ECOSOC High-level Segment – 2004

Issues Paper for ECOSOC Investment Forum Roundtable D:
"Unleashing Entrepreneurship: the role of partnerships in mobilizing resources for LDCs"
Hosted by UNFIP and UNDP
28 June 2004
3:35 p.m. – 5:30 p.m.
Conference 7

Background

The recent G8 Summit at Sea Island, Georgia endorsement of the Report of the Commission on the Private Sector and Development in a *G8 Action Plan: Applying the Power of Entrepreneurship to the Eradication of Poverty* acknowledges the centrality of the indigenous private sector in promoting growth in developing countries. The Commission, co-chaired by Prime Minister Paul Martin of Canada and Ernesto Zedillo, Mexico's former president, was convened by the Secretary-General and sponsored by UNDP in an effort to identify and address the legal, financial and structural obstacles blocking the expansion of the indigenous private sector in developing nations—especially in LDCs. The Commission's final report to UN Secretary-General Kofi Annan, <u>Unleashing Entrepreneurship: Making Business Work for the Poor</u>, was presented on March 1, 2004.

Harnessing private investment toward the achievement of the Millennium Development Goals is critical, as has been recognized by the Secretary-General's Global Compact, which has forged new partnerships with major multinational corporations to encourage better corporate social responsibility. The United Nations Fund for International Partnerships (UNFIP) is another example of how the UN is building partnerships with corporations and foundations to further the Millennium Development Goals. To date, UNFIP's partnership with the UN Foundation has yielded $577 million for over 290 projects with activities in 121 countries involving 35 UN organizations. Projects are funded worldwide in four programme areas: children's health; population and women; environment; and peace, security and human rights.

International development institutions have worked toward increasing direct investment flows into developing countries and improving their foreign trade opportunities. But relatively little emphasis has been placed to date in international development policy on expert assistance and regulatory reforms aimed at the smaller-scale indigenous enterprises that in most countries are the primary engine of job creation and domestic commerce.

The private sector can alleviate poverty by contributing to economic growth, job creation and poor people's incomes. It can also empower poor people by providing a broad range of products and services at lower prices. Small and medium enterprises can be engines of job creation—seedbeds for innovation and entrepreneurship. But in many poor countries, small and medium enterprises are marginal in the domestic ecosystem. Many operate outside the formal legal system, contributing to widespread informality and low productivity. They lack access to financing and long-term capital, the base that companies are built on.

The Report focuses on the domestic private sector in developing nations for the following three reasons:

First, domestic resources are much larger than actual or potential external resources. Domestic private investment averaged 10–12% of GDP in the 1990s, compared with 7% for domestic public investment and 2–5% for foreign direct investment (FDI).

Second, when informal resources are examined, such as potential land value, the domestic assets that can be tapped for investment are significantly larger than cumulative FDI or private portfolio flows.

Third, unleashing the domestic resources in an economy--both financial and entrepreneurial--is likely to create a more stable and sustainable pattern of growth. At the same time, external resources in the form of capital and know-how have a vital role to play in allowing domestic capabilities to be better utilized.

Constraints on the Private Sector in Developing Countries

Developing countries have remarkable energy and assets and all segments of the private sector have demonstrated the ability to respond when empowered. But, there are three structural challenges that seem to confront the private sector in all developing countries, to varying degrees.

- Micro enterprises and many small and medium-sized enterprises operate informally;
- There are few competitive SMEs and most of them face significant barriers to growth; and,
- A lack of competitive market pressure shields larger firms from market forces and the need to innovate and become more productive.

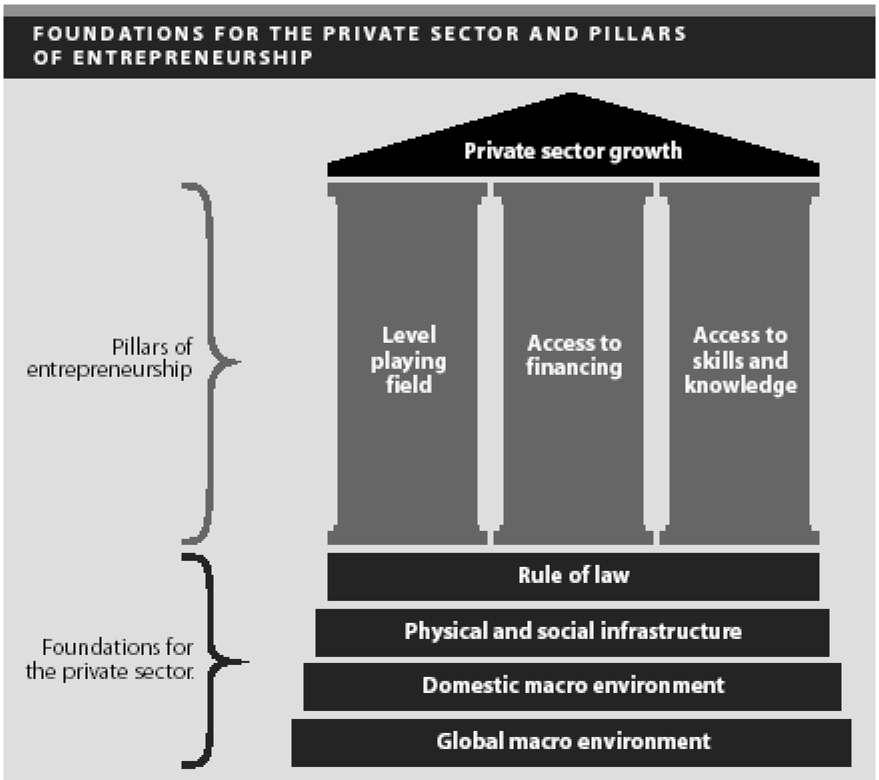
Four billion people at the bottom of the pyramid

The world's poor are also consumers—many of whom live in high-cost economies. Fully four billion people in the world—those who earn less than US$1,500 a year—make up these 'bottom of the pyramid' markets. The quality of goods that those at the bottom of the pyramid purchase is substandard —whether food, water or financial services. Often, an informal private sector fills the gaps with goods of higher prices and varying quality. It serves an important need, for informal economies sustain the majority of poor families in many countries. Yet the advantages of economies of scale and scope are missing from the lives of people at the base of the pyramid.

How can the private sector alleviate poverty? It can do so by contributing to economic growth and empowering poor people by providing them with a wider choice of goods and services at less cost. The first, they argue, creates employment and income growth. The second improves quality of life. And greater interaction between those at the base of the pyramid and the private sector creates opportunities for direct involvement in the market economy.

The private sector is already meeting the needs of poor people in places governments do not reach. In some countries, for example, the government has little impact on the poor. In the slums there are no health services, no public education and no infrastructure. This story repeats itself across the developing world. In many cases, where services exist, they are provided by private sources. Anywhere from 15% to 90% of primary education is provided in private schools. Some 63% of health care expenditures in the poorest countries are private, almost twice the 33% in high income countries that belong to the Organisation for Economic Co-operation and Development.

Bringing the informal business sector into the legal and economic mainstream is a principal focus of the Report. In most developing countries it is costly to be formal. Formal players are often overtaxed (a vicious circle, since they are overtaxed because a few formal companies carry most of the tax weight). Registering a business can be a long and expensive proposition (in Angola it takes 146 days and more than eight times the per capita income). Regulations and government requirements are complex—and compliance costs high. The opportunities for bribery increase with the complexity of regulations, exposing smaller players who lack the legal resources to defend themselves. The Report identifies three additional factors as indispensable for entrepreneurship and the private sector to flourish in an economy: access to finance, knowledge and skills, and, perhaps most importantly, a level playing field for firms competing in the domestic market. This would allow entrepreneurship and the private sector to blossom keeping in mind that a level playing field can only be created by a system of rules and enforcement mechanisms that is fair, trustworthy and effective.



The Report identifies three additional factors as indispensable for entrepreneurship and the private sector to flourish in an economy: access to finance, knowledge and skills, and, perhaps most importantly, a level playing field for firms competing in the domestic market. This would allow entrepreneurship and the private sector to blossom, argue the Report's authors, warning at the same time, that a level playing fie ld can only be created by a system of rules and enforcement mechanisms that is fair, trustworthy and effective.

An important element for a level playing field is simplifying regulations affecting the entry, operation and exit of private enterprises. There are example of excessive procedural requirements for business registration and licensing procedures that raise the cost of entry into the formal sector and tilt the playing field in many developing countries. For example, the World Bank's Cost of Doing Business survey estimates that starting a business requires US$5,531 in Angola (more than eight times the per capita income) and about $28 in New Zealand (far less than 1% of the per capita income). Cumbersome entry regulations are directly correlated with lower producivity.When countries are ranked by ease of starting a business, the top quartile of countries has labour productivity of about $40 per worker, almost twice that of the bottom quartile. Longer registration processes are directly associated with higher levels of corruption.

Governments can act as facilitators of private sector development and avoid actions that impede it. Governments and intergovernmental agencies can facilitate private sector development by fostering properly functioning competitive markets.

Primary responsibility for achieving growth and equitable development lies with developing countries. This responsibility includes creating conditions that make it possible to secure needed financial resources for investment. The challenge is to capitalize on advances in macroeconomic stability and democracy and launch further institutional reforms that would unleash and foster private sector growth.

Developing country governments must make a strong, unambiguous policy commitment to sustainable private sector development—and combine that with regulatory reforms eliminating artificial constraints to economic growth.

Governments must create real partnerships with the domestic private sector to implement needed changes-- and ensure that these partnerships include small and mid-sized businesses, and micro-enterprises as well.

There should be clear official recognition of the "informal" business sector, accompanied by rapid steps to analyze its local characteristics and put into place measures to improve access to finance and support from mainstream business.

Governments should work with the private sector to draw up action plans with clear deadlines and commitments to address the barriers to private sector growth.

The private sector, for its part, needs to make a sincere commitment to sustainable development with a sharp focus on corporate governance and transparency. Successful companies have shifted the development debate within their economies and created a political consensus that eases the way for governments to make the critical policy decisions that facilitate the expansion of a vibrant private sector. Such a shift will occur when pioneering management realize the value of leading from the front, being responsive to social development needs, and setting new standards that demonstrate the value of sustainability.

Bilateral and multilateral agreements designed to provide trade preferences to exports from developing countries have been part of the international trading system for a number of years, starting with the Generalized System of Preferences (GSP) which granted duty-free entry for imports from developing countries. However, over the years, the implementation of the GSP grew to be more and more restrictive, eroding the scheme gradually.

In recent years however, because of the growing concern over the dire economic prospects for accelerated growth, industrialized countries, bilaterally or as groupings, have adopted trade preference regimes that grant more favorable treatment to products originating particularly from the LDCs, in some cases quota-free and duty-free.

Preferential market access regimes for LDCs exports include the US "African Growth and Opportunity Act" (AGOA)[1], the EU's "Everything But Arms" (EBA) and similar schemes adopted by Japan, Canada, Australia and other industrial countries. Some LDCs have been able to boost their exports to the United States and the European markets since the introduction of these market access measures.

[1] Even though AGOA coverage goes beyond LDCs, many of the AGOA eligible African countries are LDCs.

Implementation of the AGOA regime shows that while there were almost no US imports in 2000 when the AGOA law came into being, at the end of 2003, AGOA exports of textiles and apparel to the US market had jumped to $1.2 billion, up from $800 million in 2002. In the case of Madagascar for example AGOA exports increased from almost $80 million in 2002 to close to $190 million at the end of 2003, or an almost 140 percent increase. Malawi AGOA exports continued to grow in 2003 and reached $58 million, with the number of jobs directly linked to AGOA regime reaching 7,500 workers in 2003. AGOA exports of textiles from Uganda have increased from $0 in 2002 to $812,000 in the first 8 months of 2003. While data of export performance of LDCs as correlated to market access privileges are not yet widely available for all the regimes, the implementation of the AGOA regime shows that a number of LDCs have already started to benefit from this regime. Unfortunately, there is scant data available on other similar schemes and monitoring the performance of such regimes remains a challenge.

The expansion of LDC exports to the United States and the European Union and other industrial countries greatly benefited from domestic and foreign investments attracted by the prospect of market access preferences. Countries such as Lesotho, Madagascar, Uganda, Mozambique and Malawi have seen their rates of investment significantly increased including from other developing countries such as Mauritius and Asian countries.

Issues

1) How can trade preferences accorded to LDCs (i) increase the level of domestic investment and (ii) attract foreign direct investment in order to take advantage of these market access privileges?

2) To what extent can (i) ODA, (ii) trade preferences and (iii) FDI be part and parcel of the policy dialogue between LDCs and development partners, including the active participation of the LDC private sector?

3) What measures would improve the rate of utilizing trade preferences? In addition to market access measures, how can donors use ODA to further stimulate FDI flows to LDCs, as well as domestic investments in local SMEs, through, for example, investments guarantee and risk mitigation mechanisms and funds. ODA-financed pre-investment feasibility studies and ODA-financed economic infrastructure that pave the way for investment?

4) To what extent do trade preferences accorded to LDCs by industrialized countries provide incentives for expanded flows of investments to LDCs from other developing countries, including in triangular relationship?
