Private sector development in countries progressing from poverty

Final report

Client: Department for International Development, UK

Dr. Peter Davis

February 2016

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List of Abbreviations

ADB	Asian Development Bank
AMEXCID	Mexican Government's development agency
ASEAN	Association of Southeast Asian Nations
CPI	Corruption Perceptions Index
CSR	Corporate social responsibility
DAC	Development Assistance Committee
DFAT	Department of Foreign Affairs and Trade
DFID	Department for International Development
EU	European Union
FDI	Foreign Direct Investment
FDL	Microfinance Institution in Nicaragua
FT	Financial Times
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GEPI	Global Entrepreneurship Program Indonesia
GNI	Gross National Income
GPS	Geo-Political Support
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
HMG	Her Majesty's Government
IBRD	International Bank for Reconstruction and Development
ICAI	Institute of Chartered Accountants of India
IDA	International Development Association
IDB	Inter-American Development Bank
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
JICA	Japanese International Cooperation Agency
KfW	Kreditanstalt für Wiederaufbau (German Development Bank)
LIC	Low-Income Country
MDG	Millennium Development Goal
MIC	Middle-Income Country
MSME	Micro-, small- and medium-sized enterprises
NGO	Non-Governmental Organization
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PIND	Partnership Initiative for the Niger Delta
PPP	Public Private Partnership
PRISMA	Promoting Rural Income through Support for Markets in Agriculture
PROPEMCE	Promote Equality through Economic Empowerment
PSD	Private sector development
SCPZ	Staple Crop Processing Zone
SME	Small- and medium-sized enterprises
SoE	State-owned enterprises
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US	United States
USAID	United States Agency for International Development

1 Executive summary

This study is focussed on ‘transition countries’, which are defined as “a set of middle income countries (MIC) countries where the longer term prospects of the poor are overall good, but not necessarily secure or sustainable, and at risk of development reversals.”[1] Specifically, the aim of this study is to provide evidence, conclusions and recommendations on the development of PSD strategies in such places.

These countries pose a particular challenge: even if a country has achieved middle income status much remains to be done. The so-called ‘middle income trap’ demonstrates that countries’ progress away from poverty can stall or even go into reverse. Moreover, middle-income countries often have highly uneven, non-inclusive economic development. The result is that levels of poverty often remain high, or in some cases even deteriorate further. According to the Nigerian Statistics Agency, for example, in 2010 61% of Nigerians were living on less than a dollar a day, up from 52% in 2004. The challenge for development agencies, however, is that their experience historically has largely been with low income countries. Donors are increasingly aware that these transition countries need “different support:”[2] The issue is to establish exactly what this ‘different support’ ought to look like. The aim of this paper is to address this issue at least in relation to PSD programming.

The challenge to transition countries in transforming economic development into durable poverty reduction stems from a number of factors. Firstly, countries are at risk where there is a narrow economic base and low degree of structural sophistication in the economy. When a country relies on a small number of basic products for their economic success it is more vulnerable to shocks such as falls in commodity prices. A second challenge is that of infrastructure: and not just in building the infrastructure that has never been in place, but also building that required as a consequence of the country’s progression to middle-income status. Thirdly, although the existing literature sees a demographic bulge as an asset, this is not necessarily the case. Plentiful labour is only an asset if it is well-skilled and there are employment opportunities available. Fourthly, and underlying all of the previous three challenges is the quality of a country’s governance systems and processes. The development of institutions capable of providing good governance, rule of law and transparency are vital. They give confidence to both foreign and domestic investors that their investments are safe and that challenges involved in broadening the economy, building the infrastructure, and delivering education and training will all be properly addressed.

Within these states, significant challenges also face the private sector. A number of factors can prevent firms from growing and thereby creating jobs, generating higher levels of income, and being able to pay taxes. Firstly, the private sector is frequently subject to elite control and political interference. This leads to a lack of transparency which saps the confidence of investors and company owners. The continued existence of state-owned enterprises further complicates the situation for the ‘real’ private sector. Secondly, the business environment companies face is often poor. As demonstrated by international benchmarks, corruption is a significant problem and the regulatory environment is extremely challenging. Thirdly, the structure of the private sector itself poses difficulties. In particular the absence or weakness of a cadre of mid-sized companies. Large companies or foreign investors are unable to access local suppliers, and there is a limited market for small companies to sell into. Finally, the private sector in these countries is often limited by the

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[1] Dercon S & N Lea. *Building a DFID for the future: DFID’s offer to transition countries* DFID, London. November 2014.

[2] Ibid

capabilities of companies internally, in particular the ability of their management teams to develop coherent business and financial plans.

Given these particular circumstances of transition economies, the 'different support' which development partners need to provide in the PSD space needs to be guided by a number of key considerations. Firstly, PSD needs to be linked to a wider, comprehensive approach in a country and not be seen as a separate endeavour. Secondly, there is a need for PSD interventions to be very highly-targeted. Broad-brush tax reform programmes, for example, are unlikely to succeed whereas tax reform in a specific area may be exactly what is needed. Thirdly, there is a need to be realistic about what can be achieved, and over what time-frame. The issues facing middle-income countries are highly complex, and highly-politicised: they will not be solved quickly or easily.

There is a need to develop a new approach on how to undertake PSD and who to work with. Donors need to recognise that, although money is useful, there are other types of assistance they are able to provide to transition economies which are at least as important. Firstly, their status as governmental agencies gives donors significant convening power, and access at high levels in all sectors. Donor agencies need to see themselves as facilitators of processes, rather than necessarily as primary actors. As part of this process, there is a need to develop better and more strategic relationships both within and outside of government. It is clear that as new challenges emerge in transition economies donors will need to reach out to other departments in their own governments, foreign ministries, trade and business ministries and to other organisations in their home countries to identify those best placed to offer solutions. Similarly, as other non-traditional actors become more important, donors need to develop good relationships with corporates, foundations, non-DAC agencies and others.

Therefore, to develop appropriate and relevant PSD programming in transition countries development agencies need to ask a series of questions: a series of questions which will enable an assessment not just of where a country is at present but also its direction-of-travel over time. These questions address four areas. Firstly what factors indicate how well advanced a country is in developing a secure economic base. Secondly, how well-placed is the private sector to create jobs and income. Thirdly what PSD modalities are most appropriate in this context. Fourthly, who are the partners to work with and who will do what?

Transition countries face very particular challenges, and it is clear that development agencies – and the governments which they represent – could do a great deal to assist. The current inclination, to withdraw from these countries therefore needs to be re-thought. Donor governments need to re-think their approach and work out how the package of support they give and the tools they use need to shift and change over time to ensure that these countries are able successfully to continue their progress from poverty.

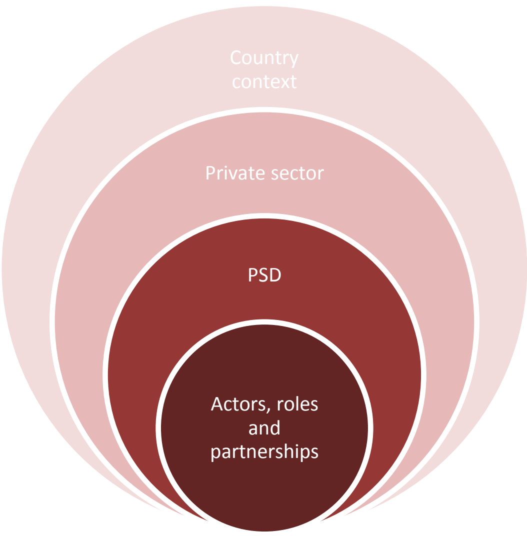
2 Introduction

This paper reports a research project undertaken over a 6 month period between May and November 2015. The project was supported by DFID's Policy Research Fund, and was primarily qualitative in nature. It incorporated both desk-based research and in-country case studies of 6 locations: Indonesia, Nicaragua, Nigeria, Tajikistan, Vietnam and Zambia.[3]

The objective of this research, as described in the initial Terms of Reference, was "to provide evidence, conclusions and recommendations which will guide DFID and other donor organisations in developing PSD strategies for countries transitioning from aid." An initial challenge was over the use of the expression, 'countries transitioning from aid'. In part this was because of the politically-sensitive (and incorrect) implication that countries being surveyed in this study, and by extension others like them, may soon lose concessional support from donors. More importantly however, the research quickly identified that there is in fact not a binary 'aid/ no aid' question. Rather, the question is about defining different modalities of support that are most relevant and useful at different stages of different countries' development processes. Latterly therefore this project has been described as looking at the routes countries take as they 'progress away from poverty'. What was clear however was that this study needed to focus specifically on the role of private sector development activity within the development process, rather than on that wider process itself.

This study is therefore a contribution to the wider, on-going discussions about what the role of donor agencies is in transition countries, particularly in relation to private sector development. Nevertheless, even if the definition of that role remains a work-in-progress it became apparent from the inception phase of this study that a good deal of thinking is going on in different places about the role of PSD in countries progressing from poverty. In order to collate this emerging thinking, in the inception report the project team developed a mapping diagram. This diagram has proven useful also in the development of the team's thinking since the inception phase, and thus a modified version of it forms the basis for the structure of this report. Chapters 4 to 7 of this report explore successively each of the following concentric circles:

Figure 2.1 Mapping the role of PSD in countries moving away from poverty



[3] A team of experts conducted the case studies: Peter Davis (Nicaragua, Nigeria, Vietnam), Nora Plaisier (Indonesia), Ivo Gijsberts (Zambia) and Viera Spanikova (Tajikistan).

Each of these circles will be defined in more detail in the relevant chapter; however the main questions raised are briefly described as follows:

- **Countries:** What stages are there for countries in their graduation from development aid, and can key 'markers' be identified which allow a judgment to be made on where a country is in this journey?
- **Private sector:** What sort of private sector is most desirable in developmental terms? Which contributes best to its host country's progression? What challenges exist to the creation and durability of a private sector which contributes to wider development?
- **PSD:** What private sector development modalities work best at different times to create stable states and a developmentally-positive private sector?
- **Actors, roles and partnerships:** Who are the main actors relevant to the development of the private sector. How do they or ought they to interact, and what forms of collaboration between them have been most effective?

Each of these four analytical chapters, based substantially on the evidence generated by our country case studies, seeks both to assess the issues that have emerged, and to make action-oriented recommendations which will be useful to development practitioners. The final chapter of this report then draws together overarching themes and conclusions from the research as a whole and identifies what further research avenues exist to be pursued.

It is important also to note what this report does not do, and the limitations to its scope. Firstly and most obviously, as is inevitable with a study based on case-studies, what has emerged from the 6 countries studied may not necessarily hold true for other locations. Secondly, whilst this report focusses on middle-income countries and what makes them distinctive, we did not conduct a comparative survey with countries at other stages of development. Thirdly, the study did not include any countries classified as being fragile or conflict-affected. Given the importance of such locations an examination of some such countries in light of this paper would be of value.

Finally, it is important to note that this paper, though funded by DFID, is intended as a contribution to the development debate as a whole. It is anticipated that its findings (and indeed the questions arising from those) will be useful not just to 'traditional' donors, but also to the numerous other actors which are seeking to understand the role that the private sector plays in supporting transition countries' continued progress from poverty.

3 Policy and research context

This study is focussed specifically on ‘transition countries’, defined as “a set of MIC countries and their features where the longer term prospects of the poor are overall good, but not necessarily secure or sustainable, and at risk of development reversals.”[4] Specifically, the aim of this study is to provide evidence, conclusions and recommendations on the development of PSD strategies in such places.

These countries pose particular challenges to donor organisations. Firstly, although donors have enormous experience in working in developing countries, they have less experience in dealing with the particularities of those in transition. As DFID makes clear, donors need to “develop [their] offer for transition countries.” Second, in an environment where development aid remains politically-sensitive these transition countries – places such as India, China and South Africa – are a particular problem. How is it possible, the critics say, to justify a Western aid programme to India when that country now has its own space programme?

This chapter explores some of the existing policy developments and research focussed on whether it is relevant for donors to maintain relationships with these ‘transition economies’ and if so what the nature of that relationship might be. There are four areas in particular. Firstly, what specific challenges face middle income countries (of which transition countries are a subset) in continuing their progress away from poverty, and what gives rise to these challenges? Secondly, what critique has been made of the effects of previous donor exits: what is regarded as having worked and not worked in the past from which we can learn? Thirdly, especially given the focus of this study on the role of the private sector, how can economic growth translate into inclusive development; ensuring that GDP increases translate into broad-based poverty reduction? Finally, what does the ‘development eco-system’ look like in transition economies: who are the main actors and how might they be worked with?

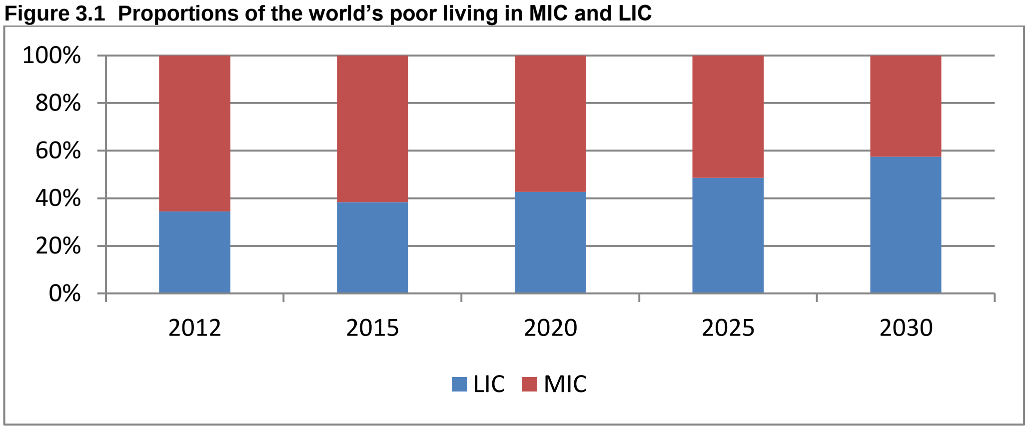
3.1 The relevance of middle income countries to development agencies

The core business of bilateral and multilateral donor agencies is reducing poverty. The challenge for these agencies however is how best to go about achieving this goal, and how to allocate resources given many competing priorities. The focus on results measurement and on value for money is testament to the desire to ensure that monies are well spent. Who the poor are, where they are and how best to reach them remain matters of on-going debate.

Seen in this light, the importance of middle income countries becomes much clearer: middle income countries contain large populations of poor people. The following chart, developed by DFID in 2012, shows that although the proportions are declining, even by 2030 middle income countries will still be home to 42% of the world’s poor.

[4] Dercon S & N Lea. *Building a DFID for the future: DFID’s offer to transition countries* DFID, London. November 2014.

Figure 3.1 Proportions of the world's poor living in MIC and LIC



3.1.1 The challenges to continued poverty reduction in middle-income countries

It is apparent even from the 6 country cases reviewed for this study that 'middle income' countries vary very considerably in their characteristics, and in how they have achieved middle income status. Places like Nigeria and Zambia have relied heavily for their accession on the export of primary resources; other places such as Indonesia and Vietnam have relied more on manufacturing – even if levels of value-addition are low. Given these differences, and given the fragility of some of the means by which countries achieve middle-income status greater attention has been paid to how best to secure these gains.

Therefore, in the past decade the challenges for middle income countries in continuing their progress from poverty has been widely explored. The term 'middle income trap' seems first to have been used to describe apparent growth slowdowns in many former East Asian miracle economies.[5.] A variation on the term had also been used in 2006 about the sustainability of China's economic development.[6] Since then the phenomenon by which countries rapidly acquire middle income status only to stall at that point has been observed by several studies. Robertson and Le conclude from their analysis that "the growth trajectories of a large number of current middle-income countries are consistent with what we would expect to observe if they were in a middle income trap."[7] According to a 2012 OECD paper, "over the last decade, 28 new countries have reached middle-income status…, while only 12 countries have graduated into high-income country status…"[8] By calculating the threshold number of years for a country to be considered to be in the middle-income trap economists from the ADB concluded that, "in 2010, 35 out of the 52 middle-income countries were in the middle-income trap, 30 in the lower-middle-income trap … and 5 in the upper-middle-income trap."[9] Indeed, data from the World Bank makes it clear that the issue is not just one of stalling at middle-income status: countries can actually back-slide. The Bank calculated that since the inception of the International Development Association (IDA), 36 countries have graduated from IDA and become IBRD-only borrowers, but of these, 11 countries experienced setbacks in their developments and have become 'reverse graduates'[10].

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[5] Gill I & H Kharas. *East Asian Renaissance: Ideas for Economic Development*. World Bank, Washington. 2007.

[6] Pei. M. *China's Trapped Transition.* Harvard University Press. 2006.

[7] Robertson P E & Le Y. 'On the existence of a middle income trap'. *Economics Discussion Paper 13.12.* University of Western Australia. Feb 2013.

[8] Jankowska, J, A J Nagengast & J R Perea. 'The Middle-Income Trap: Comparing Asian and Latin American Experiences'. *Policy Insights No96.* OECD Development Centre, Paris. May 2012.

[9] Felipe J, A Abdon & U Kumar. 'Tracking the Middle-income Trap: What Is It, Who Is in It, and Why?' *Working Paper 715.* Ley Economics Institute of Bard College. April 2012.

[10] World Bank. *IDA16 Mid-term Review: Review of IDA's graduation policy*. World Bank, Washington, DC.

But what causes this stalling in progression from poverty? Studies by the IMF[11], World Bank[12], ADB[13] and the OECD[14] have all sought to understand what factors assist a successful transition and which hinder it. Drawing on all these studies, the key factors appear to be the following:

- Stability
  Stability is seen as a sine qua non of continued development. Countries which are affected by war, conflict or natural disasters will face significant challenges in maintaining stable development. Their focus will tend to be on dealing with these issues, rather than on those factors needed for longer term development. Some studies identify issues such as ethno-linguistic fragmentation as being significant since this is likely to affect a country's stability and possibly also indicate a risk of internal conflict.
- Political institutions and transparency
  The institutional underpinnings of politics and the economy are of key importance. Four areas in particular are highlighted: size of government; rule of law; freedom to trade internationally; and the presence of effective regulation. Excessive political intervention in the economic sphere is seen as particularly detrimental too because it engenders corruption, nepotism and lack of transparency. By contrast countries which have a strong policy environment fare well. The studies demonstrate clearly that government's key contribution is to create a landscape favourable to enterprise development.
- Structured development
  Whether by government edict or through government allowing the private sector space, countries succeed where there is a structured but realistic approach to development. The key factors highlighted in the studies are:
  - FDI and international networks (for example Diaspora groups) are leveraged to fill gaps in financial and knowledge resources which would otherwise be obstacles to continued growth;
  - Trying to start too big can be counterproductive. It is better to start small and then gradually to grow and expand;
  - Establishing islands of success by keeping targeted policies selective and within a country's limited resources. This means that economic growth can be going on before all major challenges are fully tackled throughout the country.
- Economic management
  Capital inflows are valuable, but key is macro-economic stability. If too much money comes in too fast, then there is a risk of excessive borrowing and a consequent rapid accumulation of public and/or external debt. Likewise countries which rely too heavily on resource exports are also unstable. Such countries are vulnerable to reverses in commodity prices; will often see their currency appreciate; and frequently fail to invest in other areas of the economy.
- Industrial diversification
  Countries which have graduated most swiftly and successfully from lower-middle to upper-middle and then to high-income status have been those which had a greater diversity and sophistication of exports. Moreover, the more successful countries were those which had developed sequentially in industries between which skills could relatively-easily be transferred. A focus on high "connectivity" sectors allowed these countries to undertake a gradual yet systematic transition towards higher value added activities, especially those requiring similar technology and production techniques.
- Internal and external resources and infrastructure
  Inside a country, power, roads and other infrastructure are key for productive activities, and in

[11] Aiyar S *et al. Growth Slowdowns and the Middle-Income Trap*. IMF, Washington. 2013

[12] Dinh H T. *Tales from the Development Frontier.* World Bank, Washington DC. 2013.

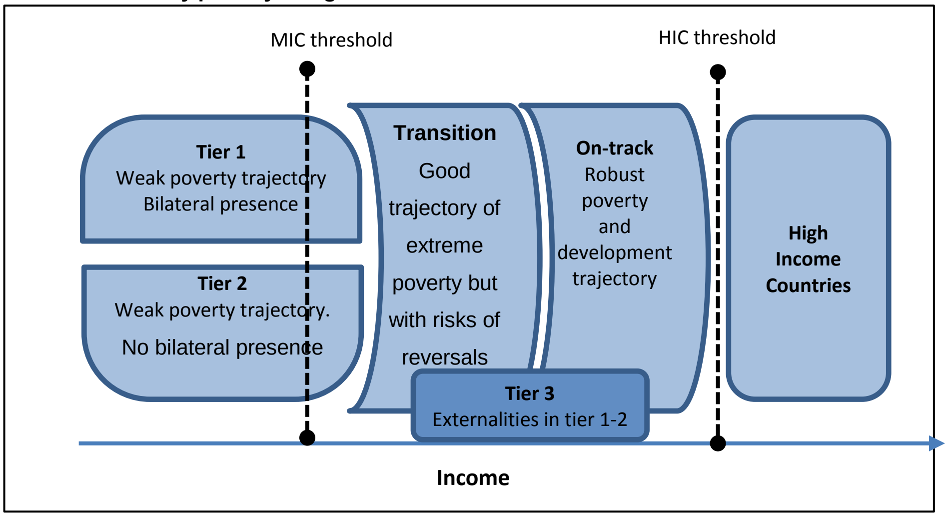
[13] Felipe J, A Abdon & U Kumar. 'Tracking the Middle-income Trap: What Is It, Who Is in It, and Why?' *Working Paper 715.* Ley Economics Institute of Bard College. April 2012.

[14] Jankowska, J, A J Nagengast & J R Perea. 'The Middle-Income Trap: Comparing Asian and Latin American Experiences'. *Policy Insights No96.* OECD Development Centre, Paris. May 2012

some cases are also a public good. A bulge in the working age ratio is seen as an asset in continued stable development. The presence of more, young people contributes to higher savings rates, increasing the domestic resources available for productive investment. However, external links are also important to success. Proximity to trade partners makes business more straightforward: the greater the GDP-weighted distance of a country from potential trade partners, the higher the probability of an economic slowdown.

The development community is beginning to develop responses to address these risks. For example, in 2013 the World Bank proposed the creation of a new transitional facility to support countries struggling in middle-income status.[15.] It proposes three criteria to determine access to this facility: (a) GNI per capita below the historical threshold at the time of graduation; (b) a significant poverty agenda, as measured by poverty levels and other social indicators; and (c) a significant prospective reduction in available financing from the World Bank after graduation from IDA. The amount and conditions of transitional support would be less generous than under IDA but more favourable than under IBRD. The facility will also provide technical assistance, for example advisory services to support the country in accessing alternative sources of finance. India is the first country to benefit from such support, reflecting its still-low GNI per capita and its significant poverty agenda. The country will receive transitional support under the new facility for the period 2015-17.
Recent work from DFID has focussed also on the challenge of addressing these 'transition countries', defined as those which have established a good poverty reduction mechanism,…but where there are risks of reversals…"[16] This categorisation is set-out diagrammatically thus:

Figure 3.2 DFID's country poverty categories



A further, very recent paper from DFID[17] takes these ideas still further, introducing the concept of a 'self-financing frontier' – the point at which a country has sufficient domestic resources to address its poverty needs, which can be achieved either through lowering poverty or raising incomes. This paper highlights the vulnerability of countries which have just crossed this development frontier[18.] Dercon and Lea propose that these transition countries may still require "relatively modest aid", but also may require "different support, focusing more on their government systems both to raise resources, via taxation, and to spend it effectively. They may also require support to build strong political, economic and social institutions."

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15 International Development Association. *Follow-up on IDA's Graduation Policy and Proposal for Transitional Support for Graduating Countries.* World Bank, Washington. 2013.

16 Dercon S & N Lea. *Building a DFID for the future: DFID's offer to transition countries* DFID, London. November 2014.

17 Lea N & S Dercon. *Benchmarking Aid Allocation: A Background Note for the BAR and MAR.* DFID, London. September 2015.

18 The paper specifically mentions the following countries as being at risk in this regard: India, Ghana, Tajikistan, Kyrgyzstan, Djibouti, Cambodia, Philippines, Guatemala, Nicaragua and Indonesia.

The as-yet unanswered question is precisely what form this 'different support' might take and, in the context of this study, what might/ would 'different support' look like in the private sector development space. This is a question to which this study offers additional insights.

3.2 Lessons from previous donor exits

Over the past decade there have been a number of examples of international donor withdrawal from recipient countries. For differing reasons, DFID, the Dutch Government, the Swedish International Development Agency (Sida) amongst others have all reduced the number of countries in which they operate.

In 2008 Sida published a study of the experience of 14 cases of aid withdrawals undertaken by the Governments of Sweden, Holland, Norway and Denmark. Of these 9 were from countries "no longer aid dependent"[19]. The report found that, in general, aid withdrawals had been badly planned. "Only few elaborate exit plans were found, in the sense of a comprehensive document with a clear timeframe, guidelines on communication, indication on monitoring, and a step-by-step approach." The study recommended a number of "critical factors for successful exit management". These can be summarised under three headings:

- Including partners in the decision
  Recipient countries and partners in those countries need to be included in the decision to withdraw and in the planning and implementation of exist processes. Including partners also meant that commitments which donors had made which were not yet formally agreed could be reassigned.
- Timing and phase out
  The report found that in phase-outs lasting for 2 years or less were likely to be failures. When, on the other hand, a realistic timeframe was set and the exit was allowed to take time, attention was given to sustainability and mitigation of adverse consequences.
- Institutional capacity
  The report found that donors tended to underestimate the capacities of the recipient country, and, in most cases, did not carry out institutional assessments to identify needs for building capacities that would enable the partner country institutions to cope with the exit. However institutional capacity was an issue also for donors too. Exit decisions reviewed were often accompanied by immediate downsizing of embassies or, in some instances, even closure. As a result the donor capacity to address post-exit issues was compromised.

In 2012 the Swiss Agency for Development and Co-operation (SDC) also undertook an assessment of donor exit processes. This concluded that the empowerment of local partners was crucial to the success of donor phase-out processes. Particularly where exits are swift there is a strong risk that worthwhile activities will not be sustainable as local partners lack key capabilities or resources, or are unable to take up the slack quickly enough. As a result, the paper advises, a clear exit strategy should be agreed upon from the beginning and if donors are working with government or civil society partners this should be discussed and accepted by all partners. Within this, there is a need to break own traditional patron-client relationships between donors and in-country partners. Also, as part of programme activities there should be a strong emphasis on capacity building of local partners.

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19 Slob A & Jerve A M. *Managing aid exit and transformation.* Sida, Stockholm 2008.

As part of its strategic review DFID announced its withdrawal from South Africa and India. The decision attracted criticism, some of which echoes the conclusions of the Sida and SDC studies. The South African Government claimed that they had received no prior notification of what they said was a “unilateral announcement” on the part of the British Government. In the view of Oxfam, "whilst South Africa should be in a position to fund its own development, there remains widespread poverty and inequality so UK aid is still a lifeline for poor people.”[20] Another commentator observed that whilst British aid was only a small proportion of those countries’ funding, the impacts of a UK presence and therefore the risks of a UK withdrawal were much greater than purely the financial. In South Africa for example, it was noted that the Gini coefficient had risen from 0.66 in 1993 to 0.7 in 2008. Therefore “DfID’s continued presence in countries like South Africa can still play a vital role in driving progressive policies on inequality.”[21]

3.3 Inclusive growth

The analysis of the challenges to middle income countries identifies that corruption is a problem in part because it leads to the benefits of growth accruing to a minority rather than to the wider population; criticism of previous ‘aid exits’ have focussed on the role that on-going donor support might play in promoting inclusive development. Clearly therefore, supporting countries in continuing their progress from poverty is not simply about economic growth per se, but about ensuring that this growth benefits as wide-a proportion of a country’s population as possible.

This issue of inclusive growth is particularly pertinent to a study which focusses on the private sector given the considerable debate about whether companies promote pro-poor development, or instead worsen inequalities. A recent statement by the EU argued that “private sector can be an engine of inclusive growth by generating decent jobs, contributing public revenue and providing affordable goods and services.”[22] Likewise, according to an article by a senior ADB official “the private sector promotes not just growth — it promotes inclusive growth..”[23]

Some of the evidence suggests that this hope is well placed. A Harvard study in 2007 concluded that development of the food and beverage sector is particularly important “in creating both economic and social value.”[24] As the revenues generated as the industry grows “a large portion of the value flows to: farmers involved in raw materials production; ...both direct and indirect labour; governments as taxes....” Similarly, a review of China’s development concluded that the private sector not only contributed to economic growth but also helped the country to cope with the societal impacts of the decline in state industry.”[25]

However, other evidence suggests that the private sector can fail to foster inclusive growth. A CAFOD paper, for example, concluded that oil, gas and mining operations may bring considerable FDI but create relatively few local jobs.”[26] Other studies also suggest that while FDI can be beneficial to overall GDP numbers, it does not necessarily create broader-based growth, and

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[20] Oxfam UK. *Oxfam response to Justine Greening's announcement that the UK will stop giving direct aid to South Africa in 2015*. Press release 30th April 2013.

[21] Glennie, J. & J Hubert, J., ‘UK should revisit its decision on South Africa and it’s concept of aid’, *The Guardian*, 2 May 2013,

[22] EU. *A Stronger Role of the Private Sector in Achieving Inclusive and Sustainable Growth in Developing Countries*. EU Commission 2014

[23] Venkatachalam L. *Why partnering with the private sector is key to inclusive growth*. GPEDC blog. 11th August 2014.

[24] Pfitzer M & R Krishnaswamy. *The Role of the Food and Beverage Sector in Expanding Economic Opportunity*. FSG Social Impact Advisors & The Fellows of Harvard College. 2007 p4

[25] Hasan, I., Wachtel, P., & Zhou, M. ‘Institutional development, financial deepening and economic growth’. In *Journal of Bank & Finance*, 33(1), 157–170. 2009

[26] CAFOD. *Everyone’s Business: Towards a mature understanding of the role the private sector in development.* CAFOD, London 2011. p8

whether it does depends on a number of variables. These include, for example, the strategies of the investing companies and the extent to which they are prepared to share knowledge and expertise with domestic firms.[27] The ability of local firms to absorb the technological and practices presented by foreign companies is also important. Foreign investment therefore has greater developmental impacts when domestic firms are larger and the technological gap between them and incoming companies is smaller.[28]

There are also examples which suggest that the private sector can actively damage the interests of poor people, as is demonstrated by the on-going debate on corporate land acquisitions in Africa and elsewhere. These have been labelled by critics as 'land grabs' which adversely affect local populations and small farmers in developing countries: "the expansion of corporate farming is exacerbating tenure insecurity, displacing local producers, undermining the ecological sustainability of local land and water resources, with profound and long-term implications for the economic and social structures of rural societies."[29] The UN Special Rapporteur on the Right to Food, has argued that the increased focus on food for export will increase food insecurity: "the countries targeted by these deals...will be potentially increasingly dependent on international markets to achieve food security. They will produce more food, but this food will be exported."[30]

Clearly therefore, for PSD practitioners operating in 'transition economies' a key priority is to ensure that the private sector as far as possible avoids ways of working which damage the interests of poor people and encourages business practices which improve the inclusiveness of development. This might be achieved both through direct engagement with the private sector, and also through establishing a regulatory environment which promotes developmentally-beneficial business practices.

3.4 A different development 'eco-system'.

As well as changes in the issues which need to be addressed, the 'eco-system' of actors in transition economies also changes. More and different entities are active, and the relationships between them are different from those in low-income countries. As the following chart demonstrates the balance of funding sources changes markedly as a country develops, and the development landscape becomes more crowded:

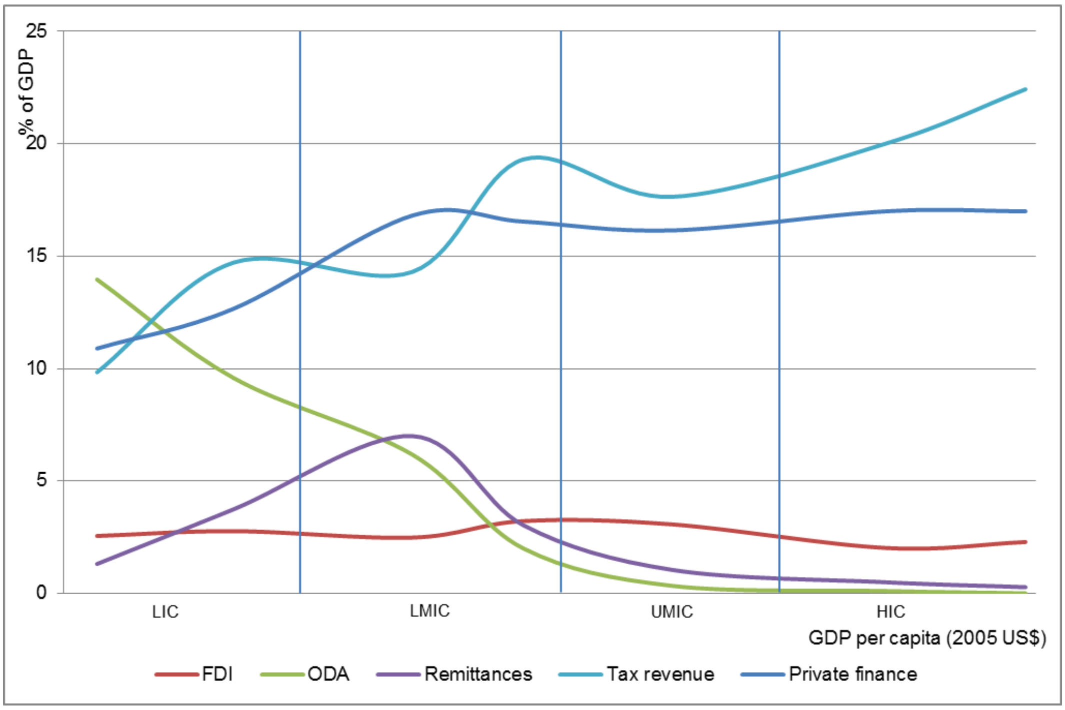
[27] Spencer, J. 'The Impact of Multinational Enterprise Strategy on Indigenous Enterprises: Horizontal Spillovers and Crowding Out in Developing Countries'. In *The Academy of Management Review*. Vol 33, No2. 2008 pp341-361

[28] ' Zhang Y, et al. 'FDI spillovers in an emerging market: the role of foreign firms' country origin diversity and domestic firms' absorptive capacity'. In *Strategic Management Journal*. Vol 9, pp969-989. Sept 2010.

[29] Da Via. E. 'The Politics of "Win-Win" Narratives: Land Grabs as a Development Opportunity'. Paper presented to *International Conference on Land Grabbing* IDS 6-8 April 2011 p4

[30] de Schutter, O. Quoted in <http://www.dw-world.de/dw/article/0..4524232.00.html>

Figure 3.3 Sources of funding to developing countries[31]



Source: Ecorys, based on WDI indicators.

This graph clearly shows that ODA becomes less important as a source of finance as countries develop as other types and levels of private financing to developing counties greatly outstrips official development aid. According to World Bank figures, net private capital flows to developing countries in 2010 amounted to US$ 524.8bn[32] By comparison, in the same year net ODA disbursements by the 22 member countries of the Development Assistance Committee (DAC) of the OECD totalled US$ 128.7bn[33]. This changing dynamic has a number of implications relevant for this study.

First, as countries develop to a point where they rely on international and domestic private financial resources it is important that the private sector is properly governed and regulated. Given that a key element of PSD programming is business environment reform it may be the case that development partner support to host governments in providing technical advice on getting things like this right becomes of greater importance than absolute levels of financing provided.

Second, the change in the relative importance of ODA changes the relationship between the donor and recipient countries. Donor agencies have less leverage when partner countries can rely on their own tax base, remittances from diaspora and other financial sources. Arguing the case for specific policy reforms requires a different approach when those arguments are not backed by financial resources. Donors therefore have to seek new relationships with partner governments to be able to effect change on often sensitive topics, and this can be difficult to achieve.

Thirdly, there is a need to develop closer working relationships with a wide and growing range of different actors in the ‘international development’ space. Historically the main players have been bilateral donor agencies and other members of the Development Assistance Committee (DAC), and the international development banks such as Word Bank, African Development Bank, the Inter-

[31] EU. *European Report on Development 2015.* European Union, Brussels, 2015.

[32] UNCTAD. ‘Global and Regional FDI Trends in 2010’. *Global Investment Trends Monitor No 5* 20th Jan 2011 p3.

[33] OECD. *Development Aid Reaches an Historic High in 2010.* 6th April 2011 <http://www.oecd.org/document/35/0,3746,en_2649_34447_47515235_1_1_1_1,00.html> (accessed 15/08/11).

American Development Bank and the Asian Development Bank. There is now a plethora of other actors, ranging from development agencies from non-DAC countries, many of which were themselves until recently recipients of donor aid (indeed, some still are); private development agencies such as the Bill and Melinda Gates Foundation; corporate foundations; other impact and development capital funds; and, perhaps most significantly for the long-term development map, an increased engagement by the corporate sector with development issues and support provided through 'corporate social responsibility activities. Traditional' donors are working out what new opportunities these new partners might bring, and how best to work with them. The recent mergers of the aid agencies of Holland, New Zealand, Canada and Australia into wider foreign and trade ministries is providing some useful insights into how best to work with the private sector. The experience of the Dutch foreign ministry, for example is that although the corporate sector can be valuable partners, their interests may not always correspond with the wider development objectives of the host country. There is therefore a need to balance the use of corporate collaboration where possible, with more usual interventions in other areas. Any lessons this study can provide in how best to work with the private sector and other new partners are likely to be valuable.

3.5 Issues raised for this study

It is clear from existing policy and research debates reviewed briefly in this chapter that that 'transition countries' face significant challenges. Even if a country achieves middle income status, it is not possible to declare 'job done'. There are a number of risks which can result either in a country's progression from poverty stalling or, worse, going into reverse. Furthermore, even when a country has achieved strong growth, that growth is not necessarily inclusive. Despite its overall economic growth, South Africa still has 20 million people living below the poverty line, and other 'transition countries' have also seen inequality grow even as their economies have expanded. India has seen its Gini coefficient widen from 31.1 in 1983 to 42 in 2009; and Indonesia's has worsened from 30.5 in 1984 to 35.6 in 2010.[34]

What is also clear is that there is an important, if yet imprecisely-defined role for development agencies working in these countries. To date the general approach has been to exit from countries as they get to middle-income status but this approach seems to need revisiting. Even though donors' financial contribution to these countries will be much less important, there is an important role to play in terms of policy and capacity-building. The aim of this paper is to try to define more clearly what this new role might be, particularly in relation to work on private sector development. The subsequent chapters will therefore plot successive steps in understanding what issues PSD programming should address in transition countries, and how a set of PSD-related activities might be put together.

Firstly, (corresponding to the 'country context' categorisation in fig 1.1), what do the country cases for this study tell us about the risks to continued poverty reduction? The existing literature has identified a number of 'key success factors' which appear to determine a country's likely success in avoiding the middle-income trap and ensuring inclusive growth. What do the country cases for this study add to this? What appear to be the principal challenges for the countries studied which require most urgent attention?

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[34] World Bank. *Gini index (World Bank Estimate)* http://data.worldbank.org/indicator/SI.POV.GINI?page=6&order=wbapi_data_value_2011%20wbapi_data_value%20wbapi_data_value-first&sort=asc

Secondly, within this country context, what challenges face the private sector? Again, the existing literature indicates that there are issues – an excessive reliance on a small number of products and low levels of value-added, for example – which suggest vulnerability to the middle-income trap or worse. What do the countries examined for this study add to these insights?

Thirdly, what role does private sector development programming play – or might it play – in addressing these issues? When countries are at middle-income status but potentially vulnerable to stalling there or falling back, or struggling to achieve inclusive growth, what does 'different support', to use Dercon and Lea's term, look like? What different approaches and modalities may be needed - what 'toolbox' do PSD practitioners need in these contexts?

Finally, how do development partners respond to the changing environment in which they find themselves? How do they collaborate effectively with the other actors that have appeared on the development stage? This paper aims to set out a clear set of recommendations about how PSD programming needs to operate in these countries, and how that might differ from past practice, while leaving the issue of how to tackle poverty in low-income countries for the moment to the traditional aid practitioners.

4 Country context

As the previous chapter makes clear, the progress that a country makes from poverty is not linear, nor is progression to high-income status – or even remaining at middle income status - a given. From the policy perspective of international development actors therefore must focus on identifying those issues which need most urgently to be addressed if a target country is at least to maintain its middle income status, and ideally to progress even further from there. Picking out what these key issues may be is of course made more complicated by the fact that there is no single trajectory of development. Take the 6 countries studied for this research (Indonesia, Nicaragua, Nigeria, Tajikistan, Vietnam, Zambia): each has achieved middle-income status by different means, and their likely courses in the future will also be different.

Stability comes to a country when it is able to tax successfully domestically, and to operate systems capable of allocating those resources effectively; and to be able to access funding from international capital markets at sustainable rates of interest. This chapter considers the 6 countries studied to assess how close they are to this stability, and the vulnerabilities they exhibit. This chapter then draws out a series of critical success factors which appear most important in determining whether a country will be able at least to sustain middle income status, and hopefully progress further.

4.1 The persistence of poverty

It is very interesting to observe that although all 6 countries studied qualify for middle-income status, considerable poverty still exists in most of them, and inequality – the gap between the haves and the have-nots – remains high. Vietnam has done the best job: according to World Bank figures, only 2.5% of the population live on $1.25/ day or less (down from 58% in the early 1990s). In Indonesia too, the poverty rate has fallen, from 24% in 1999 to 11.2% in 2014. However this means that around 28.6 million people still live below the poverty line, a figure which could easily rise dramatically, with around 40% of the population clustered around just above the national poverty line.[35] In addition, inequality has increased over the past decade, with a Gini coefficient that has risen from 0.32 in 1999 to 0.41 in 2012. “Nicaragua ranks second in Latin America in terms of the reduction in inequality”[36], and the country’s GINI coefficient still stands at 0.46. The Human development index ranks Nicaragua 132nd in the world. Indeed, according to a report published in 2014, the number of Nicaraguans living in extreme poverty – defined as less than $1 a day – increased from 7.6% to 9.5% from 2012 to 2013. Reducing poverty is Zambia’s greatest development challenge. Poverty is falling slowly, but 60% of the total population, and three quarters of the 60% of Zambians who live in rural areas, are still poor, and the country’s HDI in 2011 was 0.43 in 2011, ranking it 164th out of 187 countries surveyed. Poverty in Nigeria is still widespread, and indeed rising; the most recent poverty survey by the Nigerian Statistics Agency, published in 2012, shows that 61% of Nigerians were living on less than a dollar a day in 2010, up from 52% in 2004.[37] Poverty is especially prevalent in the northwest and areas to the east and rural areas of the southwest. Such regional differences also define poverty in Tajikistan with significant disparities in wealth between rural and urban areas. The same is true in Zambia where wealth has come to the new ‘copperbelt’ and to Lusaka, but has largely bypassed the remainder of the country.

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35 All World Bank figures: http://www.worldbank.org/en/country/indonesia/overview.

36 IMF. *Nicaragua: Poverty Reduction Strategy Paper— Progress Report on National Human Development Plan as of 2010*. IMF, Washington, 2011.

37 Magnowski D. ‘ Nigeria Overtaking South Africa Masks Poverty Trap: Economy’ Bloomberg News 18th March 2014.

The stark contrast between relatively (and sometimes very wealthy) urban areas and very poor rural ones is marked in all the countries surveyed. In Nigeria Lagos is virtually a first-world city in its development, yet large swathes of the country's north are extremely poor. This reinforces the argument that donor agencies have a significant role in ensuring that such areas are not further neglected and that the needs of these large remaining poor populations are responded to even when overall economic development remains strong.

4.2 Challenges for poverty reduction

Why do such high levels of poverty exist, and what challenges do these countries face in reducing levels of poverty further, and indeed to securing their middle income status? This study identifies a number of challenges.

4.2.1 A narrow economic base, low value addition and vulnerability to shocks

The core economic challenge to all the countries studied, to varying degrees, is that their rise to middle-income status has been predominantly achieved by over-reliance on a narrow economic base, and moreover one which has low levels of value addition. The countries are therefore vulnerable if that base is threatened.

The most obvious example of this risk is Zambia, whose increased wealth has been almost exclusively achieved on the back of rampant raw material prices. In recent years copper exports have provided about 70% of the country's foreign exchange earnings and 25-30% of government revenue[38]. Nor is such a high degree of reliance on a single commodity merely a hypothetical risk, but a very real one. The past 18 months has seen a significant reduction in international demand for raw materials and a consequent slump in commodity prices, including that of copper. As a result mine owners in Zambia have recently announced significant reductions in production. In September 2015, for example, Glencore announced that it was suspending operations at its Mopani mine for at least 18 months[39]. On the same day, production at the Chinese-owned Baluba mine was also suspended: the company's announcement, in addition to the plummeting copper price, also cited energy shortages and high in-country cost structures as reasons for the suspension[40]. Although less vulnerable than Zambia, falling commodity prices have also had adverse impacts on Indonesia too, where the oil and gas sector accounts for around 11% of GDP. The decline in commodity prices has been a key factor in turning Indonesia's consistent trade surplus since the 1970s into a trade deficit in 2013[41].

However, it need not just be an over-reliance on primary commodity exports that constitutes vulnerability: so too is an inability to add value within the economy, as is demonstrated by the example of Vietnam. The country's success has stemmed largely from its ability to attract foreign investors looking for cheap assembly sites close to trade routes, markets and existing suppliers. However, the degree of value-addition in Vietnamese manufacturing is very low – the country imports around 90% of all it exports. Looking forward, therefore, the question for Vietnam is what happens when another country is better able to do the same thing even more cheaply? Even though companies such as Samsung have invested significant amounts in Vietnam, there is no

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38 World Bank. *Zambia Economic Brief: Making Mining Work for Zambia*, World Bank, Washington. June 2015.

39 England A & Aglionby J. Glencore deals mining blow to African copper producers. Financial Times, London. 8th September 2015.

40 Sakala J. *Luanshya Copper Mines suspensions Baluba ops…put employees on forced leave.* The Independent Observer, Lusaka. 7th September 2015.

41 Based on figures included in McKinsey Global Institute (2012). In 2014, Indonesia had a trade surplus again, mainly due to falling imports.

particular reason why they need to stay there if the economics of moving elsewhere stack up. Unless and until Vietnam develops more strings to its bow, adds greater value to its manufactures, and diversifies its economic base, it will remain vulnerable to investors moving on elsewhere[42].

Nigeria's recent re-basing of its GDP demonstrates that its economy is less wholly-reliant on oil and gas than was previously thought. The telecoms and banking sectors have grown strongly, and Nollywood (the Nigerian film industry) is estimated now to form around 1.4% of GDP[43]. However, Nigeria's non-hydrocarbon exports remain negligible, and the domestic manufacturing sector remains small: as a share of GDP it is half the level of Indonesia and a third of South Korea or China. In fact, much of Nigeria's manufacturing base has been neglected since the discovery of oil – the once-thriving textile industry in the north, for example, has been all-but extinguished[44].

The geo-political links of a country's economy can also present significant vulnerabilities, as is demonstrated by the cases of Nicaragua and Tajikistan. Nicaragua's economic base is narrow, and consists mainly of agriculture, manufacturing and tourism, and its exports are relatively low value-added and consist mainly of coffee, clothing and fibre cables[45]. The country has therefore relied heavily on the *Petrocaribe* deal with Venezuela, under which Nicaragua has received an estimated US$400m discount on its oil bill through concessional loans, as well as significant investments in development projects and Venezuelan FDI[46]. As with the threat to Zambia from falling copper prices, the risk to Nicaragua of its reliance on Venezuela is not hypothetical: the death of Hugo Chavez and the impact of falling oil prices on Venezuela's economy put the durability of this deal into question. The country also relies heavily on remittances, which were estimated to amount to aroundUS$800m in 2010, in comparison net ODA flows in the same year of US$600m and FDI of US$700m. Remittances therefore amounted to US$ 100m more than corporate foreign investment in the country[47.] The level of remittances has continued to rise and were estimated at US$1.1bn in 2013,[48] around 10% of GDP. Tajikistan relies even more heavily on remittances, which have amounted to as much as 40-50% of GDP for much of the past decade[49]. A high proportion of these remittances come from Tajiks working in Russia, and as a result Tajikistan is highly vulnerable to any downturn in the Russian economy, which results in Tajiks being made unemployed. Once again, this is not a hypothetical threat: challenges in the Russian economy have led to a sharp reduction in remittances in 2015.

4.2.2 Infrastructure

That poor infrastructure is an impediment to economic development is well-known: for example, as the World Bank Investment Climate Report makes clear, poor roads and power provision are seen as the number one constraint on business in Nigeria[50]. However, what this study has identified is that the process of development to middle-income status can put pressures on infrastructure which themselves actually make the country more vulnerable, as is demonstrated by the example of Vietnam.

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42 Duc *et al. Trade Facilitation, Value Creation and Competitiveness: Policy Implications for Vietnam's Economic Growth.* World Bank. Washington DC. 2013 pp 47-51.

43 The Economist. *Step change: Revised figures show that Nigeria is Africa's largest economy*. 12th April 2014.

44 Al Jazeera. *Crunch time for Nigeria's textile sector.* 21st June 2015.

45 Inter-American Development Bank. *Nicaragua: A perspective.* http://www.iadb.org/en/mapamericas/nicaragua-old/nicaragua-a-perspective,5910.html.

46 International Business Publications. *Nicaragua: Mineral, mining sector investment and business.* International Business Publications 2011.

47 World Bank. *Migration and Remittances Factbook 2010: Nicaragua.*

48 Cohn D et al. *Remittance trends*. Pew Research Centre. 14th November 2013.

49 World Bank. *World Development Indicators: Tajikistan.*

50 Iarossi G *et al. An assessment of the investment climate in Nigeria.* World Bank, Washington.

Vietnam's development over the past 2 decades has had implications that are only now becoming apparent, and which as yet are grossly underfunded. A key change in the country since the 1990s has been the huge increase in the urban population. Yet not all of the infrastructure to provide for that increased population has kept pace. Roads have been built – and indeed there are now two routes from Hanoi airport into the city – but amenities like waste water treatment have been neglected. At present Vietnam only treats around 10% of its waste water and effluent and is, according to one interviewee, only spending about one twentieth of what it needs to if water treatment provision is to be brought up to the required standard. Vietnam is therefore faced with two options. Either it has to find a lot of money over a 20 year period to spend on water treatment: money that will need to be diverted, perhaps, from other priorities. Alternatively, Vietnam can continue to neglect this important aspect of its infrastructure, with the long-term result of huge pollution in the country's waterways and rivers. As a 2007 presentation to the Vietnamese Academy of Sciences observed, already "many rivers are choked with contamination and untreated waste from craft villages and industrial production zones."[51] If this is the case in relation to waste water treatment, it is likely also to be the case in other areas of infrastructural development. High-profile infrastructure like roads and bridges get political attention, but unless these more basic areas such as sanitation are addressed then Vietnam will find itself facing financial or environmental costs which could not just slow its further development, but actually undermine its achievements to date.

4.2.3 Demographics: blessing or burden?

The case study countries call into question the received economic wisdom that a population bulge is an asset to a country: "a bulge in the working age ratio contributes to higher savings rates, increasing the domestic resources available for productive investment."[52] The challenge is that, in the absence of 'productive investments' to provide employment, what do these additional young people do? In Indonesia, for example, according to the World Bank the anticipated population growth means that the country needs to grow by over 5% per year to absorb the increasing labour force. Failure to do so will see poverty increase again. Similar challenges face Tajikistan, where 55% of the population is under the age of 25, and Zambia, where around 50 % of the population are under 15.

However, failure to provide young people with a job can threaten more than simply a renewed rise in poverty levels, it can also risk violence. In Nigeria the population is expected to double in the next 30 years, and so "sustained broad-based economic growth and poverty reduction are critical to Nigeria's economic stability."[53] This is especially true in the north. The link between high youth unemployment and violence is well-established.[54] Failure to create jobs in northern Nigeria, therefore threatens to make worse the Boko Haram insurgency, and violence more broadly.[55]

This puts the focus squarely on the need for education, an issue that poses a challenge in a number of the countries studied. In Nigeria's northern states rates of illiteracy are as high as 58%[56]; the WEF Global Competitiveness Index[57] ranks Nicaragua 124th in the world (out of 140 states) for the quality of its higher education and training; and in Zambia, learning assessments indicate that

51 Nguyen T H. *The Present State of Water Environment in Vietnam*. Presentation to the WEPA Forum 2007.
52 Aiyar S *et al. Growth Slowdowns and the Middle-Income Trap*. IMF, Washington. 2013.
53 USAID. *Nigeria: Economic Growth.* https://www.usaid.gov/nigeria/economic-growth.
54 Collier, P & A Hoeffler. 'Greed and Grievance in Civil War'. *Oxford Economic Papers* Vol 56(4), 2004 pp 587-595
55 This is one of the main reasons for the significantly increased focus by donors on the north, with programmes such as Mafita.
56 National Bureau of Statistics: *Annual Abstract of Statistics*, Government of Nigeria. 2012.
57 WEF/ *Global Competitiveness Index 2015: Nicaragua* http://reports.weforum.org/global-competitiveness-report-2015-2016/economies/#economy=NIC.

students have severe learning deficits[58], and that the poor, rural youth, and girls are particularly disadvantaged in terms of access to good quality basic education.

4.2.4 Governance: weak institutions and elite control

In different ways, a number of the countries studied are, *de facto,* under the control of small elites: something that has significant and adverse impacts on the broader economic as well as political development of these places. Probably the most eggregious example is Nigeria, which has been described by one author as "a privatized state where personal contacts and material gains constitute the triggers for state action."[59] A 2007 Human Rights Watch[60] report on violence in Nigerian politics cites a number of examples of what it termed 'godfather politics', and how malign this is to good democratic practice, and to governance in Nigeria.

A not-dissimilar situation exists too in Nicaragua, where the rule of Daniel Ortega has been described as "electoral authoritarianism"[61], in which the institutions of the State are in the hands of a small elite and where there are few institutional counterweights to his rule. Ortega himself has been President since 2007, and intends to run again in 2016, having twice overturned consitutional term limits in what some commentators have described as a "power grab"[62]. Furthermore, his Sandinista National Liberation Front (FSLN) controls virtually the entire local administration, winning 134 of 153 municipalities in elections in 2012.

Vietnam too is controlled by a small elite, though the structure is different. Despite the *Doi Moi* liberalization process, it remains the case that real power in Vietnam resides not with the Government in its own right, but with the Communist Party. The Party has sought to balance the desire to develop the economy and to open it to international markets, with the imperative of maintaining control over the process. The result has been a hybrid approach, referred to often as the socialist market economy. Others have referred to it – slightly less flatteringly – as 'market Leninism[63].

Why then does this matter? In part it is because the concentration of power in the hands of relatively few people encourages a culture of corruption, and the consequent use of resources to fatten the pockets of a few rather than support the population at large. All of the countries studied for this report fare badly on international corruption rankings. According to the Transparency International Corruption Perceptions Index 2014 Zambia fared best, ranking 85th out of 174 countries surveyed. Indonesia was ranked 107th, Vietnam 119th, Nicaragua 133rd, Nigeria 136th and Tajikistan 152nd.

However more damaging for a country's stable development even than corruption is the effect that elite control has on governance and on the durability and capability of the public institutions. Courts, government ministries and agencies are unable to go against the wishes of the political elite, and the fact that many in those institutions are in their jobs because of loyalty to a particular faction or elite rather than because of their qualifications further weakens public governance and leads to poor decision-making.

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58 An Early Grade Reading Assessment (EGRA) in Zambia for example, found that 91 percent of students at the end of second grade could be classified as non-readers.

59 Routley. L. 'NGOs and the Formation of the Public: Grey Practices and Accountability.' In *African Affairs* 111/142. 2011 p134.

60 Human Rights Watch. *Criminal Politics: Violence, "Godfathers" and Corruption in Nigeria*. HRW, New York 2007.

61 Bertelsmann Stiftung, *Bertelsmann Transformation Index 2014 — Nicaragua Country Report*. Bertelsmann Stiftung, Gütersloh. 2014.

62 The Guardian. *Nicaragua court allows Ortega to seek new term in 2011*. The Guardian, London. 20th October 2009.

63 Pincus J R. *Vietnam's Reforms: The Road to Market Leninism.* Legatum Institute, London. 2012.

This has significant and adverse ramifications. For example, the failure of governance in Nigeria is well demonstrated by the country's failure to capitalise on its huge oil wealth: there is very broad agreement that Nigeria has badly managed its natural resources over the past four decades. As Paul Collier argued in 2008, "since the discovery of oil Nigeria has received revenues of around $300 billion, but per capita income is little changed from before the discovery."[64]

Similar challenges exist in Nicaragua. The mid-term review of the EU's 2007-2013 country strategy observed "a worrying trend in the governance area…The separation of powers has also suffered setbacks, such as the behaviour of the Supreme Electoral Council…[which] did not live up to its role as independent guardian of the electoral process. Presidential decrees have frequently been used to allow the executive to bypass parliamentary control…alongside the discretionary use of extra-budgetary public funds"[65]. Zambia also suffers from weak accountability: The Auditor Generals' reports continue to report misuse and misappropriation of public resources with limited follow up of audit report issues and recommendations.

In Indonesia too in spite of the changes in the roles and responsibilities of the public institutions, the World Bank[66] indicates that many of the elements and challenges of the earlier structures remain, such as the central planning function and a lack of coordination between stakeholders involved in formulating and implementing policies. The World Bank therefore finds that "the outcome has been poor delivery of services by government institutions, inconsistent policy settings across sectors, and a lack of responsiveness of the administration to the priorities of the government and citizens."

If this analysis is correct, then we are not seeing the emergence of competent, strong state institutions capable of guiding and securing development into the future. Instead ruling elites are able to bend those institutions to their own will. This has serious ramifications not only for politics in in these countries, but also for the private sector. As will be seen later in this paper, institutional weakness in the political realm are mirrored by weakness in institutions in the private sector, and in wider issues of corporate governance. In the longer term these challenges seem likely seriously to constrain levels of FDI and the potential for growth of the domestic private sector.

4.3 Key success factors

So what then does this study find to be the key success factors against which to adjudge how well placed a country is to continue its progression from poverty? Countries reach middle-income status through a wide variety of routes, but what are the common factors which can be looked at in order to evaluate the risks to their ability to maintain that status and to progress further in that journey? This study finds that there are four of these key success factors:

4.3.1 Structural sophistication of the economy

In different ways all of the countries surveyed have a relatively narrow economic base, and the degree of value-addition created is quite low. Most obvious is Zambia's almost-complete reliance on copper exports. However, the risks to exporters of primary products is well-known, but what this study shows is that risks exist for countries that have made it further up the value chain. Vietnam's success over the past 2 decades has come from manufacturing. Yet that manufacturing base adds

[64] Collier P. 'Oil, Growth and Governance in Nigeria'. In Collier P et al (eds) *Economic Policy Options for a Prosperous Nigeria* Palgrave Macmillan 2008.
[65] European Union. *Nicaragua Country Strategy Paper 2007-2013: Mid Term Review annex*. EU, Brussels 2010.
[66] World Bank. *Indonesia Development Policy Review 2014: avoiding the trap*. World Bank, Washington 2014.

little value and, until this changes, the country is highly vulnerable to its low cost-base manufacturing migrating elsewhere.

This narrowness of the economic base and low levels of value-addition matter because it makes these countries vulnerable to shock and change. Thus even if effective structures are put in place to tax these sectors, those revenues are not reliable – as Zambia is currently finding out. Until an economic base is created which is able to withstand a downturn in one area; and in which sufficient value is added to give protection from competition, then a country will remain vulnerable to shocks and therefore lack stability.

4.3.2 Infrastructure and the impact of development

It is not novel to observe that poor infrastructure is an impediment to development. However, what this study has identified is that a key challenge for middle-income status countries is not just to build the infrastructure that has never been in place, but also to build the infrastructure required as a consequence of the country's development to middle-income level. Vietnam's failure to invest properly in water treatment is a good illustration of these 'pinch points': a growing urbanisation has put pressure on water provision and treatment for which the infrastructure has not kept pace.

Once again, the implication here is one of vulnerability and the risk of reversals. In the case of Vietnam the country has the choice of spending immense sums to make good the water system, or risk serious environmental pollution with all the costs, financial and otherwise, involved. Either may well cause serious challenges to the country's on-going development. It is key therefore that these countries build their infrastructure as they develop: the non-attractive, but essential (such as effluent plants), as well as the more media-catching (such as new airports).

4.3.3 Demographics: what to do with the 'surge'?

Demographics covers many criteria including urban migration, women's participation, children per woman. However, in the context of continued poverty reduction in transition economies, the issues of demographic bulge is particularly focussed on. The IMF, for example concludes that "a bulge in the working age ratio contributes to higher savings rates, increasing the domestic resources available for productive investment"[67]. However, this is not necessarily the case. Unless that surge of labour has the right skills to be able to contribute to the labour market, and unless there are enough companies wanting those skills, then a youth bulge becomes a problem. In places like Nigeria for example, it is, a problem with significant implications for peace and stability.

A country with real potential to continue its progression from poverty is one therefore which properly focusses on education; on developing precisely those skills which will enable diversification and the attraction of investment to develop new areas of the economy. Failure to do this again gives rise to the risk of vulnerability and the risk of reversal.

4.3.4 Governance

Underpinning the first three of these success factors is a fourth. The quality of governance in a country is critical to it being able to diversify its economy; to respond to infrastructure challenges; and to create an educational system capable of making the best of a youth bulge. Crucially for this paper, which is focussing specifically on the role of the private sector, good governance is also a *sine qua non* to attract investment. Investors, both domestic and international, will mostly choose to

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[67] Aiyar S *et al. Growth Slowdowns and the Middle-Income Trap*. IMF, Washington. 2013.

invest in places where there is stable government, transparency, and an effective rule of law[68]. Examples identified by this study – the fact that some companies in Tajikistan reported staying small in order to avoid political interference; and the effects of economic oligarchies in Nicaragua and Nigeria – are illustrative of this point. Even in Vietnam, which has attracted significant levels of FDI, potential investors interviewed for this study said that a lack of transparency was a significant factor in their decision to-date not to invest.

Some authors have argued that it is only in democratic states where these challenges are properly addressed: Richard Youngs of the Carnegie Foundation, for example finds that, “many of the states where FDI inflows have decreased or reached a plateau since the late 1990s are those where democratic reform has either stagnated, or failed to materialise.”[69] It is not the role of this paper to take a view on the link between democracy and growth. Nevertheless, it is apparent from all the countries examined that control by a small elite breeds weak institutions, corruption, and a lack of transparency and predictability.

The fourth and final factor therefore, perhaps the most significant factor, is the degree to which a country progressing poverty is developing institutions capable of providing good governance, rule of law and transparency. This will then give confidence to both foreign and domestic investors that their investments are safe; and indicate that challenges such as the need to broaden the economy, infrastructural development, and education will all be properly addressed.

[68] Jensen, Nathan M. *Nation-States and the Multinational Corporation: A Political Economy of Foreign Direct Investment.* Princeton University Press. 2006.

[69] Youngs, R. (2004) ‘Democracy and the multinationals’. In *Democratization* Vol. 11, No 1, Feb 2004. p127.

5 The private sector

The previous chapter identified those key success factors which seem to be most pertinent to a country's continued ability to progress from poverty. This chapter moves on to look at the role of the private sector within this. What factors will prevent firms from growing and thereby creating jobs and generating higher levels of income, and being able to pay taxes, which can then be used to strengthen state provision and reduce the need for further development aid?

5.1 Challenges to the private sector

5.1.1 How private is the private sector?

A significant challenge to the development of private companies in all the countries surveyed is that in reality large chunks of the private sector are not actually private at all. This study finds that political interference in the private sector, and the continued presence of state-owned enterprises (SoEs) are significant impediments to the development of genuinely privately-held companies.

Political interference and elite control

In most of the countries studied, the private sector is heavily-influenced by politically well-connected elites. This is a feature for which Nigeria is virtually a stereotype: where amongst the best-known tycoons are Aliko Dangote, whose Dangote group is dominant in cement, sugar and salt and the manufacture of flour products; and Femi Otedola, whose company, Zenon has a licence to import and distribute diesel. Furthermore, there is a revolving door of ex-ministers becoming senior executives in the private sector, and senior corporate figures holding influential governmental roles.

Many of those interviewed spoke of adverse interference in commercial activities from political figures: that it was not advisable for a company to grow beyond a certain size because if it did a local power-broker would want to acquire a slice of the ownership. One interviewee in Nigeria observed that the reason that even large companies like Virgin and Barclays had withdrawn was because of lack of transparency and elite interference in their business. The same seems also to be true in Tajikistan. A number of interviewees there said that people close to leading figures in the ruling party seek to find ways to get involved in large, successful and growing private businesses, creating a fear that these businesses will be confiscated. As a consequence, some large private businesses split their activities into smaller entities; move out of the country to avoid being 'captured', or simply decide to remain small and therefore 'under the radar'.

In Nicaragua, the private sector is dominated by an oligarchy which has close ties to the Ortega regime. A report in the FT in 2012 quoted a local economist, Francisco Mayorga, as having identified a dozen families "that each control business groups with assets of more than US$100m, as well as a second tier comprising some 1,500 millionaires; this is followed by an anaemic middle class and the majority poor."[70] Indonesia's economy too has long been characterized by a small group of business elites that has controlled a significant share of the country's wealth. There had been hopes that this might have changed after the end of the Suharto regime, but evidence seems to suggest that the ties between business and politics do not seem to have weakened. Indeed, as a recent report concluded, if anything the ties seem to be getting closer as companies play an

[70] Mander B. *Spirit of Enterprise.* FT Wealth. 28th September 2012.

important role in funding campaigns of political parties; and decentralisation gives rise to even more possibilities for influencing policy making at different levels.[71]

State-owned enterprises

This political interference is exacerbated in some countries by the presence of SoEs, which further distort the transparent functioning of the private sector. In Indonesia, for example, there are close to 140 SOEs operating in sectors as diverse as energy, power, transportation, aviation, agriculture, banking and telecommunications. It is estimated that in total these companies control about 20% of the Indonesian economy and employ more than 850,000 people.[72] In Tajikistan, official statistics suggest that SoEs provide one-third of all the jobs[73]. In Vietnam, despite a process of 'equitisation' and repeated political commitments to further reduce the number of state-held companies, it is estimated that SoEs still amount for as much as 40% of national output[74].

The persistence of SoEs is problematic for three reasons. Firstly, they have a habit of expanding into all areas of the economy, so pushing out genuine private sector actors. In Vietnam for example, many large SoEs have expanded and diversified into sectors well beyond the core activity meant to be their focus. In Indonesia and Tajikistan too, SoEs operate in a wide range of sectors and, according to interviews undertaken, are always prone to further expansion into new potentially-lucrative areas. Given their easier access to capital and the fact that they can – literally – afford to fail, SoE presence across the economy acts as a major brake on the development of private actors.

This then raises the second way in which SoEs distort the market: they have unfair access to resources, in particular access to land. SoEs also have better contacts and links with government agencies, both centrally and at regional level, which means that they get disproportional access to Government contracts. Interviews in Vietnam, Tajikistan and Indonesia all suggested strongly that SoEs have privileged access to government contracts. The result is that private companies are significantly constrained in their ability to access these contracts.

Thirdly, the presence of SoEs, and the fact that they are often poorly-run presents a wider systemic threat. SoEs are supported with government monies, and in some cases there is also significant state-owned bank lending to SoEs. Much of this debt is un-performing. For example, according to McKinsey, "Vietnam's financial system is run by state banks, some of which may, at times, lend based on political or policy grounds rather than on strict financial merit."[75] This too has negative wider ramifications since it ties up valuable government cash in poorly-run investments. This means that these revenues are not therefore available to areas of the private sector where the monies could be better used. From a policy perspective the existence of large numbers of SoEs perpetuates in the mind of a government that they are a provider within the economy, rather than a guide of it.

5.1.2 Regulation, governance and the business environment

The previous chapter has already observed that a key marker – perhaps the key marker – of a country's likely ability to continue a progression from poverty is the quality of governance and the strength of its institutions. This study has identified clearly how the lack of such structures acts as a severe brake on the development of the private sector. Poor regulation, corporate governance and

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[71] Johansson (2014) Political Change and the Business Elite in Indonesia, Stockholm School of Economics Asia Working Paper, No. 34, December 2014. http://swopec.hhs.se/hascer/papers/hascer2014-034.pdf.

[72] Figures based on Wall Street Journal interview with Minister of SOEs, 20 April 2015, http://www.wsj.com/articles/indonesia-pushing-more-soes-to-issue-bonds-1429584616.

[73] World Bank. 2014. Tajikistan: Fiscal Risks from State-Owned Enterprises. Washington, DC. © World Bank. https://openknowledge.worldbank.org/handle/10986/20749 License: CC BY 3.0 IGO.

[74] Breu M *et al. Sustaining Vietnam's Growth*, McKinsey Global Institute, 2013.

[75] Ibid.

a weak operating environment are major constraints in all the countries surveyed. This is demonstrated clearly by the generally poor (sometimes very poor) rankings that all of our study countries receive on international benchmarks for governance and transparency:

Table 5.1 International benchmarks, a comparison

	TI Corruption Perceptions Index (of 174)[76]	World Bank Doing Business Indicators (of 189)[77]	WEF Global Competitiveness Index (of 140)[78]
Indonesia	107	109	37
Nicaragua	133	125	108
Nigeria	136	169	124
Tajikistan	152	132	80
Vietnam	119	90	56
Zambia	85	97	96

This study identified a number of specific instances which illustrate these bald figures: examples that give insights into the challenges that companies face in reality. Furthermore, what is interesting to speculate is the degree to which a poor operating environment for the private sector can be linked directly to the issues of poor governance at a political level which we observed and commented on in the previous chapter.

For example, in its country assessment of Nicaragua, Transparency International identifies key areas of criticism relevant to the private sector. The country has “minimal” openness in the State budget, and a poor score on judicial independence, where the country is ranked 136th out of 142. A weak court system acts as a disincentive to investment – a lack of transparency and rule of law leads investors to fear for the enforceability of contracts and the security of their investment. In the case of Nicaragua, the weakness of the court system in the corporate sphere appears to reflect the elite capture of the judicial process at a political level.

As demonstrated by the World Bank’s Investment Climate Assessment in 2010[79] corruption in Nigeria remains a serious impediment for the private sector. According to this report only 44% of companies believe that government officials have a predictable interpretation of the law, with corruption cited as the reason why this is the case. Significant numbers of companies reported being asked for ‘informal payments’ in respect of many aspects of doing business. The private sector also reported problems with the court system too, with only half of firms believing the system to be “fair, impartial and uncorrupted”. Once again the link with wider political issues seems clear. In a country which operates on the basis of elites and networks, is it surprising that the environment for doing business is so opaque? The impact of a protective oligarchy in the private sector is clearly reflected in two of the World Bank’s Doing Business Indicators: Nigeria rates 140th on contract enforcement and 159th on cross-border trading.

Perhaps unsurprisingly given the degree of opacity resulting from the role of SoEs, and the challenges with the business environment, Vietnam has challenges in relation to corruption and corporate governance. According to a World Bank survey, “44% of enterprises and 28% of citizens

[76] Transparency International. *Corruption Perceptions Index 2014.* https://www.transparency.org/cpi2014/results.

[77] World Bank. *Doing Business Indicators: Economy Rankings 2015.* http://www.doingbusiness.org/rankings.

[78] World Economic Forum. *Global Competitiveness Index 2015.* http://reports.weforum.org/global-competitiveness-report-2015-2016/competitiveness-rankings/.

[79] Khemani S. ‘Local Government Accountability for Health Service Delivery in Nigeria’. In *Journal of African Economies* Vol. 15 No 2 June 2006.

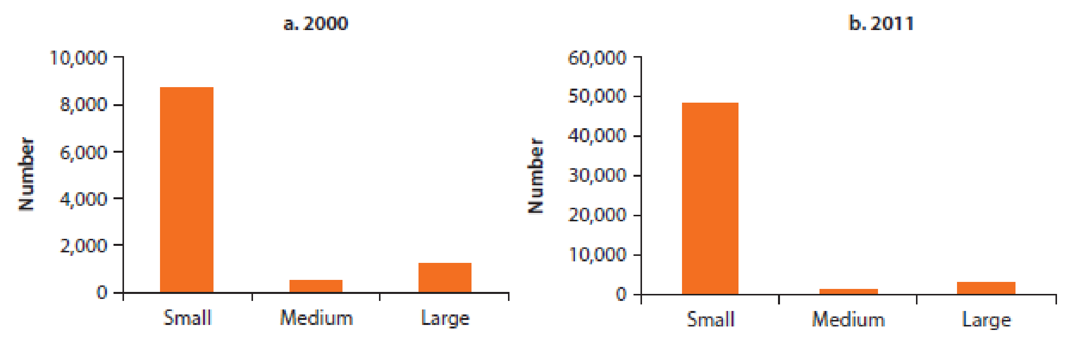
reported direct experience with paying unofficial payments and 45% of public officials encountered corrupt behaviour."[80]

In Vietnam too, it is possible to discern in the detail of some international rankings of the business environment the wider political challenges facing the country. In the *Doing Business* rankings Vietnam fares better than the other countries studied, but the specifics are revealing. The country is ranked poorly on access to electricity (135th), which reflects wider infrastructure challenges associated with rapid urbanisation. However, perhaps the most worrying is the low ranking on investor protection (117th), something which probably reflects the on-going role of SoEs, and the high levels of political interference in the private sector. Many of those interviewed for this study observed that many potential investors are put off by the fact that their investment may not be secure.

5.1.3 Structure of the private sector

The private sector in many of the countries studied is typified by the existence of a small number of big businesses, a large number of MSMEs, and not much in between: there is a 'missing middle' in the private sector. In Indonesia, a recent study concluded that as many as 99% of the companies in the country are MSMEs[81]. The same structure exists too in Zambia, where just 200 large enterprises produce the bulk of Zambia's industrial output. Only a relatively small number of businesses in Zambia are thought to have the potential to grow and contribute to job creation, the majority of which are located in the big urban centres of Lusaka and Livingstone. Fewer than 1% of enterprises have more than 5 employees. Even "large" firms in Zambia mostly employ between 51 and 70 people. Vietnam too has a 'missing middle' between SoEs and large investors such as Samsung at one extreme, and the estimated 97% of the private sector made up by MSMEs. This gap is well illustrated by the following figure:

Figure 5.1 Vietnam's 'missing middle'[82]



Source: GSO 2013.

This skewed structure of the private sector matters because the result is a lack of firms which can export to overseas markets themselves, or act as in-country suppliers to foreign companies investing in the host country. In Vietnam, for example, the failure to link enough Vietnamese firms to this international trade has reduced FDI spill-overs to the domestic economy. Currently Vietnam imports around 90% of the value of its exports, and only 21% of Vietnamese SMEs are integrated into global supply-chains, as compared to 30% in Thailand, and 46% in Malaysia. Many have found

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80 World Bank. *Corruption from the Perspective of Citizens, Firms and Public Officials* World Bank 2012 p92.

81 Mourougane, A. (2012) Promoting SME development in Indonesia, Economics department working papers No. 995, October 2012, OECD. http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2012)72&docLanguage=En.

82 World Bank, *Light Manufacturing in Vietnam: Creating Jobs and Prosperity in a Middle-Income Economy, Directions in Development*, Washington DC. 2013.

it extremely difficult to move up the value chain, resulting in a two-tier corporate sector of domestic and foreign businesses operating in virtual isolation from each other. Indonesian and Nicaraguan companies too are not well-integrated into international markets – the latter less integrated even than lower-middle income countries as a whole. Only around 12% of firms export internationally (compared to around 18% for lower middle income countries as a whole), and only a little over 50% make use of imports (compared to more than 60%). Zambia too has suffered from an inability to secure knock-ons from its foreign investments into its copper mines: a lack of properly-skilled local firms has meant that these investors have largely had to use foreign suppliers (and indeed foreign workers) rather than local firms. The additionality which this would have brought has therefore been lost. There is much therefore that these countries can learn from the experience elsewhere of how best to leverage the wider benefits of foreign investment. The first is to identify and attract investors which are prepared to share knowledge and expertise with domestic firms.[83] Second, there is a need to boost the ability of local firms to absorb the technology and practices presented by foreign companies. Foreign investment has greater developmental impacts when domestic firms are larger and the technological gap between them and incoming companies is smaller.[84]

The on-going importance of agriculture

In all the countries surveyed, the economic changes in recent years, and the accession to middle-income status have not changed a key underlying tenet: the importance of agriculture in job-creation, but it's weakness in value addition. The example of Nigeria is illustrative of this. According to the country's newly-rebased figures, agriculture accounts for around 34% of GDP[85]. However, in terms of employment, agriculture is the activity in which 62% of households nationally are engaged – the proportion even higher in the north. Moreover, subsistence farming is the norm: the average landholding per household is only a little over a hectare, and commercial scale farming is relatively rare. 80% of rural households grow staple crops while only 20% grow cash crops[86]. Even in Vietnam, which has developed a significant manufacturing base - The shares of industry in GDP increased from 23% in 1990 to 38% in 2013[87] – agriculture remains very important in employment terms, but adds relatively little value. Agriculture continues to employ nearly one in two (48%) Vietnamese, yet accounts for only 18% of GDP.

Table 5.2 Share of main sectors in GDP, 2014

Share of GDP (%)	Indonesia	Nicaragua	Nigeria	Tajikistan*	Vietnam	Zambia*
Agriculture	13,7	20,5	20,2	27,4	18,1	9,6
Industry	42,9	25,7	20,7	21,7	38,5	33,9
Services	43,3	53,8	59,1	50,8	43,3	56,5

*2013 figures.

Wide-spread informality

The study countries also continue to have large informal sectors. Even in Vietnam which has seen the development of a manufacturing base, figures suggest that the informal sector contributes to nearly 20% of GDP[88]. Elsewhere figures are much higher. In Indonesia the informal sector is

[83] Spencer, J. 'The Impact of Multinational Enterprise Strategy on Indigenous Enterprises: Horizontal Spillovers and Crowding Out in Developing Countries'. In *The Academy of Management Review*. Vol. 33, No2. 2008 pp341-361.

[84] ' Zhang Y, et al. 'FDI spillovers in an emerging market: the role of foreign firms' country origin diversity and domestic firms' absorptive capacity'. In *Strategic Management Journal*. Vol. 9, pp969-989. Sept 2010.

[85] Eczellon Capital. *Contribution to Nigeria's GDP.* http://www.eczellon.com/see-sectors-contributions-to-gdp-in-nigeria-as-at-2013/.

[86] World Bank, *Nigeria: Competitiveness and Growth Country Economic Memorandum, Volume I: Executive Summary* World Bank. 2007.

[87] World Bank. *World Development Indicators*, *Vietnam* http://databank.worldbank.org/data/reports.aspx?source=World-Development-Indicators.

[88] Cling J.-P, Razafindrakoto, M, & Roubaud, F, *The informal economy in Vietnam, Hanoi*: International Labour Organization. 2011.

estimated at 70% of the private sector.[89] In Tajikistan government does not give a figure, however some of those interviewed suggested that as much as 30% of the economy is in the informal sector. In Zambia, of the 5 million people in employment, roughly 2.1 million are in formal employment with the remainder in informal employment.[90]

These levels of informality are important for two reasons. First, the explanations for why informality exist tell us much about local perceptions of the business environment. For example, in Indonesia, businesses interviewed spoke of the registration process as being expensive and time-consuming, and with benefits often ambiguous, uncertain and difficult to quantify. Many other firms are not interested in growing or are catering for a lower-tier market, and for them it did not make sense to try to formalise[91]. Something similar is true in Nicaragua, where the IFC Enterprise Survey reveals that senior management in formalised companies spend as much as 20% of their time dealing with the requirements of government regulation[92]. It is unsurprising therefore that many companies prefer to remain informal. In Tajikistan, interviewees reported that political interference in the private sector causes firms to prefer to remain small or move abroad.

The second reason why high levels of informality are significant is that by definition informal companies are largely outside systems of tax payment. As a result the tax base of a government is constrained. Furthermore such companies tend to be small, and often have more to do with subsistence level activity – survival businesses – than they do with SMEs which aim to grow, and create wealth and employment.

5.1.4 Company-level weaknesses

It is apparent from all the countries reviewed that as well as significant challenges in their operating environment, companies also face internal challenges and lack capacity in crucial areas.

The issue of education and skills training has already been mentioned in the previous chapter. A frequent challenge for middle-income countries is that they lack well-resourced and effective educational systems. Whilst they have often focussed on improving primary education, secondary and tertiary education often remains weak. In Zambia, for example, the country has improved attendance in schools, yet most of the skilled workers in the copper mines have been flown in from South Africa and elsewhere. The same is true in Vietnam, where the majority of industrial labour is relatively unskilled. The country's development model to date has relied on taking former farmers and putting them in factories to undertake repetitive, low-skill assembly manufacturing jobs. Whilst this has allowed Vietnam to attract, inter alia the world's largest mobile phone assembly plant, the lack of skills at this basic level is highly problematic.

However, it is not just at the level of technical skills where there are significant gaps. A number of those interviewed for this study reported that a key challenge to the growth of domestic small businesses is the level and quality of management skills amongst those companies' management teams. Many of these businesses have been set up, and are still run by families with a patriarch leading the entity who, in many cases, has little or no managerial training. As a result internal systems of management, oversight and financial control are weak. Whilst they might be just about fit-for-purpose for the current state of the company they do not allow scope for diversification or expansion. Indeed, many MSMEs are simply 'survival' businesses whose owners do not necessarily want to expand them.

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89 ADB, *Country Partnership Strategy: Indonesia 2012-2014, Private Sector Assessment*. Asian Development Bank 2011.

90 World Bank PowerPoint presentation: "Zambia Jobs", a comparison of the Labour Force Surveys of 2008 and 2012.

91 Burger N *et al. Reforming Policies for Small and Medium-sized Enterprises in Indonesia*. Rand Corporation. May 2015.

92 Vargas O, Garcia L & Ramos M. 'Growth Diagnostic Framework: Case Study of Nicaragua*'*. In *Investigacion Administrativa.* Number 112 pp39-50.

This lack of managerial skills manifests itself in other ways too. Access to capital is often cited as a challenge to company growth. However interviews for this study demonstrate that often the challenge is not access to capital *per se,* but rather an absence of the right skills to be able to access financing. In Vietnam for example, interviewees in private venture capital firms reported that Vietnamese SMEs lack some basic management skills such as business planning and financial control. The result is that they are unable to develop and present expansion opportunities which would be fundable. Thus a lack of managerial skills is materially holding back the development of Vietnamese businesses. It is also reported that Vietnamese businesses lack an understanding of what opportunities there might be for them, either internationally or domestically.

The lack of skills has a wider implication too – for the public sector. It is not just in manufacturing companies where the correct skills are needed, but also in the government ministries and departments responsible for overseeing the private sector. As has been discussed above, there are a range of political challenges to good regulation. However, weak regulatory control of the private sector is not just a function of political interference, but also of capability and capacity amongst administrators. Poor skills levels will lead to the introduction of poor regulation, and sub-standard services to companies seeking to grow.

Given the issues of high-end management skills it is unsurprising that a further challenge to company growth is corporate governance. MSMEs have often grown on the basis of the *modus operandi* of its boss, and few companies will have paid much attention to the need for proper processes of corporate governance. Such companies do not have good standards of corporate governance, but crucially may not understand the need for it. As a recent ASEAN report, looking at corporate governance in Asia, concluded that “moving from the regulations to actual practice requires not only top-down enforcement, but also voluntary commitment by the companies, which must devote significant time and effort to the undertaking.”[93].

5.2 Critical success factors for the private sector

The previous chapter identified 4 critical success factors against which to evaluate how well placed a country is to continue its progression from poverty. What might analogous indicators be that tell us about the state of the private sector in such countries? What factors ought to be considered to understand how well set up a country’s private sector is to be able to support a progression from poverty, and avoidance or escape from the middle income trap? It is highly relevant to observe that the nature of the success factors at both country and private sector level are quite similar:

5.2.1 Political interference

Elite control of government seems often to result into elite interference in the private sector. Key sectors of the economy become controlled by the associates of those in power, and businesses that become successful are seen as targets for acquisition by politically well-placed people. As is illustrated by the situation in Tajikistan for example, the fear of having to cede control means that business owners keep their businesses small and ‘below the radar’. However, it is not just predation by politicians which is a threat, so too is the existence of a state-owned sector which significantly and unfairly skews the market.

93 ADB/ ASEAN. *ASEAN Corporate Governance Scorecard* ADB, Manila 2013 p64.

5.2.2 Corporate governance

Even in the absence of direct political interference in the market, governance structures for the private sector are vitally important. The presence of a clear, transparent operating environment will encourage investment and enterprise growth. As middle-income countries, it is not perhaps surprising that all the countries reviewed for this study have challenges in this regard. It is important therefore to look at the trajectory: is there good reason to believe that the operating environment is on-course to improve over time. In this regard, the evidence which suggests that challenges to transparent business regulation are symptoms of wider political factors demonstrates that it is by addressing these wider issues that durable improvements in corporate governance will be achieved.

5.2.3 Private sector structures

The emergence of a private sector capable of expanding and of paying taxes is also determined by the structure of the private sector, and the linkages that exist between companies. The absence of a cadre of middle-sized businesses means both that foreign investing companies find significant difficulties in identifying local firms to work with, and that domestic firms struggle to export. The persistence of a large agriculture sector means that large amounts of labour will be employed in very unproductive activities. High levels of informality illustrates challenges within the operating environment, but also means that a sizeable chunk of private sector activity is not contributing to the growth of tax revenues.

5.2.4 Corporate capabilities

Finally, the capability of the private sector to be able to contribute to its country's continued development stems from the capacity of the firms that make it up. Unless firms have (or can reasonably acquire) the relevant skills at technical and managerial level, and develop processes of corporate governance, their ability to expand will be constrained. The evidence of this study demonstrates that this may be a significant challenge. A patriarch or a founding family may have successfully developed a business to a certain point but not have the skills to move further. Processes to ease this shift, and to encourage businesses continually to up-skill and improve corporate capabilities are therefore critical indicators that companies can continue to expand over time.

6 Private sector development

In this section we now turn to the question of what private sector development programming is needed in countries progressing away from poverty. Is the type of activity required different from that in 'other' countries or not? The literature reviewed in chapter 2, and the findings of our own research suggest that countries, which have attained middle-income status exhibit very distinctive features which raises the following questions: do PSD professionals need to respond, indeed are they responding in different ways to address these differences?

6.1 The challenges for PSD programming in transition economies

6.1.1 Complexity and detail

The critical success factors facing transition countries both in their political and economic development are intricate and multi-faceted. For example, if a country's business environment is problematic because of the influence of elite groups, a solution will be complex, and will need to involve identification of incentives which might make those elite groups release their grip. If foreign investment cannot effectively stimulate the local economy because of a lack of properly-qualified local firms, the solution will need to involve a range of interventions ranging from improving the enabling environment; skilling up business owners; and encouraging foreign investors to be flexible in their operating processes. Moreover, not only are these issues complex, but they are highly intractable given the highly-political and sensitive nature of the issues involved.

PSD programmes therefore need to address this complexity. Generic programmes on tax reform, or investment promotion seem to be less relevant. Instead there seems to be a need for much more specific expertise and the ability to respond to sometimes highly-technical issues. "Broad-based projects are not really relevant: we need to be focussed on addressing really specific issues", was the comment of one interviewee.

The issue of water provision and treatment in Vietnam is illustrative of this point. As was noted in chapter 3, one of the risks to Vietnam's further development is the need to invest strongly in the types of infrastructure needed to support that. At present, in the field of water provision and waste water treatment Vietnam is investing at a significantly lower level than it will need to if the issue of waste water treatment is to be addressed effectively, particularly as the process of urbanisation continues apace. Within this overarching issue, a particular need is to establish a network of private water companies. At present, this is proving problematic since most of the companies attempting to undertake this role are former SoEs, with all the challenges that this presents. However even taking the SoE issue to one side, there are issues that demonstrate the need for highly-specific PSD interventions. These relate to water charges and billing processes.

The first problem is that because Vietnam was/ is a Communist country, there is no system of local rates and property taxes in place to pay for civic amenities such as water and sewerage. Expertise is therefore required to put such a system in place to enable property owners to be charged for the services that are provided to their property and also add to those properties' value. However there is also a need to work with the companies themselves to develop their own systems for cost-based billing. At present little of the basic information and structures are in place to make this possible. What infrastructure is a company responsible for? What are annual maintenance and development costs? How does this reflect into a cost-based pricing for water? There is, therefore a need for highly-specific expertise working with both public and private sectors.

6.1.2 Materiality and timescales

However, as well as the need to respond to highly-complex challenges, a further issue raised by our research is the need for development partners to be realistic about what can be achieved given their size, and the timeframes involved. Effecting lasting change in complex systems is hard, and takes time.

Firstly, donors need to recognise that they are one among many players in these countries, and the resource they bring to bear is relatively small. In most of the countries studied, DAC donors are reducing their funding. Bilateral DAC aid flows to Nicaragua peaked at nearly US$1bn in 2004, but have declined steadily since then, to a US$240m in 2013[94]. This reflects the fact that some donors, like DFID and Sida have closed their offices, and other donors have considerably scaled back their activities. In Tajikistan ODA from DAC members amounts to around 2% of GDP, compared to around 40% from remittances. In Zambia with the phasing out of general budget support by all donors, foreign grants will account for only 2.6% of the 2015 government budget[95]. Even in Nigeria, where donor interest continues apace, their budgets and activities are dwarfed by the sheer scale of need in the country. ODA to Nigeria in 2013 was around US$2.5bn; tiny by comparison with GDP of nearly US$ 570bn.

Secondly, as is demonstrated by an issue such as education, making change happen takes time. Many of those interviewed from development partners made the point that the sorts of challenges they are addressing require a long-term perspective. Undertaking tasks such as a fundamental overhaul of a country’s education system is something that needs to be seen as a 20-year challenge: not an issue that can be ‘solved’ by a traditional 5-year development project. The same is true of the need to develop a cadre of mid-sized companies capable both of competing internationally, and acting as in-country suppliers to foreign investors. Such companies cannot be created overnight, or indeed within a few years: a longer-term perspective is required.

6.2 The evolution of PSD

In response to these challenges, the evidence from countries studied for this report is that PSD programming is evolving. We observed a change in emphasis between different types of PSD modality, and within that programming being much more specific. Moreover, the links between PSD activities and the wider developmental agenda appear to become much closer.

6.2.1 Macro-economic stability

Whilst not strictly PSD activity, macro-economic stability is an important ingredient in the development of a strong economy. Indeed, the activities of the World Bank and other development banks have been valuable in helping countries achieve this and so achieve middle income status. For example in Nicaragua in 2004 the International Monetary Fund (IMF) and the World Bank Group's International Development Association (IDA) agreed to support a comprehensive debt reduction package of US$4.5bn under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. This amounted to 72% of the debt outstanding. A further debt relief package was granted by the IDB in 2006 “to strengthen the country’s fiscal sustainability and allowed the government to reorient public spending from debt service.”[96]

94 World Bank. *World Development Indicators.*

95 Zambia Inclusive Growth Diagnostic, DFID Zambia, March 2015.

96 IDB *Debt Relief for Nicaragua*. http://www.iadb.org/en/mapamericas/nicaragua-old/debt-relief-for-nicaragua,5894.html.

6.2.2 *Investment climate reform*

All of the countries studied fare badly (some, very badly) on international benchmarks of the business environment. Unsurprisingly therefore efforts to reform the business environment have been and continue to be a key part of the work of the international development community. In Nigeria for example, DFID and World Bank support the GEMS3 programme, aimed at undertaking reform at Federal and state-level in the areas of tax, land registration and investment. The Facility for Oil Sector Transparency and Reform in Nigeria (FOSTER) works specifically on governance in the country's oil sector, and aims to reduce the many incentives for misuse of power and capture of oil revenues in Nigeria. ENABLE2, also funded by DFID works to stimulate the demand for reform by improving public-private dialogue on issues of business environment reform. In Tajikistan, as part of the World Bank's US$10m 'Private Sector Competitiveness Project', a 'one stop shop' has been established to help companies cut through red tape and get licences and permissions more rapidly. In Zambia, a business climate reform project funded by a group of donors including the UK, Sweden and Finland operated from 2006-2014, the second phase of which had funding of just over US$10m. The project had three work streams: to improve regulations, laws and policies that govern business; to streamline and simplify processes so as to increase compliance and to reduce the time needed to comply with all necessary regulations.

6.2.3 *Support to the private sector*

As well as working at macro-economic and business environment level, development partners have also been working with companies in 'traditional' value chain, micro-credit and other programmes. In Nicaragua, for example, IFC and German development bank KfW have provided a $3 million loan to a local microfinance institution FDL[97] to provide funding to rural MSMEs. In addition, FDL provides companies with skills, for example in basic management techniques and book-keeping. One of the last DFID projects in the country to be closed, PROPEMCE[98], also worked to improve the capabilities of Nicaraguan companies. In Zambia, JICA has established a network of rural Business Support Centres to provide business development services to MSMEs in value addition activities using locally available primary materials. Similarly, the ILO's *Zambia Green Jobs* programme is supporting sustainable MSMEs in the building and construction value chain to become more productive and competitive. The programme expects to create 5,000 new 'green' jobs in the construction industry by 2017.

6.2.4 *New issues and new approaches*

However, in the countries reviewed for this study we observed the evolution of PSD programming to deal with the particular challenges of transition economies. The most obvious challenge in these places is that many of the issues relating to the private sector are reflections of wider challenges in the host country's political economy. The question of how to deal with the challenges in the private sector cannot therefore be disconnected from wider issues of change and reform. This is reflected in a number of novel approaches.

Ownership and SOEs

An obvious example of this is the question of SoE reform; a significant issue in several of our case study countries. This issue can be seen through three lenses, moving from the practical to the rather more political. The most practical of challenges is that of maintaining stability. Many SoEs,

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97 IFC. NICARAGUA: Increasing Microfinancing to Rural and Agribusiness Sectors. http://www.ifc.org/wps/wcm/connect/db8ca280446511ee8cb38cc66d9c728b/FDL.pdf?MOD=AJPERES.

98 Carter R. *PROPEMCE Annual Review 2012*. DFID, 2012.

despite being unviable in purely commercial terms, continue to employ and provide social provision (pensions, maternity care etc.) to many people (in Tajikistan, as much as 40% of the population). To allow SoEs to collapse would thus risk undermining the living standards of many people and so risk civil unrest. Second, there is the issue of habituation: governments have become used to regarding SoEs as another arm of government, through which its aims can be pursued. Getting governments out of this habit will require a significant change in mind-sets and behaviours. Thirdly, and probably most intractably, those who need to reform SoEs are precisely those who benefit most from their privileged position: those in political power. In both Tajikistan and Vietnam for example, government and Party figures are significant owners of SoEs. The challenge therefore is that the people who will be required to reform SoEs, and to reduce their influence in the economy are precisely the same people who benefit from the current privileged status of these companies. Thus the 'PSD' issue of creating a more level playing field for all parts of the private sector in these countries cannot be disconnected from the wider issue of political reform and change.

Skills and education

However, the need for inter-connected actions between development activities in different sectors does not relate simply to things political. The solutions to other challenges for the private sector also do not lie simply within the scope of PSD programming. Take the issue of skills and education, an issue which poses a significant challenge to private sector growth in all countries studied. It would of course be possible for PSD practitioners to design and implement projects to focus on worker training and management education. However, this would probably only focus on particular companies or specific geographic areas. What is needed is a fundamental shift in these countries' education systems to improve skills across the board and provide a workforce capable of helping the country continue its economic growth. Work to address the skills challenges in the private sector have to be seen as part of a wider process of systemic change in the education system as a whole.

A more integrated Approach

The reality therefore is that PSD programming cannot be seen as a separate stream of activity, but needs to be integrated much more carefully into a skein of activity including PSD, governance, anti-corruption efforts and human and social development. The point was also made by many of those interviewed that it is harder to avoid the really tough, political questions. As one interviewee said, when operating in a low income country, it is often possible to design PSD interventions in such a way as to avoid wider issues of corruption and political competence and control. However in middle income countries these issues need to be tackled head-on.

It is apparent from our research that this need for a more joined-up approach is being reflected in practice, a good example being the 'Prosperity Committee' operated by the British High Commission in Nigeria. This brings together all elements of The British Government operating in the country, agrees a common position on key issues, and then coordinates the activities of different British entities to pursue a coordinated approach. In Indonesia too, our research found that programmes to support regulatory reform are increasingly not stand-alone activities but integrated in larger, more governance-related projects and programmes. The *Australia Indonesia Partnership for Economic Governance* is an example, which seeks to improve economic governance "around a theme of enhanced economic competitiveness and strengthened institutions with the goal of higher, more sustainable, and inclusive economic growth."[99]

[99] http://aipeg.or.id/index.php/webmain/main/home/126.

6.3 PSD in transition economies: towards a new approach

It seems clear then that although many of the interventions undertaken by development partners in these middle-income countries look the same as those in other countries, the reality is rather different. As the challenges facing middle-income countries differ, so too do the development responses to address those challenges. PSD strategies in such locations need to be guided by four key success factors:

6.3.1 Focus on the key issues

Given that in all the countries studied poverty remains a very real challenge, it may be tempting for PSD practitioners to continue with 'PSD programming as normal', for example, with micro-finance to rural communities or value chain programmes in relevant commodities.

However, the aim of PSD programming in middle-income states is clear: to address those constraints which risk the country sliding backwards and which may prevent it from moving upwards to high-income status. Whilst it is relevant for some of this sort of programming to continue, the central issue for this study is that whilst 'traditional' PSD programming may assist in poverty reduction for focal communities, it does not address the systemic issues in the host country which would enable sustainable poverty reduction for the population as a whole, and over time. It is only by addressing the core political economy issues of elite control, corruption, institutional weakness and so on that these countries will be able to create the basis for a durable graduation from the need for concessional aid.

In these countries, therefore, PSD programming needs, in collaboration with other programme streams, to focus on addressing these issues. They are much tougher, and highly-intractable, but only by addressing them can PSD (and other) programming properly help countries in a fundamental way. Therefore those approaches and modalities which address the success factors identified in chapter 4 need to be the focus of PSD programming.

6.3.2 PSD needs to be linked to a wider, comprehensive approach

It is a moot point whether PSD ought in all circumstances to be better connected to other programme streams. However in these middle-income countries, it is clear that PSD programming cannot sensibly be seen as a stand-alone sphere of endeavour. Challenges to the private sector such as a problematic regulatory environment are not stand-alone issues capable of simple, technical solutions. The reason that the investment regulations in Nigeria are so tortuous is not because no-one has ever got round to sorting them out, but because there are significant vested interests for whom the current regulations work very well by protecting their monopoly positions. Similarly, the development of a cadre of SMEs capable of linking effectively to foreign investors requires interventions in the skills and education sector.

6.3.3 PSD interventions need to be highly-specific

The challenges to be addressed are complex and the responses required from PSD programming need to be highly specific, and tailored to the precise needs of a given situation. Broad-brush approaches and generic programmes on business-environment reform, or micro-finance are therefore instruments too blunt in such situations. This requires much more detailed understanding of the issues at hand, and the ability to call on highly-specific expertise when required.

6.3.4 Realism about what is achievable, and in what time-frame

Development partners, and those with whom they work need to be very sanguine about what they can achieve, and that results may take a long time to be realised. Interventions need therefore to be conceived with a suitably long-term horizon, and resource committed for the duration. Equally, there needs to be greater flexibility about how goals may be achieved. Events will change things, and programmes need to alter their tactics in response. Ends may remain the same: means may have to change.

7 Actors, partnerships and instruments

Having considered the changing nature of PSD modalities, this chapter now examines the practical environment in countries moving away from poverty. Who are the different actors present in these contexts; what roles do they perform; and what are the relationships between them?

7.1 Actors

The development environment in all of the countries surveyed is being changed greatly by the arrival of new actors. The process of PSD specifically and development more generally is no longer the remit just of host governments and 'the usual suspects' of bilateral and multilateral donors: a whole new ecosystem of other entities is emerging.

7.1.1 Non-DAC donors

The past few years have seen the emergence of a raft of new non-DAC donors. Many of these countries are themselves recipients of aid (for example Indonesia), or until recently have been. Only gradually is the role, intent and potential of these new donors becoming more apparent.

Illustrative of this trend is the situation in Nicaragua where even as 'traditional' DAC donors have scaled-back their level of activity so south-south support, largely from fellow-Hispanic countries, is on the rise. The amounts of money involved are significant. Reports suggest that Brazil is investing US$1.2bn in the Tumarin hydro-electric plant; Mexico is committing US$400 to the telecoms sector, and Venezuela nearly US$4bn in oil refining capacity (though the domestic politics of Venezuela may put this last one in doubt).[100] Some present this as providing the opportunity for the national government to take greater control of its development agenda: a process in which the "Nicaraguan government [is] back in the driver's seat of its development agenda, [with] emerging donors facilitating this process."[101] This view may be slightly rose-tinted, since many of these new donors make it clear that their desire to support their neighbours is an element of their own wider foreign policy. For example, the Mexican Government's development agency, AMEXCID, makes it clear that its economic development programmes "are focused on increasing the presence of Mexican products and services in international markets…and help those Mexican companies wishing to invest abroad and participate in global value chains."[102]

The balance in aims of these new donors is an interesting one. Interviews with representatives of some of these new partners made it clear that these agencies believe that they have something different to offer their neighbours than 'traditional' donors. Countries like Mexico, which themselves have recently gone through the process of development and who share elements of similar history and culture think that the lessons they have learned can be more beneficial than experience brought in by, for example, European donors. Certainly the experience of the countries of central and Eastern Europe in the 1990s, where lessons about ways to approach political and economic development were learned between countries, suggests that regional support between countries can be beneficial.

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[100] Walshe-Roussel L. *The Changing Donor Landscape in Nicaragua.* International Development Research Centre. Presentation. 3rd November 2012.

[101] Ibid.

[102] AMEXCID. *Promoción Económica*. http://www.amexcid.gob.mx/index.php/es/ique-hacemos/promocion-economica.

However, such support can also be political, as in the case of the *Petrocaribe* deal providing Venezuelan support to Nicaragua. Similarly, in Tajikistan, there is considerable involvement from China, which is driven at least in part by political considerations. Early in 2015 the President of Tajikistan announced that China will invest around US$ 6 billion in Tajikistan over the next 3-5 years. The investment flow from China will be supporting infrastructure and agriculture.

7.1.2 The corporate sector

Another significant new player in the 'development business' is the international corporate sector. A growing number (though probably still quite a small group) of companies are building new businesses in ways, which proactively take account of the development landscape in which they are operating. Importantly, in doing so they are looking to collaborate with development partners in new and innovative ways.

In Nigeria, DFID's GEMS3 project, which is primarily focussed on business environment reform is also working with the agribusiness company, Cargill who, according to their Vice Chairman and Chief Risk Officer, Emery Koenig, "are currently exploring opportunities for the establishment of a cassava-based starch and sweetener facility that develops a local supply chain."[103] GEMS3's involvement began in 2012 with a feasibility study on cassava production. Since then GEMS3 has acted as the link between Nigerian officials and the company. By spring 2015 Cargill had developed their plans sufficiently-far to commission a social and environmental feasibility study for a "planned investment in the Kogi State Staple Crop Processing Zone (SCPZ) of up to USD 100 million to develop an agro-processing complex and associated cassava supply chain within an area of approximately 30,000 hectares."[104]

A similar arrangement is also taking place between the Propcom Mai-karfi project, which is also funded by DFID, and the agriculture company, Syngenta. The latter is seeking to develop a market in Nigeria for its seeds and seed treatments. From a market-access perspective Syngenta found it hard to find ways to reach small-scale farmers, and therefore approached Propcom as a vehicle to access rural farmer networks. Subsequently Syngenta and Propcom have established a number of demonstration farms across 5 states. Sygenta claim to have worked directly with 30,000 farmers, and to have indirectly reached six times that number. Because the seeds and treatments significantly increase yields – the company claims yields as much as 400% higher[105] – farmers who adopt this new approach should see their incomes increase significantly. The project therefore has considerable developmental impact, but is also going to be sustained over time because Syngenta will be able to create a profitable business.

Syngenta is also working in a similar way in Indonesia, in the mango sector with the Australian Government-funded PRISMA programme. The modalities and aims are similar to their project in Nigeria. The company is training small-scale mango farmers in the use of their chemicals and other inputs. The programme aims to benefit more than 17,400 farmers and 2,400 collectors by 2018,[106] and PRISMA has calculated that the farmers involved can more than double their net income. As in Nigeria Syngenta's rationale for engagement is to build a profitable business.

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[103] Federal Ministry of Agriculture and Rural Development. *Nigeria launches first staple crop processing zone.* Press release 15th Jan 2014.

[104] ERM. Cargill Agricultural Production and Processing Project Final ESIA Scoping Report. Cargill. March 2014.

[105] Propcom Mai-karfi. *Propcom Mai-karfi and Syngenta Farmer Field Days.* http://www.propcommaikarfi.org/results/propcom-mai-karfi-and-syngenta-farmer-field-days.

[106] Source: Interviews with DFAT, http://www.grminternational.com/projects/aip_prisma, and PRISMA, Stories from the field, A Budding New Business Improving mango farmers' income with early flowering technology, September 2015.

The potential for symbiotic partnerships between donors and companies is demonstrated also by the involvement of Starbucks in Nicaragua. A joint project announced in June 2015[107] bringing together IDB, IFC and Starbucks to improve coffee production, specifically by addressing the challenge of coffee rust fungus. IDB and IFC will each invest US$12m; and Starbucks and the local coffee trader, Exportadora Atlantic, US$3m each. The resulting fund will be used to provide farmers with financing to replace old, diseased plants with disease-resistant varieties, as well as technical assistance to help them make farming practices more sustainable. Starbucks has then committed to buy the resulting, certified-disease-free coffee.

7.1.3 Private foundations

As well as private companies, the development landscape is being changed by the growing role of private foundations. Typically funded by very high-profile individuals, the impact of some of these is well documented: for example the Gates Foundation and the Clinton Foundation. The trend seems also towards the creation of more such entities: for example Mark Zuckerberg has recently announced that he will use much of his wealth to support education and other projects internationally[108]. Such entities often have their own very clear agenda, and are not always amenable to easy collaboration with traditional development partners. However, as well as the international foundations, others may be more local. For example the MADE programme in southern Nigeria works closely with a corporate foundation, the Chevron-funded Partnership Initiative for the Niger Delta (PIND).

7.2 Partnerships

This changing environment is obliging 'traditional' development agencies to think about how best to partner with the new range of actors. In many cases this can be complicated by differences in aims and approaches, as well a mutual lack of familiarity.

However, the most significant partnership remains that between development partners and their host government. It is apparent from interviews in a number of the countries studied that notwithstanding continuing governance challenges, host governments feel that their success in achieving middle-income status puts them in a more powerful position relative to their development partners. This means that the relationship between government and its donors has had to change. Illustrative of this trend is the World Bank's *Jakarta Commitment* in relation to its work in Indonesia, which stated that "since 2004, World Bank support for Indonesia has moved towards supporting a country-led and owned policy agenda, consistent with Indonesia's status as a middle-income country."[109]

Development partners now see their role as being to persuade ministers and their officials of the value of possible policy choices and provide evidence-backed advice. The balance seems to be quite subtle. On the one hand, governments realise that they still need specialist and expert advice, and that development partners are able to provide this. On the other hand they are wary of being seen as not being able to define their own way forward. Many of those interviewed described their relationship with ministers and officials as being one of providing advice; discussing ideas; and providing guidance. As the World Bank in Indonesia put it, the role of development partners is to

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107 IDB. *IDB partners with IFC, Exportadora Atlantic and Starbucks to help Nicaraguan farmers combat coffee rust disease*. IDB Press Release, 24th June 2015.

108 Cellan-Jones R. Facebook's Mark Zuckerberg to give away 99% of shares. BBC News. 2nd Dec 2015.

109 World Bank. *Jakarta Commitment Aid for development effectiveness, Indonesia's roadmap to 2014*. World Bank, 2010.

play “a catalytic role in allowing Indonesia to access international knowledge and best practice, to enhance institutional capacity, and bring about strategic systems improvements.”[110]

However, though host governments see themselves as being more in the driving seat, this does not necessarily mean that the relationship is always an easy one. In Indonesia, donors made a number of observations. First is lack of coordination within government: there is for example, a Ministry of SMEs, but at the same time, many other ministries have SME departments as well. Second the continued power of vested interests in government sometimes leads them to reject international advice. In Vietnam development partners commented that the GoV has become adept at ‘managing’ its donor partners – that ministers and officials had become very adept at ‘dividing and ruling’ the international donor community: getting different donors, for example, to work with different ministries, and so making combined donor positions, or donor cooperation hard to achieve. Money – or rather lack of it – also seems to be a complicating factor. Governments have become used to receiving large financial injections from overseas. A number of development partners expressed that they felt a degree of annoyance coming from government officials that those partners’ governments were no longer effectively providing ‘free money’.

7.3 Instruments

A further change can be seen in the range of instruments that are available to address development challenges. Whilst the ‘traditional’ concessional grant-making approach remains widely-used a range of other modalities have been developed. This range looks set to expand further as new actors explore new ways of getting things done.

7.3.1 Commercial investment funds

In Vietnam investment companies like Dragon Capital and Mekong Capital are looking for commercial investments. The companies mobilise funding from individuals and institutional investors. Whilst they can take a longer-term view of the market than might be possible for listed funds, their aim is to present fully-commercial terms to their funders. Similarly in Zambia the Kukula Fund was launched in 2010 with capital of US$5.5 million, raised from high net-worth individuals.

7.3.2 ‘Patient’ capital

In Zambia DFID is working with AgDevCo (which DFID helped to create) to provide a revolving funding mechanism to act as an incubator for early-stage agricultural firms, and to create clusters of farmers and agribusinesses. Investments can be either debt or equity, and amount typically to between US$300,000 and US$1,000,000. Investments appear to be undertaken on less than fully-commercial terms and the funding from the UK will be revolving, allowing AgDevCo to reinvest in new opportunities as existing investments mature[111].

7.3.3 Social impact bonds

Although a new mechanism, there is a good deal of talk about this mechanism, which is described as a “public-private partnership via a structured finance instrument for a social or development outcome.”[112] These mechanisms leverage private capital and promise to deliver developmental

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[110] *Ibid.*

[111] DFID estimates that over 67% of the funding invested by AgDevCo will be returned to AgDevCo by 2021 to be used for reinvestment. In this way UK aid money will be redeployed several times over, multiplying the developmental impact.

[112] Vanderwaal P. *Development Impact Bonds*. Presentation to DFID Nigeria, 11th September 2015.

benefits. However, at the same time these instruments also promise quite high rates of return – between 7% and 13%. However this return is quite risky as investors can lose their entire investment.

7.4 Towards a new approach to PSD

The upshot of this raft of new actors and instruments in the development world is that traditional development partners are having to modify their ways of working. Far from being a problem, this imperative is driving development agencies to find new PSD modalities.

7.4.1 It is more than money

Historically, donor agencies have seen themselves (as can be discerned even from the term 'donor') largely as a provider of funding. Indeed, the focus on donor countries providing 0.7% of GNI in ODA demonstrates this. However, in these middle-income countries money is not necessarily the most important tool in the donor toolbox. In fact with other entities – venture capitalists, companies and so on – able to provide funds, it seems that development partners need to look closely at what else they provide which accords them a unique role.

The evidence of this study suggests that what development partners are best placed to add are those softer contributions which emanate from their structure as governmental entities. Donors can advise and (gently) cajole partner governments; they have the legitimacy directly to address issues of reform and governance; and they can provide those in the private sector with access to those in political power. It seems likely that these contributions are more important than hard cash in these middle-income countries where it is precisely these political economy issues which are the most significant. A paper last year written for the Dutch Government referred to the contribution which donors are best able to make as GPS (geo-political support) diplomacy:

"This is a process of building coalitions on issues of shared interest between private sector and other stakeholders, such as government, NGOs and media. This is done through lobbying, mediation, matchmaking and negotiation... Financing...is part of this service package – a means to achieve a result: its success is not to be measured by the amount spent."[113]

7.4.2 Development agency as facilitator

The examples of Cargill in Nigeria, and of Syngenta in Nigeria and Indonesia demonstrate a new modality for PSD: the development agency as a facilitator of action. In these cases as well as in others – for example in the Niger Delta, the MADE programme has worked with PZ Cussons and Wilmar on palm oil production using smallholder farmers – the principal role of the donor project has not been to spend large sums of money. Instead the role has been to facilitate contacts and access, to provide specialist expertise and knowledge and to be a broker of relationships. A further example is the GEPI programme in Indonesia, which was established in 2011 by the US Department of State and 13 prominent Indonesian business leaders. GEPI works to identify start-ups with high potential, help develop networks and link entrepreneurs to mentors, and provides on-going support. From the development partner perspective however, it demonstrates the need to be innovative and respond to opportunities that arise: in this case to work with motivated local business leaders.

[113] Balt M & P Davis. *Dutch SMEs in Fragile Settings*. Springfactor 2014.

7.4.3 Cross-government working

It is also apparent that the development entities of donor governments are also finding new ways of working with other elements of their own government, often to very good developmental effect. In Indonesia the Dutch Foreign Ministry has concluded Memoranda of Understanding between Dutch and Indonesian institutions, for example between the customs authorities, to transfer expertise. Likewise the UK, through its Prosperity Fund, has stimulated information exchange between experts from Ministry of Justice who shared the UK experience in implementing the UK Anti-Bribery Act with the Indonesian anti-corruption commission.

Of course, in some cases, the closer links between development staff and others in their government has been obliged by the merger of development ministries into wider departments of trade and foreign affairs, as in the case with Holland, New Zealand, Australia and Canada. Despite the fact that such mergers have happened as a matter of domestic political expediency rather than for development reasons, there is some evidence from this study that the arrangements can work well. In Vietnam, for example, the Canadian Embassy is running a programme aimed at "increasing agricultural competitiveness…and the development of marketing techniques for farmers and traders."[114] One element of this programme focusses on pig rearing, in which the Embassy is working with a Canadian firm Semex to improve the quality of the pigs themselves. The Embassy reported that their closer links to trade and business specialists made the identification of Semex much more straightforward.

Sceptics of this approach argue that there is a point at which collaboration with companies from a development partner's home country amounts to tied-aid, contrary to the Paris Declaration. The debate in early 2015 in Vietnam about a new Decree on Public Private Partnership illustrates the differences of opinion on this point. The decree had been broadly welcomed by ADB, European development partners and others as a way of opening up opportunities for private involvement in financing of public projects. "Under the new system, prospective investors will enjoy a drastically less complicated route to market, with …[a dedicated] steering committee [at the Ministry of Planning and Investment] acting as a portal through which licences, permits and advice can be organised, and project details accessed."[115]

The new decree was welcomed with rather more scepticism by the Japanese and Korean development agencies, who criticised the openness anticipated by the new decree. Yamamoto Kenichi, senior PPP specialist at JICA Vietnam, argued that the crackdown on directly-negotiated projects could have a negative effect, adding that the World Bank and the ADB "insisted on introducing transparency and fairness too much"[116] by advocating competitive tendering as the procurement norm.

Nevertheless, it does seem clear that co-operation between development specialists and their colleagues in other parts of their own government can be very useful indeed, and can provide a raft of other opportunities and new modalities for addressing PSD challenges. Indeed, it was noted with regret by a number of those interviewed in Vietnam that DFID had withdrawn from the country. The observation was made that there were still significant ways in which UK engagement, through new modalities, could be extremely valuable. For example, the work that DFID has been doing recently on tackling corruption is seen as important and effective. There is disappointment that British expertise would not in future be brought to bear.

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[114] Foreign Affairs, Trade and Development Canada. *Vietnam. http://www.international.gc.ca/development-developpement/countries-pays/vietnam.aspx?lang=eng.*

[115] Global Water Intelligence. *Revamped Vietnam PPP decree divides donors.* Global Water Intelligence, Vol. 16, Issue 3. March 2015.

[116] Ibid.

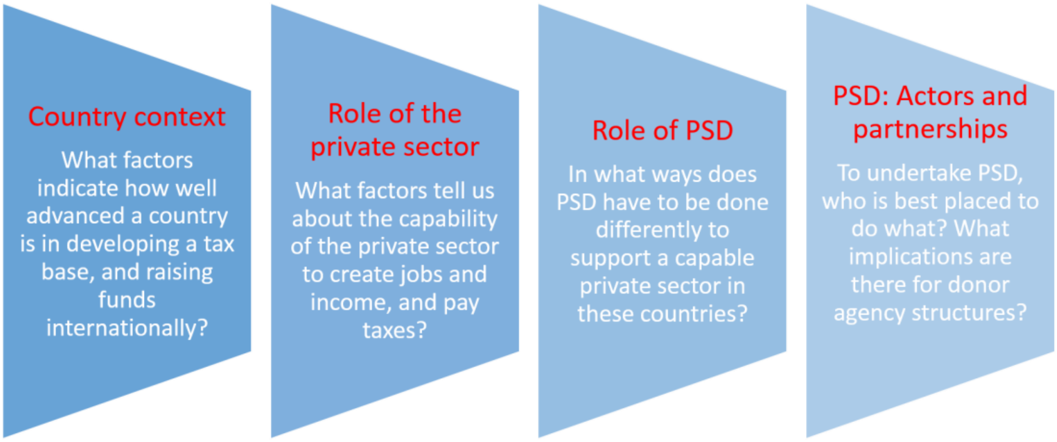
7.4.4 External partnerships and links

However, as well as being able to work more effectively with other elements within their own governments, development partners also need to establish who they want to work with externally. As this study has demonstrated, there is an expanding range of organisations now engaged in development, and for very different reasons and motivations. Often it will be these other partners who are better placed than a donor agency to achieve developmental impact: it is companies which can create jobs; non-DAC donors may be able to provide more tailored advice to recipient countries; and longer-term funding might more relevantly come from private capital sources. Understanding these additional players, and developing effective links with them will be critical to PSD practitioners in these middle-income countries.

8 Conclusions

This study was undertaken in order to provide greater insight into the role that private sector development programming ought to play in countries as they progress away from poverty. Given that all of the countries studied are of middle-income status, this research is therefore relevant to the growing examination of the ‘middle-income trap’. Countries will continue to develop and reduce their need for concessional aid as they are gradually able to develop a domestic tax base and borrow at sustainable rates on international capital markets. This paper explores where the private sector, and donor efforts to develop the private sector fit into this process. The sequence of this analysis can be represented as follows:

Fig 8.1 Steps of analysis



8.1 Frames of analysis

At each of these four stages, it is possible to identify key assessments which can guide PSD practitioners in developing programmes and interventions which will best serve the goal of enabling the host country to continue its progress from poverty, and to avoid or escape the middle income trap. In each case, there is a need to understand, not just the situation at present, but also the direction-of travel over time. The key questions are as follows:

8.1.1 Country context:

- **Economic structures:** What steps are being taken to enable the country’s economic base to broaden into more areas and add more value in the goods and services it produces?
- **Infrastructure:** What efforts are being made to build an appropriate infrastructure, including responding to the infrastructure challenges that themselves stem from the country’s development to date?
- **Demographics:** What actions are being taken to ensure that the opportunities and risks of a demographic bulge are being properly and proactively managed?
- **Governance:** What evidence is there that the institutions and processes of government are developing in such a way as to provide transparency and rule of law?

8.1.2 Private sector:

- **Political interference**: How far can the private sector operate free from adverse political interference from those in power and their associates?
- **Corporate governance:** What structures are emerging that provide for good corporate governance and transparency and fairness in the business enabling environment?
- **Private sector structure:** What is being done to improve the structure of the private sector both to permit greater collaboration between firms, and to ensure that companies are able to contribute to the country's tax base?
- **Corporate capabilities:** What challenges exist with the capacities, skills and capabilities of the private sector, and what steps are being taken to address these gaps?

8.1.3 Private sector development:

- **Focus on core issues:** What PSD interventions will do best to address the critical success factors, the failure to achieve which pose most risk to the country's continued progression from poverty?
- **Joined-up approaches:** How can PSD programming be best joined-up with other streams of activity not just within the development sphere, but in international cooperation more broadly?
- **Detail:** How can a clear understanding be developed of the detailed needs that a country has, and of how these needs might be addressed?
- **Timelines:** How realistic are the timelines being set to achieve what amounts to some fundamental changes?

8.1.4 PSD: actors and partnerships:

- **Development agency as facilitator:** How can development partners move away from seeing their primary role as being a funder of programmes, to being a facilitator of processes and partnerships?
- **The need for innovation:** How can development partners work in more innovative ways and respond to opportunities as they arise?
- **Cross-government working:** How can processes be developed that allow the development entity in government to work most effectively with other departments and ministries?
- **External partnerships:** As the development space gets more crowded, what relationships and partnerships should be established, with whom, and to do what?

8.2 Implications and challenges

To answer these questions effectively, and to create PSD programming that responds effectively to the particular challenges of middle-income countries has implications for the way donors operate, and in some ways challenges existing pre-conceptions and ways of working. There are implications at three levels:

8.2.1 Country strategy

New approaches need to be taken at the level of country strategy. Most obviously there is a need to take a much longer-term perspective on getting permanent improvement to happen. Typically donors think in terms of 5-year programmes, possibly with extensions for 2 or 3 years beyond that. However, the sorts of issues identified in this study – creating good corporate governance, the development of quality education systems and so on – are not going to be solved in such short time-frames. How can donors think, plan and respond to the need for horizons of 15-20 years, not 5-10?

There is also a need to see PSD programming as part of a wider strategy for a country. As this study has made clear, issues facing the private sector frequently derive from wider challenges in the country, and need to be addressed as such. PSD programming therefore needs to be planned alongside activities relating to governance, education, infrastructure and so on. There is also a need to consider what a donor can actually best provide. Is money really the issue, or would access to expertise, or political clout be a more appropriate and relevant contribution?

All of this has implications for current donor priorities. How do you measure and evaluate effectively in an environment where opportunities are being taken as they arise, rather than work being dictated by an *ex ante* plan? How do you assess value for money when money may not be the key need, and when the effect of actions may take a long time-frame to be realised?

8.2.2 Organisational

There are implications at an organisational level. Firstly, how do donor ministries work most effectively with other elements of their government. In the case of New Zealand, Australia, Canada and Holland the answer has been to merge the development function into wider ministries. This is one approach, but there can be others. In the case of DFID, for example, how can the *One Government* agenda be properly enacted so that the department is more straight-forwardly able to draw on the full range of expertise in HMG?

Secondly, how are relationships to be formed with the myriad other players in the development space. Donors have long tried – with varying degrees of success – to work with the corporate sector, and such efforts need to be re-doubled if these and other potential partners are properly to be engaged. These need to be operational, functional links, aimed at specific activities: how is that to be achieved?

Thirdly the challenge of how to attract and develop staff capable of understanding the private sector and working in this more dynamic, less-planned environment. The research process for this paper brought us into contact with many in donors who are working in more flexible ways: how is this to be encouraged and replicated?

8.2.3 Projects and programming

It is apparent that financing is only a small part of what donors can bring to this new environment. Access to expertise, political weight and connections are all at least, if not more important capabilities. This has implications for the traditional programme-based structure which donors typically use. The need to be 'entrepreneurial' also runs counter to the usual way in which donors – indeed all government entities – operate. There is a need to encourage staff to be more innovative and entrepreneurial, but still within a framework that is well-analysed and thought through.

Some donors are changing – in Vietnam less than 50% of the Australian DFAT budget is project-based, and this figure will fall further. Nevertheless, there is a need to move further; to use log-frames more flexibly and so position donors to be able to respond to opportunities as they arise, but to do so wisely, in an informed way, and in a manner that will allow sensible responses to be taken to new events and developments as they occur. A new 'Theory of Change' may represent an interesting new approach.

8.3 Areas for further enquiry

Whilst this study has been successful in providing insights into the role of PSD in transition economies, it has also served to raise a number of other issues which would be worthy of further research, be that by DFID or other development partners with an interest in these issues. The areas where further research would be interesting and valuable include:

- Most obviously, it would be of great interest to test the conclusions reached by this paper in other transition economies. It is a limitation of a case study methodology that there are limits to drawing generalisable conclusions. Therefore it would be valuable to examine whether the conclusions of this study apply elsewhere. Such a piece of research would serve to strengthen and further define those conclusions;
- It would also be relevant to examine in more detail specific issues identified by this paper. For example it is clear that much can be gained by better collaboration between development partners and the corporate sector. Research which examined these specific issues in more detail would be of great value;
- Equally, a further piece of research might explore how some of the approaches identified in this paper might be applied elsewhere. Where and how might donor/ corporate collaboration work? How, for example, might a package be developed that blends donor financing with provision of other support such as technical assistance?
- Specifically it would be of great interest to explore how the conclusions of this study might apply to conflict-affected countries. A number of fragile states are also middle-income, and developing a better understanding of how PSD programming might operate in such places would be valuable to know.
- Finally, it is clear that in transition economies PSD needs to be integrated into the wider, political development process. It would be of great interest therefore to conduct a review of a specific country at or approaching middle-income status and recommend how a PSD portfolio might best be integrated into the wider development strategy.

8.4 Concluding remarks

PSD in middle-income countries poses real challenges to donor agencies – indeed to all those working in the development field. These issues in these countries are complex, intractable and inevitably will take time to address. The temptation therefore is to sink back into 'PSD as normal' working with specific communities or regions. However, this is to miss the point. Developmentally the challenge in these countries is to address the fundamental political economy constraints to a country's stability, and to the sustainability of its economic development.

PSD in these environments therefore needs to be more nakedly-political, and better joined-up with the wider processes of reform. This is difficult and the challenges great. However, so too are the potential rewards. For what is at stake here is the opportunity, not to reduce poverty for select communities and then perhaps only for a time, but to create an environment in which poverty reduction and development can be achieved for a whole population, and achieved in a durable fashion.

Finally, and perhaps most importantly, this report questions the advisability of withdrawal from countries just because they get to middle-income status, as for example DFID has done in Vietnam. As was observed at the start of this report, the binary decision 'aid/ no aid', is an illusion. What this study has demonstrated is that the situation is more fluid – there is a changing set of tools and modalities relevant to different countries at different stages of their development. In less-developed countries, the focus of support may well be largely on concessional tools. But middle-income countries need support too – they need specialist advice, they need support in undertaking difficult political changes and so on. It may well be that such 'different support' (Dercon and Lea's term) may better be provided by other elements of a donor government than its development agency, and there may well be other financial or political reasons why donor governments might wish to focus on fewer partner countries. However the fact remains that there are many tasks in middle-income countries with which development partners can do much to assist. Donor governments therefore need to re-think their approach in middle income countries to work out how the package of support they give and the tools they use need to shift and change over time to ensure that those countries are able successfully to continue their progress from poverty.

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