PRIVATE SECTOR DEVELOPMENT AND POVERTY REDUCTION

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P.O. Box 20061
2500 EB The Hague
The Netherlands

Telephone + 31 70 348 5108/6060
Fax + 31 70 348 6256
E-mail aiv@minbuza.nl
Internet www.aiv-advice.nl

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Foreword

On 24 June 2005 the government asked the Advisory Council on International Affairs (AIV) to produce an advisory report on private sector development. The core issue was how private sector development could generate economic growth in such a way as to make a maximum contribution to poverty reduction.

To prepare this advisory report, the AIV set up a committee under the chairmanship of Professor L.B.M. Mennes and made up of the following AIV members: Dr L. Schulpen (vice-chair), Dr B.S.M. Berendsen, Professor B. de Gaay Fortman, H. Kruijssen, F.D. van Loon, G.H.O. van Maanen and A. van der Velden. The civil service liaison officer was J.C.J. Vlaar and the executive secretary was Ms W.A. van Aardenne, assisted by trainees Ms E.G. Boschker, Ms M. Kersten and Ms E.H. van der Bijl.

The committee consulted people from various international institutions, members of the business community, managers of Dutch development cooperation instruments relating to the private sector and employers' and employees' representatives (see Annexe III). The AIV is grateful to them for their input.

The AIV finalised this report at its meeting on 13 October 2006.

I Introduction, summary and recommendations

Introduction

In January 2003 the AIV issued an advisory report entitled '*Pro-Poor Growth in the Netherlands' Bilateral Partner Countries in Sub-Saharan Africa; an analysis of poverty reduction strategies*' (Advisory Report No. 29). This report stated that private sector development (PSD) should be a central element in countries' poverty reduction strategies and that it would therefore be interesting to see how PSD could be promoted in such a way that it contributes to pro-poor growth (PPG) in developing countries. Since then, the role of private sector development in economic development and the factors that influence this have been the subject of many international analyses and evaluations. In the light of these studies, the Minister for Development Cooperation felt that this was a good moment to ask the AIV to produce an advisory report on the subject. The core issue to be examined was how PSD could generate economic growth in such a way as to make a maximum contribution to poverty reduction.

The Minister asked the AIV to address the following specific questions:

1. Is there scope for governments to support private sector development in such a way as to maximise the contribution to poverty reduction? Is it effective, for example, to introduce measures aimed specifically at certain sectors or companies, such as small and medium enterprises (SMEs), what kind of measures should be introduced, and how could they be identified and integrated into a Poverty Reduction Strategy Paper (PRSP)?
2. What are the dangers of too much management of the economy by governments and donors? The World Development Report (WDR) 2005 indicates that the more specific measures are, the less chance they have of success. This calls into question the value of measures aimed at specific sectors or companies.
3. In what way can the positive role of foreign direct investment be strengthened, such that it contributes as much as possible to employment and promotes local companies?
4. What do you see as the relatively strong and weak points of the various instruments I have at my disposal to encourage the private sector to play a more active role in Dutch development cooperation? In what ways can these instruments be improved?

In this advisory report, the AIV adopts the definition of 'private sector' that is currently employed by the OECD's Development Assistance Committee (DAC) in relation to private sector development:[1]

'Private sector is conceived by the donor community 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. The private sector principle can be applied in all economic activities – agriculture, industry and services (including the delivery of public services). Donor motivations for supporting private sector development are based on promoting economic efficiency and social welfare. Donors agree that private sector development

1 Organisation for Economic Cooperation and Development (OECD) DAC, *Support of Private Sector Development*, Paris 1995.

is fundamentally about people: releasing and harnessing their productive potential and satisfying their human needs and desires: and creating pluralistic societies which provide both human freedom and human security'.

Since the term 'private sector' is described in this definition as an 'organising principle', it clearly encompasses far more than simply companies, ranging from multinationals right through to small and medium enterprises (including one-man firms). In Western societies, businesses of this kind exist mainly in the formal economy: however small they may be, businesses are registered with the Chamber of Commerce, have VAT numbers, produce annual accounts, etc.[2] In developing countries, however, the majority of people are employed in the informal rather than the formal economy and their activities account for a substantial proportion of Gross Domestic Product (GDP). People working in the informal economy try to earn a living without having a fixed contract of employment, a fixed income, etc. Their activities include street trading, small-scale manufacturing, casual labour, rickshaw driving, subsistence farming and every other conceivable kind of income-generating activity. A key feature is the absence of formal structures, job security, insurance and social protection. In many countries, over 70% of the population is active in the informal economy, including virtually 100% of the poor. This means that any study of the significance of the private sector to poverty reduction must investigate the effect of stimulating not only the formal but also the informal economy. The links between the two are relevant, as is the scope for encouraging the transfer of income-generating activities from the informal to the formal economy. Both aspects are discussed in this report.

Poverty reduction is the primary aim of development cooperation. Like the DAC, the AIV regards poverty as a multifaceted concept comprising the following dimensions: economic (income, livelihood, decent employment), human (health, education), political (empowerment, rights, participation), sociocultural (social status, dignity) and protective (insecurity, risks, vulnerability).[3] These dimensions are interconnected and any effective poverty reduction strategy must address all of them, not just the economic one. As AIV Advisory Report No. 29 points out, this requires not only a 'growth framework', but also an 'emancipation framework'. However, the present report confines its attention principally to the economic dimension.

Since the level of poverty is heavily dependent on the local context, that is where the search for solutions must begin. There are no universal, ready-made panaceas. Each individual situation calls for a new effort to identify the particular policies that will do most to alleviate the specific problem of poverty.

Ever since the Millennium Declaration of 2000, the Millennium Development Goals (MDGs) have been at the top of the international development agenda. At the UN World Summit in September 2005, heads of government reaffirmed their intention to achieve the MDGs by 2015. In the case of MDG 1, this means that the proportion of people living on less than a dollar a day must by that date be reduced by half in comparison with 1990.

2 Western societies also have informal economies, but they are considerably smaller and less significant than those in developing countries and there is little comparison between the two situations.

3 OECD, *The DAC Guidelines on Poverty Reduction 2001.*

To say what pro-poor growth is and how it can be achieved, this advisory report adopts the DAC's relative and absolute definitions of the term. According to the *relative* definition, growth is pro-poor if, on average, the incomes of the poor rise faster than per capita income for the population as a whole, showing that income inequality between the poor and the rest of the population is being reduced. Under the *absolute* definition, by contrast, what matters is the rate of increase in the incomes of the poor and whether it is fast enough to achieve MDG 1. Both these definitions of pro-poor growth are regarded as important, depending on the context in which pro-poor growth is being examined.[4]

Finally, it may be useful to indicate the extent of the problem of income poverty. In 2001, 1.1 billion people in the developing countries (including the transition countries) were living under the absolute poverty line of 1.08 USD a day. This is equivalent to 21% of the population of the countries concerned. In the same year, no fewer than 2.7 billion people were living on less than 2.15 USD a day (equivalent to 53% of the population of those countries).[5]

Poverty reduction is a long-term process and results are often difficult to quantify in the short term. This is certainly true of measures in the field of private sector development and pro-poor growth. It is clearly a problem when it comes to assessing current instruments in this area within Dutch development cooperation (question 4 in the request for advice). Such instruments can therefore only be assessed in the light of a frame of reference charting the relationship between private sector development, economic growth, pro-poor growth and poverty reduction. This report aims to provide the basic materials for such a frame of reference.

The structure of the report is as follows. Chapters II and III respond to question 1 in the Minister's request for advice. Chapter II analyses the relationship between poverty reduction, economic growth and pro-poor growth. The conclusions of that analysis are taken into account in the analysis of the role of private sector development in growth and pro-poor growth presented in chapter III. That chapter also discusses whether it is effective to take measures aimed at specific sectors or companies (such as SMEs), and examines the role of the PRS process and PRSPs in private sector development. Chapter IV addresses question 2 in the Minister's request for advice, concerning the effects of management of the economy by governments and donors in the private sector. Chapter V deals with question 3, on the best way to strengthen the positive role of foreign direct investment (FDI). Chapter VI discusses the informal economy and policy to stimulate growth and pro-poor growth within it, and goes on to consider financial sector development and the importance of universal access to appropriate financial services. Chapter VII answers question 4, concerning the relative strengths and weaknesses of the relevant instruments at the Minister's disposal, and ways of improving them. The earlier findings of the report are used in this chapter to formulate a number of core elements and quality criteria for private sector development and poverty reduction (Tables VII.1 and VII.2). These are then used to answer two questions: *'Are we doing the right things?'* and *'Are we doing things right?'*.

4 OECD, *Accelerating Pro-Poor Growth through Support for Private Sector Development 2004.*

5 Shaohua Chen and Martin Ravaillon, *How Have the World's Poorest Fared since the Early 1980s?* World Bank Research Observer, Vol. 19, No. 2, Fall 2004, pp. 141-169.

Summary, conclusions and recommendations

Chapters II and III
Question 1: Is there scope for governments to support private sector development in such a way as to maximise the contribution to poverty reduction? Is it effective, for example, to introduce measures aimed specifically at certain sectors or companies, such as small and medium enterprises (SMEs), what kind of measures should be introduced, and how could they be identified and integrated into a Poverty Reduction Strategy Paper (PRSP)?

The AIV feels that there is certainly scope for governments to support private sector development in such a way as to maximise the contribution to poverty reduction. However, this response requires amplification. The AIV has adopted both the absolute definition of pro-poor growth (the fastest possible growth in the income of the poor) and the relative definition (reduction of inequality between the poor and the remainder of the population).

The AIV's analysis reveals that growth is by far the most important factor in poverty reduction and that on average growth in per capita income among the poor is equal to that in the population at large. It also shows that poverty reduction resulting from growth has two components: growth and distribution. The two can reinforce each other – if income distribution is relatively equal – or counteract each other if it is not. In the first case, growth will be pro-poor, in the second it will not. For this reason, it is vital to know – and to be able to influence – the conditions under which the two components will reinforce each other.

Growth is the main factor in poverty reduction and the quality of domestic institutions is by far the most important factor in generating faster growth. The rule of law, democracy, political stability, government effectiveness, regulatory quality and control of corruption are all relevant because they determine the quality of the investment climate (the location-specific factors which enable companies to invest, expand and provide employment, and citizens to develop as entrepreneurs, employees and consumers).

To achieve pro-poor growth requires policies that reduce income inequality or, put more generally, ensure more equal access to the means of production. The analysis also shows that growth, when spread across all regions and all sectors of the economy, offers greater opportunities for the poor. This means that extra investments in education, health care, infrastructure and the development of the financial sector need to be concentrated in poor regions and in sectors in which poor people are active (agriculture). A striking conclusion is that policy measures designed to generate pro-poor growth need not be very different from those directed at increasing the rate of growth generally. It is important, however, to maintain a focus on pro-poor growth and to place the emphasis on the effect of every individual policy measure on the position of the poor.

The best analysis and recommendations on this subject are contained in the latest OECD report on private sector development and pro-poor growth.[6] The starting point of this report is the finding that measures to improve the general investment climate

6 Promoting the Supply-Side Response: Technical and Financial Assistance, in: *Promoting Pro-Poor Growth – Private Sector Development,* OECD, Paris 2006, pp. 40-46.

generate faster growth, including pro-poor growth. To generate pro-poor growth, priorities must be set within a general programme of reform in order to establish a primary or additional focus on markets, sectors and regions in which poor people live and work. The aim must be to give them improved access to means of production in general, and to business development services and financial services in particular.

Improving the quality of the investment climate reduces costs and risks for the private sector and improves market functioning. Where the private sector is the main engine of growth and encompasses most of society and the national economy, it is an obvious step to explore what policies are required to use it to generate a faster rate of growth and pro-poor growth. In addition to a reduction in trade protection and in measures restricting Foreign Direct Investment (FDI), more development aid is required to strengthen institutions and improve infrastructure.

As country contexts differ widely, it is hard to devise a universally applicable set of policies and institutions that will ensure pro-poor growth. It is better to follow the example of the OECD and to analyse the likely pro-poor effects of each policy measure and institution on the basis of whether it will:
- provide incentives for entrepreneurship and investment;
- increase productivity, through competition and innovation;
- harness international linkages;
- improve market access and functioning;
- reduce risks and vulnerability.

As a rule, pro-poor policies should benefit private sector activities and enterprises across the board, while at the same time paying extra attention to particular regions and sectors. Pro-poor growth policies should consist primarily of measures to reduce discrimination against and exclusion of the poor, but also include measures to ensure that the poor can exploit their increased opportunities in practice. These measures will usually need to be generic rather than selective. The right combination of the two will depend on the specific situation.

Policies should not specifically target SMEs, since this will tend to distort markets rather than generate growth and poverty reduction. However, existing discrimination against SMEs should be eliminated.

The Poverty Reduction Strategy process and Poverty Reduction Strategy Papers tend to leave a great deal to be desired. The PRS should be the key to achieving poverty reduction, while the PRSP should show how that aim is to be achieved in practice. The effectiveness of measures to promote private sector development depends to a great extent on the quality of the PRS and the PRSP. Growth, pro-poor growth, poverty reduction and the contribution of PSD to them will only be satisfactory if private sector development and the PRSP are of adequate quality. This means that private sector development directed at growth and pro-poor growth must be accorded a greater role in the PRSPs and that there must be simultaneous improvement in the quality of the PRS process and the PRSPs.

Chapter IV
Question 2: What are the dangers of too much management of the economy by governments and donors? The WDR 2005 indicates that the more specific measures are, the less chance they have of success. This calls into question the value of measures aimed at specific sectors or companies.

Improving the general investment climate is likely to generate a faster rate of economic growth and increase the incomes of the poor. To achieve pro-poor growth, it is necessary to accelerate and/or increase the measures and resources concentrated on those markets, sectors and regions in which many poor people live and work. The aims must be to strengthen institutions, improve market access and functioning, produce a level playing field, invest in infrastructure, education and health, encourage access to the formal economy, increase the availability of technical assistance and financial services, and end grants to businesses or intermediary organisations (while perhaps maintaining or creating grants to end-users). 'Selective' interventions of this kind are likely to generate pro-poor growth.

Selective interventions in the form of support for individual activities, businesses or business categories should be avoided. More often than not, such measures will damage the national economy by failing to pick the right 'winners', promoting rent-seeking behaviour and producing solutions which are not cost-effective.

Chapter V
Question 3: In what way can the positive role of foreign direct investment be strengthened, such that it contributes as much as possible to employment and promotes local companies?

FDI is clearly preferable to other forms of foreign capital. It creates no debts and the investment is repaid only if profits are made, and then only after they have been taxed. The flow of FDI has proved to be more stable than that of loans, because it is difficult to withdraw business investments of this kind. FDI is especially popular because it is associated with an efficient form of knowledge transfer relating to production, management, marketing etc. which leads to greater integration in the global economy. As a rule, foreign owners will behave no differently from their domestic counterparts. However, if a limited number of foreign companies were to dominate a major sector of the economy, this might limit the scope for government policymaking and be undesirable on that account.

The opportunities for Dutch development cooperation policy to reinforce the beneficial effects of FDI on poverty in developing countries lie particularly in the field of the investment climate, infrastructure and financial sector development. In addition, the Netherlands might direct its attention to improving public-private cooperation in the development not just of risk mitigation instruments such as guarantees and insurance, but also of newer instruments such as derivatives, for countries, regions or industries with large concentrations of poor people. It would be worth investigating the extent to which Dutch development aid could be supplied in this field to organisations like the Multilateral Investment Guarantee Agency (MIGA) and the Netherlands Development Finance Company (FMO), for example via partial or full reinsurance or counter guarantees. This would make it possible for them to offer insurance, guarantees or derivatives (financial products such as options and futures) to mitigate risks relating to such countries, regions or activities, where this is not currently practicable.

FDI is influenced mainly by the quality of the investment climate. This depends in turn on the efficiency of local markets for labour, capital, goods and services. It would therefore be wrong to influence the outcomes of the market system, except perhaps temporarily in the case of markets which are seriously distorted. Even then, it is important to remember that temporary protection tends to become permanent.

Employment and the volume of transactions with local companies are results of the free market process. Competition is, in fact, the very essence of an 'enabling environment' in which the private sector flourishes, generating growth and reducing poverty.

Caution should be exercised when seeking to regulate the way investors run companies, for example by obliging them to use local products and services. The World Development Report 2005 refers to the adverse effects of such regulations, in particular where technology transfer and local producers are concerned. They tend to lead to stagnation and ultimately to the withdrawal of foreign investors.

In most cases, the desired policies will consist of measures that increase the productivity of local producers, enhancing the profitability of existing foreign investment so that production can increase, local employment and the volume of transactions with local producers can expand, attracting more FDI. Foreign companies can also be helpful in terms of encouraging corporate social responsibility in relation to management, the environment, corruption, social protection, and child labour. In this respect, the AIV would emphasise the importance of compliance with the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

Chapter VI
The informal economy and financial sector development

It is clear that the target group for Dutch development cooperation policy and the MDGs – the 1.1 billion people who live on less than 1 USD a day – is likely to be concentrated in the informal rather than the formal economy. More women than men are active in this sector. Their lives are marked by a lack of social protection and a high level of labour insecurity. The informal economy offers no long-term means of poverty reduction. The only way to reduce poverty is to generate a broad pattern of growth that also benefits poor people. The main focus must be on promoting employment and entrepreneurship (including microenterprises) to provide incomes. In addition, it is important to promote the transfer of people and activities from the informal to the formal economy.

The main barriers to formalisation seem to be connected with government regulation, corruption and access to the financial sector. The national enabling environment plays a major role in this respect. Good governance is an essential precondition, not only to protect people's rights, but also to ensure their economic development.

To get results, national governments and local authorities, supported by international financial institutions and donors, will have to develop specific policies for each country and sector. Such policies should give priority to the following four aims:

1. To encourage entrepreneurship (including microenterprises).
   - To promote a level playing field for poor people in general.
   - To promote opportunities to earn a living.
   - To eliminate barriers to the market participation of women, for example through policies enabling them to own, buy, sell and inherit land.
2. To promote the transfer of businesses from the informal to the formal economy.
   - Institutional change and policies directed both at reducing the risks and costs of enterprise and at increasing the incentives for enterprise and investment.

- Measures that help actors in the informal economy to move gradually towards formalisation, such as creating formal associations in order to ensure access to microcredit, insurance, land rights and markets.

3. Gradually to pare down and simplify regulations, permits, procedures etc. To reduce regulation in the formal economy by eliminating rules which discourage or prevent participation. To reduce regulation in the informal economy by eliminating rules which promote exclusion, as in the case of certain permits and levies.
4. To promote the growth of the formal economy (and employment in it), especially in poor regions.

The financial sector has a key role to play in giving poor people the chance to share in economic growth and its benefits. The AIV therefore recommends a considerable strengthening and expansion of support for financial sector development as an effective way of promoting PSD leading to pro-poor growth.

As a first step, the AIV feels that the Directorate-General for International Cooperation (DGIS) should initiate the formulation, together with the Dutch Ministry of Finance and Ministry of Economic Affairs, of a joint strategy and distribution of tasks in the general field of financial sector development. In view of the complementary nature of the three ministries' responsibilities, competencies and participation in international forums, a joint strategy and clear distribution of tasks in this field would enhance the coherence, and hence the effectiveness, of Dutch government action in this area.

Financial sector development relates to both the public sector (government regulation, supervision and control) and the private sector (management, up-scaling etc.) and, above all, to close cooperation between the two. For that reason, the AIV recommends that DGIS involves the Dutch public-private platform for financial sector development (the Netherlands Financial Sector Development Exchange or NFX), which it helped to set up, in the preparation of this joint strategy for financial sector development.

The AIV also suggests that the two key themes for this strategy and an action plan based on it should be:
a. risk management, and
b. access to finance.

Risk management will mean two things: improving government regulation, supervision and control of the financial sector, and encouraging the development of instruments such as small-scale insurance, guarantees and derivatives which can be offered to farmers, entrepreneurs and households.

Improving access to finance means increasing and strengthening the links between microfinance institutions and the existing financial system. Microfinance has a major role to play in increasing interest in private sector development and financial sector development as a means of poverty reduction. Although nobody doubts the importance of microfinance as a way of achieving poverty reduction, there are problems in relation to the microfinance institutions. These have to do with their scope, size, product range and passive funding practices. For this reason, it is important to create an 'inclusive financial sector', featuring safe savings, loans to poor households and micro, small and medium enterprises, and the availability of insurance and remittance facilities. A second and equally important aim is to strengthen financial systems, which are often still fragile.

These two themes sum up recent insights concerning the role of financial sector development in achieving poverty reduction. They are appropriate in terms not only of the traditional position of the Netherlands in international financial discussions and the approach of the leading multilateral financial institutions in this field, but also of the Netherlands' ability to offer assistance.

Chapter VII
Question 4: What do you see as the relatively strong and weak points of the various instruments I have at my disposal to encourage the private sector to play a more active role in Dutch development cooperation? In what ways can these instruments be improved?

To assess the entirety of Dutch government efforts in the PSD field, the AIV has asked itself two questions in relation to current instruments: firstly, *'Are we doing the right things?'* and secondly, *'Are we doing things right?'* To answer these two questions, the AIV has tried to determine the extent to which DGIS's PSD instruments exhibit a number of core elements in private sector policy likely to generate both growth and pro-poor growth, and the extent to which they meet a number of quality criteria. The AIV would emphasise that this is not a blueprint but a conceptual approach based on knowledge and experience in the business world and elsewhere.

The AIV has the impression that a multitude of instruments have developed over time, which were only later classified under the theme of private sector development. This is perfectly understandable in view of the recent increase in interest in this field and the importance now attached to it. However, it does mean that there is little apparent coherence between the instruments. Nor is it always very clear on what basis instruments have been categorised. Moreover, there is no consistent policy framework based on lessons learned in the past.

In this context, strategy, the operationalisation of the strategy, evaluation and review are the main factors. There are really two levels of planning: strategic and operational. Any planning process should begin with the establishment of a strategy. This will be based both on external knowledge and information (such as authoritative studies by multilateral organisations like the World Bank, the IMF or the OECD) and on internal knowledge and experience, opportunities, competencies, and political and other priorities. The strategy will need regular evaluation and modification at appropriate intervals. The evaluation must consider the progress achieved in processes relevant to PSD and the extent to which PSD is actually being achieved. This is a dynamic process by which to establish *'what should be done'.*

Once the strategy has been established, the next step is operationalisation: in other words, to translate the strategy into the actions and instruments necessary to achieve the strategic aim in practice. This means making choices, setting priorities and formulating objectives in specific areas. At this stage, it will be vital to take account of the importance of the separate areas of action both to the countries involved and in achieving the goals set. Account must also be taken of the efforts of other donors and institutions and of the Netherlands' own competencies and capacities. Quantifiable objectives must be established for the resulting activities, instruments, etc. These should not be at the high level of *'the contribution to PSD'*, but at the practical level of *'progress made'* (for example, in setting up a land registry). Progress in these terms could be measured, for example, every two years under the aegis of the organisation responsible for implementation. This would produce a constant optimisation of the

answer to the question *'how should it be done?'*. If this system is adopted, individual instruments will not be assessed in terms of inappropriate questions like *'what is the contribution to PSD?'* or, even more ambitiously, *'what is the contribution to PPG?'.*

Finally, the AIV arrives at the following conclusions and recommendations:

Within the existing set of PSD instruments, there seems to be relatively little focus on improving the national policy environment in developing countries, even though national policies are a necessary precondition for PSD, economic growth and pro-poor growth. Current instruments pay little attention to improving the national investment climate and very little to the financial sector.

The majority of instruments are directed at financing infrastructural projects involving investments and/or exports by Dutch companies. Because the aid is tied, the result may be to drive up prices. It is unclear whether these instruments are actually a form of export promotion and whether they genuinely help to achieve pro-poor growth.

Grants are sometimes used to encourage investment where guarantees would be more appropriate. Where risk management is the intention, grants are regularly used instead of guarantees or insurance.

Based on the information available and discussions with representatives of various organisations, the AIV concludes that current strategy and control mechanisms regarding PSD are inadequate. It therefore advocates a fundamental reformulation of integrated PSD policies. This will mean making choices, setting priorities and formulating objectives. This should be turned into an on-going dynamic process, for example in the form of a biennial cycle of planning, implementation, progress monitoring and adjustment. Given the important role of PSD in generating both growth and pro-poor growth, the AIV feels that the sum of €285 million for PSD instruments looks modest in the context of a total ODA budget of €4.2 billion in 2005.

The AIV feels that the Sustainable Economic Development Department (DDE) has a special responsibility both to provide a complete overview of Dutch PSD efforts and to ensure their coherence. It believes that centralised supervision by the Director-General for International Cooperation would be a good way of achieving this.

The main policy aim should be to establish the right conditions and meet the necessary preconditions, rather than to provide any form of direct, concrete support for individual businesses.

More effort should be made to achieve synergy between instruments. At the moment, any such synergy is more accidental than the result of deliberate policy.

The AIV feels that given the large number of instruments taking the form of funds managed by the FMO, there is a considerable degree of fragmentation and inflexibility. This is likely to be detrimental to the effectiveness and efficiency of the FMO. It would be better to replace these funds by an equivalent annual contribution to the FMO's own capital, accompanied by a number of agreements between the State and the FMO on the various uses to which the money is to be put. The AIV is aware that this will entail a number of rules for the State and the FMO concerning risk-sharing and the concessionality of loans, but believes that the benefits in terms of flexibility, effectiveness and efficiency will substantially outweigh this difficulty.

The PSD instruments should be directed to a greater degree at strengthening national investment climates, for example by eliminating barriers and reducing risks. The same applies to strengthening the financial sector, with extra attention being paid to improving access for the poor to financial services including microfinance. Cooperation between various stakeholders will be required to enable developing countries to develop and implement strategies for access to financial services. In this connection, the Minister could ask the NFX to work hand in hand with the Dutch Microfinance Platform.

II Poverty reduction, growth and pro-poor growth

II.1 Introduction

This chapter and chapter III address the Minister's first question:
'Is there scope for governments to support private sector development in such a way as to maximise the contribution to poverty reduction? Is it effective, for example, to introduce measures aimed specifically at certain sectors or companies, such as Small and Medium Enterprises (SMEs), what kind of measures should be introduced, and how could they be identified and integrated into a Poverty Reduction Strategy Paper (PRSP)?'

This question has been considered at length in the international literature and the results are summed up in publications from various bodies, most notably the World Bank[7] and the OECD.[8] However, the results take the form of fairly general trends, guidelines, insights and suchlike, which can be translated into specific, practical policies only in the national context. Chapters II and III deal with the question principally from a macroeconomic point of view. The later chapters in the report provide more specific and detailed answers based on information obtained from entrepreneurs and employers' organisations, embassies, international institutions and so forth.

In order to answer the Minister's first question, the AIV has analysed four sub-issues:
(i) what is the relationship between economic growth and poverty reduction?
(ii) what factors promote growth?
(iii) how can growth be turned into pro-poor growth?
(iv) what contribution does private sector development make to growth and pro-poor growth?

The first three of these analyses are presented in chapter II and the fourth in chapter III. The summary of chapter II is included in that of chapter III, as part of the answer to question 1.

II.2 Relationship between economic growth and poverty reduction

The main findings in this area are as follows:[9]

- Increasing average incomes is a necessary precondition for reducing poverty.
- The higher the rate of growth, and the longer it is sustained, the more rapid the process of poverty reduction will be.
- Across countries and time periods, as average incomes rise, the incomes of the poorest fifth of the population rise proportionally.
- Over long time periods, between 66% and 90% of the reduction in poverty can be explained by changes in average incomes.

7 See World Development Report 2005, *A Better Investment Climate for Everyone*, and World Development Report 2006, Equity and Development.

8 See OECD, *Accelerating Pro-Poor Growth through Support for Private Sector Development*, OECD, Paris 2004, and OECD, *Promoting Pro-Poor Growth – Private Sector Development*, OECD, Paris 2006.

9 See OECD 2004, pp. 13-14.

For further information on these findings, see the sources specified below.[10]

It is important to recognise that these findings relate only to averages, around which there are considerable variations. For example, one of the empirical analyses listed above shows that between 66% and 90% of the total variance in poverty reduction is linked to economic growth and the remainder to changes in the underlying distribution of incomes.[11] Consequently, when seeking to calculate how much poverty reduction results from economic growth in a particular country, it is necessary to distinguish two components: growth and distribution. The two can reinforce each other ? if income distribution is relatively equal – or counteract each other if it is not. In the first case, growth will be pro-poor; in the second it will not.

For this reason, it is vital to know – and to be able to influence – the conditions under which the two components will reinforce each other. Section 4 of this chapter discusses this point further.

II.3 What factors promote economic growth?

Growth in per capita income is generated by the accumulation of physical and human capital and by increased productivity. These depend in turn on the geographical location of the country concerned, the extent to which it participates in international trade and capital flows, and the quality of its domestic institutions.[12] Circumstances linked to geographical location (such as distances, climate, the presence of natural resources, etc.) take a great deal of time and heavy investment to change. In fact, the relationship of geographical location to economic growth was until recently largely ignored.[13] Now, however, an unfavourable geographical location and lack of natural resources are identified, alongside inadequate institutions, as the main causes of persistent 'poverty traps'.[14]

10 See William Easterly, *The Elusive Quest for Growth*, The MIT Press, Cambridge, Massachusetts and London, England, 2001, p. 14. For the evidence supporting these results, see WDR 2006, pp. 84-85; Guillermo E. Perry et al, *Poverty Reduction and Growth: Virtuous and Vicious Circles*, The World Bank, Washington DC, 2006, chapter 4; and OECD 2004, pp. 13-16. Where the relevant results are based on macroeconomic analysis (cross-country regression analyses) in these three sources, they are confirmed by microeconomic research conducted at household level in eight African countries in the 1990s: Luc Christiaensen, Lionel Demery, and Stefano Paternostro, *Macro and Micro Perspectives of Growth and Poverty in Africa*, The World Bank Economic Review, Vol. 17, 2003, No. 3, pp. 317-347.

11 See WDR 2006, p. 85 and p. 237, footnote 29.

12 See Dani Rodrik, *Introduction: What do we learn from Country Narratives?* In Dani Rodrik (ed.), In Search of Prosperity, Princeton University Press, Princeton and Oxford, 2003, p. 4; *UN Millennium Project, 2005, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*, New York (the Sachs report), p. 28.

13 The only exception is Paul Krugman, *Development, Geography and Economic Theory*, The MIT Press, Cambridge, Massachusetts and London, England, 1995.

14 Jeffrey D. Sachs, I*nstitutions Matter, but Not for Everything*, Finance and Development, June 2003, Vol. 40, No. 2, pp. 38-41; Jeffrey D. Sachs, *The End of Poverty,* The Penguin Press, New York, USA, 2005, chapter 3; *UN Millennium Project, 2005, Investing in Development: A Practical Plan to Achieve the Millennium Development Goals*, New York.

Closer integration into the global economy – international trade and capital flows – is accompanied by faster growth. However, the importance of greater participation in international trade should not be overestimated. Although recent surveys of the literature strongly suggest that greater openness resulting from trade liberalisation is associated with faster growth in the longer term, there is no irrefutable evidence of this. Moreover, trade liberalisation alone certainly does not produce faster growth. It does so only when linked to improved investment policies and more effective institutions.[15] In addition, the evidence suggests that trade liberalisation is by no means always one of the main factors in poverty reduction. The distribution effects related to it can also work to the disadvantage of the poor.[16]

It is important, therefore, to identify the potential consequences of further trade liberalisation for economic growth and poverty reduction (especially those relating to the Doha Round of trade talks). Earlier studies by bodies such as the World Bank and the Center for Global Development have predicted that further trade liberalisation will have substantial positive effects. The global economic benefits of full trade liberalisation are estimated at 1.0% - 1.4% of world GDP. In the case of the developing countries, the economic benefits are estimated at 1.4% - 2.5%.[17] However, more recent models have produced considerably smaller estimates: no more than 40% - 50% of the global benefits suggested above, with no more than 30% reaching the developing countries.[18]

Since chapter V of this report contains a detailed discussion of the role and importance of FDI in relation to growth, pro-poor growth and poverty reduction in developing countries, the AIV will confine itself here to the following observations. The benefits of FDI are well-known: a higher investment rate than the domestic savings rate, transfer of technology and management, a possible catalytic effect on domestic investment, training, and a positive impact on the current account of the balance of payments. A 1% increase in the FDI share in the GDP of a developing country has been shown to increase per capita GDP by 0.4% - 0.7%, provided that there is sufficient domestic capacity to absorb the accompanying technology.[19] This makes FDI a major factor in economic growth in developing countries.

15 See L. Alan Winters (2004), *Trade Liberalization and Economic Performance*, An Overview, The Economic Journal, Vol. 114 (February), pp. 4-21.

16 L. Alan Winters, Neil McCulloch and Andrew McKay, *Trade Liberalization and Poverty: The Evidence So Far,* Journal of Economic Literature, Vol. XLII (March 2004), pp. 72-115.

17 World Bank 2002, *Global Economic Prospects and the Developing Countries 2002: Making Trade Work for the World's Poor*, World Bank, Washington DC, 2002; William R. Cline, *Trade Policy and Global Poverty*, Center for Global Development and Institute for International Economics, Washington DC, June 2004.

18 Sandra Polaski, *Winners and Losers: Impact of the Doha Round on Developing Countries*, Carnegie Endowment for International Peace, Washington DC, 2006. Thomas W. Herkel and L. Alan Winters (eds.), *Poverty and the WTO: Impacts of the Doha Development Agenda*, World Bank and Palgrave Macmillan, Washington DC and New York 2006. Chapter 1, pp. 3-30.

19 A.P. Thirlwall, *Growth and Development*, Macmillan, London, 1999, pp. 400-402.

By far the most important factor in generating faster economic growth is the quality of domestic institutions. There even appears to be a causal link between the two.[20] However, this statement raises the question of what is meant by institutions. The best definition is that offered by the pioneer in this area, Douglass C. North: 'the rules of the game in a society .... the humanly devised constraints that shape human interactions'.[21] The World Bank employs a broader definition: 'institutions are the rules, including behavioural norms by which agents interact and the organisations that facilitate coordination of human action'.[22] In other words, institutions are not just norms and rules, but also the organisations associated with them. Again, Douglass North says that 'how effectively agreements are enforced is the single most important determinant of economic performance'.[23] The protection of property rights is the other relevant institution most frequently mentioned.

In the six groups of indicators that are now commonly employed to judge the quality of institutions, both the institutions mentioned above ('protection of property rights' and 'effectively enforced agreements') fall under the 'rule of law' indicator. The other five are: voice and accountability (democracy), political stability, government effectiveness, regulatory quality and control of corruption.[24] However, there is no clearly defined set of institutions that provide the best enabling conditions for generating growth. As so often, there are many different ways to achieve the same goal. The interaction between institutions is an important factor. Accordingly, the effects of an entire policy package need to be analysed, rather than the effects of particular policies considered in isolation.[25] And, of course, democratic institutions include those directed at emancipating the population, such as the trade union movement and farmers' organisations.

The examples of China and India show, moreover, that considerable growth can sometimes be achieved without making sudden, extensive, radical reforms.[26] For instance, China has experienced extremely rapid growth in GDP over the last 20-25 years (approximately 10% a year) without having made all the reforms that might seem necessary to achieve such a result. Of the reforms theoretically required – political

20 See Dani Rodrik and Arvind Subramanian, *The Primacy of Institutions,* Finance and Development, June 2003, Vol. 40, No. 2, pp. 31-34; Hali Edison, *Testing the Links*, Finance and Development, June 2003, Vol. 40, No. 2, pp. 35-37.

21 Douglass C. North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, New York, 1990, p. 3.

22 World Development Report 2002: *Building Institutions for Markets*, World Bank, 2002, p. 38.

23 See Erik Berglöf and Stijn Claessens, *Enforcement and Good Corporate Governance in Developing Countries and Transition Economies*, The World Bank Research Observer, Vol. 21, No. 1, Spring 2006, pp. 123-150.

24 See Daniel Kaufmann, Aart Kraay, Massimo Mastruzzi, *Governance Matters III: Governance Indicators for 1996, 1998, 2000 and 2002,* The World Bank Economic Review, Vol. 18, 2004, No. 2, pp. 253-287.

25 See Winters (2004), p. 14.

26 See Rodrik (2003), p. 16.

democratisation followed by stabilisation, liberalisation and privatisation – only stabilisation has occurred in practice. There has been only partial liberalisation and little or no democratisation or privatisation. In practice, China has introduced an efficiency-enhancing partial free market system which takes account of the interests of the ruling class. Nevertheless, the result has been considerable growth and poverty reduction.[27]

In India, limited reforms were made in the early 1980s and these resulted in significantly faster growth. In the decade between 1980 and 1990, the country's GDP grew by 5.9% a year, compared with 3.7% a year between 1950 and 1980. In the early 1990s, when more radical and extensive reforms were made, these had the result of generating faster growth, although this time the effect was distinctly weaker. Between 1990 and 2000, GDP grew by 6.2% a year, compared with 5.9% a year in the 1980s.[28] The reason for the relatively low impact is probably that a first round of reform measures, however limited, will always have a greater impact in encouraging entrepreneurialism than subsequent rounds. This phenomenon is not confined to large countries; it was also observed in South Korea in the mid-1960s and in Chile in the early 1980s.[29]

The AIV welcomes the realisation that implementing even a relatively small part of a reform programme can have a major impact on income poverty, particularly with regard to the so-called head count index. At the same time, it is important to remember that the rise in income is generally from 1 USD to only 2 USD a day. Moreover, in the case of India, there is growing concern about both the quality of government services (health, education and water supplies) and the sustainability of the current rate of economic growth. The latter is also a concern in the case of China. There is reason to believe that the time may be ripe for new reforms in both countries.[30]

II.4 How can growth be turned into pro-poor growth?

As a general rule, 'the policies that promote growth are probably not that different from those that target the poor directly'.[31] The best analysis and recommendations on this subject are contained in the latest OECD report on private sector development and pro-poor growth.[32] The starting point of this report is the finding that measures to improve the general investment climate generate faster growth, also for the poor. To generate

27 Yingyi Qian, *How Reform Worked in China*, in Dani Rodrik (2003), pp. 297-333.

28 J. Bradford DeLong, *India since Independence: An Analytic Growth Narrative*, in Dani Rodrik (2003), pp. 184-2004.

29 The Economist, *Economics focus; Development piecemeal*, The Economist, 7 August 2004, p. 63.

30 The Economist, 25 March 2006, *Balancing act, a survey of China*, The Economist, 12 August 2006, *Economics Focus: Light and shade*, p. 57.

31 Dani Rodrik, *Growth versus Poverty Reduction: A Hollow Debate*, Finance and Development, Vol. 37, No. 4, December 2000, pp. 8-9.

32 Promoting the Supply-Side Response: Technical and Financial Assistance, in: *Promoting Pro-Poor Growth – Private Sector Development*, OECD, Paris 2006, pp. 40-46.

pro-poor growth, as defined in chapter I, priorities must be set within a general programme of reform in order to establish a primary or additional focus on markets, sectors and regions in which poor people live and work. The aim must be to give them improved access to means of production in general, and to business development services and financial services in particular.

When formulating and implementing growth-oriented policies, it is important to focus on pro-poor effects. It will often be possible to pay particular attention to pro-poor effects when designing policy measures. This topic is discussed in detail in a recent study on the effects of policies directed at pro-poor growth in 13 countries in Asia, Africa and Latin America and in Romania.[33] This study confirms that many policy measures directed at pro-poor growth are identical to policies designed to achieve faster growth generally. It also calls, like the World Bank, for a focus on poverty reduction through the elimination of barriers preventing poor people from sharing in growth. The study also provides a good insight into the policy measures that can help to increase the incomes of poor households in the agricultural sector. It mentions improving access to markets and reducing transaction costs, strengthening property rights, particularly in relation to land, creating financial and other incentives for households, and assisting small producers in their attempts to boost production and manage risks. In addition, it identifies policy measures that can give poor households greater access to non-agricultural income. These include improving the investment climate, providing greater access to secondary education and in particular ensuring that girls have greater access to education, the introduction of labour market controls so as to generate better quality employment, and measures providing greater access to physical and institutional infrastructure. Chapter III comes back to this point.

As section 2 of this chapter showed, the extent of poverty reduction in any given country is determined by a combination of a growth and a distribution component. Whether the results of growth are pro-poor will depend, therefore, on the empirical values of these two components. Greater inequality in access to the means of production is associated with lower growth and with a greater probability that the distribution component will have an adverse effect on poverty reduction. In such situations, growth will produce less poverty reduction than in those where distribution is more equal (in other words, where the poor have greater access to the means of production). These values can be influenced by government policies. The World Development Report 2006 discusses in detail how current income inequality can be reduced by reducing inequalities in access to means of production, economic resources and political influence. This means investing in the 'human resources' of the poor, ensuring greater and more equal access to public provision in the education, health care and information fields, guaranteeing property rights (especially in relation to land), improving the market position of the poor (in financial markets and the labour market), and pursuing balanced macroeconomic policies characterised by effective institutions.

Although the World Bank places greatest emphasis on the often considerable long-term benefits of greater equality, it also calls attention to the possible short-term costs of policies directed at achieving it. Such measures can reduce the static and dynamic

33 Agence Française de Développement, Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung, UK Department for International Development and World Bank, *Pro-Poor Growth in the 1990s; Lessons and Insights from 14 Countries*, World Bank, Washington DC, 2005.

efficiency of resource allocation, in particular by eliminating valuable individual incentives connected with disparities in income.[34]

Policies directed at reducing inequality are not the only way of making economic growth more pro-poor. Another way is to influence the pattern of growth, in terms of both regions and sectors. There is evidence that a broad pattern of economic growth – encompassing all regions and all sectors – is not only quicker to achieve, but also more pro-poor. This means, however, that extra investments in education, health care, infrastructure and financial sector development need to be specifically targeted at the poorer regions of the country and the sectors in which poor people tend to work (e.g. agriculture). This will permit faster formalisation of the local economy and more rapid increases in labour productivity.

When developing and implementing such policies, however, care must be taken not to stray too far in the direction of selective interventions (such as targeted grants, support for small enterprises, and direct investments). Chapters IV and V will come back to this point when answering questions 2 and 3 in the Minister's request for advice.

Finally, the AIV would like to call attention in this respect to the UN Millennium Project report 'Investing in Development; A Practical Plan to Achieve the Millennium Development Goals' (the Sachs report). In its advisory letter of April 2005 on this comprehensive report, the AIV praised the content and form of the report, while at the same time criticising it for paying insufficient attention to the role of civil society and for failing to attach priorities to the objectives, to financing and to good governance.[35] The Sachs report breaks new ground in the way in which it describes how pro-poor growth can be achieved. It is the first document to address all the aspects of poverty relevant to achievement of the first seven Millennium Development Goals. It reviews strategy, infrastructure, scaling-up, institutions, civil society, the private sector, conflict prevention and management, aid, trade, and the resources necessary in relation to each of the relevant aspects of poverty. There is much to be said in favour of casting national pro-poor growth programmes in the mould of 'MDG-based poverty reduction strategies' but this would require a reform of the present PRS process and the resulting PRSPs. (See chapter IV of the Sachs report and chapter III of this report).

34 World Development Report 2006, p. 88.

35 See AIV, *Observations on the Sachs report: How do we attain the Millennium Development Goals?*, Advisory Letter No. 9, The Hague, April 2005.

III Contribution of private sector development to growth and pro-poor growth

III.1 Introduction

Chapter II examined the relationship between economic growth and poverty reduction, the factors relevant to the generation of growth, and the way growth can be turned into pro-poor growth. This chapter now looks at how the private sector contributes to economic growth and pro-poor growth. It also discusses the part of question 1 in which the Minister asks whether it is effective to introduce measures aimed specifically at certain sectors or companies (such as SMEs). Finally, it examines the role of the PRS process and PRSPs in private sector development.

III.2 What contribution does private sector development make to growth and pro-poor growth?

III.2.1 The private sector and the investment climate

The private sector is the main engine of economic growth. Ninety per cent of the population of the developing countries – in some countries 95% – is active in the private sector. The main factor determining the contribution made by the private sector to economic growth is the investment climate (the location-specific factors which together produce the opportunities and incentives for the private sector – companies and individuals – to invest, create employment and expand). Together with policies directed at investing in people and giving them a voice, a good investment climate lays the foundation for successful development policies.

The quality of the investment climate is determined by the risks and transaction costs associated with investing and running a business. These risks and costs depend in turn on the quality of regulation in the country, the amount of competition, and the efficient functioning of the financial markets and markets for labour, information, infrastructural services, and other inputs to production.[36] As such, the quality of the investment climate is no different from that of domestic institutions, as discussed in section II.3.

A recent evaluation of action taken by the World Bank Group (World Bank, IFC and MIGA) to improve the investment climate in developing and transition countries (see footnote 1) distinguishes between first-generation reforms (macroeconomic stability and trade policies) and second-generation reforms (administrative reforms and regulatory institutions and activities). It shows little improvement in the quality of the investment climate in the decade between 1993 and 2003, with developing countries lagging behind transition countries in this respect. Moreover, those improvements that were identified related far more to first-generation reforms (macroeconomic policies) than to second-generation reforms (institutions). The Doing Business reports published by the World Bank and IFC every year since 2004 contain detailed accounts of the regulations enhancing or constraining business activities in the various countries.[37]

36 See in particular: World Development Report 2005, *A Better Investment Climate for Everyone*, World Bank, Washington DC 2005; pp. 1-5. World Bank Independent Evaluation Group, *Improving Investment Climates*, World Bank, Washington DC, 2006.

37 World Bank, *Doing Business in 2006*, World Bank, Washington DC, 2006.

III.2.2 The investment climate, the contribution of trade, foreign direct investment and development aid

In the sphere of *international trade*, the developing countries need to improve their investment climates both by reducing trade protection (tariffs and non-tariff barriers) and by improving the quality of their customs administrations.[38] The industrialised countries should help not only by reducing tariffs, quotas and non-tariff barriers on goods and services, but also by eliminating production and export subsidies in sectors relevant to developing countries.[39] However, the most important thing for all the groups of countries involved (but especially for developing countries) is the success of the current Doha Round of multilateral trade negotiations. The failure of the talks might threaten the very existence of the WTO. They must be completed by the end of 2006, if only because the 'fast track' powers of the US President are due to expire in mid-2007. The end of the WTO would have serious consequences. It would spell the end of international trade negotiations aimed at producing a system of multilaterally agreed, enforceable regulation. This would strengthen and accelerate the trend towards a system of preferential and chiefly bilateral trade agreements in which the economic clout of the major countries or groups of countries would determine trade relations to a far greater extent than it does now. It would also spell the end of a successful system of arbitration (something which would be contrary to the interests of virtually all developing countries). Finally, the prospective economic gains – albeit perhaps smaller than once believed – would not be achieved.[40]

Since 1995, the developing countries have eliminated many measures restricting *foreign direct investment*. This is especially true in the manufacturing sector and far less so in sectors like power, telecommunications, transport, banking and insurance.[41] Chapter V of this report discusses the relationship between FDI and national and international investment climates in greater detail.

Between 1998 and 2002, annual *development aid* for the improvement of the investment climate totalled around 21 billion USD worldwide (at a time when net annual ODA was about 55 billion USD worldwide). The greater part of this was spent on infrastructure.[42] Much of the aid in this sector is tied. In the case of the Netherlands, this is true of the Development-Related Export Transactions (ORET) and Environment and Economic Self-Sufficiency (MILIEV) programmes, for example. The direct cost of tying aid is put at 10% - 30% but tying also has the effect of reducing competition, increasing administrative costs and encouraging the use of less appropriate technology. Chapter VII of this report discusses the various Dutch aid instruments designed to promote the private sector in developing countries.

38 World Development Report 2005, chapter 5.

39 World Development Report 2005, chapter 10.

40 See also Martin Wolf, *Ten days that should shake the World Trade Organisation*, Financial Times, Wednesday 21 June 2006, p. 17.

41 WDR 2005, chapter 5.

42 WDR 2005, p. 190.

Technical assistance is another major component of tied aid. In 2003, 4.4% of all aid committed worldwide was 'aid for trade'.[43] The related infrastructure expenditure came to no less than 25% of all aid commitments in that year.[44] The Policy and Operations Evaluation Department (IOB) report 'Aid for Trade?' shows that the effectiveness and efficiency of, at any rate, the Dutch component of this expenditure was at best mediocre.[45] (See chapter VII for further details).

III.2.3 The private sector, the investment climate and pro-poor growth

The UNDP's Commission on the Private Sector and Development has recently examined the role of the private sector in generating pro-poor growth.[46] The Commission arrived at a long list of recommendations relating to the public sector, public-private partnerships and actions in the private sector. Where the public sector is concerned, its recommendations are directed at creating a good investment climate. In the case of public-private partnerships, they focus on joint action regarding the financial sector, education and training, and water and energy supplies. For the private sector, the recommendations relate to measures concerning larger domestic and foreign companies, SMEs and corporate social responsibility. The Commission's specific priorities and recommendations concerning pro-poor growth relate to the formalisation of the informal economy, increasing the supply of financial products and improving relations with SMEs. All three points are discussed in more detail later in this report.

Another relevant publication is the previously mentioned study by the OECD's DAC Network on Poverty Reduction.[47] This important study identifies the factors that enable the private sector to achieve faster economic growth and the institutions and policy measures that help to ensure that economic growth benefits the poor. It recognises that, given that country contexts differ widely, it is impossible to arrive at a universally applicable set of policies and institutions that will ensure pro-poor growth. It is possible, however, to devise an analytical framework that can be used to determine whether the right conditions are in place to enable the private sector to generate growth. This framework can also be used to decide what changes are required in policies and institutions in order to achieve pro-poor growth.

43 Aid for Trade is intended to help developing countries improve their trade-related infrastructure, tackle supply-side problems, expand their knowledge of international trade and deal with problems of adjustment resulting from liberalisation. The Aid for Trade Task Force was set up at the 6th Ministerial Conference in Hong Kong to advise on the operationalisation of Aid for Trade in the context of the Doha Development Agenda.

44 See World Bank, *Global Development Finance 2006*, World Bank, Washington DC, p. 82.

45 Ministry of Foreign Affairs, *Policy and Operations Evaluation of Trade-Related Technical Assistance*, IOB Evaluations No. 300, The Hague, October 2005.

46 Commission on the Private Sector and Development, *Unleashing Entrepreneurship: Making Business Work for the Poor*, United Nations Development Programme, New York, 1 March 2004.

47 OECD, Paris, 2004.

The analytical framework is composed of five elements:

- providing incentives for entrepreneurship and investment;
- increasing productivity, through competition and innovation;
- harnessing international economic linkages;
- improving market access and functioning;
- reducing risks and vulnerability.

For each of these elements, the study identifies a number of relevant institutions and policy measures (90 in total) and specifies the associated pro-poor effects (totalling 49). All in all, it is an excellent checklist enabling policymakers to look at each policy area and identify the relevant institutions and instruments in the 'enabling environment' and the pro-poor growth effects that can be achieved. Chapter VII lists the core elements and categories thought to be especially important for PSD instruments (see tables 7.1 and 7.5).

An example of how a national investment climate can be improved in practice is given in box III.1.

Box III.1 International Investment Round Table in Tanzania

In November 2002, the first International Investment Round Table (IIRT) meeting was held in the Tanzanian capital, Dar es Salaam, under the chairmanship of President Mkapa of Tanzania and in the presence of the President of the World Bank, James D. Wolfensohn, and the Managing Director of the IMF, Horst Kohler. Representatives of major multinationals in the mining, banking, ICT, tourism and manufacturing sectors talked to the president about their experiences as investors in Tanzania. Where necessary, the president then called on his departmental ministers or senior civil servants to respond in detail to the questions raised.

The meeting was inspired by previous contacts between the president and representatives of the local business community. These strictly private, informal meetings were designed to inform the president about current problems in every conceivable area, including access to credit, tax legislation and the functioning of the commercial courts.

Since 2002, five IIRT meetings have been held under the leadership of President Mkapa, one in Zanzibar, one on the edge of the Ngorongoro crater and the rest in Dar es Salaam, at which a range of subjects were discussed. In Ngorongoro, for example, there were fierce negotiations about new tax legislation; this led to renewed scrutiny of the proposed legislation by the Ministry of Finance and considerable amendments to it.

The IIRTs have not, of course, cured all the ills of the Tanzanian business world. However, they have proved an effective way to draw the attention of people at the highest level to problems in the field of private sector development, and hence to create the prospect of improvement.

III.2.4 The PRS process and PRSPs

Chapter II has already indicated the importance of PRSPs and the Minister's first question refers to the PRS process. The question is what role private sector development plays in the PRS process and what is known about the quality of PRSPs and the underlying strategies.

A survey of the PRS process in 23 Dutch partner countries reveals that the questionnaire used in it contained not one specific question about private sector development.[48] There was, however, a question about the active involvement of 'stakeholders' in the process and industry associations and agricultural organisations are mentioned in that context as part of 'civil society'. The results of the study show considerable room for improvement with regard to the two main issues examined: 1) the adequacy of the national PRS as a basis for poverty reduction, and 2) political commitment to poverty reduction and the priority given to implementation.

A study by Gerster Consulting shows that, although the private sector does play a role in the PRSPs, some government authorities still see it as less important than the public sector and regard grants as the main way of achieving poverty reduction.[49] Too little attention is paid to the informal economy and to the participation of the private sector in the PRS process. The most serious shortcoming, however, is the lack of concrete indicators of progress (or lack of it) in achieving poverty reduction.

An evaluation of the role of the private sector in PRSPs published by USAID in October 2003 concludes that the private sector has in general participated in the PRS process and that its essential role in poverty reduction has been foregrounded. According to this evaluation, the most serious weakness of the majority of PRSPs is the absence of concrete targets and indicators by which to measure progress.[50] The same shortcoming has also been identified by the OECD, together with the fact that the private sector has been given little or no role in the design of relevant measures.[51]

The Global Monitoring Report 2005 contains the results of an evaluation of the PRS process conducted by the IMF's Independent Evaluation Office (IEO) in 2004. Despite some progress, the IEO felt that '…PRSs fell largely short in providing strategic difficult trade offs, setting out clear priorities, and addressing capacity constraints, particularly in budget and expenditure management'.[52]

Even so, the IMF attributes a major role to PRSPs, for example in achieving the MDGs. The IMF does, however, stress the urgent need to coordinate the PRS process and the

48 See Anja de Vries and Marten de Boer, *Poverty Reduction Strategies in Dutch Partner Countries*, Ministry of Foreign Affairs, The Hague, 5 December 2005.

49 Niklaus Eggenberger-Argote, *Private Sector Development in the Context of Poverty Reduction Strategy Papers*, Gerster Consulting, February 2005.

50 USAID Development Information Services, *Poverty Reduction Strategy Papers: Review of Private Sector Participation*, Washington DC, 31 October 2003.

51 OECD, *Promoting Pro-Poor Growth - Private Sector Development*, OECD, Paris, 2006, p. 5.

52 World Bank, *Global Monitoring Report 2005*, Washington DC, 2005, p. 228.

PRSPs. It is not itself prepared to take on the role of coordinator, but is prepared to take the lead in tackling certain 'growth-critical issues' in consultation with other institutions. In this context, it is important to recognise that a PRSP cannot and should not contain all the relevant policy information about poverty reduction. Other information may be available from, for example, Medium Term Debt Strategies in the context of the Multilateral Debt Relief Initiative, or progress reports on the MDGs and the associated need for foreign aid. National budget estimates can and should also contain extra information of this kind.[53]

All in all, the AIV concludes that there are clear shortcomings in the quality of the PRS process and the PRSPs, particularly as regards the role of private and financial sector development and the attention paid to pro-poor growth both in the process and in the PRSPs themselves. A major problem is that, while PRSPs inform the strategy of donors, they very often do not inform those of national parliaments. More attention should also be paid to the role of the trade union movement in this process. In addition, the AIV would call policymakers' attention to the urgent need to eliminate much of the excessive bureaucracy associated with the PRS process and producing PRSPs.[54]

III.2.5 The role of SMEs

The Minister's first question asks, among other things, whether it is effective '… to introduce measures aimed specifically at certain sectors or companies, such as Small and Medium Enterprises (SMEs)'.

SMEs are of great importance to any national economy. They account for a large proportion of national employment and starting small is a natural part of business life. In that sense, SMEs should be regarded as a seedbed or nursery for the larger companies of the future.

In the past, SMEs were assumed to promote both growth and pro-poor growth. It is becoming ever clearer, however, that this is not the case. SMEs are actually more likely than larger companies to combine labour and capital in ways that fail to produce maximum employment and productivity. Larger companies achieve higher average employment and output per unit of capital. A number of studies have shown this empirically.[55, 56] They demonstrate that measures to protect SMEs have never generated economic growth and/or led to poverty reduction. Optimum company size is

53 International Monetary Fund, *The Role of the Fund in Low-Income Countries*, Washington DC, 20 March 2006, Table 1, p. 53-54.

54 See William Easterly, *The White Man's Burden*, The Penguin Press, New York, 2006, pp. 144-146, 174, 185 and 195-196.

55 Ian M.D. Little, Dipak Mazumdar and John M. Page jr., *Small Manufacturing Enterprises: A Comparative Analysis of India and Other Economies*, Oxford University Press and World Bank, Washington, DC, 1987. Thomas Beck, Asli Demirgüç-Knut and Ross Levine, *Small and Medium Enterprises, Growth, and Poverty: Cross-Country Evidence*, World Bank Working Paper, No. 3178, December 2003.

56 William Easterly (2006), p. 55. Easterly also discusses the donor misconception that SMEs act as a catalyst in the process of development and poverty reduction. In this respect, he refers to the study by Beck et al., 2003.

determined by market conditions and the current state of technology, not by poverty reduction goals. These findings are reflected in the analysis and recommendation of the OECD's DAC Network on Poverty Reduction.[57]

On the other hand, there is often considerable discrimination against SMEs in developing countries. Trade policy, investment promotion and credit provision measures are frequently designed to benefit larger companies and exclude SMEs. Eliminating such discrimination helps to create a level playing field. Economic and other institutions have a major role to play in this respect. It is not scale but the promotion of productivity, the market mechanism and competition that determine general economic growth and pro-poor growth.

III.3 Summary and concluding remarks

In answer to the Minister's question, the AIV feels that scope certainly exists for governments to support private sector development in such a way as to maximise the contribution to poverty reduction. However, this response requires amplification. The AIV has adopted both the absolute definition of 'pro-poor growth' (the fastest possible growth in the income of the poor) and the relative definition of the concept (reduction of inequality between the poor and the remainder of the population).

The AIV's analysis reveals that growth is by far the most important factor in poverty reduction and that on average growth in per capita income among the poor is equal to that in the population at large. It also shows that poverty reduction resulting from economic growth has two components: growth and distribution. The two can reinforce each other – if income distribution is relatively equal – or counteract each other if it is not. In the first case, growth will be pro-poor, in the second it will not. For this reason, it is vital to know – and to be able to influence – the conditions under which the two components will reinforce each other.

Growth is the main factor in poverty reduction and the quality of domestic institutions is by far the most important factor in generating faster growth. The rule of law, democracy, political stability, government effectiveness, regulatory quality and control of corruption are all relevant because they determine the quality of the investment climate (the location-specific factors which enable companies to invest, expand and provide employment, and citizens to develop as entrepreneurs, employees and consumers).

To achieve pro-poor growth requires policies that reduce income inequality or, put more generally, ensure more equal access to the means of production. The analysis also shows that growth, spread across all regions and all sectors of the economy, offers greater opportunities for the poor. This means that extra investments in education, health care, infrastructure and the development of the financial sector need to be concentrated in poor regions and in sectors in which poor people are active (agriculture). A striking conclusion is that policy measures designed to generate pro-poor growth need not be very different from those directed at increasing the rate of growth generally. It is important, however, to maintain a focus on pro-poor growth and to place the emphasis on the effect of every individual policy measure on the position of the poor.

57 OECD (2004), p. 30.

The best analysis and recommendations on this subject are contained in the latest OECD report on private sector development and pro-poor growth.[58] The starting point of this report is the finding that measures to improve the general investment climate generate faster growth, also for the poor. To generate pro-poor growth, priorities must be set within a general programme of reform in order to establish a primary or additional focus on markets, sectors and regions in which poor people live and work. The aim must be to give them improved access to means of production in general, and to business development services and financial services in particular.

Improving the quality of the investment climate reduces costs and risks for the private sector and improves market functioning. Where the private sector is the main engine of growth and encompasses most of society and the national economy, it is an obvious step to explore what policies are required to use it to generate a faster rate of growth and pro-poor growth. In addition to a reduction in trade protection and in measures restricting FDI, more development aid is required to strengthen institutions and improve infrastructure.

As country contexts differ widely, it is difficult to arrive at a universally applicable set of policies and institutions that will ensure pro-poor growth. It is better to follow the example of the OECD and to analyse the likely pro-poor effects of each policy measure and institution on the basis of whether it will:
- provide incentives for entrepreneurship and investment;
- increase productivity, through competition and innovation;
- harness international linkages;
- improve market access and functioning;
- reduce risks and vulnerability.

As a rule, pro-poor policies should benefit private sector activities and enterprises across the board, while at the same time paying extra attention to particular regions and sectors. Pro-poor growth policies should consist primarily of measures to reduce discrimination against and exclusion of the poor, but also include measures to ensure that the poor can exploit their increased opportunities in practice. These measures will usually need to be generic rather than selective. The right combination of the two will depend on the specific situation.

Policies should not specifically target SMEs, since this will tend to distort markets rather than generate growth and poverty reduction. However, existing discrimination against SMEs should be eliminated.

The PRS process and PRSPs tend to leave a great deal to be desired. The PRS should be the key to achieving poverty reduction, while the PRSP should show how that aim is to be achieved in practice. The effectiveness of measures to promote private sector development depends to a great extent on the quality of the PRS and the PRSP. Economic growth, pro-poor growth, poverty reduction and the contribution of private sector development to them will only be satisfactory if private sector development and the PRSP are of adequate quality. This means that private sector development directed at growth and pro-poor growth must be accorded a greater role in the PRSPs and that there must be simultaneous improvement in the quality of the PRS process and the PRSPs.

58 Promoting the Supply-Side Response: Technical and Financial Assistance, in: *Promoting Pro-Poor Growth – Private Sector Development*, OECD, Paris 2006, pp. 40-46.

IV Management of the economy and selective interventions

This chapter addresses the Minister's second question: 'What are the dangers of too much management of the economy by governments and donors? The WDR 2005 indicates that the more specific measures are, the less chance they have of success. This calls into question the value of measures aimed at specific sectors or companies'.

The WDR 2005 stresses that, in a national economy, policy measures designed to improve the investment climate should as a rule benefit all enterprises and private sector activities.[59] As part of a pro-poor growth policy, however, extra attention can be paid to the pattern of growth in particular sectors and regions. This can be done by means of additional investments in infrastructure, education and health care, and by providing extra financing facilities in those regions and sectors in which many poor people live and work. Those regions and sectors can also be given precedence as regards other measures to improve market access and market functioning. After all, a programme of reform to improve the investment climate will not be implemented overnight, but will be spread over time.

Such reform programmes are difficult for governments to implement in practice, since vested interests are often involved. For that reason, governments wishing to speed up economic growth are inclined to resort to special and selective support for individual companies and activities. This option also tends to be politically attractive.

As indicated in chapter II, such selective interventions should be approached with considerable caution. They take the form of privileges such as market protection, for example by means of import barriers, special tax rates, or targeted and subsidised credit arrangements. The aims of these measures may be small business development, research and development, or (most commonly) the development of specific industries and activities.

The disadvantages of programmes specially designed to provide incentives for SMEs have been discussed in chapter III. Selective interventions tend to be particularly associated with problems concerning the identification of 'winning' industries and activities. According to the World Bank, such measures are at best a gamble (WDR 2005, p. 161). Moreover, they are often part of systems that invite 'rent-seeking' behaviour and corruption (see also V.5.1 corporate social responsibility). The first are lobby activities connected with the presence of policy measures such as quantitative restrictions and licences. These are associated with bonuses and unexpected profits which again benefit successful lobbyists. Such systems have the effect of transferring costs and risks from businesses, where they belong, to consumers and/or taxpayers. Well-known examples are import barriers, tariffs and quotas, subsidised credits and guarantees. Not only do such systems provide the relevant businesses with monopoly profits, they are also extremely difficult to terminate. Moreover, measures of this kind are frequently not cost-effective. The benefits accrue to individual enterprises, while the relatively high costs have to be met by consumers and taxpayers.

59 WDR 2005, *A Better Investment Climate for Everyone*, pp. 159-174.

To sum up, selective interventions frequently fail to produce the desired and expected results in terms of employment, production, incomes and improved standards of living. This is a lesson learned from experience in developed as well as developing countries.

Although it is preferable to strive for simultaneous improvement in all aspects of the investment climate, this is frequently impracticable. As stated in chapter II, priorities must be set. In setting them, it will not always be possible to avoid selective interventions. For example, giving priority to improving the investment climate for the informal economy and agriculture will lead to measures and institutions improving market access and functioning in favour of the relevant target groups (and perhaps thereby produce the intended result in terms of pro-poor growth). When implementing such priorities, it must be remembered that the subsequent implementation of other components of policy to improve the investment climate will lead to faster growth of the national economy as a whole, and hence to more rapidly rising incomes for the poor.

The OECD likewise warns against politically understandable measures in the form of direct support for the private sector.[60] As examples of this it cites not only direct support for companies (particularly SMEs), but also technical assistance for and/or financing (via grants) of banks providing loans for small businesses and microfinancing organisations. As the disadvantages of such measures, particularly for donors, the OECD cites distortions in the market leading to distortion of competition. This is the result both of the process of 'picking winners' and of the crowding out of private-sector service provision by public-sector agencies. Such measures are ultimately unsustainable, if only because of the lack of long-term private or public sector funding.

On the basis of these considerations, the OECD derives a new paradigm for private sector development leading to growth and pro-poor growth. The focus must be on the causes of problems rather than their symptoms, and on the creation of a level playing field for producers and consumers. There should be no subsidising of businesses or intermediary organisations, although grants may be given to end-users, such as consumers. Examples of selective interventions to be avoided include all types of direct support for activities, businesses or categories of businesses.

IV.1 Conclusions

On the basis of the above, the AIV's answer to the Minister's second question can be summed up as follows. Improving the general investment climate is likely to generate a faster rate of economic growth and also increase the incomes of the poor. To achieve pro-poor growth, it is necessary to accelerate and/or increase the measures and resources concentrated on those markets, sectors and regions in which many poor people live and work. The aims must be to strengthen institutions, improve market access and functioning, produce a level playing field, invest in infrastructure, education and health, encourage access to the formal economy, increase the availability of technical assistance and financial services, and end grants to businesses or intermediary organisations (while perhaps maintaining or creating subsidies to end-users). 'Selective' interventions of this kind are likely to generate pro-poor growth.

Selective interventions in the form of support for individual activities, businesses or business categories should be avoided. More often than not, such measures will damage the national economy by failing to pick the right 'winners', promoting rent-seeking behaviour and producing solutions which are not cost-effective.

60 OECD, *Accelerating Pro-Poor Growth through Support for Private Sector Development*, OECD, Paris, 2004, chapter 4, pp. 57-65.

V The role of foreign direct investment

V.1 Introduction

This chapter deals with the Minister's third question:
'In what way can the positive role of foreign direct investment be strengthened, such that it contributes as much as possible to employment and promotes local companies?'.

To answer this question, the chapter starts by outlining the background to FDI as a component of international capital flows. It goes on to describe how FDI is generated, the role of government in this, the factors that can strengthen the pro-poor effects of FDI and the ways in which Dutch development cooperation can promote them. Finally, it answers the Minister's question.

V.2 Background

Since the 1990s, FDI – direct foreign investment by companies in other countries – has been the main source of foreign capital in developing countries. In 2005, the flow of private capital to developing countries reached the record sum of 490 billion USD.[61] For a long time, this flow consisted primarily of loans, but this began to change in the late 1980s. A combination of technological and politico-economic developments led to a structural change in the ability of companies to organise their production processes on an international basis. It became much easier for them to invest in other countries. This led to a sharp increase in FDI, making it both a cause and a result of the current wave of globalisation. Moreover, as developing countries managed increasingly to develop their own capital markets, there was growing foreign investment in the shares of their domestic companies. Of the 490 billion USD of private capital flowing into developing countries in 2005, 299 billion (61%) took the form of equity capital, the majority of it (237 billion) in the form of FDI and 61 billion in the form of portfolio equity.[62]

In the case of the very poorest countries, and to some extent also the poorest regions of middle income countries, this general picture requires qualification.

In the first place, *private transfers* from abroad and *remittances* from migrant workers are a very important source of external finance for these countries, if only because of the amounts involved. Far from all of this money can be regarded as investment. Although it is not regarded as part of the inward flow of capital,[63] it constitutes a major proportion of the foreign currency income of many low-income countries. The World Bank estimates that in 2005 these transfers to developing countries totalled 167 billion USD, double the amount remitted in 2000. The true amount, adjusted for unrecorded transfers, must be assumed to be around 50% higher.[64]

61 *Global Development Finance 2006*, the World Bank, p. 13.

62 *Global Development Finance 2006*, the World Bank, p. 3.

63 It is classified as 'remittance flows': returns on the export of manpower.

64 *Global Development Finance 2006*, The World Bank, p. 3.

Secondly, it is often said that *FDI is heavily concentrated* in a limited number of countries and that the poorest countries hardly benefit. This calls for some qualification. While it is true that in 2005 ten countries received 65% of the total flow of FDI to the developing world,[65] those ten countries are home both to the majority of the population of the developing world and to the majority of the poor.[66] Moreover, the concentration is decreasing and FDI is also extremely important to the poorest countries. In 2005, approximately 10% of all FDI in developing countries went to them.[67]

The flow of FDI to the poorest countries increased at about the same rate as that to developing countries in general. A proportion of it consists of investments in remote mining projects or projects relating to commodities almost exclusively produced for export. Because of the capital-intensive nature of these projects, their often geographically isolated location and their vulnerability to corruption because of the large sums involved, the contribution to sustainable domestic development – and certainly to pro-poor development – has generally been limited.[68] This is especially true of investments in unstable countries and regions, where government is not in a strong position to work constructively with the investor. However, where government authorities are more alert to national economic interests, enclave projects of this kind can make a major contribution to growth and development.

Thirdly, there has been a rapid increase in *capital flows between developing countries*. This is particularly important to the poorest countries. After all, other developing countries are a major source of the 'remittance flows' to them.[69] There has been a very rapid increase in the outward flow of FDI from developing countries: up from 3 billion USD in 1991 (then equivalent to 0.1% of the gross national income of those countries) to 47 billion USD in 2003 (0.6% GNI), bringing this South-South FDI to 36% of the total FDI flow to developing countries.[70] Firms in Brazil, China and South Africa are clearly in a better position than their competitors in developed countries to confront conditions in the poorest countries, and they are proving well able to exploit their advantage.[71]

65 China, India, Brazil, Russia, Mexico, the Czech Republic, Poland, Chile, South Africa and Malaysia.

66 In 2001, 51% of poor people (in developing countries) were living in China and India. Source: Shaohua Chen and Martin Ravaillon; *How have the World's Poorest Fared since the Early 1980s?* The World Bank Research Observer, Vol. 19, No. 2, Fall 2004, Table 4, p. 153.

67 *Global Development Finance 2006*, The World Bank, p. 5, Table 2.6.

68 *Global Development Finance,* 2005, p. 9.

69 Not just oil-exporting countries like Saudi Arabia, but also, for example, Brazil.

70 A striking detail here is that a considerable proportion of FDI in China comes from Chinese people elsewhere. See Maggi W.H. Leung *'Overseas Chinese as Agents for Economic Development in China'*, Radboud University Nijmegen, August 2006, p. 5.

71 *Global Development Finance*, 2005 and 2006.

V.3 Pros and cons of FDI

There is a great desire to attract FDI. Almost every country in the world is competing hard for it. Most national, provincial and municipal governments have their own agencies to attract investment by foreign companies. It creates no debts and the investment is repaid only if profits are made, and then only after they have been taxed. The flow of FDI has proved to be more stable than that of loans, because it is more difficult to withdraw business investments of this kind. However, the main reason for the popularity of FDI is that it tends to be associated with an efficient form of knowledge transfer relating to production, management, marketing etc. which leads to greater integration in the global economy.[72] The spin-off effects of FDI in the form of deliveries of goods and services by local companies are also welcome.

The disadvantages of FDI are connected mainly with the foreign ownership of companies operating within the recipient country. The host government needs to be capable of exercising adequate control by means of legislation, regulations and supervision.[73] This is a major challenge, especially in the poorest countries, although the challenge is equally great where investment by local companies is concerned. Moreover, it is constantly apparent that the financial and economic aspects of globalisation are far outpacing the political and cultural aspects. For example, unease about foreign ownership can remain latent and suddenly flare up.[74] As a rule, foreign companies/owners will behave no differently from their domestic counterparts. However, if a limited number of foreign companies were to dominate a major sector of the economy, this might limit the scope for government policymaking and be undesirable on that account.

V.4 The FDI decision

There is a substantial literature on the reasons for corporate investment decisions but what it comes down to is that companies strive to *maximise value and profits in the long term*. They are increasingly finding that parts of the overall value chain – whether it involves goods or services – can be split off and located in different places or countries. The information and knowledge needed to make these investments are

72 '…private investment is a crucial prerequisite for economic growth because it allows entrepreneurs to set economic activity in motion by bringing resources together to produce goods and services. Rapid and sustained growth is facilitated by a virtuous circle whereby entrepreneurship and investment leads to higher productivity, making it possible to invest larger sums in the future. In the course of this process, jobs are created and new technologies are introduced, especially through international trade and investment linkages. Competitive and well-functioning markets are crucial because they promote and reward innovation and diversification, foster form entry and exit and help to ensure a level playing field for all private sector actors. They also have an important role in making the growth process more socially and geographically inclusive, which expands the opportunities for poor people to participate in and benefit from growth. Successful mobilization of private (domestic and foreign) investment is thus increasingly important for creating employment, raising growth rates and reducing poverty….. *'Mobilizing Private Investment for Development: Policy Lessons on the role of ODA'*, OECD, 2005.

73 Without introducing market-distorting subsidies and forms of protection: see also pages 5 and 6.

74 And certainly not only in developing countries: see the various recent fusses about foreign investment, in the USA concerning Dubai Ports, in France about energy and in Poland about the financial sector.

provided by governments, the private sector and international organisations. Companies all over the world now have ever-easier access to this information, particularly via the internet. However, this is certainly not a process in which objective information and clear decision models automatically lead straight to investment. Despite all the progress, information remains incomplete, its interpretation can vary and there are considerable uncertainties.

This is especially the case where corporate investment in developing countries is concerned. The *perception of risk* is the most important factor. Companies frequently perceive developing countries as presenting greater risks concerning political stability, law enforcement, rates of exchange etc. and will therefore set higher criteria for the expected returns on any investment. In the case of Africa, there is objective evidence that the continent is an exceptionally high-risk place in which to invest.[75] Long-term strategic considerations relating to population growth, geopolitical balances and access to raw materials, which can work out very differently for companies from different countries, also play a role.[76] In the last few years, *corporate social responsibility* has become a consideration for major Western companies, especially if they are marketing their products to the general public. In the investment field, however, it will usually be a secondary one. There is no doubt that the vast majority of the innumerable decisions that companies worldwide are taking every day of the week and which together determine the flow of FDI are based chiefly on financial management considerations. The promotion of pro-poor growth in the recipient country is not a decision-making factor of any significance.

V.5 FDI and pro-poor development

This brings us to the issue of FDI and pro-poor development and to our answer to the question put by the Minister: 'In what way can the positive role of foreign direct investment be strengthened, such that it contributes as much as possible to employment and promotes local companies?' We begin by discussing the aspects of an investment by a foreign company that can produce pro-poor effects and then proceed to describe the ways in which Dutch development cooperation can influence those effects.

V.5.1 Factors that influence the pro-poor impact of FDI

The first factor is the *region or sector* in which the investment is made. As noted in chapter II with regard to investments in general, FDI offers better prospects of pro-poor growth when it takes place in poor areas or in sectors in which many poor people are active. Because these regions and sectors tend to suffer from poor physical access, communications and education, their ability to attract FDI will depend on extra investments in physical infrastructure (roads, energy, water, telecommunications, etc.) and human resources (education, training, etc). These will have to be made by the national government, perhaps through development aid.[77]

75 Paul Collier and Catherine Patillo (eds.), *Investment and Risk in Africa*, Macmillan, 2000.

76 For example, in the investments made in African commodity-exporting countries by Chinese and Brazilian companies with state participation.

77 For pro-poor outcomes of FDI, see OECD 2004, *Accelerating Pro-Poor Growth through Support for Private Sector Development*, p. 33, box 4.

A second factor is the *industry or sector* in which the company invests. Recent studies have shown that PSD in some specific sectors produces not only economic growth , but pro-poor growth as well. The three sectors of main current interest in this respect are the financial sector, agriculture/food processing and infrastructure (and its private sector exploitation). As chapter II explains, this is true of investments in general and hence also of FDI.

A third factor is the *quality of management*. Although there are no known research findings to support this, it is reasonable to assume that the quality of management can enhance the pro-poor impact of FDI. An example is the extent to which management is able to adapt to local conditions and make optimum use of available local services and products. The internationalisation of management in globally integrated enterprises[78] means that investors are increasingly good at combining local and international knowledge and experience, although conditions in the poorest countries constitute a major challenge even for these companies. Such enterprises' growing understanding of the importance of *corporate social responsibility* also plays a role in this. It is expressed in their attitude to issues such as management development, the environment, control of corruption,[79] social protection and child labour (with regard to corruption, see the recommendations). Improvements in the quality and sustainability of the entire production chain seem to be important in this respect, especially where the first links in the chain are in developing countries.[80]

The final factor is two aspects of measures which are designed to enhance the positive role of FDI but which we know from experience actually present a risk.

The first of these is the offer of government *subsidies and protections*[81] to companies making investments. Such offers are made by virtually all national, provincial and municipal authorities (even in developed countries) in the attempt to attract FDI. However, research has shown that this is largely ineffective and that authorities waste money on investments which would have been made anyway, even without such *incentives*.[82] Moreover, if such subsidies and protections are offered only in relation to foreign investment, the effect is to distort competition with local companies. There is also a risk that investment will become dependent on the permanent availability of subsidies and protections which were originally offered only to help companies surmount initial difficulties. In that case, the company will profit at the expense of the

78 The term 'globally integrated enterprise' is a better description of present-day international companies than 'multinational', which reflects the situation in the 20th century; Samuel Palmisano: Foreign Affairs, May/June 2006.

79 OECD, *Convention on Combating Bribery of Foreign Public Officials in International Business Transactions*, 21 November 1997.

80 Well-known examples are coffee (Max Havelaar, Utz Kapeh), timber (Forest Stewardship Council), fish (Marine Stewardship Council), palm oil (Roundtable on Sustainable Palm Oil).

81 Such as tax concessions, import protection, subsidies on costs of land or energy, or subsidised finance.

82 New Horizons: Multinational Company Investment in Developing Countries. McKinsey Global Institute, 2004. Summary in McKinsey Quarterly, 2004, No. 1: *The truth about foreign direct investment in emerging markets*.

economic benefits for the recipient country. Given the often considerable cost of an eventual failure in terms of socioeconomic development, authorities can feel obliged to maintain such arrangements indefinitely. After all, especially where the activities involved are labour-intensive but not capital-intensive, firms can easily decide to move their operations if they are offered more attractive conditions elsewhere. This is true of all investment, of course, but the fragile economic position of the poorest people and areas and the fast-moving nature of the international business world mean that the impact of failure will be more difficult for these people to bear and may be suffered more frequently by them. For this reason, considerable caution should be exercised when offering such subsidies and protections.

Caution is also required in relation to the second aspect: the use of government regulation to control the way investors run companies. One example is the imposition of rules for the use of local products and services or for the participation of local investors.[83] The study by Moran cited in chapter II calls experience of such measures 'decidedly negative'.[84] More recent research has also shown that protectionist measures of this kind are generally counterproductive. The benefits, such as greater use of local suppliers or increased financial participation of local parties, are outweighed by the adverse economic impact of the resulting distortion of the market. Indeed, the artificiality of such constructions increases the risk of failure.[85]

V.5.2 Ways for Dutch development cooperation to strengthen the pro-poor impact of FDI in developing countries

(a) assistance to government in the recipient country

By supporting improvement in the *investment climate* generally (see chapters II and III), the Netherlands can help to eliminate obstacles to FDI *in the poorest areas.* These obstacles, as described in the 'Doing Business' analysis and elsewhere, can be reduced by providing support for local research, region-specific information and decentralised investment in government support services focused on the poorest areas (the 'De Soto desks', see chapter VI). Priority should be given to tackling rules, taxes and corruption that make it impossible for entrepreneurs in the informal economy to transfer their operations to the formal economy. The same applies to many smaller foreign investments, generally emanating from neighbouring countries, which are directed at the provision of products and services for the poorest.[86] The Netherlands can also join forces with civil society organisations and microfinancing bodies to pay more attention to these parts of the private sector, thereby increasing opportunities for the poorest entrepreneurs.[87]

83 Local content and joint venture regulations.

84 Theodore H. Moran, 1998, pp. 41-48.

85 Research conducted in 2004 by the McKinsey Institute, see footnote 19.

86 C.K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits*, Wharton School Publishing, Upper Saddle River, New Jersey, 2005.

87 See chapter VI.

In providing assistance for the development and, more especially, maintenance of *infrastructure,* the Netherlands can pay extra attention to provisions of particular importance to rural and extremely poor areas, such as roads providing access to markets, telecommunications, education and water management. Assistance can be provided for the development of appropriate forms of public-private partnership, including maintenance and management as well as construction. This can ensure that attracting FDI for this kind of infrastructure benefits not only the poorest entrepreneurs, such as farmers, but also the poorest sections of the entire population.

In view of the great importance ascribed to improving poor people's access to financial services (not just loans, but also current and savings accounts, payments, cash withdrawals and insurance),[88] extra support for *financial sector development* appears to be a good way of promoting pro-poor PSD. See chapter VI.

(b) assistance for companies considering investing in a developing country risk mitigation

The Netherlands (through development cooperation and the Ministry of Finance) supports many forms of finance provided by multilateral institutions and the FMO to either foreign or local companies wishing to invest in developing countries. These days, almost all these forms of finance could also be offered by commercial institutions: the added value of the public sector institutions lies in their ability to take risks which are not regarded as acceptable in the private sector market.

It is odd, therefore, that guarantees, insurance and derivatives – the instruments specifically directed at mitigating risks – are largely ignored by these institutions in favour of far less user-friendly alternatives.[89] After all, non-commercial risks (relating, for example, to economic and political stability, exchange rate policies, regulation, the administration of justice and law enforcement) are constantly cited as the main barrier to FDI in developing countries, especially Africa.[90] Risks relating to climate and natural disasters – against which insurance is usually available in other parts of the world – are also a barrier to investment in developing countries.[91] Partial guarantees or similar instruments can also be preferable to loans or equity as a way of managing commercial risks.[92] As part of the stronger financial sector programme proposed in chapter VI, the Netherlands could therefore aim to improve public-private cooperation in the development of risk mitigation instruments like guarantees, insurance and newer instruments like derivatives for countries, regions or industries with large

88 OECD, *Promoting Pro-Poor Growth - Private Sector Development*, OECD 2006, pp. 47-49.

89 Apart from MIGA, which concentrates exclusively on guarantees, the organisations offer a wide and regularly updated range of guarantees and insurance. They tend to prefer to provide loans or equity capital, even where guarantees or insurance would be a more efficient way to use aid funds.

90 Paul Collier and Catherine Patillo (eds.), *Investment and Risk in Africa*, Macmillan, London, 2000.

91 This applies, of course, not just to FDI, but first and foremost to local investors, such as farmers.

92 This is true, for example, of support for microfinancing bodies which operate in local currencies and where a guarantee giving access to the local money and capital market will often be better than a hard currency loan from abroad.

concentrations of poor people.[93] Research could be done to see whether measures such as reinsurance or counterguarantees would make it possible for organisations like MIGA or FMO to use Dutch development cooperation support to offer insurance, guarantees or derivatives to cover risks in such countries, regions or areas of activity where this is currently not practicable.[94]

(c) international

An important, albeit indirect, contribution made by the Netherlands to the promotion of pro-poor investment in developing countries is the support provided for *international cooperation* in the areas of vital interest to investors (i.e. stability and transparency). This support takes the form primarily of cooperation within existing international organisations and forums like the EU, the IMF and the WTO in the fields of economic and financial stability, trade and investment liberalisation, and migration. In the investment field, public-private consultations within the OECD (such as the forthcoming Policy Framework for Investment) are particularly important.[95] The effectiveness of the Dutch contribution in this area depends on coordination between the various ministries and especially on the integration of development cooperation policy into Dutch investment policy.[96]

The way in which governments cooperate with each other and with the private sector in these areas is starting to change. International organisations that were set up following the Second World War are now reconsidering their role and activities in the very different world of today.[97] Whereas international decision-making was initially ruled by a fixed structure of government organisations dominated by Western countries, there is now a more flexible network of cooperative relationships between governments, including those of huge, fast-developing countries like China, Brazil and India, and the multilateral organisations. These networks have proved particularly valuable because of the scope they offer for participation by the private sector and civil society organisations.[98] To mobilise the FDI required – in addition to domestic savings, other capital flows and ODA – to achieve the MDGs, it will be necessary to strengthen

93 For instance, Credit Default Swaps have become an important way to shift the repayment risks of loans to developing countries to parties who are ready and able to bear them. See Global Development Finance 2006, p. 58.

94 See also chapter VI. The World Bank aims as part of its new strategy for the financial sector to expand its activities in this area. The planned cooperation via the Knowledge for Change programme may provide a suitable context for this.

95 Previously e.g. the *OECD Guidelines for Multinational Enterprises*.

96 See also policy option 10: Organisatie van OS-coherentie, in the Interdepartementaal Beleidsonderzoek Effectiviteit en Coherentie van Ontwikkelingssamenwerking, Dutch Ministry of Finance, October 2003.

97 See *'Adding value to the IFI system'*, Dutch Ministry of Finance, June 2006. One example of a now unnecessary activity undertaken by international organisations is the identification of investment opportunities for companies (e.g. UNIDO).

98 See AIV, *The Netherlands in a changing EU, NATO and UN*, Advisory Report No. 45, The Hague, July 2005, p. 49.

these new networks. It would be appropriate for this to include expanding and broadening the partnerships that the Ministry has already initiated with the private sector (see annexe VIII).

V.6 Summary and concluding remarks

FDI is clearly preferable to other forms of foreign capital. It creates no debts and the investment is repaid only if profits are made, and then only after they have been taxed. The flow of FDI has proved to be more stable than that of loans, because it is difficult to withdraw business investments of this kind. FDI is especially popular because it is associated with an efficient form of knowledge transfer relating to production, management, marketing etc. which leads to greater integration in the global economy. As a rule, foreign owners will behave no differently from their domestic counterparts. However, if a limited number of foreign companies were to dominate a major sector of the economy, this might limit the scope for government policymaking and be undesirable on that account.

The opportunities for Dutch development cooperation policy to reinforce the beneficial effects of FDI on poverty in developing countries lie particularly in the field of the investment climate, infrastructure and financial sector development. In addition, the Netherlands might direct its attention to improving public-private cooperation in the development not just of risk mitigation instruments such as guarantees and insurance, but also of newer instruments such as derivatives (financial products such as options and futures), for countries, regions or industries with large concentrations of poor people. It would be worth investigating the extent to which Dutch development aid could be supplied in this field to organisations like MIGA and FMO, for example via partial or full reinsurance or counter guarantees. This would make it possible for them to offer insurance, guarantees or derivatives to mitigate risks relating to such countries, regions or areas of activity where this is not currently practicable.

International cooperation is also important within organisations like the EU, IMF, World Bank, OECD and WTO in the fields of economic and financial stability, trade and investment liberalisation, migration and expanding and broadening public-private partnerships.

The AIV's response to the Minister's third question is based mainly on the contents of section V.3, and on its response to the Minister's second question, in which it recommends avoiding selective interventions.

FDI is influenced mainly by the quality of the investment climate. This depends in turn on the efficiency of local markets for labour, capital, goods and services. It would therefore be wrong to influence the outcomes of the market system, except perhaps temporarily in the case of markets which are seriously distorted. Even then, it is important to remember that temporary protection tends to become permanent.

Employment and the volume of transactions with local companies are results of the free market process. Competition is, in fact, the very essence of an 'enabling environment' in which the private sector flourishes, generating economic growth and reducing poverty.

Caution should be exercised when seeking to regulate the way investors run companies, for example by obliging them to use local products and services. In the study previously quoted, Moran calls experience with these 'domestic-content

requirements' decidedly negative.[99] He cites numerous studies that report major inefficiencies and stagnation as a result of technical, economic and managerial problems caused by attempts to influence the way markets function by imposing such requirements. The WDR 2005 also refers to the adverse effects of such regulations, in particular where technology transfer and local producers are concerned.[100] They tend to lead to stagnation and ultimately to the withdrawal of foreign investors.

In most cases, the desired policies will consist of measures that increase the productivity of local producers, enhancing the profitability of existing foreign investment so that production can increase, local employment and the volume of transactions with local producers can expand, attracting more FDI. Foreign companies can also be helpful in terms of encouraging corporate social responsibility in relation to management, the environment, corruption, social protection, and child labour. In this respect, the AIV would emphasise the importance of compliance with the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (see footnote 79).

99 Theodore H. Moran, 1998, pp. 41-48.

100 WDR 2005, pp. 171-172.

VI The informal economy and financial sector development

VI.1 Introduction

This chapter begins by discussing the distinguishing features of the informal economy and the obstacles it presents to achieving growth and pro-poor growth. It also recommends policies likely to stimulate both these types of growth. The second part of the chapter then considers financial sector development and the importance of giving all members of society access to appropriate financial services. For the many poor people working in the informal economy, access to basic financial services is the key to economic development.

VI.2 The informal economy

As indicated in the introduction, the term 'private sector' embraces both the formal and the informal parts of the economy. The term 'informal sector' was first used by the International Labour Organisation in 1972.[101] Since then, it has won its own place in the literature. For statistical purposes, the definition of the informal sector produced in 1993 at the 15th International Conference of Labour Statisticians is used.[102] For practical purposes, however, this term is felt to be too limited.

These days, the term 'informal economy' is increasingly being used. It better describes the wide variety of businesses, households and individuals working informally in rural and urban areas. The informal economy tends to be described mainly in terms of what it is not, does not have or does not do (not having legal frameworks, not paying taxes, not complying with regulations, not having job security etc.). While the formal economy conducts its activities within formal legal and fiscal frameworks, the informal economy is characterised by the absence of formal structures, forms of security and protection.

In many developing countries over 70% of the population, including virtually 100% of the poor, rely on informal activities for their day-to-day subsistence.[103] This informal economy has existed from time immemorial and pre-dates the formal economy, which has grown in Western societies over the last hundred years to encompass over 90% of the economy. In developing countries the formal economy accounts for only 30% of the working population.

101 ILO (1972) *Employment, Incomes and Equality: A strategy for Increasing Productive Employment in Kenya*. Geneva: International Labour Office.

102 For a good overview of what the informal sector and informal economy include, see ILO (2002) *International Labour Conference 90th Session 2002, Report VI. Decent Work and the Informal Economy*. Geneva: ILO, pp. 122-128.

103 See e.g. Palmade, V. and A. Anayotos (2005) *Rising Informality. Reversing the tide*. Private Sector Note, World Bank, August 2005. An exact estimate is difficult to produce, particularly because many activities go unrecorded by officialdom.

In the West, the informal economy accounted in 2002/2003 for 16% of GDP.[104] Its breeding ground in industrialised countries is different from that in developing countries. In the first case, participation in the informal economy tends to be motivated by the desire to evade taxes and other forms of government regulation or by purely criminal considerations, whereas in the second it is motivated mainly by the desire simply to survive. In developing countries, people have no other choice. They have to make a living or perish. In most cases, their income is below the legal threshold for income tax, so tax evasion is not a motive.[105]

To some extent, the informal economy contributes to the formal economy, through the fact that part of its procurement is done in the formal economy, through levies and the cost of permits etc. Also, some formal businesses exploit the opportunities offered by the informal economy to keep a proportion of their turnover out of company accounts or to hire cheap labour. Consequently, there is a degree of interlinkage between the two.

The informal economy is important not only because it provides incomes for the poor, but also because it generates a substantial proportion of GDP. According to a study by Professor Friedrich Schneider of the University of Linz,[106] the 'shadow economy' in 96 developing countries accounts for an average 39% of their GDP. In Africa, the average figure is 43%. At the top of the list are countries like Nigeria, Tanzania and Zimbabwe, with around 60%. South Africa has the lowest score, with 29%. Asia also scores high with an average of 30%, with Thailand topping the list at 54%. In Latin America, the average is 43% and Bolivia scores highest with 68%. These figures show how broadly and deeply the informal economy penetrates society in these parts of the world, even in countries with well-developed formal economies, like Thailand and South Africa.

The various national and international strategies might have been expected to have reduced the size of the informal economy, in some countries at least. However, Schneider's research shows that its share in all 96 developing countries is still growing. There is a correlation between a better quality business climate (simple procedures, lower costs, shorter waiting times) and a smaller informal economy, as the World Bank/IFC Doing Business report for 2005 shows.[107]

It is clear that the target group for Dutch development cooperation policy and the MDGs – the 1.1 billion people who live on less than 1 USD a day[108] – is likely to be concentrated in the informal rather than the formal economy. More women than men are active in the informal sector. Their lives are marked by a lack of social protection

104 Friedrich Schneider and Robert Klinglmair (2004) *Shadow Economies around the World: What do we know?* CREMA, Working Paper No. 2004-03.

105 Gërxhani, K. (1998) *The Informal Sector in Developed and Less Developed Countries: A Literature Survey*. Tinbergen Institute Discussion Paper, TI 1999-083/2.

106 Schneider, F. (2005) *Shadow Economies of 145 Countries all over the World: Estimation Results over the Period 1999-2003.*

107 IFC (2005) *Doing Business 2005. Removing Obstacles to Growth*. Washington DC and New York, World Bank, the International Finance Corporation and Oxford University Press, pp. 6-7.

108 World Bank (2006) *Poverty at a glance* (11 August 2006).

and a high level of labour insecurity. The informal economy offers no long-term means of poverty reduction. As we saw earlier, the only way to reduce poverty is to generate a broad pattern of economic growth that also benefits poor people working in the informal economy. The main focus must be on promoting employment and entrepreneurship (including microenterprises) to provide incomes. In addition, it is important to promote the transfer of people and activities from the informal to the formal economy.

The ILO's Decent Work Agenda stresses that productive employment and humane working conditions are the best way to achieve sustainable development and reduce poverty.[109] It is clear that corporate social responsibility also has a major role to play in this area, especially as regards the attitude of Western companies to employment and working conditions in developing countries.

Relatively little research has yet been done on the reasons why businesses remain in the informal economy and on the barriers to transfer to the formal economy. However, the OECD (2006) has provided an excellent overview of good practice in reducing administrative barriers and government regulation which can act as an obstacle to the transition.[110]

The main barriers to formalisation seem to be connected with government regulation, corruption and the financial sector. The national enabling environment plays a major role in this respect. Good governance is an essential precondition, not only to protect people's rights, but also to ensure their economic development.

To get results, national governments and local authorities, supported by international financial institutions and donors, will have to develop specific policies for each country and sector. Such policies should give priority to the following four aims:

1. To encourage entrepreneurship (including microenterprises).
   - To promote a level playing field for poor people in general.
   - To promote opportunities to earn a living.
   - To eliminate barriers to the market participation of women, for example through policies enabling them to own, buy, sell and inherit land.
2 To promote the transfer of businesses from the informal to the formal economy.
   - Institutional change and policies directed both at reducing the risks and costs of enterprise and at increasing the incentives for enterprise and investment.
   - Measures that help actors in the informal economy to move gradually towards formalisation, such as creating formal associations in order to ensure access to microcredit, insurance, land rights and markets.
3. Gradually to pare down and simplify regulations, permits, procedures etc.[111] To reduce regulation in the *formal* economy by eliminating rules which discourage or

109 ILO, Decent Work Agenda.

110 OECD (2006) *Promoting Pro-Poor Growth – Private Sector Development*. Paris: OECD, p. 24.

111 See also De Soto, H. (2000) *The Mystery of Capital. Why Capitalism Triumphs in the West and Fails Everywhere Else*, New York: Basic Books. He points out that it is often impossible for people to register formal ownership of the land on which they live, even if it belongs to nobody else. This means that the land cannot be used as collateral for loans, which would in fact double its value to the owners.

prevent participation. To reduce regulation in the *informal* economy by eliminating rules which promote exclusion, as in the case of certain permits and levies.
4. To promote the growth of the formal economy (and employment in it), especially in poor regions.

The AIV feels that special attention should be paid to the third of these aims (reducing regulations, permits, procedures etc. which prevent people from earning a living in the informal economy).[112] A good example of the kind of measures that can be taken is the 'De Soto desks' which have been set up in a few countries to systematically identify such government regulation and replace it with more appropriate procedures and processes.

VI.3 Financial sector development

In discussing ways of promoting pro-poor economic development by strengthening the private sector, the AIV would like to emphasise the role of the financial sector.[113]

In most developing countries, financial services are still available only to a minority of the population. International policy is therefore focused on creating a wider range of financial products and services and making them accessible to all sections of the population.[114]

Recent studies have revealed a clear relationship between development of the financial sector and pro-poor economic growth.[115] Financial sector development reduces disparities in income by disproportionately increasing the income of the poor.[116] This

112 See De Soto, H. (1989) *The Other Path: The Economic Answer to Terrorism*, New York: Basic Books, and De Soto, H. (2000) *The Mystery of Capital. Why Capitalism Triumphs in the West and Fails Everywhere Else*, New York: Basic Books.

113 The entire range of institutions, companies and organisations involved in the world of financial intermediation: the central bank, supervisory authorities, commercial banks, insurance companies, payment service organisations, savings banks, non-bank financial organisations (such as credit unions, credit cooperatives, microfinance organisations) and financial markets. In the informal part of the economy, money changers, savings groups, ROSCAs, tontines and other informal intermediaries are also part of the financial sector.

114 For an excellent overview, see Stijn Claessens, Access to Financial Services: *A Review of the Issues and Public Policy Objectives*, The World Bank Research Observer, Vol. 21, No. 2, Fall 2006, pp. 207-240.

115 The Financial Sector's Contribution to Pro-Poor Growth; in: *Promoting Pro-Poor Growth – Private Sector Development*, OECD 2006, pp. 47-55.

116 Thorsten Beck, Asli Demirguc-Kunt and Ross Levine, *Finance, Inequality and Poverty; Cross Country Evidence*, World Bank Policy Research Paper 3338, June 2004. This study includes a cross-section analysis based on a sample of 52 countries with datasets extending over 30-40 years. The findings show that changes in the provision of private credit have significant, positive effects on general economic growth, pro-poor growth, and trends in income distribution. They even reveal a causal relationship. *The importance of financial sector development for economic growth and poverty reduction*, DFID, 2005; Patrick Honohan, *Financial Sector Policy and the Poor; Selected Findings and Issues*, World Bank Working Paper No. 43, World Bank 2004, Appendix C, Poverty Rates and Financial Depth, p. 63.

is a noteworthy finding because it has proved impossible to demonstrate any such clear relationship in the case of other sectors of the economy traditionally associated with poverty reduction, such as SMEs.[117] See also chapter III.

VI.4 Background

Over the last few years, there has been a surge in interest in the role and functioning of the financial sector. The importance of a healthy financial sector to economic development and the clear positive relationship between financial sector development and economic growth had long been widely recognised and described in the literature.[118] In the context of private sector development, it was clear that a healthy financial system was indispensable as a reliable way of channelling savings into enterprises which could make productive use of the money, thereby creating employment. On the other hand, experience of the attempts of public sector banks to target their loans in accordance with political preferences (based on industrial policy) was often so disastrous that radical changes were necessary.

Initially, the main priority in this area was to open up financial markets rather than to improve the financial infrastructure (central bank, supervisory authority, branch network, operational management, payment system, etc.). The reason for this was that the liberalisation of financial markets started to gather pace in the 1980s, especially in the developed countries. Because it made it easier to invest savings capital across borders, liberalisation quickly proved to be an engine of globalisation. The improved access to international money and capital markets gave developing countries the opportunity to accelerate their development by attracting investment from abroad. The flow of capital from the affluent countries to the developing world (and more especially to the larger countries in it) swelled rapidly, but the associated risks quickly became apparent. Where the capital flows ended up on local financial markets which were not yet ready to receive them – for example, on foreign exchange markets and the interbank market – they caused serious problems, sending rates of exchange spiralling out of control and triggering excessive growth in lending, etc. Part of the background to both the debt crisis of 1982 and the financial crises of 1997 and 1998 was the conflict between relatively small, traditional local financial systems with inadequate supervisory systems and powerful, sometimes volatile, international flows of capital in search of higher returns.[119] The economic damage and increased poverty which directly resulted from these financial crises were considerable. The World Bank estimates the cost of financial crises in developing countries over the last thirty years at no less than one trillion USD (approximately equal to the cumulative ODA of all those years).[120]

117 Thomas Beck, Asli Demirguc-Kunt and Ross Levine, *Small and Medium Enterprises, Growth and Poverty: Cross Country Evidence*. World Bank Working Paper, No. 3178, December 2003.

118 For example, Niels Hermes and Robert Lensink (eds.), *Financial Development and Economic Growth*, Routledge, 1996.

119 See AIV, *Key lessons from the financial crises of 1997 and 1998*, Advisory Report No. 14, The Hague, May 2000.

120 World Bank: *Financial sector strategy update*, concept note, 29 March 2006.

Accordingly, the main response of the financial world and of organisations like the World Bank and the IMF was to take measures to alleviate the consequences of the crises and to avoid their recurrence. This meant that action to strengthen the financial sector in developing countries became chiefly defensive: it was designed to protect against the risks of volatile foreign capital flows. Partly because multilateral financial institutions like the World Bank, the IMF and the regional development banks had to provide large loans to countries hit by the financial crises of 1997 and 1998, they started to invest more heavily in expanding their expertise and research capacity in the field of financial sector development.

Now, eight years later, financial sector development is taking place in a different context. The post-crisis loans disbursed by the multilateral financial institutions have now been repaid and memories of the financial crises are fading. The measures prompted by the crises have proved beneficial, and there is greater vigilance concerning the risk of a new crisis. The years of close attention to the functioning of the financial sector in developing countries have paid off in terms of new insights and new policy emphases.

At macro-level, this was apparent in 2003 from the conclusions of the UN International Conference on Financing for Development in Monterrey. The conference was about how the various sources of finance could contribute to the achievement of the Millennium Development Goals. Although the political and media emphasis was again placed on just one of those sources (ODA) and how it could be increased, the first item on the agenda concerned the importance of the local financial sector.[121] Only when developing countries manage to get their own financial systems in order and mobilise their own savings capital,[122] will the funding necessary to achieve the MDGs prove effective.[123] For this reason, it makes sense to give priority to the health, development, expansion, accessibility and therefore depth, of local financial systems, firstly in order to promote and make proper use of local savings and secondly to provide a basis for the effective and reasonably safe absorption of savings capital from abroad (such as ODA and FDI).

VI.5 Financial sector development as a pro-poor instrument

The importance of financial sector development to economic growth and to the achievement of the MDGs has thus been recognised for some time. However, the realisation that there is a direct relationship between financial sector development and pro-poor growth is relatively new. This insight, which is now shared by major multilateral organisations like the World Bank and the OECD,[124] encompasses a number of different elements and gives rise to the policy principles discussed in brief below.

121 Financing for Development, The final text of agreements and commitments adopted at the International Conference on Financing for Development, Mexico, 18-22 March 2002.

122 Eswar Prasad, Raghuram Rajan, Arvind Subramanian, *Foreign Capital and Economic Growth*, Research Department, IMF, 11 August 2006.

123 Stijn Claessens and Erik Feijen, *Financial Sector Development and the Millennium Development Goals*, World Bank, August 2006.

124 World Development Report 2005, chapter 6, p. 116. see also OECD 2006: *The Financial Sector's Contribution to Pro-Poor Growth*.

VI.5.1 Research and insight

As reported above, recent studies have pointed to a direct relationship between financial sector development and pro-poor economic growth.[125] Where the poorest section of the population is able to make use of elementary financial services, two factors prove to contribute to generate a disproportionate growth in their income:

Risk reduction

The costs of uncertainty are highest for the poorest individuals and smallest-scale entrepreneurs, because they have no buffer to absorb variations in income. For them, the consequences of natural disasters, crop failures etc. are particularly catastrophic. The risk-avoiding behaviour that results from this fact reduces still further their prospects of escaping poverty by taking initiatives of their own (growing a different crop, starting a microtrading enterprise, etc.). If poor families and entrepreneurs have no safe, low-cost way of saving their temporary financial surpluses and if there is no simple and reliable way of making or receiving money transfers, they are denied chances to make productive investments. Keeping savings under the mattress or investing them in difficult-to-sell jewellery or livestock is not an answer. The absence of insurance to protect incomes or possessions has similar adverse consequences. The availability of elementary financial services like savings and current accounts with reliable institutions, payment services and simple insurance is therefore extremely valuable to poor people, who generally have no way of creating any stability in their economic lives. It is also probable that a more productive use of savings will help to avert the need to take children out of education in order to undertake income-generating activities.[126]

Increased opportunities

We have already mentioned the poverty trap created by the barriers facing energetic and enterprising people who need access to the necessary financial resources and means of production to establish or expand a business, however small, but have no recorded property.[127] This is true of female market stallholders and other traders, of people running small repair and manufacturing businesses,[128] and certainly of farmers who have no money for seed or to store their crops. Reliable, ongoing access to credit and other elementary financial services can allow people to seize opportunities to boost their incomes through their own efforts. Various studies conclude that access to finance is the ideal way to remove barriers to access to the means of production.

A developed financial system is also essential to increase local investment and attract foreign direct investment (FDI). These contribute to poverty reduction both directly by creating employment and indirectly by generating economic growth. Businesses cannot function without a reliable financial system with clear rules and proper supervision,

125 See footnote 117.

126 WDR 2005, chapter 6, pp. 115-124.

127 Hernán de Soto's *The mystery of capital* points in this respect to the inadequate registration of property ownership (especially of land), but even where there are adequate records, there must also be an institution which is ready and willing to provide credit on that basis. There is evidence, moreover, that records of ownership are a necessary but not sufficient precondition for the provision of credit. See The Economist, 26-8-2006: *'The mystery of capital deepens'*, p. 58.

128 Rosen, H. (2003), *Improved Access to Finance: A Key to SME Growth*.

which is able to provide essential services like bank accounts, payment services, trade finance, loans in the local currency, foreign exchange transactions and insurance. Nor can they function without infrastructure such as energy, communications and roads to transport agricultural and other products. As discussed above, the absence of such provision is an obstacle to private sector growth that particularly affects the poorest section of the population and the poorest areas. Financing such infrastructure – whether through the public sector or through public-private partnerships – proves in practice to be easier to achieve where there is a system whereby individual users can pay at least part of the cost of their use of such facilities.[129] This requires the presence of a developed financial system. The success of mobile phones, even in the poorest areas, proves this point, because payment for those services is relatively easy to organise.

VI.5.2 Policy

In view of the above, the OECD operates on the basis of the following assumptions about the contribution of financial sector development to economic growth and poverty reduction.[130] Financial sector development has a direct effect on poverty reduction in two ways: by ensuring easier access to financial services and by making it easier to finance the infrastructure necessary to provide basic facilities for the poor (water, energy, health and education). It also has an indirect effect: financial sector development generates more rapid growth of the economy and therefore faster poverty reduction (see chapter II).

Moreover, the OECD stresses, financial sector development is '… essential for making economic growth pro-poor'. The OECD refers in this respect to the analytical framework mentioned in chapter III.2.3, which can be used to decide what changes are required in policies and institutions in order to achieve pro-poor growth. This analytical framework is composed of five elements:

- providing incentives for entrepreneurship and investment;
- increasing productivity, through competition and innovation;
- harnessing international linkages;
- improving market access and functioning;
- reducing risks and vulnerability.

Financial sector development plays a major role in strengthening each of these elements.

The following observations should be added to the foregoing. In the WDR 2006,[131] the World Bank points out that the relative exclusion of poor people from access to financial services is not just a consequence of technical and economic factors which make such services too expensive for them to afford. There are also reasons connected with differences in influence and control between the poor and economic elites. The World Bank reports a number of case studies in which, for political reasons (influence and control), sound policies and good institutions have not produced the

129 The poorest countries, in particular, find it difficult to pay for infrastructure construction and operation/maintenance entirely out of public funds. Experience of infrastructure maintenance argues therefore for a linkage between users and costs.

130 See OECD 2006, pp. 47-48.

131 WDR 2006, *Equity and Development*, chapter 9, pp. 180-185.

desired results. Cost reductions brought about by technological advances, better supervision and greater competition will not have the effect of giving the poor greater access to financial services unless such political situations are changed.

VI.5.3 Microfinance

The success of microfinance – and its high profile in the development world – has played a major role in creating greater interest in private and financial sector development as a means of achieving poverty reduction.[132]

This is not surprising, since microfinance – very small-scale financial services, initially mainly loans, designed for poor households and small entrepreneurs – has proved extremely successful in increasing economic independence and stimulating small enterprise among the poorest people and in the poorest parts of developing countries. A particularly noteworthy aspect is the very high loan repayment rate (which is, in fact, necessary to ensure the survival of the microfinancing institutions (MFIs).[133]

Microfinance has influenced thinking about poverty in three areas. Firstly, it has shown that it is possible by providing credit on a commercial basis to help even very poor clients to lift their economic activity to a higher level and earn their own living. Secondly, it has demonstrated in the world of development organisations that a commercial approach is more effective in reducing poverty than many charitable programmes or government programmes conditioned by political aims. Finally, it has triggered efforts to deepen and strengthen the financial sectors of developing countries where the financial establishment (generally state banks) had previously shown little interest in the poor who make up most of the population.[134] It is in this niche that the MFIs have developed, often with external support.

However, the volume of microfinance and its significance to developing countries is hard to determine.[135] There are a number of reasons for this. Firstly, definitions of microfinance vary and the thousands of organisations providing such small-scale financial services exhibit great diversity. Secondly, its volume, economic returns and profitability are calculated differently by the various kinds of organisations with their differing, often charitable, goals. A useful, but not comprehensive, definition focuses on clients who borrow from MFIs and sometimes also save with them and mentions a target of 100 million clients by 2005.[136] At the end of 2004, there were over 3000

132 For brief overviews and analyses of microfinance, see Elizabeth Littlefield and Richard Rosenberg, *Microfinance and the Poor, Finance and Development*, Vol. 41, No. 2, June 2004, pp. 38-40; The Economist, *The hidden wealth of the poor*, 5 November 2005, pp. 1-12; IMF Survey, *Pros and cons of microfinance*, Vol. 34, No. 5, 21 March 2005, pp. 72-73. For a more extensive and detailed overview, see C.K. Prahalad, *The Fortune at the Bottom of the Pyramid*, Wharton School Publishing, Upper Saddle River, New Jersey, 2005, pp. 289-318.

133 See Gert van Maanen, *Microcredit*, SGO Uitgeverij, Hoevelaken, 2004, pp. 42-43.

134 The main reason for this was usually that commercial banks found it much easier to make money by giving loans to government and major companies.

135 *Financial Sector Policy and the Poor; Selected Findings and Issues*, Patrick Honohan, 2004. World Bank Working Paper No. 43, 2004.

136 Microfinance Summit; Daley Harris, 2003.

MFIs with 92 million clients, 66 million of whom were reckoned to belong to the poorest section of their own countries' populations when they took out their first loan. However, the number of MFI clients varied widely from one developing country to another.[137] In only eight countries was it more than 2% of the population (in Bangladesh 13.1%!) and in most of the remaining countries it was less than 1%, although considerably higher as a percentage of the total number of households.

Because the loans are by definition small, MFI lending seldom totals more than 1% of all credit provision in the country concerned (in Bolivia 7%).

Although nobody doubts the importance of the contribution that microfinance has made, and is still making, to financial sector development and poverty reduction, there are problems associated with it. While the risk of MFI insolvency poses no threat to national financial systems, given the very limited overall size of the sector, at micro-level it does pose a threat to poor clients, especially if they also entrust their savings to MFIs and the institutions are not subject to adequate bank supervision. More generally, the IMF regards only 1% of the current institutions as financially stable, judged on the basis of their size, product range and limited passive financing capacity (especially foreign capital).[138] In a number of countries, supervisory authorities have developed special criteria for the supervision of MFIs, opening the way for them to attract savings and deposits. Depending on the nature and quality of supervision, this can considerably enhance the probability of continuity and increase the number of stable MFIs.

VI.5.4 Integrated financial sector

Although it features a wide range of institutions, products and services, the financial sector performs only a limited number of basic functions.[139] It is important therefore, for both its direct and indirect effect on poverty reduction, to continue to view the financial sector as a coherent whole.[140]

Despite the focus on credit, lending is certainly not always the financial service for which there is the most urgent need. There is often a more urgent need for a safe way to deposit savings and later withdraw them and a means to make payments (transaction banking).[141]

The same applies to access to insurance. As already stated, for poor people especially, simple insurance can mitigate risks sufficiently to create the scope for

137 Patrick Honohan, 2004, pp. 3-10.

138 See IMF 2005, p. 73.

139 DFID (2005) lists 5 functions: (1) mobilisation of savings (2) risk management (3) acquiring information about investment opportunities (4) monitoring borrowers and exerting corporate governance control, and (5) facilitating the exchange of goods and services.

140 See DFID 2004: *Financial Sector Development: a pre-requisite for growth and poverty reduction? Building Inclusive Financial Systems: Donor Guidelines on Good Practice in Microfinance*, CGAO/The World Bank, December 2004.

141 *Household Financial Assets and the Process of Development*; Patrick Honohan, World Bank/CEPR, July 2006.

initiative and to allow them to avoid expensive alternatives. The main need in this respect is for business and health insurance. In the context of an integrated approach to the financial sector, insurance also has the advantage of generating premiums which have to be used to make long-term investments in the local currency.

In developed economies, the role of banks as intermediaries is declining in relative terms, while the role of the money and capital markets is expanding. Savers and investors are increasingly making their transactions directly with the users of their money, without the intervention of a bank. The size and international transparency of these markets have made it possible to develop products, called 'derivatives', based on them. At first sight, this may seem fairly irrelevant to developing countries and to the provision of financial services for the poorest members of society. However, there is a growing realisation of the value of even a small-scale capital market mechanism to the development of a healthy financial system. This is especially true as regards the availability of relatively long-term loans in the local currency. Developing countries generally have a few longer-term investors with commitments in the local currency, such as insurance companies and pension funds, but even so promoting collective savings of this kind is a necessary first step towards the development of a local capital market. It is easier to find businesses wishing to take out fairly long-term loans in local currency (like mortgage banks for housing, government or infrastructure companies and also MFIs). A capital market can bring these parties together.[142]

VI.5.5 Remittances

Money transfers made by migrants to their countries of origin are another topic of current interest which has focused attention on the role of the financial sector. The immense size of these flows,[143] the high charges that poor people have to pay for simple transactions, and the link between these flows and the sensitive subject of migration have together roused much stronger interest in this part of the financial system.[144] The greater part of the flow of money is composed of transfers of petty sums by migrant workers sending money home to their families. Because migrants have not trusted the commercial banks and because banks have done little to tailor their services to the wishes of these migrants, a large proportion of these transactions have traditionally been made via unsupervised informal remittance agencies. For a number of reasons, it is important to try to bring these flows of money into the mainstream financial system. At macro-level, this will enable government or the central bank of the recipient country to pursue better monetary and foreign exchange policies. But at micro-level too, it will make it possible to use this flow of money in a better way – without, of course, in any way infringing the individual freedom of the migrants and the recipients of the money transfers – to strengthen the financial sector of the recipient country. There is already a major effect on development if migrants are able

142 The multilateral financial institutions are especially active in this field, but bilateral donors are also active on an incidental basis. One example is Sweden, which combined export promotion and financial sector development by providing a guarantee for the issue of bonds by the Ugandan telecommunications company (which was buying Ericsson equipment) so that a local pension fund could purchase them safely.

143 167 billion USD in 2005, see chapter V.

144 The increased concern about the way terrorism is financed and about money laundering practices is adding to the interest in remittances, given that a large proportion of them remain below the official radar of supervisory authorities.

to make their transfers in a cheap and reliable way via bank accounts instead of via unsupervised agencies. This effect can be further enhanced if they have the choice of various forms of transfer, such as savings, investment or insurance schemes. Because the recipients tend to belong to the poorest section of society, such schemes may also have a pro-poor effect. Commercial banks are now showing a growing interest in this market, the costs have been reduced and, certainly for the larger developing countries, countless new products have been launched, making inventive use of modern communications technology.

Multilateral financial institutions are encouraging initiatives designed to increase the impact of the remittance flow on development. If banks in the recipient countries managed to capture a larger proportion of the transaction flow by improving their services to the migrants and their families, this would be valuable from the point of view of development generally and pro-poor development in particular, especially because new (generally poorer) groups of clients would then start to make use of formal financial services. Quite apart from the economic value of the expenditure and investments that could be financed, the flow of remittance money would also help to strengthen the financial sector in the recipient countries.[145]

VI.6 Conclusions

The financial sector has a key role to play in giving poor people the chance to share in economic growth and its benefits. The AIV therefore recommends a considerable strengthening and expansion of support for financial sector development as an effective way of promoting PSD leading to pro-poor growth.

As a first step, the AIV feels that DGIS should initiate the formulation, together with the Dutch Ministry of Finance and Ministry of Economic Affairs, of a joint strategy and distribution of tasks in the general field of financial sector development. In view of the complementary nature of the three ministries' responsibilities, competencies and participation in international forums, a joint strategy and clear distribution of tasks in this field would enhance the coherence, and hence the effectiveness, of Dutch government action in this area.

Financial sector development relates to both the public sector (government regulation, supervision and control) and the private sector (operational management, up-scaling etc.) and, above all, to close cooperation between the two. For that reason, the AIV recommends that DGIS involves the NFX,[146] which it helped to set up, in the preparation of this joint strategy for financial sector development.

The AIV also suggests that the two key themes for this strategy and for an action plan based on it should be:
- risk management, and
- access to finance.

145 For example, the Inter-American Development Bank (IDB) and in particular the Multilateral Investment Fund (MIF), to which the Netherlands contributes, are active in this area.

146 The Netherlands Financial Sector Development Exchange, set up in 2004. The members of the NFX are the Dutch ministries of Foreign Affairs, Finance, and Economic Affairs, plus ABN AMRO, FMO, Fortis, ING, Rabobank and Triodos Bank.

These two themes sum up recent insights concerning the role of financial sector development in achieving poverty reduction. They are appropriate in terms not only of the traditional position of the Netherlands in international financial discussions and the approach of the leading multilateral financial institutions in this field, but also of the Netherlands' ability to offer assistance.

VI.6.1 Risk management

This means, first and foremost, improving the regulation, supervision and control of the financial sector. The main international aspects of this are a matter for the Ministry of Finance. This report is concerned primarily with national-level regulation, supervision and control. In view of the great economic and pro-poor benefits of making financial services more widely available, special attention will need to be paid to changing the rules limiting access to small-scale financial services in a way that respects the nature of the institutions while continuing to guarantee maximum financial stability.[147]

There is a need, therefore, to increase the transparency and openness of the financial sector (both public and private) in order to reduce the scope for corruption, and the growth of oligopolies and elites. After all, as long as the losses of state and other banks remain concealed from the public, the funding of inefficient public undertakings, businesses run by cronies, and pointless prestige projects can continue with impunity.

With a more immediate eye to poverty reduction, more attention needs to be paid to risks that prevent poor households and small entrepreneurs from taking the initiatives necessary to improve their circumstances. This can be achieved by encouraging the development of small-scale insurance, guarantees, derivatives etc. which can be offered to farmers, entrepreneurs and households to mitigate the risks important to them.

This is an example of an area calling for cooperation between the financial institutions, government and the universities. Various initiatives have already been launched.[148] However, in the context of a pro-poor PSD policy and in cooperation with the NFX, DGIS could formulate a strategy which would encourage cooperation, launch new research and elicit new proposals from the industry.[149]

147 Current rules (minimum capital and reserve requirements, maximum interest rates, reporting requirements, etc.) are generally geared to commercial banks with mainly business customers. They partly explain why so many MFIs and small-scale remittance agencies continue to operate as part of the informal economy.

148 The World Bank has a number of projects, including for example the Mongolian Index Based Livestock Mortality Insurance Scheme; DGIS itself is cooperating with the World Bank on the development of schemes to cover fluctuations in commodity prices. Rabobank International is involved in this and has recently made it possible via the Health Insurance Fund for poor people in Africa to gain access to health insurance. The Amsterdam Institute for International Development has conducted research in this area.

149 To increase the representativeness and capacity of the NFX in the whole area of financial development, DGIS could encourage membership by other financial services companies, especially in the insurance field.

VI.6.2 Improving access to financial services (especially for the poor)

Now that research points so clearly to a direct causal link between financial development and economic growth, including pro-poor growth, if the poor are given access to financial services, it is important to consider how such access can be rapidly improved.

In many developing countries, the formal financial sector still caters only to government, the largest companies and the wealthiest section of the population. Over the last few years, however, some banks and insurance companies in the larger developing countries have developed new schemes to serve the poor and rural population. Savings banks and post office banks, which still tend to confine their products to payment services and savings schemes, already serve far more of the world's poor than the microfinancing institutions. However, there is still a major difference between their approach and that of the MFIs, which focus entirely on the poorest section of the population. There are hundreds of MFIs in every developing country but they reach only a small proportion of their target population. For this reason, the Consultative Group to Assist the Poorest (CGAP) has devised a number of 'Key Principles of Microfinance'. These are endorsed by institutions like the United Nations, the OECD and the World Bank and are a list of best practices for the healthy development of microfinancing.[150] The principles fall into three categories: regulation to create a strong legal and institutional framework; consolidation of financially viable microfinancing institutions to generate sufficient critical mass and a large enough client base; and action to multiply and strengthen the links and ties between MFIs and the existing financial system. The aim is to create an 'inclusive financial sector' featuring safe savings schemes, credit facilities for both poor and low-income households and micro, small and medium enterprises, and insurance and payment facilities. A secondary, equally important, aim is to strengthen often still fragile financial systems.

To help achieve these aims, a UN Advisors Group on Inclusive Financial Sectors has been appointed, and recently held its first meeting. The agreed programme of work is three-pronged: setting up an extensive information system, designing and modifying regulations, and actually involving the private sector.

The ultimate goal is to extend the range of financial services on offer sufficiently to produce an 'inclusive' financial system able to cater for really large sections of the population, including the poor. To achieve this will require up-scaling. So far as the desired pro-poor effect is concerned, it makes no difference whether this is achieved by banks' expanding their services (top down) or by consolidation and strengthening of efficient and effective MFIs (bottom up). In practice, both approaches will need to be pursued simultaneously.[151] In both cases, it will be essential to strengthen cooperation between these two branches of the financial sector.[152] In this respect,

150 CGAP/World Bank, *Building Inclusive Financial Systems: Donors Guidelines on Good Practices in Microfinance*, December 2004.

151 DFID, 2004. See also *Separate and Unequal: Raghuran Rajan*, Director of the IMF research department, in Finance and Development, March 2006.

152 *Meeting summary of the organisational meeting of the UN advisors group on inclusive financial sector*, UN, 17 July 2006, and *'Building Inclusive Financial Sectors for Development'*, UNCDP, 2006.

there are high expectations concerning the use of new communication technologies (for example, the use of mobile phones, mobile offices and flexible agencies such as post offices or shops).

VII A survey of Dutch PSD instruments

VII.1 Introduction

This chapter answers question 4 in the request for advice:
'What do you see as the relatively strong and weak points of the various instruments I have at my disposal to encourage the private sector to play a more active role in Dutch development cooperation? In what ways can these instruments be improved?'

This question could be read as an invitation to conduct a comprehensive evaluation of the relevant instruments. The AIV has deliberately chosen not to do this. It has neither the mandate nor the capacity to conduct such an evaluation. Moreover, there are insufficient recent evaluations available to provide the necessary basis for an overall review of the PSD instruments. The AIV has therefore answered this question as follows. To begin with, the preceding chapters have been used to identify the main aims and characteristics of a private sector policy directed at growth and pro-poor growth. These *core elements* are shown in Table VII.1. Note, however, that this is only a rough and by no means definitive selection; items might well be added or subtracted. Next, the AIV has analysed the extent to which DGIS's existing PSD instruments exhibits these selected core elements. In addition, it has drawn on its own knowledge and experience to formulate seven quality criteria which it feels the various instruments should meet. These *quality criteria* are listed in Table VII.2. Finally, the AIV has analysed the extent to which the PSD instruments appear, on the basis of the available information, to meet these quality criteria.

The term 'instrument', as used in the question, does not appear to be clearly defined within the Ministry. In practice, it is used as a catch-all term encompassing not only almost all kinds of expenditures, but also all the activities, policies, projects, programmes and organisations funded by it, and even policies or policy changes in general. In the PSD context, 'instruments' are therefore not just expenditures on programmes with established rules and conditions, but also the programmes themselves. Indeed, the term is also used to refer to organisations responsible for the implementation of one or more projects or programmes designed to achieve a specific aim.

The instruments do not fall exclusively within the budget and sphere of responsibility of the Ministry of Foreign Affairs/DGIS. For example, major programmes like the Dutch contribution to multilateral development banks and funds are funded by the Ministry of Finance, while some trade and investment promotion programmes feature in the budgets of both the Ministry of Foreign Affairs and the Ministry of Economic Affairs. In budgetary terms, these programmes all come under the Homogeneous Budget for International Cooperation (HGIS), irrespective of whether they count as ODA or not.

Depending on the budgetary arrangements for the programmes, responsibility for their implementation lies in some cases in the hands of external organisations, such as Netherlands Development Finance Company (FMO),[153] the Centre for the Promotion of

153 The FMO programme is roughly divided into FMO-A and FMO-B. FMO-A concerns loans, guarantees and equity financed out of the organisation's own capital assets. Since these have been built up over the years mainly as a result of contributions from DGIS, FMO-A is counted as an 'instrument of the Minister for Development Cooperation'. FMO-B embraces various funds and programmes (such as ORET, MOL, NIMF and FOM) that are financed directly out of the Ministry of Foreign Affairs' budget.

Imports from Developing Countries (CBI) and the Netherlands Management Cooperation Programme (PUM), or in those of other ministries (mainly the Ministry of Economic Affairs). In all such cases, the organisations involved bear independent responsibility for the programmes and operate autonomously from DGIS within established frameworks and financial limitations.

In the context of this report, the AIV regards the term 'instrument' as including all expenditures, activities and policies that fall under policy article 4 ('more wealth, less poverty') of the Homogeneous Budget for International Cooperation (HGIS) and are directed at achieving growth and pro-poor growth (PPG) via PSD (see also Box VII.1).[154] In analysing the instruments, the AIV has focused on the lists provided by the Sustainable Economic Development Department (DDE) of a. DDE activities in 2005/06 by cluster (annexe IV) and b. total DGIS expenditure on PSD in 2005 (annexe V).

Box VII.1 Policy article 4

'Policy article 4 comprises five operational objectives, each of which is associated with specific items of expenditure. Expenditures relating to article 04.01 relate to trade and financial systems and take the form, for example, of loan guarantees from the Netherlands Investment Bank for Developing Countries (NIO), NIO overheads, interest subsidies with respect to DC loans, and the Common Fund for Commodities. Expenditure on poverty reduction (article 04.02) includes a large number of general items of expenditure which cannot be ascribed to specific themes, such as payments to UNDP, UNIDO, IFAD, IMF and the World Bank, and also spending on macro support, debt relief, institutional development, cross-sectoral embassy programmes and exit programmes in non-partner countries. Support provided for the business climate in developing countries (article 04.03) includes embassy spending on supporting the business climate, the PSD instruments (ORET, PSOM, NIMF, FMO), the CBI and payments to non-governmental organisations via theme-based co-financing (TMF). Efforts to enhance the quality and effectiveness of development cooperation (article 04.04) are associated with very little expenditure (on the Associate Expert programme and the winding up of the expert programme). Finally, all expenditure under article 04.05 is for the purpose of promoting Dutch trade and investment'.

Source: answers to written questions on the Ministry of Foreign Affairs' 2006 Budget, 14 November 2005, answer to question 182. (http://www.minbuza.nl)

For an insight into the funding flows associated with the PSD instruments, the reader is referred to the OECD-DAC classification. This distinguishes between:
1. 'Official Development Assistance' (ODA), which may be either multilateral or bilateral;
2. 'Other official flows' (non-ODA);
3. 'Private flows' (from non-profit organisations and from banks and other private sector sources).

154 This means that other instruments and programmes (activities in the field of education, health care, etc.) are excluded, even though they may actually be relevant to private sector development, and hence to growth and pro-poor growth.

The majority of PSD instruments are funded out of multilateral or bilateral ODA. A smaller proportion, like the activities in the FMO-A programme, which are funded out of the FMO's own accumulated assets, and those of the Multilateral Financial Institutions, which are partly financed by the Netherlands, are reported under 'Other Official Flows'.

For DGIS, the distinction between bilateral instruments (whether managed by the ministry itself or by other agencies) and multilateral instruments is relevant. Bilateral projects and programmes are implemented on the basis of agreements directly involving the government of the recipient country and that of the Netherlands. They are, for example, activities at national policy level and business level, contributions to and via civil society organisations in the Netherlands and elsewhere,[155] and public-private partnerships. By contrast, multilateral PSD instruments are activities that take place at both international policy level and business level, and mainly take the form of contributions to multilateral organisations via DGIS or the Dutch Ministry of Finance.

VII.2 The core elements

The key issue so far in this report has been how PSD can promote economic growth in such a way as to make a maximum contribution to poverty reduction. This means measures with regard to the private sector which generate either the fastest possible growth in the incomes of the poor (the absolute definition of PPG) or income growth disproportionately benefiting the poor and hence changing the distribution of income in their favour (the relative definition of PPG).

From this discussion, a number of core elements can be derived that are important to the achievement of PSD generating growth and pro-poor growth. Table VII.1 lists these core elements, maintaining the distinction between growth and pro-poor growth. In addition, a number of quality criteria can be identified (table VII.2) as applying in principle to all PSD instruments.

These quality criteria for PSD instruments have been formulated on the basis both of knowledge and experience and of insights gained through discussions with programme managers and with representatives of the private sector and multilateral organisations. As such, they need no further explanation, with the exception of the last criterion but one, which relates to the financial form of the instrument. This is especially important when support goes directly to companies (as in the case of grants and in particular forms of 'banking' support, such as the various types of loans, equity capital, share holdings, guarantees, insurance or derivatives), firstly to ensure that finance is not provided if it is available on the commercial market and secondly to ensure that support is provided in the most efficient possible way (i.e. at least cost to the public purse.

155 These are sometimes called 'civilateral' instruments. They are directed at pro-poor economic growth and PSD-oriented activities by NGOs, such as those funded in the past under theme-based and other cofinancing programmes (TMF and MFP). From 2007, these activities will come under the Cofinancing System (MFS). In addition, it is the intention to provide support for two international NGOs under the sustainable development theme of the Strategic Alliances with International NGOs (SALIN) policy framework.

Table VII.1 Core elements for economic growth and pro-poor growth via PSD

Economic growth	Pro-poor growth
PSD instruments should be aimed at achieving one or more of the following: • promoting international cooperation directed at stability and transparency, global trade liberalisation, investment flows and the international legal order; • achieving coherence in the policy framework for investment; • strengthening the national policy level of institutions directed at improved governance, the quality of the rule of law, government effectiveness, control of corruption and regulatory quality; • promoting macroeconomic stability; • strengthening the financial sector, including microfinance and insurance provision; • strengthening the national investment climate, for example by eliminating barriers and reducing risks; • promoting the proper functioning of markets, promoting market access, eliminating disturbances; • promoting public-private partnerships and networks; • making it attractive to transfer from the informal to the formal economy; • mproving the physical and non-physical infrastructure (education, health care). For both economic growth and pro-poor growth, the promotion of economic, environmental and social sustainability (corporate social responsibility) should be an overall aim.	Promoting the PPG character of PSD leading to a less unequal distribution of income by focusing in particular on: • promoting the interests of the least developed countries (LDCs) in international cooperation; • creating a level playing field for poor people's economic activities, for example via institutional changes and policies; • infrastructure important to the poor; • giving the poor improved access to the means of production; • the recording of ownership rights and other rights and titles; • strengthening the financial sector by giving poor people better access to financial services, including micro and other finance and insurance; • supporting improvements in markets, regions and sectors in which many poor people live and work; • measures to help actors in the informal economy to take gradual steps in the direction of formalisation.

Table VII.2 Quality criteria for PSD instruments

- not supply-driven, but demand-driven;
- deployable in a country and context-specific way (flexibility);
- additional (i.e. not available via the market);
- accessible and user-friendly;
- effective and efficient;
- in the right form (technical assistance, loans, insurance, guarantees, etc);
- synergistic with other instruments.

VII.3 Dutch PSD instruments

Like other donors, the Netherlands has an extremely wide range of PSD instruments. Policy article 4 ('more wealth, less poverty') of the Homogeneous Budget for International Cooperation (HGIS) alone encompasses instruments relating to trade and financial systems, the business climate in developing countries, innovation, the promotion of international entrepreneurship, debt cancellation in relation to expert credits, contributions to multilateral development banks, the further liberalisation of international trade and investment, strengthening of the rule of law in the economic field, etc. Spending on this policy theme in 2005 totalled €1388 million of ODA,[156] including policy article 4 of the Dutch Foreign Affairs budget. Expenditure related mainly to article 04.02 (poverty reduction, €418.7 million) and article 04.03 (business climate in developing countries, €279.9 million), and to article 04.20 of the Ministry of Finance budget (multilateral development banks and funds, €172.3 million) and debt cancellation in relation to the export credit insurance and investment guarantees (EKI) scheme €481.6 million. In the case of article 04.02, spending relates mainly to general budgetary support for the public sector in developing countries, debt relief and contributions to multilateral organisations working in the field of poverty reduction, such as the UN. In other words, it concerns general support for poverty reduction via national governments (via the PRSP process and multilateral organisations), rather than any specific sector (such as education, health, good governance or PSD).

Since neither the HGIS nor the explanatory memorandum on the budget of the Ministry of Foreign Affairs explains what expenditure should be counted as relating to PSD instruments as a category, the AIV has adopted a pragmatic approach in this respect and has confined its attention to those PSD instruments directly or indirectly connected with the private sector, as referred to in question 4 of the Minister's request for advice. In doing so, the AIV has also based itself on a list supplied by the Sustainable Economic Development Department (DDE) showing total DGIS spending on PSD in 2005 (ODA and non-ODA) amounting to €285.1 million (see annexe V).

Within the development cooperation field, DDE is the most important department in relation to PSD. It was set up after the reorganisation of the then Private Sector Programme and Rural and Urban Development Department after publication of the policy memorandum on economy and development (DGIS 2000).[157] DDE comes under DGIS and aims to achieve sustainable poverty reduction by promoting economic development in developing countries. To this end, it:

- works to improve trade opportunities for developing countries on world markets;
- identifies and tackles problems in the business climate in developing countries;
- stimulates business investment in 36 partner countries.

However, DDE is not directly responsible for all the PSD-related activities undertaken or cofinanced by DGIS. Activities for which it is not directly responsible include those undertaken by the Centre for the Promotion of Exports from Developing Countries (CBI), which – as an agency of the Ministry – comes directly under DGIS, the PSD-related activities undertaken by Dutch embassies and certain contributions to

156 HGIS annual report 2005 *Homogene Groep Internationale Samenwerking*. The Hague: Dutch Ministry of Foreign Affairs.

157 DGIS (2000) *In business against poverty,* Dutch Ministry of Foreign Affairs.

multilateral development banks, like the World Bank and the ADB, and activities under the aegis of DGIS departments. These include activities in the field of infrastructure (energy and water), which come under the Environment and Water Department (DMW), and good governance and the control of corruption, which come under the Human Rights and Peacebuilding Department (DMV).

Where programmes under the aegis of DDE since 2000 have been specifically pro-poor, there has been a need to ensure close harmonisation with other *pro-poor* programmes in fields like basic health care and primary education and to achieve coherence with 'arm's length' organisations like FMO and CBI, with the Netherlands Management Cooperation Programme (PUM) and the Emerging Markets Cooperation Programme (PSOM), with other instruments relating to the private sector, and with the many new initiatives launched since then in fields like corporate social responsibility, credit provision, PPPs and energy.

Before discussing the DDE list of total DGIS expenditure on PSD in 2005, it should be stressed that it displays a significant deficiency so far as the present analysis is concerned. Based as it is on expenditure within the current budget period, the list ignores earlier Dutch government contributions, made via DGIS or the Ministry of Finance, to the capital of both multilateral financial institutions[158] and the FMO.[159] Those past contributions are now making it possible for the organisations concerned to finance the private sector in developing countries on a large scale and are mentioned in this respect in DGIS's reports to the OECD/DAC.[160]

In 2005, expenditure on PSD-related activities (ODA and non-ODA) totalled approximately €285 million.[161] DDE was responsible for the majority of this (€195 million or 68%).[162] The CBI accounted for around 6% (€17 million), IFC (via the United Nations and the International Financial Institutions Department (DVF)) received 4% (€11 million) and Dutch embassies in partner countries spent around 22% (€62 million) on improving the business climate and rural development.[163] DDE is therefore not only the main intermediary department in the PSD field, but the instruments for which it is responsible clearly reflect the range of instruments regarded in the national and international discourse as relating to PSD.

The exact classification of these PSD instruments is open to discussion. The Ministry itself adds to the confusion on this point by applying a number of different classification criteria. For example, the policy memorandum on economy and development employs a

158 Such as IBRD, IFC, MIGA, IDB, IIC, MIF, ADB, AfDB and EBRD.

159 51% of FMO shares are in the hands of the State.

160 As Gapgemini (2004, *Evaluatie FMO*, Utrecht, Capgemini) has concluded: 'the sustainability of the FMO as a banking institution is to a large extent ensured by the contributions of government to the Development Fund and by guarantees given by the State'.

161 See annexe V.

162 See Table VII.3, annexe IV and annexe V for an overview of total PSD expenditure in 2005.

163 See annexe III.

classification based on three aims: to increase knowledge, to increase profitability and to reduce risks.[164] The memorandum on 'Africa and Trade' talks of seven categories within the combined national policy and business level, ranging from activities directed at macroeconomic stability to activities to improve market functioning and market access, and from knowledge development to physical infrastructure.[165] DDE itself classifies its PSD-related instruments in six different clusters: Legislation, Infrastructure, Market Access and Market Development, Business Development/Capacity-Building, Financial Sector Development, and Other, including Public-Private Partnerships. The same instruments (projects, programmes and organisations) recur in each of these classifications. Some of the clusters preserve the distinction between three intervention levels: international policy level, national policy level and business level. This corresponds to the DAC classification into bilateral and multilateral and is useful in analysing the PSD instruments.

VII.3.1 Intervention levels, volume of funding, geographical concentration and categories on the basis of the core elements

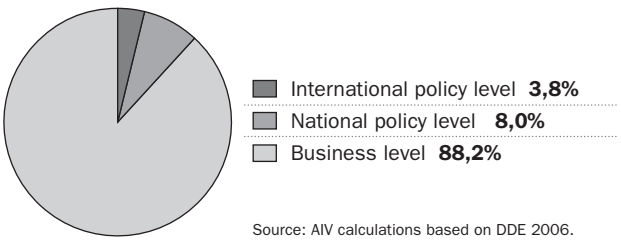
a. Intervention levels

This section contains a description and analysis of the set of PSD instruments at international policy level, national policy level and business level.

Figure A shows a breakdown of Dutch PSD activities at these three levels. As already stated, DGIS spent (according to the DDE list) a total of €285.1 million of its budget on PSD activities in 2005. Of this, 88% went on activities under the heading 'entrepreneurship and business development' or, in other words, interventions at business level (see also annexe IV).

Although the AIV is unable to identify the exact nature of the relevant expenditures, it would call attention to the warnings issued by both the World Bank and the OECD about various forms of direct business support which must be regarded as selective interventions, with all the associated disadvantages (see chapter IV).[166] According to

Figure A PSD activities by level (in % total expenditure in 2005)



Source: AIV calculations based on DDE 2006.

164 DGIS (2001), *In business against poverty*, The Hague, DGIS (October).

165 DGIS (2004), *Notitie Afrika en Handel*, The Hague.

166 World Bank (2004) *World Development Report 2005. A Better Investment Climate for Everyone*. New York: Oxford University Press, pp. 193-195. OECD (2004) *Accelerating Pro-Poor Growth through Private Sector Development*. Paris: OECD, pp. 57-61.

the World Bank, between 1998 and 2002 spending on such direct (non-ODA) business support and transactions amounted to no less than 26.4 billion USD a year.[167]

b. Volume of funding

Table VII.3 lists the main items of expenditure and shows that the largest items relating to infrastructure (development-related export transactions (ORET) and the LDC-Infrastructure programme) together amounted to €285.1 million: equivalent to over 36% of the whole (see annexe V). Various FMO funds and the PSOM, which finance businesses in developing countries, accounted for 13%. Eight activities score above average and are together good for over €173.4 million, equivalent to 60.8%. Apart from Solidaridad, the development organisation for Latin America, all the above-average items of expenditure are outsourced bilateral PSD instruments relating to the private sector. Since the appearance of the policy memorandum on economy and development, the FMO has managed almost all instruments directed at financing businesses in developing countries. In terms of the policy memorandum, these activities fall under the aim of increasing the rate of return. The PUM and the CBI fall under the aim of increasing knowledge and are 'autonomous' organisations. The other two exceptions in Table VII.3 are the PSOM (implemented by the Ministry of Economic Affairs' Agency for International Business and Cooperation (EVD))[168] and Solidaridad.

Table VII.3 Expenditure per organisation/activity (2005) (in million €)

	Organisation/activitity	Expendituren	Level	Category
1	FMO/ORET-MILIEV	92,5	Business	Infrastructure
2	FMO/Massif:			Financing companies in developing countries
	FMO/Seed Capital Fund	8,52	Business	
	FMO/KB fonds	4,54	Business	
3	FMO/MOL Infrastructure fund	10,90	Business	Infrastructure
4	FMO/NIMF	10,10	Business	Financing companies in developing countries
5	PUM	7,2	Business	Other
6	PSOM	19,1	Business	Financing companies in developing countries
7	CBI	17	Business	Trade promotion
8	Solidaridad	3,34	Business	Other
	Subtotal	**173,4**	**60,8%**	
9	**Other expenditure**	**111,6**	**39,2%**	
	Total	**285,1**	**100,0%**	

167 *World Development Report 2005. A Better Investment Climate for Everyone*, pp. 194-195.

168 The EVD implements numerous schemes and programmes involving the provision of financial support, information and/or expertise. The aim of the Partners for Water Programme, for example, is to stimulate Dutch companies with international projects in the water sector via 'feasibility studies, identification and market studies, business development processes, demonstration and pilot projects and institutional development'. Important instruments in the context of this advisory report are: PESP (export promotion), PSOM (stimulating investment, knowledge transfer and cooperation), PSB (helping SMEs to move into international markets) and the EVD's Trust Fund programme (run by IFC and EBRD and aimed at increasing the use of Dutch consultants, training institutions and project managers by international organisations).

However, a breakdown on the basis of the available funds says little about either the effectiveness of the instruments concerned, or the importance of the instrument in the light of PSD and general economic or pro-poor growth. For PSD to generate such growth, more is required: for example, investment in infrastructure and changes in legislation. While it is true that activities directed at the latter require far less financial support, they do call for support in the form of knowledge transfer. Nevertheless, this report concentrates mainly on those instruments that make heavy demands on the development cooperation budget. Many of these are instruments managed by the FMO or 'instruments' like CBI, PUM and PSOM (see annexe VI for background information on these). Although this does not cover the entire range of PSD instruments financed or cofinanced by the Netherlands, these four 'instruments' cover enough of it to judge how far Dutch policy exhibits the core elements identified in this report.

c. Geographical concentration

As the initial chapters in this report have shown, the extent to which PSD activities are targeted at poor countries and at poor regions within those countries is a major factor determining their potential pro-poor effectiveness. Looking at the geographical spread of a number of instruments, it is obvious that the majority of the countries targeted are in the low and middle-income categories.[169] In the light of the need for action to be demand-driven and context-specific, such a broad geographical focus calls for considerable effort on the part of the organisations managing PSD instruments. FMO and PUM-related expenditure in the low income countries proves to be relatively low, whereas PSOM expenditure in that category was relatively high.

The available data from 2003 show that the FMO strives to place 70% of its finance in the two poorest country categories, including 35% in the low income countries. Over half of the FMO's focus countries are in this category. In 2003, 33% of FMO-A financing was done in low income countries.[170] The PSOM contribution for the low income countries is 60%.[171] PUM has around 27% of its projects in low income countries and around 45% in middle income countries.[172]

d. Categories on the basis of the core elements

As already indicated, the AIV feels that the Ministry contributes to the confusion surrounding the classification of PSD interventions. Although the AIV has no wish to add to it, the analysis in the previous chapters of this report leads it to propose a different classification, for example, to that currently employed by DDE. The AIV would like to

169 The DAC List of ODA Recipients in 2005, 2006 and 2007 uses the following categories:
(1) Low income countries (including least developed countries) = ≤ $825;
(2) Lower middle income countries = $826 – 3,255; Upper middle income countries = $3,256 – 10,065;
(3) High income countries = ≥ $10,066. The classification is based on per capita GNI in 2004.
See also: http://www.oecd.org/dataoecd/43/51/35832713.pdf.

170 Cap Gemini (2004) *Waarde in ontwikkeling. Eindrapport evaluatie FMO*. p. 29.

171 EVD, *PSOM: Landen*.

172 Figures calculated by AIV on the basis of the PUM website and the DAC classification, see www.pum.nl (landen) and http://www.oecd.org/dataoecd/43/51/35832713.pdf.

emphasise that its proposal is not an exact blueprint. The proposed classification recognises the following seven categories: (1) investment or business climate; (2) infrastructure; (3) financial sector development including microfinance; (4) financing of individual businesses in developing countries; (5) trade promotion; (6) sustainability (social, economic and environmental = corporate social responsibility) and (7) other (including technical assistance and Fair Trade).[173] This classification is based on Tables VII.1 and VII.2. Table VII.4 classifies a large proportion of the PSD instruments contained in the DDE list in this way. In the opinion of the AIV, this classification corresponds better than the existing one to the core elements for economic growth and pro-poor growth through PSD identified in this report.

Table VII.4 shows that infrastructure is the largest category, although this is due primarily to the ORET programme. It is extremely doubtful whether this is sufficiently demand-driven and pro-poor. In second place is the investment climate, although here the majority of spending is by the embassies or IFC and therefore falls outside the DDE's direct sphere of influence. The third largest category as regards current budget spending is financing of individual businesses in developing countries.

The fourth category is trade promotion, dominated by CBI spending. The sustainability category comes in fifth place. This also includes Fair Trade and features here and there in the DDE clusters. The sixth category is instruments in the field of research, health and technical assistance and the seventh is financial sector development including microfinance. The last category is certainly pro-poor. In this context, the DDE list omits to mention Dutch contributions to the MIF.

All this means that by far the largest proportion of Dutch development cooperation resources devoted to PSD instruments are used to make various forms of finance (loans, equity, guarantees etc.) available (via ORET) to businesses investing in developing countries or supplying goods and/or services for infrastructure projects in developing countries. This is discussed in greater detail later in this chapter.

173 In view of its key role in current discourse, corporate social responsibility is included here as a separate category despite the fact that the philosophy behind it is regarded as also applying to action within all the other categories.

Table VII.4 Instruments by category and level (based on expenditure in 2005)*
N.B. This table is based on annexe IV plus information from DDE. The table includes both ODA and non-ODA instruments but should not be regarded as complete and gives only centrally managed resources. This means, for example, that it does not include bilateral projects managed at embassy level.

	International policy level	National policy level	Business level
Investment climate	• Investment Climate Facility • Investment climate assessments • UNIDO • ODA/POVNET • IFAP-DCC	• LAND partnership • ABC scans • IFC for SB/SME (NIPP) • Business climate by embassies • Dutch Employer Partnership programme • Trade Union Cofinancing • POP • DECP • Agripofocus (strengthening capacity of farmers' organisations)	
Infrastructure	• (Part of) capital injections for IFC, MIGA, IDB, ADB, AfDB, EBRD, EIB • IPTRID • INPIM • ICID • Infraco • MIAP	• Practica • DevCo • Taskteam PSD Tanzania • SIMI • LAND partnership • EVD pilot projects Colombia,Vietnam	• ORET/MILIEV • FMO-A • FMO MOL fonds • FEMIP Trust Fund • PIDG • Financing by IFC, MIGA, IDB, ADB, AfDB, EBRD, EIB • EAIF • PPIAF (via BNPP) • Fokker Ethiopia guarantee
Financial sector development including microfinance	• IMF (through Min. Fin.) • (Part of) capital injections for: IFC, MIGA, IDB, IIC, AfDB, ADB, EBRD, EIB • Commodity risk mgmt group (WB) Study remittances (WB) • FIRST (WB/BNPP) • MIF (IDB) • CGAP • UN advisory group • OECD	• FIRST (IMF/WB) • NFX projecten • African health insurance fund	• FMO-A • Financing by: IFC, MIGA, IDB, IIC, AfDB, ADB, EBRD, EIB • NFX • CD/IBTA • WWB • Oikocredit • Strohalm • NL Platform Microfinance • Financing of MFI's via NGO's* • ShoreCap • INAFI
Financing of individual businesses in developing countries	• (Part of) capital injections for: IFC, MIGA, IDB, IIC, AfDB, ADB, EBRD, EIB • UNCTAD		• FMO-A/NIMF/Massif/CD • Financing by: IFC, MIGA, IDB, IIC, ADB, AfDB, EBRD, EIB • PSOM • PESP (Min. Ec. Aff.) • FMO energy fund • Allochtoon ondernemen (IntEnt) • Woord en Daad

	International policy level	National policy level	Business level
Trade promotion	• UNCTAD • TRIPS • AITIC • Int. Cotton Advisory commission • Codex alimentarius • WTO/TRTA • ACWL • ACWL-technical advisory trust fund • NL trainee programme WTO • SOW-VU • Evert Vermeer Foundation	• JITAP • Support for countries in Africa Embassy projects • Market access partnerships • ETC COMPAS • EVD Database • Linkages trade dev./ poverty reduction • ILEAP • UNCTAD biotrade initiative • CFC • STDF • Globalising Trade justice • Consumer Trade Watch • Handel tegen honger • IFDC	• CBI • WSSD market access • Export credit insurance (Min. Fin./Ec. Aff.) • Agromisa • EurepGAP partnership
Sustainability (social, economic and environmental = corporate social responsibility) and Fair Trade	• UN Global compact • Fair Trade (lobby) • GRI • ISCOM SOMO • SMO • OECD Watch/Irene • NWSP • CSR conference	• AVALON Organic chain development in NIS • WUR agro supply chain programme • Promotion of CSR in Latin America	• CSR periodical • Fair flowers and plants • Albert Heijn/FTO cooperation • Solidaridad • Fair Wear Foundation • Max Havelaar • Fair Trade Assistance • Dutch Clean Clothes Campaign • ILEIA • Ethical investment tax relief (Min. Fin.) • VAMOS • Updating of fair trade (LVWW) shops
Other, including technical assistance	• Policy support fund • FAO integrated pest management		• PUM • Dutch Habitat Platform • Youth Development Network

Source: Annexe IV & 3

* The NGOs are mentioned here because they finance many MFIs in developing countries.

VII.4 Analysis of Dutch PSD instruments

The AIV would like once again to emphasise that neither the list of 'Categories on the basis of the core elements' in section VII.3 nor the analysis of Dutch PSD instruments in the present section is meant as an exact blueprint. The intention is rather to provide an illustration of a conceptual approach based on knowledge and experience in the business world and elsewhere.

To assess the entirety of Dutch government efforts in the PSD field, the AIV has asked itself two questions in relation to current instruments: firstly, *'Are we doing the right things?'* and secondly, *'Are we doing things right?'* To answer the first of these questions, it is important to know the policy of Dutch government (the strategy) and then how it is being translated into efforts, actions and instruments (operationalisation). The policy memorandum 'In business against poverty' (see footnote 157) provides a good starting point for an analysis of the entirety of efforts necessary in this respect. What is lacking in that document, however, is information on the operationalisation of the policy (i.e. choices, priorities and objectives).

BOX VII.2 Strategy, operational plan, evaluation and Review

In this chapter, the terms strategy, operationalisation of the strategy, evaluation and review are used in a fixed relationship to each other. There are really two levels of planning: strategic and operational. Any planning process should begin with the establishment of a strategy. This will be based both on external knowledge and information (such as authoritative studies by multilateral organisations like the World Bank, the IMF or the OECD) and on internal knowledge and experience, opportunities, competencies, and political and other priorities. The strategy will need regular evaluation and adjustment at appropriate intervals. The evaluation must consider the progress achieved in processes relevant to PSD and the extent to which PSD is actually being achieved. This is a dynamic process by which to establish 'what should be done'.

Once the strategy has been established, the next step is operationalisation: in other words, to translate the strategy into the actions and instruments necessary to achieve the strategic aim in practice. This means making choices, setting priorities and formulating objectives in specific areas. At this stage, it will be vital to take account of the importance of the separate areas of action both to the countries involved and in achieving the goals set. Account must also be taken of the efforts of other donors and institutions and of the Netherlands' own competencies and capacities. Measurable objectives must be established for the resulting activities, instruments, etc. These should not be at the high level of 'the contribution to PSD', but at the practical level of 'progress made' (for example, in setting up a land registry). Progress in these terms could be measured, for example, every two years under the aegis of the organisation responsible for implementation. This would produce a constant optimisation of the answer to the question 'how should it be done?'. If this system is adopted, individual instruments will not be assessed in terms of inappropriate questions like 'what is the contribution to PSD?' or, even more ambitiously, 'what is the contribution to PPG?'.

At this stage, it will be vital to take account of the importance of the separate areas of action both to the countries involved and in achieving the goals set. Account must also be taken of the efforts of other donors and institutions and of the Netherlands' own competencies and capacities.

To make such a judgment, it will also be important to have a clear quantitative and qualitative understanding of the totality of Dutch efforts in relation to PSD. This includes the efforts of the ministries involved (Foreign Affairs, Economic Affairs and Finance), those of the various departments in the development cooperation field (e.g. DDE, DMV and DVF), and even those under the various budget items. For example, many tens of millions of euros are allocated to microfinance under the MFO item. However, no such overall picture is available.

Table VII.4 suggests to the AIV that a multitude of instruments have developed over time, which were only later classified under the theme of private sector development. This is perfectly understandable in view of the recent increase in interest in this field and the importance now attached to it. However, it does mean that there is little apparent coherence between the instruments and instruments have been sub-categorised in many different ways, not always on any very clear basis. Moreover, there is no consistent policy framework based on lessons learned in the past.

To answer the two questions *'Are we doing the right things?'* and *'Are we doing things right?'*, the AIV has tried to determine the extent to which DGIS's current PSD instruments exhibit the core elements identified (Table VII.1) and meet the specified quality criteria (Table VII.2).

Since 2000, a number of the PSD instruments have been the subject of evaluations. These have related, for example, to specific programmes like ORET, PSOM and PUM, organisations like FMO and cooperative arrangements and partnerships with multilateral organisations (IFC, CGAP and the World Bank). A number of the evaluations, like those of the ORET and PUM programmes, are so out of date that they should not be taken into consideration. Others are still being carried out and the results are not yet available. Annexe VII contains brief details of the main results of evaluations which have been completed. The most important of them concern FMO and PSOM. The scarcity of recent evaluations prompts the AIV to question whether the tools are available to enable sufficient policy control to be exercised in the PSD field.

Those evaluation results which are available give a fairly positive picture of the specific PSD instruments concerned. The role of technical assistance receives a glowing report in the evaluations of the CBI and PUM.

The lack of any clear strategy, operationalisation and objectives (see box VII.2) for the way the relevant PSD instruments should contribute to private sector development, economic growth and pro-poor growth, must make it, if not impossible, at least difficult for government to exercise proper policy control and learn lessons in any systematic way.

It is interesting in this respect that when Stichting JIN studied the evaluations of PSOM, PUM, FMO, CBI and ORET in 2003, it found that 'none of the [...] evaluations studied answers the big questions of effectiveness' and that 'in general [...] policy and budgetary control [seems] to display no very clear relationship with the rather widely varying evaluation results'.[174]

It is also unclear what consequences the results of evaluations have in terms of future resource allocation.

Within the existing set of PSD instruments, there seems to be relatively little focus on improving the national policy environment in developing countries, even though national policies are a necessary precondition for PSD, economic growth and pro-poor growth. Current instruments pay little attention to improving the national investment climate and very little to the financial sector.

The majority of instruments are directed at financing infrastructural projects involving investments and/or exports by Dutch companies. Because the aid is tied, the result may be to drive up prices. It is unclear whether these instruments are actually a form of export promotion and whether they genuinely help to achieve pro-poor economic growth.

Grants are sometimes used to encourage investment where guarantees would be more appropriate. Where risk management is the intention, grants are regularly used instead of guarantees or insurance.

Recommendations

Based on the information available and discussions with representatives of various organisations, the AIV concludes that current strategy and control regarding PSD are inadequate. It therefore advocates a fundamental reformulation of integrated PSD policies. This will mean making choices, setting priorities and formulating objectives. This should be turned into an on-going dynamic process for example in the form of a biennial cycle of planning, implementation, progress monitoring and adjustment. Given the important role of PSD in generating both general economic growth and pro-poor growth, the AIV feels that the sum of €285 million for PSD instruments looks rather modest in the context of a total ODA budget of €4.2 billion in 2005.

The AIV feels that DDE has a special responsibility both to provide a complete overview of Dutch PSD efforts and to ensure their coherence. It believes that centralised control by the Director-General for International Cooperation would be a good way of achieving this (see VII.3).

The main policy goal should be to establish the right conditions and meet the necessary preconditions, rather than to provide any form of direct, concrete support for individual businesses. Table VII.1 shows what is meant by this and how it can be given a more pro-poor character.

174 Stichting JIN 2003, *Lessen uit evaluatiestudies van het Nederlandse OS-beleid van de afgelopen jaren.* This study was performed as part of an interministerial policy study on the effectiveness and coherence of development cooperation, 'Effectiviteit en Coherentie van Ontwikkelingssamenwerking', Eindrapport Interdepartementaal Beleidsonderzoek, 2002-2003, No. 1, The Hague, Dutch Ministry of Finance, 2003, pp. 55-56.

More effort should be made to achieve synergy between instruments. At the moment, any such synergy is more accidental than the result of deliberate policy.

The AIV feels that, given the large number of instruments taking the form of funds managed by the FMO, there is a considerable degree of fragmentation and inflexibility. This is likely to be detrimental to the effectiveness and efficiency of the FMO. It would be better to replace these funds by an equivalent annual contribution to the FMO's own capital, accompanied by a number of agreements between the State and the FMO on the various uses to which the money is to be put. The AIV is aware that this will entail a number of rules for the State and the FMO concerning risk-sharing and the concessionality of loans, but believes that the benefits in terms of flexibility, effectiveness and efficiency will substantially outweigh this difficulty.

The PSD instruments should be directed to a greater degree at strengthening national investment climates, for example by eliminating barriers and reducing risks. The same applies to strengthening the financial sector, with extra attention being paid to improving access for the poor to financial services including microfinance. Cooperation between various stakeholders will be required to enable developing countries to develop and implement strategies for access to financial services. In this connection, the Minister could ask the NFX[175] to work hand in hand with the Dutch Microfinance Platform.

175 The NFX was established in 2005 by the Dutch government and leading Dutch banks. It is a public-private partnership created to build local financial sector know-how in countries in various states of development around the globe. The NFX does this through capacity development, training and research. The overall goal is to create inclusive financial markets, which offer a diverse set of banking and insurance products to an increasing number of businesses and consumers.

Annexes

Annexe I

F. Korthals Altes
Chairman of the
Advisory Council on
International Affairs
Postbus 20061
2500 EB Den Haag

Sustainable Economic
Development Department
National Policy Environment
Division
Postbus 20061
2500 EB Den Haag

Date: 24 June 2005
Ref: DDE-0399/2005
Page: 1/2
Encl: -
Re: Request for advice on private sector development
Cc:

Author: J.C.J. Vlaar
Tel: 070-3487027
Fax: 070-3485956
dde@minbuza.nl
www.minbuza.nl

In its advisory report of January 2003, entitled 'Pro-poor growth in the Netherlands' bilateral partner countries in Sub-Saharan Africa', the AIV states that private sector development should be a central element in Poverty Reduction Strategy Papers (PRSPs) and that it would therefore be interesting to conduct a follow-up study of the role of the private sector in developing countries, with specific emphasis on the scope for governments to promote private sector development in a way that contributes to pro-poor development. What role do donors and the international business community play in this context? The core issue is how the development of the private sector can be influenced, through the creation of an appropriate business climate and other measures, in such a way that the economic growth it generates directly benefits poverty reduction.

Private sector development plays an important role in current Dutch policy on development cooperation, as laid out in the policy memorandum *Mutual interests, mutual responsibilities*, through the theme of improving the business climate and the various partnerships in which companies participate directly and for which new instruments have been developed. In the context of improving the business climate, Dutch embassies in the partner countries conduct an annual business climate scan. This 'ABC scan' is intended to identify possible areas for specific support activities, in addition to initiatives undertaken by the private sector itself in the countries concerned or by other parties in the Netherlands, as part of or outside the partnership. The policy has since been put into practice by broadening the range of activities being conducted in the partner countries and will be further elaborated in the context of the multi-annual strategic plans (MASPs) which the embassies developed this year.

Internationally, the role of the private sector in economic development and the factors that influence it have also been the subject of much analysis and evaluation in the past two years. Some of the more interesting results of these analyses include the following.

Four reports from the World Bank:
- Doing business in 2005
- World Development Report 2005: A Better Investment Climate for Everyone
- Improving Investment Climates; an Evaluation of World Bank Group Assistance (draft November 2005)
- Economic Growth in the 1990s; Learning from a Decade of Reform

In July 2004 a working group of the Committee of Donor Agencies for Small Enterprise Development produced an interesting report entitled *Donor approaches to improving the business environment for small enterprises*, and in December of the same year, the Private Sector Development task team of the OECD/DAC/POVNET published an interim report with the title *Accelerating pro-poor growth through support for private sector development*. The DCD/DAC Investment Committee also publishes interim reports, which will result in 2005 in a document containing recommendations on how ODA funds can be used more strategically to foster private investment that is relevant to development.

Lastly, there are an increasing number of evaluations of the implementation of current PRSPs, and of improved planning processes which lead to greater attention for private sector development in a new generation of PRSPs. In this context I recently requested MDF to analyse bottom-up planning processes in Tanzania (*Reforming institutions aimed at improving the enabling environment for pro-poor private sector development*, April 2005).

In light of these studies, I consider this a good moment to ask the AIV to produce an advisory report, as you suggested in your earlier report from 2003, possibly making specific use of relevant experiences in a small number of partner countries, such as Tanzania or Zambia.

I would particularly like you to address the following questions:
1. Is there scope for governments to support private sector development in such a way as to maximise the contribution to poverty reduction? Is it effective, for example, to introduce measures aimed specifically at certain sectors or companies (such as SMEs), what kind of measures should be introduced, and how could they be identified and integrated into a PRSP?
2. What are the dangers of too much management of the economy by governments and donors? The WDR 2005 indicates that the more specific measures are the less chance they have of success. This calls into question the value of measures aimed at specific sectors or companies.
3. In what way can the positive role of foreign direct investment be strengthened, such that it contributes as much as possible to employment and promotes local companies?
4. What do you see as the relatively strong and weak points of the various instruments I have at my disposal to encourage the private sector to play a more active role in Dutch development cooperation? In what ways can these instruments be improved?

(signed)

Agnes van Ardenne-van der Hoeven
Minister for Development Cooperation

Abbreviations

ACWI	Advisory Committee on Water Information
ACWL	Advisory Centre on WTO Law
ADEA	Association for the Development of Education in Africa
AITIC	Agency for International Trade Information and Cooperation
BEB	Directorate-General for Foreign Economic Relations, Ministry of Economic Affairs
BFB	Foreign Financial Relations Directorate, Ministry of Finance
BNPP	Bank-Netherlands Partnership Programme
BOF	Policy Support Fund
CBI	Centre for the Promotion of Imports from Developing Countries
CDM	Clean Development Mechanism
CD	Capacity Development programme
CEE	Central and Eastern Europe
CFC	Common Fund for Commodities
CGAP	Consultative Group to Assist the Poor
CODEX	Codex Alimentarius (FAO/WHO food standards)
CPIA	Country Policy and Institutional Assessments
CSO	Civil society organisation
CSR	Corporate Social Responsibility
DAC	Development Assistance Committee
DCC	Development Cooperation Committee
DDAGTF	Doha Development Agenda Global Trust Fund
DDE	Sustainable Economic Development Department, Ministry of Foreign Affairs
DECP	Dutch Employers Cooperation Programme
DFID	Department for International Development (UK)
DGIS	Directorate-General for International Cooperation, Ministry of Foreign Affairs
DYB	Develop Your Business programme
ECA	Economic Commission for Africa
ECOWAS	Economic Community of West African States
EDI	Energy Development Index
EMPRES	Emergency Prevention System for Transboundary Animal and Plant Pests and Diseases
EPA	Economic Partnership Agreement
EPR	Environmental Performance Review
ETC group	Action group on Erosion, Technology and Concentration (formerly RAFI)
EurepGAP	Global Partnership for Safe and Sustainable Agriculture
EVD	Agency for International Business and Cooperation, Ministry of Economic Affairs
FAO	Food and Agriculture Organisation
FEMIP	Facility for Euro-Mediterranean Investment & Partnership

FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FIRST	Financial Sector Reform and Strengthening
FTO	Fair Trade Organisation
FMO	Netherlands Development Finance Company
GDP	Gross Domestic Product
GNI	Gross National Income
GOVNET	Network on Governance
GRI	Global Reporting Initiative
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
HDI	Human Development Index
HIPC	Heavily Indebted Poor Country
HLM	High-level Meeting
IADB	Inter-American Development Bank
ICAC	International Cotton Advisory Committee
ICF	Investment Climate Facility
ICID	International Commission on Irrigation and Drainage
ICT	Information and communication technology
IEA	International Energy Agency
IFAP	International Federation of Agricultural Producers
IFC	International Finance Corporation
IFDC	International Fertiliser Development Centre
IFI	International Financial Institutions
IIC	Inter-American Investment Corporation
ILEAP	International Lawyers & Economists Against Poverty
ILEIA	Centre for Information on Low External Input and Sustainable Agriculture
IMF	International Monetary Fund
INAFI	International Network of Alternative Financial Institutions
INBAR	International Network for Bamboo and Rattan
INPIM	International Network on Participatory Irrigation Management
IPM	Integrated Pest Management (FAO)
IPTA	Investment Promotion and Technical Assistance programme
IPTRID	International Programme for Technology and Research in Irrigation and Drainage
ISCOM	Institute for Sustainable Commodities
ITC	International Trade Centre
IWMI	International Water Management Institute
JITAP	Joint Integrated Technical Assistance Programme
LAND	Land Alliances for National Development
LDC	Least Developed Country
LDC	Fund Least Developed Countries Infrastructure Fund (FMO)
LNV	Ministry of Agriculture, Nature and Food Quality

MDGs	Millennium Development Goals
MENA	Middle East and North Africa Initiative (on Governance and Investment for Development)
MIF	Multilateral Investment Fund
MIGA	Multilateral Investment Guarantee Agency
MILIEV	Industry and Environment Programme
MIR	Managing Inputs Regionally (project financed by DGIS and IFDC)
NCP	National Contact Point
NEDECO	Netherlands Engineering Consultants
NEPAD	New Partnership for Africa's Development
NFX	Netherlands Financial Sector Development Exchange
NGO	Non-governmental organisation
NIMF	Netherlands Investment Matching Fund (FMO)
NIS	Newly Independent States
NSDS	National Sustainable Development Strategies
OECD	Organisation for Economic Cooperation and Development
ODA	Official Development Assistance
ODI	Overseas Development Institute
O&M	Operation and Maintenance
OPPG	Operationalising Pro-Poor Growth programme
ORET	Development-Related Export Transactions programme (FMO)
PARIS21	Partnership in Statistics for Development in the 21st Century
PIA	Poverty Impact Assessment
PIDG	Private Infrastructure Development Group
POVNET	DAC Network on Poverty Reduction
PPG	Pro-poor growth
PPIAF	Public Private Infrastructure Advisory Facility
PPP	Public-private partnership
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
PSD	Private Sector Development
PSOM	Emerging Markets Cooperation Programme
PUM	Netherlands Management Cooperation Programme
QUNO	Quaker United Nations Office
RAFI	Rural Advancement Foundation International (now ETC group)
ROPPA	Network of Farmers' Organisations and Agricultural Producers in West Africa
SAADA	South African Academic Development Association
SADC	Southern African Development Community
SALIN	Strategic Alliances with International NGOs programme
SEA	Strategic Environmental Assessment
SEE	South East Europe

SLM	Senior-level meeting
SIMI	Smallholder Irrigation Market Initiatives
SMEs	Small and medium-sized enterprises
SMO	Society and Enterprise Foundation
SOMO	Centre for Research on Multinational Corporations
SOW	Centre for World Food Studies
SPS	Sanitary and phytosanitary standards
S&T	Science and technology
STDF	Standards & Trade Development Facility
SWAP	Sector-wide approach
TAHA	Tanzania Horticulture Association
TBTs	Technical barriers to trade
TMF	Theme-based cofinancing
TRALAC	Trade Law Centre for Southern Africa
TRIPs	Trade-related intellectual property rights
TRTA	Trade-related technical assistance
TVET	Technical Vocational Education and Training
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNECLAC	United Nations Economic Commission for Latin America
UN-HABITAT	United Nations Human Settlements Programme
VNO-NCW	Confederation of Netherlands Industry and Employers
VROM	Ministry of Housing, Spatial Planning and the Environment
WSSD	World Summit on Sustainable Development
WHO	World Health Organisation
WTO	World Trade Organisation
WUR	Wageningen University Research Centre
WWB	Women's World Banking
YDN	Youth Development Network

Interviews

People interviewed about private sector development

Washington

- The staff of the Executive Director for the Netherlands Constituency, especially Mr J. Waslander
- Ms M. Varkie (Director, External Outreach and Partner Group, MIGA) and Mr M. Williams (Advisor, MIGA Strategy and Operations)
- Mr H. Bosher (Investment Officer Small Investment Program, MIGA) and Mr W. Douw (Investment Promotion Specialist, MIGA)
- Mr C. Calari (Vice President, Financial Sector), Ms A. Ciobanu (Alternate Executive Director) and Mr E. van der Does de Willebois (Financial Sector Specialist, Financial Market Integrity)
- Mr S. Claessen (Senior Advisor, Financial Sector Department, World Bank)
- Mr J.W. van der Kaaij (Netherlands Executive Director, Dutch Constituency Office IMF/World Bank)
- Mr P. Guislan (General Manager, Foreign Investment Advisory Service, FIAS) and Mr V. Palmede (Lead Economist, FIAS)
- Mr R. Holzman (Sector Director, Social Protection Human Development Network)
- Mr P. Moorrees (Counselor for Belgium, Germany, Israel, Italy, the Netherlands and Switzerland; IADB)
- Mr T. Miller (Senior Investment Officer, MIF, IADB)
- Mr D.F. Terry (General Manager MIF, IADB)
- Mr J. Rogozinsky (General Manager, IIC) and Mr S. Reed (Deputy General Manager, IIC)
- Mr A.Vives (Interim Manager, Sustainable Development Department, IADB)
- Mr B. Frydman (Deputy Manager, Private Sector Department, IADB)
- Mr C. Novis Guimaraes (Private Sector Coordinator, IADB)
- Mr T. Takahashi (Executive Director for Croatia, Japan, Korea, Portugal, Slovenia and the United Kingdom, IADB)
- Ms A. Demirguc-Kunt (Senior Research Manager) and Mr T. Beck (Senior Financial Economist)
- Mr H. Rosen (Director, Grassroots Business Initiative) and Mr L. Carter (Director, Small and Medium Enterprise Department, IFC)
- Mr S. L. Jorgensen (Director, Social Development Department)
- Ms J. Msuya (Senior Strategy Officer, Sub-Saharan Africa Department, IFC)
- Mr D.T. Carpio (Acting Director, Operations Evaluation Group, IFC)
- Ms E. Littlefield (Director and CEO, CGAP), Mr S. Hashemi (Senior Microfinance Specialist, CGAP) and Ms O. Sananikone (Senior Microfinance Specialist, CGAP)
- Ms E. King (Research Manager, Development Research Group)
- Mr M.W. Plant (Senior Advisor, Policy Development and Review Department, IMF)
- Mr A. Ouanes (Chief, Financial Systems Surveillance Division, Monetary and Financial Systems Department, IFC) and Mr J.W. van der Vossen (Advisor, Monetary and Financial Systems Department, IMF)
- Mr W. Varghese (Senior Economist, Anglophone Africa, Monetary and Financial Systems Department, IMF)
- Mr W. Cline (Senior Fellow, Institute for International Economics/Center for Global Development)
- Ms S. Polaski (Senior Associate Director, Trade, Equity and Development Project)

- Mr V. Ramachandran (Visiting Fellow, Center for Global Development, and Assistant Professor of Public Policy, Georgetown University)

Development cooperation managers in the PSD field

- Mr A. Arnold (Chief Executive Officer, FMO), Mr H. Cornelissen (Director, Europe and Central Asia, FMO), Mr M.F. de Jong (Senior Policy Advisor, Corporate Affairs, FMO), Mr E.H.J. Groot (Financial Sector Specialist, Asia, FMO), Mr S. Stavenuiter (Senior Evaluation Officer, IMR, FMO) and Ms A. van Baar (Investment Officer, Latin America & the Caribbean, FMO)
- Mr I.G. Merison (Unit Manager, Investment and Export Finance, BEB, Ministry of Economic Affairs), Ms H.M.B. Joziasse (Deputy Director, International Private Sector Department, BEB, Ministry of Economic Affairs)
- Ms I.M. Jansen (Senior Policy Officer, Ministry of Finance, BFB), Mr E. Spijkerman (Coordinator, International Economy Section, BFB, Ministry of Finance) and Mr M. Bezemer (Policy Advisor, BFB, Ministry of Finance)
- Mr J. Röben (Managing Director, PUM)
- Mr A.H.M. Lansink (Managing Director, CBI)
- Mr A. van Ravestein (Managing Director, EVD), Ms N.C. van de Geest (Cluster Manager, Emerging Markets Cooperation Programme Unit, EVD) and Ms E.J. Bense (Deputy Director, EVD)
- Mr J. Knotnerus (Director, NFX), Mr J. Menken (Deputy Director, NFX), Mr P. van der Krogt (Global Head, ING Institutional and Government Advisory Group, ING), Mr C.T. Ruys (Manager, Rabobank Foundation, MVO; NFX), Mr E.H.J. de Groot (Financial Sector Specialist (Asia), FMO; NFX) and Ms M. Verheij (Communications Manager, NFX)

Other

- Mr Dijksterhuis (Business Practice and Business Development, DDE, Ministry of Foreign Affairs)
- Mr M. de Boer (Policy Analysis and Advice, DEK, Ministry of Foreign Affairs)
- Mr Van Praag (Executive Director, NEDECO)
- Mr J. van der Meij (General Manager, Vlisco B.V.) and Mr M. Veninga (Chairman, Executive Board, Gamma Holding B.V.)
- VNO-NCW (Chair and members of the Developing Countries Committee (COL))
- Mr Timmerman (Managing Director, Pop Vriend Seeds B.V.)
- Ms M. Vrieling (CNV Internationaal)

List of DDE activities in 2005*

This is a list of the activities of the Sustainable Economic Development Department (DDE), by theme. Only DDE activities are included; it is not an exhaustive statement of spending on private sector development at the Ministry of Foreign Affairs. Furthermore, some activities fall under articles other than 4.3. in the Foreign Affairs budget and some are non-ODA; these do not fall under the theme of private sector development in the strictest sense.

Theme: legislation	**Spending in 2005 (in euros)**
National policy environment	
Task Team on Private Sector Development (PSD) Tanzania	49,604
	49,604

Theme: infrastructure	**Spending in 2005 (in euros)**
National policy environment	
Int. Programme for Technical Development in Irrigation and Drainage (IPTRID) – Int. Water Mgmt Institute (IWMI) Network Project	253,834
Int. Water Mgmt Institute (IWMI) Comprehensive Assessment	830,000
Support for Int. Network on Participatory Irrigation Mgmt (INPIM)	95,015
Int. Commission on Irrigation and Drainage (ICID) Country Policies	116,750
Smallholder Irrigation Market Initiative (SIMI)	1,451,953
Workshops on small-scale technology	174,335
Business practice and business development	
Development-Related Export Transactions Programme (ORET) – research	671,348
FMO/ORET Industry and Environment Programme (MILIEV) 2002-04	92,462,519
FMO Least Developed Countries (LDC) Infrastructure Fund*	10,904,193
Private Infrastructure Development Group (PIDG)	190,900
Facility for Euro-Mediterranean Investment & Partnership (FEMIP)	2,000,000
Total	**109,150,850**

Theme: market access and market development	Spending in 2005 (in euros)
International markets	
United Nations Conference on Trade and Development (UNCTAD) Biotrade Initiative	166,000
Codex Alimentarius	41,500
EurepGAP, for small-scale producers in developing countries (= *partnership*)	84,128
Standards & Trade Development Facility (STDF)	300,000
Fair Flowers & Plants Public Private Partnership (PPP) (= *partnership*)	270,000
Common Fund for Commodities (CFC) partnership programme	422,620
Globalising Trade Justice	360,333
Support for INBAR	433,857
Contribution to the Evert Vermeer Stichting	56,000
Trade-Related Technical Assistance (TRTA) with European Partnership Agreements (EPAs), Trade Law Centre for Southern Africa (TRALAC)	146,403
Dutch trainee programme, WTO	599,850
Int. Cotton Advisory Committee (ICAC), annual contribution	13,446
Quno-IER, support for Trade Related International Property Rights (TRIPs)	273,990
AITIC sponsoring membership 2004-08	411,600
Joint Integrated Technical Assistance Programme (JITAP) II; WTO/UNCTAD/ITC	200,000
Linkages between trade, development and poverty reduction	333,450
Trade-Related Technical Assistance (TRTA) with the WTO's Doha Development Agenda Glocal Trust Fund (DDAGTF)	900,000
OECD Development Assistance Committee (DAC) Trade Facilitation Project (*also falls within legislation cluster*)	25,000
Consumer Trade Watch	372,388
Stichting Onderzoek Wereldvoedselvraagstukken (SOW) (Centre for World Food Studies) (art. 6.02)	792,052
Fair Trade Organisation (FTO) (= *partnership*)	350,500
Fair Trade assistance 2004-07	81,500
Int. Lawyers & Economists Against Poverty (ILEAP)	192,000
Renewed contribution to budget, Advisory Centre on WTO Law (ACWL), Geneva	207,499
National policy environment	
World Summit on Sustainable Development (WSSD) partnership on market access and phytosanitary capacity in Uganda	239,121
WSSD partnership on market access and capacity (Dutch Ministry of Agriculture)	797,000
ETC Foundation, endogenous development and cultural diversity project (COMPAS)	650,000

Theme: market access and market development	Spending in 2005 (in euros)
Avalon Foundation, organic chain development in NIS	195,421
Sustainable supply chain management and poverty reduction programme (ISCOM)	135,800
Wageningen University and Research Centre (WUR), initial stage of agricultural supply chain programme	47,500
Business practice and the private sector	
Solidaridad	3,337,000
"Clean clothes" campaign	297,020
Implementation Transf. Plan, 2002-05	633,504
Max Havelaar – awareness-raising and lobbying	175,000
	13,541,485

Access to knowledge and skills	Spending in 2005 (in euros)
National policy environment	
Stichting Woord en Daad	2,186,190
Centre for Information on Low External Input and Sustainable Agriculture (ILEIA)	809,411
Youth Development Network (YDN)	215,196
Int. Federation of Agricultural Producers (IFAP)/ Development Cooperation Committee (DCC)	1,100,731
Agromisa Foundation	211,799
Agriterra approach	1,700,000
Agriprofocus: support for agricultural producers' organisations	280,032
Promotion of CSR in Latin America	432,795
Business practice and the private sector	
Emerging Markets Cooperation Programme (PSOM)	19,115,000
PSOM external evaluation 2005	32,000
Develop Your Business Database/Agency for International Business and Cooperation (EVD)	37,242
Netherlands Management Cooperation Programme (PUM) 2004-2007	7,217,598
PUM Tsunami	266,666
Monitors, IntEnt	91,733
Internationalisation of Entrepreneurship (IntEnt)	1,062,740
Corporate Social Responsibility (CSR)	33,553
European CSR conference	66,581
CSR magazine P-plus	34,000
Centre for Research on Multinational Corporations (SOMO)	150,000
Society and Enterprise Foundation (SMO)	370,000
OECD Watch/IRENE	62,650
Total	**35,475,917**

Financial sector development (FSD) cluster	Spending in 2005 (in euros)
National policy environment	
Health Insurance Fund	360,000
Netherlands Financial Sector Development Exchange (NFX)	300,000
NFX – Projects in Tanzania/Uganda and Macedonia	147,560
Business practice and the private sector	
Investment Promotion and Technical Assistance for Developing Countries (IBTA-OL; non-ODA)	1,127,519
Netherlands Investment Matching Fund (NIMF)	10,100,000
Seed Capital Fund (non-ODA)	8,516,678
Small Business Finance Programme (KB; non-ODA)	4,537,802
ShoreCap	300,000
Core Funding CGAP	332,000
Core Funding, Women's World Banking (WWB)	516,468
Women's World Banking (WWB)/affiliate capitalisation	219,931
Social Trade Organisation (STRO)	510,591
OIKOCREDIT Int. Support Foundation (ISF)	1,271,000
INAFI Micro Finance	226,251
	28,465,800

Other	Spending in 2005 (in euros)
International markets	
LDC participation in WTO MC6	40,000
Policy Support Fund (BOF)	226,464
National policy environment	
Public-Private Partnership, HIV/AIDS	77,036
United Nations Dev. Programme (UNDP) research on AIDS in Chile	26,756
Habitat Platform, 2001-03	150,000
Habitat Platform, 2004-06	460,000
EMPRES, Desert Locust RVM3	105,427
Int. Fertiliser Development Centre (IFDC)	1,737,375
Development Assistance Committee (DAC)	8,000
Network on Poverty Reduction (POVNET)	
	2,831,058

* Received from DDE on 5 October 2006; replaces information sent earlier.

Spending on private sector development in 2005

Subject (1)	Cluster (2)	Spending in euros
Embassy programmes	All	61.6 million
IFC	All	11.2 million
Partnerships with civil society (TMF)	All	18.6 million
Trade and financial system	International market access	1.6 million
NIMF	Financial sector	10.3 million
ORET	Infrastructure	92.5 million
LDC Infrastructure Fund	Infrastructure	10.9 million
CBI	Knowledge and skills	17.0 million
PSOM	Knowledge and skills	19.1 million
PUM	Knowledge and skills	7.2 million
Other	All	14.6 million
Total: (3)		**264.6 million**

(1) Statement limited to ODA spending at the Ministry of Foreign Affairs
The above statement is limited to ODA spending on development cooperation at the Ministry of Foreign Affairs. The annual report on the Homogeneous Budget for International Cooperation (HGIS) contains a more complete statement which includes spending at other ministries. The above statement also only includes spending directly related to private sector development. It does not include contributions to multilateral organisations (such as the World Bank), general budget support or debt relief, because these forms of aid do not relate to a specific sector.

(2) Expenditures classified by theme
This relates to the set of themes established by the Sustainable Economic Development Department (DDE) in 2006. DDE policy is a response to the obstacles that businesses encounter in developing countries: 1. flawed legislation; 2. limited access to international markets; 3. poor infrastructure; 4. inadequate access to financial services; and 5. limited knowledge and skills, and thus capacity for development. Where "All" has been filled in, the Ministry is currently looking into what portion of the spending can be attributed to each theme.

(3) Relationship of this statement to the figures in the HGIS annual report
The total spending figure of €264.6 million can be found in the HGIS annual report for 2005, by adding together articles 04.01 (Trade and financial system; the ODA portion is €1.6 million) and 04.03 (Business climate in developing countries; the ODA portion is €263.0 million).

NB: In earlier versions, the figure of 285.1 million euros was used. The relationship with the figure of 264.6 million can be briefly explained. If the non-ODA portion (€14.2 million) and DEE expenditures that fall under other budget articles (€7.3 million) are taken into account, and we deduct operating expenses for the Netherlands Investment Bank for Developing Countries (NIO; €1.0 million) then the total PSD spending is €285.1 million. The figure of €264.6 million is more accurate, however.

Background information on selected PSD private-sector instruments

FMO IBTA (since March 2006: FMO-CD)

Target group

Dutch enterprises that work with businesses in emerging economies in Asia, Africa, Latin America and Europe

Objective and description

The aim of the Investment Promotion and Technical Assistance programme (IBTA) is to promote trade and industry in developing countries. The programme also offers Dutch enterprises the opportunity to tap into the demand for foreign investment, modern management methods and technologies, and the development of new markets and products. The IBTA programme finances two types of activities:

- activities (such as feasibility studies) aimed at collecting information required for investment decisions;
- activities intended to improve management and employee performance; these include interim management, short-term advice and work-related training.

The activities eligible for funding under the IBTA programme are short-term in nature, but they are intended to contribute to the long-term success of an enterprise.

The following sectors are eligible for support under this programme:

- the financial sector;
- infrastructure;
- the export sector.

The scale of the activities eligible for IBTA funding must be in reasonable proportion to the size of the beneficiary enterprise and the intended result. Funding never exceeds 50 percent of the total eligible costs, with a ceiling of €275,000 for interim management and technical assistance and €80,000 for feasibility studies.

Main criteria

- The IBTA programme is intended exclusively to support the commercial activities of private-sector enterprises.
- Small and medium-sized enterprises have priority under the programme, although large companies may also qualify.
- State-run enterprises and government organisations will only qualify if they can demonstrate that the relevant activities are commercial in nature and being managed independently.
- Educational or care institutions are not eligible.

FMO IFOM

Target group
Small and medium-sized enterprises, in select emerging markets, in which risk-bearing capital has been invested by a Dutch SME.

Objective and description
Through its Emerging Markets Investment Facility (IFOM), the Netherlands Development Finance Company (FMO) can make medium and long-term subordinated loans to a local subsidiary or joint venture in which risk-bearing capital has been invested by a Dutch company. Loans are issued in euros, from a minimum of €45,000 up to a maximum of €2.3 million. Maturities range from three to twelve years and a grace period of up to three years is possible. By providing subordinated loans, FMO helps to strengthen the balance sheet of local enterprises and attract additional commercial financing.

Main criteria
- The Dutch company must have the features of an SME as defined by EU standards.
- The Dutch company must be well-managed, financially sound and have a proven, positive track record.
- The investment being made in the emerging market must be part of the Dutch company's strategy and of vital importance to that company.
- The Dutch company must own at least 50% of the foreign company and be prepared to commit itself (and its financial resources) to making the venture in the emerging market a success.

FMO LDC Infrastructure Fund

Target group
Private investors who wish to invest in private-sector or public/private-sector infrastructure projects in the Least Developed Countries (LDCs).

Objective and description
Through the LDC Infrastructure Fund, the Netherlands Development Finance Company (FMO) supports the improvement of social and economic infrastructure in LDCs. FMO wants to encourage private investors to invest in private-sector or public/private-sector infrastructure projects in these countries. By providing risk capital, the LDC Infrastructure Fund does away with a definite risk for financiers, thereby catalysing additional private funds.

The LDC Infrastructure Fund also awards grants for new projects. The grants can cover parts of a project that would normally be the responsibility of the relevant national government (but which that government has not provided for). Grants may also be used for one-off investments that are of vital importance to projects but will not contribute to the project's profitability.

Main criteria
- LDC Infrastructure funding is available for infrastructure projects that contribute to the development and/or improvement of the social and economic infrastructure (power supply, telecoms, water, transport, or environmental or social infrastructure).
- Projects are assessed not only for their financial and economic performance, but also for corporate governance and social and environmental policies and practices, to ensure the long-term sustainability of the investment. In evaluating proposals, FMO considers the investment plan, a market analysis, a due diligence study, the expected returns, and the commitment of managers and co-financiers.

FMO ORET

Target group
Companies that wish to export capital goods, services or work to developing countries.

Objective and description
Through the Development-Related Export Transactions (ORET) programme, the Dutch government awards grants to developing countries for the export of capital goods, services or labour. ORET supports companies that aim to become active in developing countries. At the same time, it promotes the investment climate in developing countries by facilitating investment in infrastructure. The programme is run by the Netherlands Development Finance Company (FMO) on behalf of the Dutch Minister of Foreign Affairs.

An ORET grant helps developing countries defray the cost of purchasing capital goods, services or work. The programme has three facilities.
- The tied facility is intended for export transactions to selected countries. This type of grant is awarded only to Dutch companies that wish to undertake such a transaction.
- The untied facility is intended for export transactions to Least Developed Countries (LDCs). This type of grant is awarded to Dutch and foreign companies.
- The water facility is intended for export transactions related to investment in the drinking water and sanitation sector.

Main criteria
- Grants awarded to developing countries under any of the above facilities must be used to make direct payments to the Dutch or foreign supplier. Depending on which ORET facility is used, eligibility may be subject to other criteria.
- FMO assesses ORET applications for their financial, technical and organisational feasibility, and for the investment's contribution to sustainable economic development in the country in question.
- The relevant project must be commercially unfeasible (according to OECD guidelines). In practice, this means that the investment of which the export transactions form a part must have a payback period of more than 10 years.
- FMO assesses projects with respect to issues such as corporate governance and social and environmental policies to ensure the long-term sustainability of the investment.
- One rule that applies to all ORET facilities is that the total value of the export transaction must not exceed €45 million.

Companies applying for an ORET grant must demonstrate sufficient technical, organisational and financial capacity to carry out the transaction successfully, and they may not have a controlling interest in the beneficiary enterprise at the time that they submit their application. They must also be able to provide financial guarantees on request.

FMO NIMF

Target group
Dutch and foreign enterprises that wish to invest in developing countries.

Objective and description
The purpose of the Netherlands Investment Matching Fund (NIMF) is to stimulate foreign direct investment in developing countries. NIMF provides both long-term risk capital and sector-specific expertise. NIMF financing can be anywhere from €1 million to a maximum of €5 million. NIMF will match the amount of risk capital invested by the Dutch or foreign company. FMO also provides sector-specific expertise via NIMF.

Main criteria
Financing is awarded on commercial terms. The beneficiary company and/or the equity investment itself are subject to specific conditions and requirements.

FMO (general)

The Netherlands Development Finance Company (FMO) is a development bank founded in 1970, which runs a number of programmes for the private sector. Because the Dutch government invests substantially in FMO's fund, the organisation inspires enough confidence in businesses and banks to attract private investment. The government holds 51 per cent of its shares; the remainder are in the hands of more than 140 private Dutch parties, mainly businesses and banks. FMO fosters the development of companies based in developing countries. By doing so, it aims to generate jobs and income, and increase export revenues in those countries. Each year, it invests approximately half a billion euros in the private sector in developing countries, making loans – and, to a growing extent, providing venture capital – to manufacturers and, above all, local financial institutions (banks, leasing companies and so on). These institutions, in turn, finance local businesses. FMO lends money on market terms, but does not have exactly the same working methods as commercial banks, in that it operates in regions and situations that they would consider too risky.
The Dutch government also provides extra funding for a number of special FMO programmes, because FMO would otherwise run too great a risk. For example, through the Small Business Finance (KB) Programme, the organisation backs loans in local currency, so that local entrepreneurs do not have to bear the foreign-exchange risk. These monies come from a special KB fund, which is financed by the Ministry of Foreign Affairs. In addition, there is a Seed Capital Programme, which buys shares in start-ups, especially in Africa. The Dutch state carries 85 per cent of the risk and FMO 15 per cent.
One important division of FMO is the Netherlands Investment Bank for Developing Countries (NIO), which was merged into FMO in 2000. NIO Bank deals with the banking transactions involved in financial aid from the Dutch authorities to developing countries. It is responsible for both donations and loans (including collection), as well as the operational side of the ORET programme (run by DGIS; see above).

Target group
Trade and industry in the Netherlands and in developing countries.

Objective and description
The Netherlands Development Finance Company (FMO) supports the private sector in developing countries through loans, participations, guarantees and other investment promotion activities. FMO's goal is to contribute to structural and sustainable economic growth in these countries and, in cooperation with the private sector, obtain healthy returns. FMO concentrates on four sectors: the financial sector, small businesses and microenterprises, infrastructure, and trade and industry.

CBI

The Centre for the Promotion of Imports from Developing Countries (CBI) was founded in 1971 to help developing countries sell their products on West European and regional markets, in order to become economically independent. Its services to businesses from developing countries include information on markets, consultancies and training courses on special topics, and getting them into contact with European concerns. The target group consists of decision-makers, staff of trade promotion organisations, marketing managers at SMEs and organisers of trade fairs. Almost 25% of the target group is in the least developed countries (LDCs). The CBI devotes special attention to companies' social and environmental responsibilities. It is based in Rotterdam and has four divisions:
(1) Administrative and Financial Affairs (CBI/CZ); (2) Trade Promotion and Company Matching (CBI/HB); (3) International Projects and Knowledge Transfer (CBI/IK); en
(4) Market Information and Company Matching (CBI/MB).

Target group
Exporters in developing countries, importers in the Netherlands and business support organisations

Objective and description
The aim of CBI is to boost the competitiveness of exporters in developing countries so that they have easier access to the European market. To achieve this aim, the CBI offers a range of different services:
- transfer of its knowledge of structures and trends in European markets;
- technical assistance when improving products and production;
- support in applying EU product-related directives;
- help with export marketing/management;
- guidance for businesses entering European markets.

In addition to these services, the CBI also runs various programmes in support of businesses in developing countries:
- market information tools to keep exporters in developing countries in step with the very latest developments on the EU market;
- a company matching programme that links suppliers in developing countries to reliable importing companies in the EU and vice versa;
- export development programmes designed to assist entrepreneurs in developing countries to enter the EU market and consolidating their existing position and market share;
- training programmes on general export marketing and management, trade promotion, management of international trade fair participation, and developing client-oriented market information systems.

Main criteria
Countries are only eligible for CBI programmes if they are ranked, according to the OECD/DAC classification, below the 'Upper Middle Income' level (China and East European countries are not eligible).

PUM

Target group
Small and medium-sized enterprises and non-profit organisations in Africa, Asia, Latin America and Central and Eastern Europe that wish to make temporary use of the experience and skills of retired Dutch managers or experts.

Objective and description
PUM registers retired managers and experts who can assist and coach businesses and institutions that require specialist know-how but do not have access to it in their own environments. The consultants are independent and work as volunteers; in other words, they do not receive a fee for their services.

Main criteria
- Applications must be submitted by an enterprise or non-profit organisation, either via a local representative or directly to PUM.
- The applicant must be unable to recruit and finance the necessary assistance itself. The cost of the service and the anticipated results must be in reasonable proportion to one another.
- The applicant must not be a subsidiary of a foreign or international company.
- Travel and other expenses are paid. The applicants must, however, pay for the consultant's local travel and accommodation.

PSOM

Target group
The applicant that submits the proposal must be a company registered in the Netherlands. An exception is made for projects in Mozambique, Uganda and Zambia, for which either Dutch or foreign companies may submit proposals. In such cases, non-Dutch applicants should be based in countries in part I of the OECD/DAC list of aid recipients ("PSOM countries").

Objective and description
PSOM aims to finance pilot investment projects in the emerging markets of developing countries that lead to follow-up commercial investment and/or lasting trade relations between Dutch and local companies. The objective of PSOM is to reduce poverty by supporting sustainable economic development. This goal is achieved by encouraging long-term investment and trade relations between Dutch companies and local companies in PSOM countries. The programme operates by financially supporting joint pilot investments in the developing country by Dutch and local entrepreneurs.

Main criteria
Investment projects are eligible if they meet the following criteria.
- They involve a Dutch company and a company in a PSOM country that aim to set up a new activity in partnership in that country.
- The company and the local partner are financially sound, have relevant expertise and experience in the market and have entered into a long-term trade or investment relationship.
- The applicant should be a company registered in the commercial register at the Chamber of Commerce in the Netherlands. The recipient should be a private company, officially registered in the recipient country. There is no limitation on the percentage of shares of the recipient company that may be owned by Dutch companies.

- The applicant does not have the financial means to implement the plans, nor can the applicant obtain funds from a bank to finance the business plan.
- The proposal is commercially feasible in the medium or long term and will have a positive effect on the local economy of the recipient country by creating additional employment, introducing new technology, improving livelihoods, strengthening small and medium-sized businesses and/or improving environmental conditions.
- The project will lead to additional investment and greater turnover.
- The company and the local partner are each capable of financing their own contribution.

Evaluations

Netherlands Management Cooperation Programme (PUM) (2002)

The aim of this evaluation was to "arrive at a well-grounded assessment of the relevance, effectiveness and efficiency of PUM as a policy instrument from 1996 to 2000 in Croatia, the Philippines, Morocco, Poland, Romania, the Russian Federation and South Africa." The assessment of efficiency also took added value into consideration, and possible secondary effects were identified in areas such as the labour market, the environment and the supply chain. The most relevant conclusions are given here.

- In general, the relevance of PUM activities to development is beyond question. Only a very small proportion of them can be described as irrelevant to development and have done nothing to promote a socially equitable market economy.
- The added value (would the same results have been achieved without the help of a PUM consultant) is low. In a very few cases, support was given to organisations that could have afforded to pay market rates for consultancy. However, there is little real competition with foreign consultants charging such rates.
- The beneficiaries generally appreciate PUM activities, and often greatly value them. However, the tangible effects on the performance of the beneficiary businesses are limited, mainly due to the brevity of the missions and (more generally) the absence of a logical connection between the length of the missions and the nature of the problems. There are striking differences between countries in this regard.
- Training in the Netherlands seems to have been significant for individual businesses, but the overall effect was limited, because only a relatively small proportion of the businesses make use of this service.
- The secondary impact, on parties other than the direct beneficiaries, is generally limited. A few targeted interventions did significantly benefit the sector or region in which the beneficiary business was operating.
- Few respondents saw a positive impact in the environmental area (9%) or with regard to the formation of relationships with Dutch companies (8%). Much higher percentages felt that PUM support had improved the quality of the product (36%) or improved competitiveness (43%). There were large differences between countries.
- The net effect on the labour market is negative.
- The selection procedure is described as straightforward, transparent and efficient. The analysis of the problems at the businesses could be improved.

The evaluation also included a comparative study of PUM and the British Expert Services Overseas programme, the German *Senioren Experten Service,* American International Executive Service Corps and the multilateral Turn Around Management programme. This study showed that, comparatively, PUM undertakes many activities, has many local representatives and operates in many countries. The low threshold for participation in PUM compares favourably to the German SES programme, which requires a large financial contribution. Another difference is that PUM is funded almost entirely by the public sector and makes much use of volunteers. Even so, the cost per mission is comparable to the cost in the British programme and higher than the SES figure. There is no information available on which to base conclusions about relative effectiveness.

Source: ECORYS/NEI (2002), *Evaluation of the Netherlands Management Cooperation Programme (NMCP) 1996-2000*, Rotterdam, NEI (May).

FMO evaluation (2004)

The evaluation concerned both FMO-A and the government programmes and had three parts: (1) FMO as a sustainable banking institution; (2) FMO as a producer of development value and (3) scrutiny and communication structures between FMO and the state. Part 2 (FMO as a producer of development value) has the most relevance here.

On the whole, the evaluation does not shed light on the precise contribution of FMO (FMO-A and the government funds) to economic growth, pro-poor economic growth and PSD. However, it includes a number of related comments.

- Although the study does not assess the added value of FMO as such, and discusses the organisation only in relation to parties in the private sector rather than other development banks (the IFC in particular), it concludes that it is plausible that FMO has a high added value. In other words, FMO addresses shortcomings in the capital market, charges market rates, demands higher levels of good governance than private-sector banks and confers regularly with the local banking sector.
- As for the leverage that FMO exercises through its financing – in other words, the additional funding that FMO funding brings in for the beneficiaries – the organisation has no data that would allow it to establish either a causal relationship or the extent of the impact.
- As noted above, FMO does a good job of upholding the criteria of good governance in all its facets.
- FMO works only in the three poorest groups of countries, as agreed with the ministry, and more than half of its focus countries are in the very poorest group. FMO has gone to especially great lengths in Africa, resulting in growth in the number of clients in sub-Saharan Africa over the past five years. Africa is the only continent where the FMO commands a broad market share in the banking sector (rather than being confined to niche markets).
- FMO operates in three sectors: manufacturing, infrastructure and finance. It also has a fourth group of miscellaneous activities. Its involvement in the financial sector has decreased, and expanded in infrastructure.
- There is demonstrable synergy between FMO-A and the funds, but because the funds are used for activities that target a different segment of the market, they largely complement FMO-A.
- It is also interesting to note that the funds do not have an explicit strategy for selecting partners so as to generate the greatest possible development value.
- Finally, FMO has developed its own working definition of development value, based on scorecards with five ratings: (1) business/economic success; (2) contribution to a country's economic growth; (3) impact on prosperity; (4) environmental and social sustainability; and (5) development of the local private sector. Although the evaluation report approves of the effort to develop these indicators of success, a clear picture of the situation is not given. However, an internal FMO evaluation does show that, in 2003, 58% of the projects investigated received a satisfactory rating or better for development impact. It was in the area of impact on income levels that the best results were seen, followed by development of the local private sector. About 60% of the projects received a satisfactory or excellent rating for promoting economic growth.

Source: Capgemini (2004), *Evaluatie FMO*, Utrecht, Capgemini.

PSOM evaluation (2005)

This evaluation was carried out on behalf of the Sustainable Economic Development Department (DDE) at the Dutch Ministry of Foreign Affairs and is based on an evaluation of 22 PSOM projects in five countries (Ghana, Indonesia, Tanzania, Thailand and Mozambique). The findings were then applied to 23 other completed projects. PSOM funds pilot investment projects that lead to follow-up private investment and/or lasting trade relationships between Dutch and local businesses. In comparison to other Dutch instruments, it has a number of features of special interest in this context. For instance, PSOM projects are assessed specifically for the pro-poor character of the investment or the trade relationships (measured chiefly in terms of job creation and effects on income), and since 2003, the programme is not exclusively for Dutch companies (i.e. it is partly untied). The evaluation was very positive. Here are a few of the main conclusions.

- PSOM was rated 'fair' for efficiency and effectiveness (i.e., the extent to which the projects led to additional investment or promoted lasting trade relationships) and 'good' for relevance (based on its success at reducing poverty by creating jobs, increasing incomes and forging relationships with SMEs).
- PSOM 'is close to a cost-effective instrument'. If 'outgrowers in agriculture/agribusiness' become involved, it will very clearly be a cost-effective instrument for job creation.
- Each euro invested by PSOM produces 55 cents of additional private investment. However, if all the private investment generated by PSOM (both during and after the pilot stage) is taken into account, one euro of PSOM funding leads to an average of €1.46 of private investment, which rarely comes from local commercial banks but is usually funded from the profits. In a few cases, the additional funding was provided through NGOs (such as Cordaid).
- From 1998 to 2004, there was 'underutilisation of funds' – the number of PSOM projects in progress was relatively small and not enough new funding was being committed.
- As yet, PSOM has not contributed to PSD at national level, except in the horticultural sector in some African countries.

Source: ECORYS-NEI (2005), *PSOM Evaluation 2005 – final synthesis report*, Rotterdam.

ORET/MILIEV (1999)

The latest evaluation of the ORET programme took place in 1999 and dealt with the 1994-1999 period. A new evaluation of the programme will probably be completed in 2006, but cannot be taken into consideration in this report.

ORET evaluations (1991 and 1999)

Dutch evaluation studies are undertaken either by the IOB, the independent Policy and Operations Evaluation Department of the Ministry of Foreign Affairs or by independent consultants and consultancy firms. Over the last couple of years, some of the instruments for direct support to the private sector have been evaluated and, according to the ministry's Directorate-General for International Cooperation (DGIS; 2000: 54), the resulting studies show that each of these instruments, considered in isolation, functions perfectly.[1] In particular, the recent evaluation of ORET/MILIEV was said to confirm this positive picture. Considering that the ORET/MILIEV programme is probably the most controversial programme within Dutch aid,[2] it is discussed here as the main example of a Dutch PSD intervention. ORET (which was merged with the MILIEV programme in 1998 and has since been known as ORET/MILIEV) has been evaluated twice, in 1991 and 1999. Table 4.2 provides an overview of the most important findings from the 1999 study.

Title of study
ORET/MILIEV review 1994-1999 – assisting developing countries to buy investment goods and services in the Netherlands (IOB 1999).

Context of project
As a joint instrument of the Ministries of Foreign Affairs and Economic Affairs (and financed from ODA funds), the ORET/MILIEV programme pursued two objectives: enhancing the business opportunities of Dutch companies in foreign markets and enhancing the economic self-reliance of developing countries. Exports of Dutch investment goods or services were supported where transactions were part and parcel of a project (i.e., a coherent set of activities with a development objective in a developing country). The goods (that had to be partially sourced in the Netherlands) had to be destined for commercially non-viable projects that enhanced employment and economic activity and protected the environment.

The study
The study covered 30 projects in China, Ghana, India and the Palestinian territories in the environment, public service, transport and agro-industry sectors. The main questions to be examined were: the effectiveness of the programme in terms of development (e.g. employment creation, avoidance of adverse effects on the poor, women and the environment, technical and financial viability); effectiveness of the programme in terms of realising Dutch export interests; and efficiency of the various transactions in terms of price/quality and timeliness.

1 This formulation suggests that one of the main problems with these PSD micro-level programmes is the relationship between the individual programmes, an issue that has already been discussed in Chapter 3.

2 This holds more generally for many other programmes and policies involving a direct relationship with the private sector. From 1984 onwards, for instance, it was decided that contracting out of implementation to private sector companies or NGOs would be the rule. Five years later this policy change was evaluated and the IOV (the IOB's predecessor) (1989) found little evidence of the three anticipated effects of contracting out (e.g., quality improvement, increased involvement by NGOs and a reduction in DGIS's workload).

Main findings

- The programme's conditionality has successfully directed exports to sectors that were important to Dutch development policies (i.e., the environment, public services and transport).
- ORET/MILIEV transactions had no adverse effects on the poor, women or the environment. In many cases they were in fact expected to have a positive effect in this respect.
- Dutch exporters generally looked for strong and creditworthy counterparts, which were more prevalent in somewhat better off low income countries and lower middle income countries than in least developed countries. This was reflected in the distribution of transactions over the various countries.
- Some recipient public institutions indicated that they preferred a combination of commercial loans and tied aid grants to full development grants, as the former allowed them more freedom in planning, design and procurement of technologically advanced hardware.
- The condition that 60% or more of the deliverables should be sourced in the Netherlands pushed up prices. Clients had not always objected to higher prices, which were mostly more than offset by the grant.
- Where the 60% condition prevented production of parts in the recipient country, development relevance was negatively affected and a gradual transfer of technology and production (e.g. through joint ventures) might have been impeded.
- The mainstay of the programme was geared particularly to medium and longer term effects on economic development, as the projects comprised investments intended to improve the physical, economic and social infrastructure of the recipient countries. Direct short-term employment effects were relatively modest, whilst longer term indirect employment effects could not be calculated in the context of the review.
- Many projects were quite likely to have a wider impact and some had the potential to generate substantial economic effects. However, the present outlook on such effects was less clear, as some problems (e.g. in the area of technology, legislation, shortages of qualified staff, political situations) required attention.
- The technical and managerial viability of the investments was found to be positive for finalised projects and projects for which substantial deliveries had been made.
- Efficiency in terms of timeliness was rather low. In most cases this reflected the difficult local environment in the recipient countries. Little had been learned with regard to solving or preventing such problems, as monitoring and evaluation during implementation was not adequate.
- Projects in public services showed a particularly low level of efficiency, due to the institutional weakness of the client and the supplier's dependence on the completion of civil works by local contractors.
- Training and institutional support provided by suppliers was usually adequate with regard to such technical issues as operation, maintenance and repair. Given the sometimes huge institutional problems, particularly in public service institutions, there was little that suppliers could do to remedy structural inefficiencies.
- The picture was mixed with regard to financial viability, but the orientation of the programme to such developmental objectives as improved public services and physical infrastructure yielded a range of projects that were not designed to generate direct revenues, nor to offer immediate permanent employment to large groups of people. Rather, they were geared towards providing social and physical infrastructure at low cost, or no cost, to large groups of people. Raising prices for such facilities might jeopardise development objectives.
- The programme's export relevance should not be overstated.

Although in many ways the ORET/MILIEV programme is comparable to other donors' mixed credit schemes, there is at least one major difference. Whereas mixed credit schemes generally provide a mix of commercial and concessional loans, the ORET/MILIEV programme mixed commercial loans with grants from ODA funds.[3] A grant of 35% of the transaction costs (and 50% for LDCs) was standard. Understandably, the ORET/MILIEV programme is quite popular with Dutch companies and the budget for the programme has been stepped up recently. ORET was also evaluated in 1991 and the evaluation report concluded that 'trade promotion elements in the current programme overshadowed the development objectives'. The main lessons from the first Dutch mixed credit scheme refer to lack of transparency (which was also seen in the Swedish case) and to poor correlation with development cooperation objectives – exemplified by the selection of instruments, the consequent selection of countries and the selection of transfers.

Overall, the 1999 evaluation is more positive about the ORET/MILIEV export promotion programme. Partly this seems to be due to the fact that this particular PSD programme is, at least with regard to sector division, more in line with general development policy. Of course, some problems remain. One of the most interesting relates to institutional support, which was regarded as adequate as far as technical issues were concerned, but inadequate or not far-reaching enough to overcome the 'sometimes huge institutional problems' at other levels in developing countries. A recent study by the Amsterdam-based Centre for Research on Multinational Corporations (SOMO 2000) raises another issue. Based on examples of companies in the construction and dredging sector that have used ORET funds and which have been involved in allegations of corruption, human rights violations and violations of labour norms, the report argues that ORET applications also need to be assessed in relation to the ethical behaviour of the companies involved.[4] The fact that all but one of the companies covered by the study had no code of conduct is of interest here.

Source: L. Schulpen & P. Gibbon.

3 At least, this has been the case since 1991. From 1979 to 1987, the programme was a mixed credit scheme in the true sense. After the instrument of less concessional loans had been added to the programme in 1987 (differing from mixed credits in the sense that they finance the entire foreign currency component of the transaction up to a certain maximum), the traditional mixed credit form of financing was hardly used any more. At the same time, the funds available for commitments were increased substantially and the programme became such a success that the amount available for 1989 was already exhausted in 1988. The programme was then suspended in 1988 and reopened in 1990.

4 According to the report, 10 Dutch companies in the construction and dredging sectors have been awarded one third of all ORET funding since 1991. The allegations expressed in the report do not cover all 10 companies.

Netherlands-IFC Partnership Programme (NIPP) – 2006 review

NIPP focuses on PSD, in particular the use of a pro-poor approach to the development of small and medium-sized enterprises (SMEs). The main element of the programme is technical assistance (TA). Besides gaining influence over the IFC's TA programme and reducing administrative costs by streamlining cooperation with the IFC in a single programme, the Netherlands' primary substantive aim was achieving great output, outcome and impact in the area of PSD than it could operating on its own. Although the review made interesting comments about all three Dutch objectives in relation to NIPP, we will touch here only on the results concerning PSD.

The review notes that NIPP's monitoring and evaluation system is not tailored to the delivery of outputs and outcomes, let alone the impact of the TA services provided. 'Consequently, many TA facilities are unable to show what they have achieved in improving business performance, establishing sustainable business service providers and SME banking, replicating and scaling up innovative pilot technologies, and mainstreaming new ideas'. Nevertheless, the review offers some forthright comments.

NIPP concentrates on giving direct aid to SMEs, providing training to entrepreneurs running SMEs and to banks, and strengthening the SME advice network. The review notes that a 'new activity is to improve the enabling environment', as though this remark is not open to more than one interpretation. Nevertheless, the following conclusions (some tentative) are drawn:

- The activities (which reached over 10,000 SMEs and provided training to over 50,000 SME staff) were responsible for 10% of total additional sales by these SMEs of USD 2000 million and 40,000 additional jobs.
- Direct aid to SMEs is not very effective. Relatively few enterprises are helped, assistance is expensive, and 'it has poor prospects for sustainable delivery without IFC funding'.
- Providing training, however, is a way of reaching many enterprises. It is also relatively cheap and it is possible to recoup all costs. In addition, networks of advisers have been set up and strengthened that now offer their services independently (and more often at market rates).
- IFC TAAS has 'comparative advantages in enabling environment policy work, strengthening the financial sector, and TA to large enterprises on top of the value chain – in particular when combined with financing', but not – given the costs and the strong competition in the market – in working direct with SMEs.
- The theme-based facilities address market failures (primarily a lack of information). The regional facilities usually focus on the transfer of knowledge that is not at the cutting edge and can easily be obtained elsewhere.
- IFC is an expensive TA provider (high administrative costs).
- Almost every IFC programme has 'sustainability built into it due to the emphasis on market based solutions'.

Source: MDF (2006), *External review of the Netherlands-IFC Partnership Programme (NIPP) 2002-2004/2005 (final report)*, Ede, MDF.

Trade-related technical assistance (TRTA)

In the period 1992-2002, the Netherlands spent over €421 million on trade-related technical assistance (TRTA), a generic term covering all manner of technical assistance designed to enhance the negotiating capacity, national trade policy and/or export capacity of developing countries. The larger part of the activities is conducted through bilateral channels (embassies, CBI and FMO), followed by civil society organisations (NGOs and research institutes) and multilateral organisations (including the WTO, UNCTAD and World Bank). In 2005 the IOB published a highly critical study of a number of TRTA programmes based on the following cases: UNCTAD, Integrated Framework for TRTA to LDCs (IF), JITAP (Joint Integrated Technical Assistance Programme), QUNO, AITIC, and ACWL.

The key findings of the IOB evaluation:

- Too little attention was paid in the design and implementation of TRTA programmes and projects to devising and using indicators to measure the use and impact of TRTA. The ministry's files afford very little insight into what has actually been done and achieved.
- UNCTAD was not a transparent and efficient channel for TRTA. Even the integrated TRTA provided by large multilateral organisations to LDCs was inefficient and ineffective in the four countries studied.
- Country ownership of IF and JITAP (in the sense of high-level political commitment and strong private-sector and civil-society involvement) was weak in the four countries studied.
- Coordination on IF and JITAP between The Hague and the embassies was poor. Tasks were divided extremely rigidly between The Hague (global multilateral programmes), the Permanent Mission in Geneva (conveying the Dutch position in multilateral negotiations) and embassies (programmes aimed at business and the business climate), with hardly any information sharing, cooperation or synergy.
- Only the more focused TRTA (geared to building the negotiating capacity of negotiators in Geneva), provided by small international NGOs to LDCs without missions in Geneva, received a positive assessment. They were judged to be efficient and effective.

Source: IOB (2005), *Aid for Trade? An evaluation of Trade-Related Technical Assistance,* The Hague (no. 300), October.

Microfinance by cofinancing organisations (MFOs)

This study largely confirms the conclusions drawn in other studies of microfinancing, for example that clear benefits are generated by targeting services over many years at people who have a low income but relatively extensive experience as entrepreneurs, practical knowledge of financial management and a good general level of education. These benefits (which are not entirely surprising) are evident in higher turnover, employment, income and profits and improved welfare of households and confidence of customers. They are less dramatic and less discernible among poor people who lack the characteristics noted above. The study also found that it was mainly the large organisations that have been active for some time that make a difference to their customers' lives. Finally, the synthesis study shows that other non-financial services can help increase important entrepreneurial skills and small-scale income-generating activities among low-income groups.

Source: O. Hospes (2002), *De ondersteuning van Microfinancieringsprogramma's door Nederlandse Medefinancieringsorganisaties: een synthesestudie*, The Hague, MFP evaluation steering group, December.

Public-private partnerships

Table 1: PPPs in progress as at 1 November 2005 (as reported to the Dutch House of Representatives)

c = arising from the Call	Name of PPP	MDG	Countries
1 – c	Coffee-growing families in Colombia	1	Colombia
2	Community nutrition in ten disadvantaged provinces in Vietnam	1	Vietnam
3	DUNKAFA	1	Mali
4	Horticulture agribusiness development in Indonesia	1	Indonesia
5	ProCredit Bank	1	Macedonia
6	Strengthening the export capacity of the Egyptian flower sector	1	Egypt
7	Market Access and Capacity Building: Tanzania Horticultural Association (TAHA) – DDE-RNE	1	Tanzania
8	Union des Producteurs de Céréales (UPC) et Union des Productrices de Karité (UPK)	1	Mali
9 – c	Zambia Agricultural Marketing Corporation (ZAMAC)	1	Zambia
10	Combating HIV/AIDS in partnership with the private sector	6	Ghana
11	Health Care Development Project of Diabetic Association of Bangladesh	6	Bangladesh
12	European and Developing Countries Trials Clinical Partnership (EDCTP)	6	Ethiopia, Tanzania, Mali, Uganda, Rwanda, Malawi
13	European Malaria Vaccine Initiative (EMVI)	6	Worldwide
14	Global Alliance for TB Drug Development (GATB)	6	Worldwide
15	Global Alliance for Vaccines and Immunisation (GAVI)	6	Worldwide
16	International Partnership for Microbicides (IPM)	6	Worldwide
17	Medicines for Malaria Venture (MMV) framework	6	Worldwide
18	Netherlands African Partnership for Capacity Development and Clinical Interventions against Poverty-related Diseases (NACCAP)	6	ACP countries
19	Roll Back Malaria	6	Worldwide
20	Stop TB	6	Worldwide
21	Special Programme for Research and Training in Tropical Diseases (TDR)	6	Worldwide
22	PPP for the Amazon regional programme	7	Bolivia, Brazil, Peru
23 – c	Natural gas distribution in Colombia	7	Colombia
24	Centre for Environmental and Geographic Information (CEGIS)	7	Bangladesh

	Name of PPP	MDG	Countries
25 – c	Management of Liuwa Plains National Park	7	Zambia
26 – c	Productive use containers: income generation in rural off-grid areas	7	South Africa
27 – c	Solar micro-enterprise development in Sri Lanka	7	Sri Lanka
28 – c	Water infrastructure development in PDAM: Tirta Siak, Pekan Baru City, Riau Province, Indonesia	7	Indonesia
29 – c	Water supply improvement in Chokwé, Inhambane, Maxixe and Xai-Xai	7	Mozambique
30	Water Fund Indonesia in Java and Sumatra	7	Indonesia
31	Waterleiding Maatschappij Drenthe (WMD, a water supply company)	7	Indonesia
32	Arts and Culture Trust	8	South Africa
33	CAFON, a blacksmiths' cooperative	8	Mali, South Africa
34	Market access and capacity building: SPS/ food safety	8	Vietnam
35 – c	Fair flowers and plants	8	Colombia, Ecuador, Kenya, Sri Lanka, Tanzania, Uganda, Zambia
36	Development of a sustainable supply chain for Allanblackia oil	8	Cameroon, Ghana, Nigeria, Tanzania
37	EurepGap for smallholders	8	Kenya, Senegal
38	Market access and capacity building	8	Indonesia, Malaysia, Kenya
39	Market access and capacity building: strengthening phytosanitary services for export-oriented horticulture	8	Zambia
40	Netherlands Financial Sector Development Exchange (NFX)	8	Developing countries
41	Uganda Flower Exporters Association	8	Uganda
42	Vidagas: LPG distribution network providing a reliable source of energy to rural SMEs, wealthy households (on a commercial basis) and rural clinics (for storage of vaccines)	1/4	Mozambique
43	Vlisco-Ghana Industrial Skills Development Centre – vocational training at post-primary level for technicians in the agro-industry	1	Ghana
44	Sustainable Agriculture Guarantee Fund, Rabobank-Solidaridad	8	Worldwide
45	Agri-ProFocus	8	Developing countries

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