] than those associated with controlling shareholders who hold a majority of cash-flow rights. See also Morck *et al.* (2005).
8. Dominant shareholder-managers may, in other words, use pyramids, multiple-class shares and cross-shareholdings as functional substitutes for the development of a more rules-based national financial market — substitutes in the sense that such devices allow corporate insiders to gain access to large amounts of outside finance beyond their own resources — which have the remarkable added advantage, for the dominant shareholder-managers, that rather than obliging them to dilute their effective degree of control over a corporation, as would occur with their sale of equity to raise funds from extra-firm sources, these devices (especially pyramids) actually have the opposite effect, allowing dominant shareholder-managers effectively to increase their degree of control, sometimes many times, beyond their nominal share of equity in a group of corporations. In doing so these devices thereby open the gap known also as that between dominant shareholder-managers’ nominal “cash-flow rights” and their effective “control rights”.
9. Those structures of power are widely reflected in the structure of corporate ownership, often visible in the importance of state-owned enterprises as well as of large private family-owned business groups.

10. In the United States, where the right to incorporate is granted by state governments, not by the federal government, corporate charters were granted until late in the 19th century under far more stringent conditions than they are today — usually on the understanding that demonstrable public good would result from the corporation's activities. As corporations came to be seen less as agents of the public interest, however, and states came to presume (rather than demand proof of) public benefits from business enterprise, and as a growing number of firms became sufficiently national to have practical choices about which state to call home, the specific terms of state chartering came to matter more. In 1896, New Jersey adopted aggressively liberal chartering rules, and became the legal home of choice for major corporations. New Jersey nevertheless shifted to a somewhat tougher chartering law in 1913, and rapidly lost its hegemony to Delaware, which had altered its own incorporation provisions to mirror New Jersey's previous law.
11. For an analysis of the significant potential cost to a country in terms of the performance of its system of corporate governance of an oligopolistic, as opposed to a functionally monopolistic, local power structure, see Meisel (2003).
12. "Self-dealing" is the expropriation or diversion by corporate insiders for their private benefit of a corporation's assets (sometimes also called "asset stripping") and/or of its income or income-earning possibilities. Common forms, or means, of self-dealing include having the corporation purchase inputs from one or more other firms (presumably also controlled by the corporation's insiders or their close friends or relatives) at excessively high prices, or sell output at excessively low prices; having the corporation borrow money at excessively high interest rates, or lend at excessively low rates; having it lease assets at similarly non-market rates; having it guarantee other companies' (or individuals') borrowing; or even outright appropriation of the corporation's tangible and/or intangible property without compensation.
13. The term "emerging market economy" was reportedly coined in 1981 by Antoine W. van Agtmael of the World Bank Group's International Finance Corporation. Since then, especially since the 1990s, OECD-based international investors, notably banks and portfolio investors, have come widely to refer to the non-OECD countries where they lend and invest as "emerging markets".
14. Malherbe (2003) makes this point. He also provides a useful typology of the corporate-governance capabilities of domestic pension funds in such countries as Argentina; Bolivia; Brazil; Brunei; Chile; Colombia; Croatia; Cyprus; El Salvador; Hong Kong, China; India; Indonesia; Kazakhstan; Kenya; Malaysia; Mexico; Nepal; Papua New Guinea; Peru; Poland; Singapore; South Africa; Sri Lanka; Swaziland; Tanzania; Uganda; Uruguay; Zambia and Zimbabwe.
15. On the central role of a new business model in driving globalisation and regionalisation since the 1980s, see Oman (1996, 2000).
16. A good illustration is the case of Brazil, where the average level of corporate-control rents was recently estimated at 65 per cent of corporate value. See the chapter on Brazil in Oman (2003). See also OECD (2003a).
17. Olson (1982) provides a detailed analysis of the behaviour of "distributional cartels", albeit in OECD countries. Olson explains why such a group will tend to undertake actions (to gain, say, \$2 billion in increased income or wealth for the group) that often cost society as a whole much more than the group itself stands to gain (costing society the equivalent of, say, \$10 billion in wasted resources, lost growth opportunities and reduced income).
18. As Olson (1982) clearly explains, and neoclassical models of oligopoly predict, fear among members of an oligopolistic supply structure that a price war may break out among them leads them to adjust quantities rather than prices. However, in order to survive if a price war does break out, each member of the oligopoly nevertheless invests in large capacity to be able rapidly to expand output levels and take advantage of scale economies to lower average costs as well — capacity which then remains largely unused except in the event of a price war.
19. See Olson (1982).
20. See Bovespa's website at www.bovespa.com.br
21. As awareness of the importance of the quality of public governance has grown in recent years, so has the use and abuse of governance indicators. See Arndt and Oman (2006).

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Focus 8

Privatisation and Regulatory Reform in the Southern Mediterranean: Improving the Basis for Long-term Growth

The Euro-Mediterranean Partnership (Barcelona Process) is a wide framework of political, economic and social relations between the member states of the European Union and partners of the Southern Mediterranean (MEDA countries). In the 20th century, state ownership characterised all MEDA countries — Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestinian Authority, Syria, Tunisia and Turkey. The trade liberalisation agreements signed between the European Union and the Southern Mediterranean countries are now revealing structural weaknesses that are rooted in the fact that, for various reasons, most of them managed to delay structural adjustment. Rent seeking, market segmentation, a weak modern private sector and inadequate fiscal systems remain pervasive features. While privatisation is one of the main events of the economic history of the last decades, there is a general feeling that it has hardly interested the MEDA region.

In 2006, the Development Centre started a research activity to examine the political economy of privatisation and regulatory reform in the MEDA countries. This research is funded by the European Commission (FP6) as part of the Understanding Privatisation Policy: Political Economy and Welfare Effects (UPP) project co-ordinated by Fondazione ENI Enrico Mattei, a leading international research centre. It also contributes indirectly to the MENA-OECD Investment Programme. The main preliminary results were discussed at a meeting held in Prague on 16 February 2007.

The Record So Far

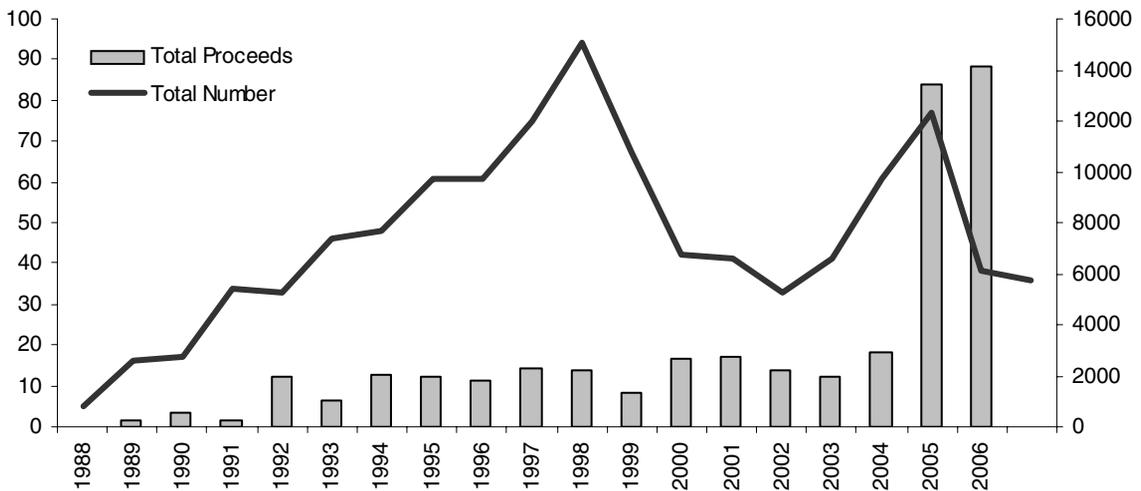
Kauffmann and Wegner (2007) built a new database reporting systematic information on privatisation operations in the MEDA countries up to end 2006. It complements the World Bank privatisation database with recent and detailed information on some 330 additional transactions. The total number of privatisations reported in the database reaches 926, including some 36 pending transactions, and total proceeds stand at \$55.6 billion.

The privatisation transactions are not evenly spread over the period. The first recorded transactions took place in 1988 in Turkey and included the divestiture from Teletas, the telecom operators, for some \$392 million. The annual number of privatisations then increased

until it peaked in 1998 when it reached just below 100 transactions throughout the region. After then, the process somehow slackened and reached a low in early 2000 before rebounding in 2005. This pattern reflects the difficulties faced by the early beginners — Egypt, Morocco and Turkey — in continuing to submit profit-making companies to privatisation or to tackle the more strategic companies in the infrastructure or energy sectors. It is also the result of the difficulties of the latecomers — Algeria, Israel, Jordan — in implementing their privatisation programme. By contrast, the programmes quickened in all countries from 2003 and culminated in 2005.

The proceeds followed a similar pattern over the period: increasing slowly between the end of the 1980s until 2000, declining sharply in the early 2000s, but then rebounding even more significantly towards the end of the period. This sudden increase mainly reflects the successful divestitures in the telecoms sector in Egypt, Israel, Morocco, Tunisia and Turkey, as well as some important operations in the petroleum sector in Turkey (TUPRAS) and Israel (Oil Refinery Ashdod).

Figure 4.1. Annual Number of Privatisations (right scale) and Proceeds (left scale) up to 2006



Source: See Kauffmann and Wegner (2007).

Such trends are not specific to the MEDA region. They mimic the sequencing of the privatisation process initiated in the OECD countries in the mid-1980s and closely follow the patterns of the African privatisation process. In MEDA, as elsewhere, governments put early emphasis on divesting small and medium-sized enterprises operating in competitive sectors (mainly industry and tourism) before turning to the more sensitive sectors of network utilities (defined as infrastructure sectors in the database). As in the case of Africa, the shift in the programme reflects the weak efficiency of public utilities and their failure to tackle the challenge of developing access for the poor. It is also the result of stringent budget constraint that led the authorities to seek quick cash flows. It is also only in a second phase that some MEDA countries have started including the geo-strategic energy and mining companies in their privatisation programmes. Compared with other regions, the MEDA countries are, however, quite heterogeneous, with some countries such as Tunisia strongly opposed to privatisation of basic services, or Algeria where energy companies have been largely shielded from privatisation so far.

Turkey and Egypt clearly lead the process with respectively some 32 per cent and 25 per cent of the recorded number of transactions. In terms of revenues, however, Turkey received almost half of the total proceeds over the period, while Morocco, with only 13 per cent of the transactions, closely follows Egypt with some 16 per cent of total financial flows. This situation reflects higher average proceeds in Morocco per transaction, almost 50 per cent greater than in Egypt.

The proceeds accrued to governments are largely a function of the sector of the privatised company. Enterprises from the industry and tourism sectors are usually smaller and therefore lead to less significant proceeds than the strategic companies of the energy or the infrastructure sectors. However, the difference in average proceeds per transaction also reflects the state of the enterprises at the time of their privatisation and the restructuring conducted by the authorities before the sale.

A Limited Impact on Private Sector Development

Most transactions (some 60 per cent) in the MEDA region have been completed through sales of shares and assets. Public flotation has also been substantially used, for some 16 per cent of transactions. In some countries, privatisation has clearly been seen as a way to strengthen the stock market: in Algeria, three-quarters of privatisation transactions have been conducted through public flotation; in Egypt, public flotation has been the most common method of privatisation (for 28 per cent of transactions). Compared with other regions, relatively few restructurings have led to complete liquidation (some 5 per cent of operations). All management buy-outs in Egypt took place in agricultural or trading companies. As elsewhere, concession is mainly used in infrastructure sectors. The remaining methods of lease, joint venture and management agreement have been very seldom used.

Private Sector Participation and Regulatory Reform in Telecommunications

During the 1990s, the globalisation of telecommunications imposed a model of development based on the suppression of public monopolies, openness to international competition and the privatisation of public telecommunication operators. In fact, all over the world telecommunications have provided reformist governments with most privatisation-related revenues and FDI flows. These dynamics have today fostered a regulatory and institutional adjustment that must guarantee a stable and predictable environment for investors and consumers. This adjustment must also set up norms enabling connection between networks and promote a satisfying quality-to-price ratio. More than this, the redefinition of the regulatory and legal framework must demonstrate a transition towards a regulation based on the impartiality of the state, the transparency of the market and the equity of legal norms.

Such an institutional setup was introduced in some MEDA countries in the mid-1990s, with the adoption of a new telecommunications code and an institutional and industrial restructuring. Most of them have been slowly introducing competition into the telecom sector

and privatising state-owned firms. This has fostered the emergence of new actors in mobile/fixed telephony, data transmission and Internet provision. But a comparative analysis underlines significant differences between liberalisation policies in the region.

Mezouaghi (2007) shows that two kinds of regulatory pattern seem to emerge. On one hand, a framework based on unbundled public monopolies and an independent and autonomous body in charge of opening up the market to competition and sanctioning anti-competitive behaviour; on the other hand, a framework centred on a strong regulation mode in which the public operator maintains a dominant position. In fact, between these two regulatory patterns, more hybrid configurations characterise the liberalisation process.

Private Sector Participation and Regulatory Reform in Water Supply

Water is like no other commodity, in the sense that it is essential to human life. It is also essential to economic growth and poverty reduction. Because of water scarcity, relatively low international investment in water and high population growth, the MEDA area faces one of the greatest water crises in the world and so far progress in this area has been disappointingly slow. The MEDA is in the area with the world's greatest water scarcity; eight of the 11 MEDA countries have less than 1 000 cubic meters of renewable fresh water per person per year. Climate and demographic changes will worsen the shortage. MEDA countries also face substantial problems of access to water in towns. With an expected urban population growth of 63.8 per cent in the MEDA region over the next 25 years, the issue of urban water supply is essential for health and economic development.

Pérard (2007) examined the organisational framework of water in MEDA countries and the development of private sector participation in the context of urban water crisis. The study has shown that governments of MEDA countries are well aware of the urgency of the situation. Some countries started to reform the organisation of the sector a long time ago; others are still at the beginning of the process. The Moroccan experience with regulatory reform and private sector participation in water services over the last ten years is an example for other countries of the region to follow. Algeria is also well on track to reorganising urban water supply successfully. The example of Tunisia reveals that efficiently managing public water delivery is also possible. However, some reforms, such as corporatisation and decentralisation, could improve the service. In other countries, such as Jordan and Egypt, the situation is more worrying; governments need to pursue their efforts in reshaping the organisation of the water supply sector and should address the problem of unviable tariffs without delay.

The Politics of Privatisation

Privatisation thus represents just one element, although a very important one, of the more general process of liberalisation or movement towards the market as a regulator of human interaction in society. The paradox, as shown by Belev (2007), is that in MEDA countries the most important feature of privatisation has been the political control which has shaped the major parameters of the process from the very beginning. This is what made

it possible for governments to pursue a public sector reform, which is usually seen as the core element of liberalisation policies, with the objective of not going too far with liberalisation i.e. to use some of the instruments of change deliberately in order to avoid radical change.

A comparison of the privatisation experiences of the two country cases in the Arab world — Egypt and Tunisia — with those of other regions, the EEC for instance, can be instrumental in throwing light on important aspects of the process in MEDA. Privatisation based on discretion and motivated mainly by political considerations cannot be an effective element of market-oriented reform. Contrary to the prevailing belief, successful reform is not necessarily more likely to happen under a less politically liberal, but developmentally minded government. True, politically controlled privatisation has its own advantages — mainly thanks to the possibility of achieving greater efficiency and lower transaction costs as the government does not need to provide professional justification for all of its steps and does not have to put too much effort in negotiating the parameters of the privatisation programme with other actors in society. But politically controlled privatisation tends not to be very effective.

As in most of the MEDA countries, the process in Egypt and Tunisia started for pragmatic reasons — the governments were looking for a way to deal with an economic crisis. As soon as the pressures coming from the domestic and the international environment were temporarily eased, some of the hard choices in the course of privatisation started to look avoidable. Thus, from a means for achieving specific economic objectives within a reasonable period of time, such as market competition, greater economic efficiency and better allocation of resources, public sector reform turned into a permanent state of affairs, an instrument for government to justify economic hardship to the public and relieve itself from responsibility for policy outcomes. In spite of the two decades of experience, privatisation in these countries is not nearing its end, nor are the social and economic benefits generally resulting from a public sector reform likely to be achieved any time soon.

Lessons Learned

Within certain parameters, the experience of MEDA countries does not differ from that of other areas of the world. Private investors did not shy away from the region when they sensed that the state was strongly committed to ensure the credibility of the reform; independent and well enforced regulation is crucial to provide the appropriate incentives to undertake investments; and the population at large is not an obstacle to reform when it perceives tangible and fairly spread results. As regards public utilities more specifically, fast technological advances have substantially weakened the argument that public ownership of integrated monopolies is necessary to ensure investment growth, service quality and lower prices in real terms. These firms, however, maintain their strategic nature insofar as they supply essential services that determine the standard of living for the population.

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