ECONOMIC DEVELOPMENT AND THE PRIVATE SECTOR

Even though the World Bank and the International Development Association must operate on the basis of requests from member governments, the World Bank, with its affiliate, the International Finance Corporation, is one of the most important sources of foreign finance for private enterprise in the developing world. This should not be surprising, as the private sector (including agriculture) plays a crucial role in the process of economic development in most developing countries.

In practice, the private and public sectors are interdependent. The public sector can have a decisive impact on the scope and vitality of the private sector's contribution to development: for example, through policies on taxes, fiscal affairs, foreign trade, and prices; through regulation or the lack of it; through the provision of necessary infrastructure; and through the creation of an environment conducive to private investment and economic efficiency. For this reason, the Bank—within the overall framework of public and private ownership that each member government has established—has consistently sought to help countries obtain the advantages of private initiative and market discipline as well as the benefits of soundly conceived and efficiently executed programs beyond the scope of private enterprise.

In all its work, including that keyed to the private sector, the Bank looks at economic benefits to the country as a whole. And its experience shows that there is no necessary conflict between efforts to foster a vigorous private sector and efforts to alleviate poverty or better satisfy basic human needs. On the contrary, such efforts are usually complementary.

The best route to poverty alleviation is to increase the productivity of the poor—that is, to reduce their unemployment and underemployment or increase their efficiency. Bank loans which benefit farmers or businesses—as many do—usually increase both the employment and productivity of the poor and add to their purchasing power. Some of the Bank's infrastructural lending—for example, for rural roads and urban dwellings—has this effect too. Loans for health services, potable water, and primary education all make people more productive and thereby help private businesses. Properly conceived, development is essentially a "plus-sum" process in which most participants benefit, not a "zero-sum" process in which one participant's gain is another's loss.

The public/private sector relationship—which has always been important but never simple—should be complementary. With this issue of Finance & Development, we are beginning a series of articles on some key aspects of the relationship as observed in the Bank's work over the past 30 years.

Public policy and the private sector

A discussion of how public sector behavior affects the private sector's contribution to development.

Barend A. de Vries

In most countries the central issue of public policy is how best to use available resources—skills, capital, and natural endowments—to achieve economic development. Although the proportion varies, a large part of all resources in most developing countries is privately owned—by numerous relatively small farmers and businessmen who, acting independently, contribute a flexibility and capacity for entrepreneurship not typical of the public sector.

Without a viable private sector, governments cannot (in most circumstances) stimulate or sustain economic growth. Conversely, without a reasonably efficient
cies that significantly distort private sector decision making, both the private sector and the overall prospects for economic development suffer.

The World Bank helps developing countries strengthen the private sector's vital contribution to economic growth in three ways. The first is through its lending program. Most of the Bank's loans (and IDA credits) affect the private sector, either directly—as in its lending for agriculture and small- and medium-scale enterprises, and in the operation of the Bank's affiliate, the International Finance Corporation (IFC)—or indirectly—through loans to public sector agencies which provide essential infrastructure (see the table). Second, in its lending to public sector agencies the Bank often looks beyond the immediate project to the long range goal of enhancing their efficiency and effectiveness in order both to conserve and develop national resources and improve the provision of public services needed by the private sector. And, third, the Bank consistently encourages countries to adopt a policy framework conducive to private risk-taking, innovation, and economically rational decision making and resource allocation. It encourages, for instance, industrial policies that do not rely on protection or subsidies to promote growth. Experience has shown that the right policy framework can increase the efficiency and competitiveness of the private sector and of the economy as a whole.

Any discussion of public policy and the

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<th>World Bank and IDA lending, 1979–81</th>
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<td><strong>FY 1979</strong></td>
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<td>Directly productive</td>
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<td>Private sector orientation:</td>
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<td>Small- and medium-scale enterprises (via development finance companies)</td>
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<td>Agricultural and rural development: total</td>
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<td>Credit</td>
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<td>Other (for example, forestry, livestock, crops, and crop processing)</td>
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<td>Nonproject lending (for example, equipment and spare parts for industry)</td>
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<td>Subtotal</td>
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<td>Heavy industry</td>
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<td>Subtotal</td>
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<td>Other lending (for example, population, health, nutrition, tourism, and technical assistance)</td>
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efficient use of capital. This article will briefly survey these and related broad issues of public policy as they affect the private sector's role in the economic development of member countries.

**Public Investment and management**

In most developing countries the public sector provides a wide range of services—from electricity, transport, telecommunications, and water to education, vocational training, health, and other social services. In many countries it has entered the production of basic commodities such as steel, chemicals, oil, and fertilizer; in most, it also controls industrial credit and agricultural credit institutions. Both the extent of public sector involvement in the economy and the efficiency with which it operates can influence the vitality of the private sector and the structure of the economy as a whole.

Most obviously, if public investment is inefficient—its costs excessive and its output low—the economic returns from the country's total available investment capital will be reduced and overall growth impaired. If state enterprises have to be subsidized, for instance, because they cost more than they earn, the private sector may be asked to bear the brunt of additional taxes, thus reducing its resources for investment. If public services such as power, transportation, or telecommunications are inadequate or unreliable, the private sector will be less efficient.

Although managers of public sector enterprises frequently have a privileged position in competing for scarce capital and materials, they are often at the mercy of political pressures and relatively cumbersome government budgeting and management practices; they are not directly subject to market forces. Usually, it is more difficult—and the incentives are less strong—for public enterprises to perform efficiently.

Nevertheless, many governments have undertaken major investments—in energy, for example, and in such heavy manufacturing as steel and basic chemicals—because the domestic private sector was unable to provide the necessary finance and organization and there was a reluctance to give foreign investors control over essential activities. Over the past two decades, however, the private sector in many countries has become more capable of handling large projects and attracting foreign investment.

The greater the involvement of the public sector in the economic life of a country, the more important it is for the public sector to be efficiently planned and managed. The Bank helps borrowers to achieve this objective in several ways. (1) Normally, in working with publicly owned enterprises, the Bank seeks to increase the extent to which they are subject to financial discipline and to the need to recover costs. This affects pricing and investment decisions. By setting prices to recover costs, public sector projects can be paid for by their beneficiaries rather than by taxpayers in general and can also generate the funds needed for maintenance and new investment. (2) In many cases (commonly in the public utility and transport sectors), the Bank encourages the creation of independent—albeit publicly owned—organizations that are managed in most respects as though they were private. (3) In many instances (ranging, for example, from agricultural extension agencies to development finance companies), the Bank may suggest changes in internal organization and procedures to increase effectiveness. (4) The Bank sometimes encourages public agencies to improve their own efficiency and stimulate private sector growth by contracting for services which they might otherwise directly perform—such as maintenance of rural roads and irrigation systems, vehicle repair, and the operation of bus systems.

Given the scale and diversity of public sector activities, and of state enterprises in particular, it is important for governments to take stock of their participation in such enterprises—to review periodically their objectives, the constraints to which they are subject, and the efficiency with which they finance, produce, and consume economic resources. An important aspect of such stocktaking should be a periodic review of cost and pricing structures of parastatal or semipublic organizations and of any subsidies provided.

**The role of prices**

Prices are fundamental to economic performance. They influence private decisions about what to buy, how much to save, what to produce, and how much to invest. Everything has a price—private goods, public services, capital, and foreign exchange. Price relationships determine which sectors or industries will grow most rapidly, and whether or not enterprises can operate at a profit. The price, for example, of foreign exchange influences the prices of a country's exports and imports and, as a result, the respective roles of industry and agriculture in foreign trade. And the pattern of exports, often the most dynamic element in a country's growth, is likely to influence the type of economic growth that occurs.

The pricing of public services can have a major impact on other prices, as can taxation, subsidies, government regulations, and direct intervention. In addition, monetary and fiscal policies can affect prices, including the price of money (that is, interest rates); these rates may then affect the availability of local savings and financial resources from abroad.

Relative prices guide private decisions about the allocation of resources in most economies. When prices reflect underlying economic costs, they encourage private consumers and producers to use the economy's resources efficiently. This, in turn, permits a country to make the best use of its comparative advantage and fosters a healthy private sector.

Where, as often occurs, nominal costs of production are understated relative to economic costs—because, for example, of subsidized interest rates and infrastructure, tax privileges, or overvalued foreign exchange rates—the prices of some domestic goods will be understated relative to their cost to the economy and to competing imports. The result will be that decisions based on nominal prices in the domestic market will be economically inefficient and growth will suffer.

The private sector is guided by nominal prices, whether or not distorted. In the public sector, analysts can and should distinguish between nominal prices and realistic economic values and costs, particularly when deciding on large public sector investments.

In assessing costs and benefits in all its project work, the Bank is careful to assess "real" costs and benefits to the economy and, to the extent possible, to look behind nominal prices. Where price distortions exist, "economic" rates of return can differ markedly from "financial" rates of return based on the nominal prices.

The prices set for the outputs of many public sector enterprises—such as power, fertilizer, credit, or rail transport—can have wide-ranging implications for the private sector, as these prices will affect the costs, prices, and competitiveness of privately provided goods and services to which they are an input. To promote economic efficiency, the price charged for a public service should normally reflect its economic cost—that is, the economic costs of the materials, capital, and labor required to provide and maintain it. Determining economic costs and prices can be far from simple for public services where market signals are often only a rough guide, even if not distorted by government action. If the prices of public services are set too high, the use of the services may be too low for the investment to be economic; if they are set too low, inefficient use, shortages, or congestion is likely and it will not be possible to generate sufficient funds to maintain the facilities and invest further.
Within a country, prices should be reasonably stable, as well as being a realistic reflection of economic costs. Ideally, price changes should reflect shifts in demand and supply and other basic forces such as technological change or developments in the outside world. When prices fluctuate erratically, they lose their effectiveness as a reference for the private sector. Sharp price fluctuations complicate decision making, increase the risk and incidence of wrong decisions on resource allocation, and may thereby reduce the willingness of entrepreneurs to make productive investments. Governments should therefore seek to avoid frequent changes in policies which have a significant impact on prices.

Trade and Industrial policy

Trade policies have occupied a central position in most countries' efforts to improve the structure of their economies. Until the mid-1960s, most developing countries tended to be relatively "inward looking," seeking to conserve foreign exchange by protecting domestic industries against import competition. A second approach—more widely adopted since then, especially among the rapidly industrializing countries in East Asia and some primarily agricultural economies, including the Ivory Coast, Thailand, Tunisia—has concentrated more on earning foreign exchange by adopting policies designed to make domestic enterprises competitive internationally. Such an approach has entailed a relatively free trade regime—under which exporters are permitted adequate foreign exchange for necessary inputs—often supported by a system of across-the-board export incentives.

Protective or "inward looking" policies are, in effect, a tax on consumers of imports and an equivalent subsidy to domestic producers of substitutes. Thus an import tariff of 80 per cent on textiles and clothing—not unusual in developing countries—substantially increases the price consumers must pay for clothing while it shields inefficiency in local textile mills and inflates the profits of their owners. Tariff systems often (in the guise of open-ended protection for "infant" industries) tend to develop or perpetuate, at the expense of the rest of the economy, industries whose international comparative advantage is low and which cannot compete without special aid. Protection may also work against the basic purpose of remedying the shortage of foreign exchange—for the domestic exporters who earn foreign exchange are forced by tariffs to pay more for their imported inputs, to raise their prices, and thereby become less competitive in foreign markets.

Moreover, most protective regimes—because tariffs are "uneven" and apply relatively lightly to machinery—favor the capital-intensive industries that use machinery and tend to bring about higher prices for the protected consumer goods produced by those industries. The resulting procyclical and proindustrial bias is undesirable in labor-surplus economies and those in need of increased agricultural production and alleviation of rural poverty. Reduced protection and a more even structure of tax incentive and protection policies will lessen the bias against labor-intensive small-scale industry and be more compatible with the growth of local entrepreneurship, job creation in the private sector, an efficient use of capital, and geographic dispersion. Electrical and mechanical engineering industries, could be likely beneficiaries (as, for example, in India, Korea, the Philippines, and Tunisia).

Experience over the past 20 years, and especially since the 1973 oil price increases, has shown that more outward-looking, relatively unprotected economies are likely to become more efficient and cope better with adversity than protected ones; efficient economies are, in turn, likely to do well at exporting. In short, because trade fosters increased efficiency through specialization, development is usually better served by efforts to increase trade and earn more foreign exchange than by efforts to reduce it and use less.

Fundamental changes, however, in cost and price relationships—due, for example, to rapid oil price increases, changes in trade or subsidization policies, and changes in the competitive environment—can create major and painful adjustment problems, including a need for rehabilitation and modernization. To help countries deal with these problems and to improve economic efficiency, the World Bank makes "structural adjustment" loans. For example, the Bank is now helping the Government of the Philippines improve its incentive policies and restructure certain industries that had become reliant on protection and subsidy. It is helping several other countries to restructure and free their agricultural and industrial pricing systems, even out trade and investment incentives, and accommodate the heightened competition between the needs for current expenditures and new investment for development.

Financial policy

Efficient means of mobilizing and allocating capital are important to the development process. In addition to sound financial policies, adequate financial institutions are needed such as cooperatives, credit unions, commercial and investment banks, special purpose intermediaries—such as agricultural credit institutions and development finance companies—insurance and rediscounting facilities, and capital markets.

The role of the financial system in development tends to become more important as per capita income rises and the private sector becomes more complex. Savings must be mobilized through financial instruments with attractive real returns. To improve the allocation of capital, financial institutions must have the incentive and capability to search out efficient entrepreneurs and productive investments.

In many developing countries, the financial systems needed to perform these essential functions have been slow to develop, and a government role has been necessary. Governments have often encouraged or actually created agricultural or industrial credit banks. In some cases, governments have intervened to reduce the dominance of a few banking groups with strong ties to the country's major industries. In broad terms, the growth of a productive financial sector is impeded by high and persistent inflation and requires a well-conceived, albeit limited, structure of government regulation to create the necessary public confidence. Direct government intervention in the allocation of credit by banks may, however, distort credit flows, impair the channeling of finance to the most rewarding investments, and in the long term discourage the growth of financial savings.

Development finance companies and agricultural credit institutions have received extensive technical assistance as well as loans and credits from the World Bank. Further, the Bank's Economic Development Institute has for years helped to

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train managers and experts from developing countries in techniques of economic evaluation, project selection, and appraisal, all with the purpose of improving their capabilities for allocating capital efficiently.

Frequently, however, the major factor in financial sector efficiency is the structure of interest rates—and these are often kept artificially low by governments; in such cases, capital is subsidized, with the intent of stimulating investment and industrialization. Subsidized interest rates, however, tend to encourage an excessive and inefficient use of scarce savings. They may also create a need for nonmarket systems to ration capital and thereby lead to an increased centralization of decision making.

The Bank, both in its project operations and its economic and sector advice, emphasizes to borrowers the importance of having interest rates that are positive in real terms and reflect the real cost of capital in the economy. The favorable impact of positive real interest rates—in particular, on the development of the key financial sector and the encouragement of private savings—is another example of the wholesome effect of the Bank's role in development.

In sum, economically "rational" pricing, sound industrial and agricultural policies, good public management, and a viable financial system are all important if independent businessmen and farmers are to play an effective role in development and if the public sector is itself to be more of a benefit than a burden to the economy. Political and social objectives do, of course, have a legitimate place along with economic efficiency. Who receives what proportion of the economic "pie" can be as important as how rapidly the pie grows. There is no way to escape the interaction, at the margins, of economics and politics, public affairs and private enterprise. It is clear, however, that the alleviation of poverty and the satisfaction of human needs can be achieved more easily in a rapidly growing economy than in an inefficient and relatively stagnant one.

On the relationship between the public and private sectors, it is not possible to be dogmatic about what policies or what blends should be adopted by the 100 or so developing countries that are members of the World Bank. One can safely assert, however, that no developing country can afford not to review the available options carefully. Public policy often has a decisive impact on the private sector, and the private sector usually has a decisive impact on the rate of economic growth.

**Related reading**


John Cody, Helen Hughes, and David Wall, editors, Policies for Industrial Progress in Developing Countries (Oxford, Oxford University Press, 1980).


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