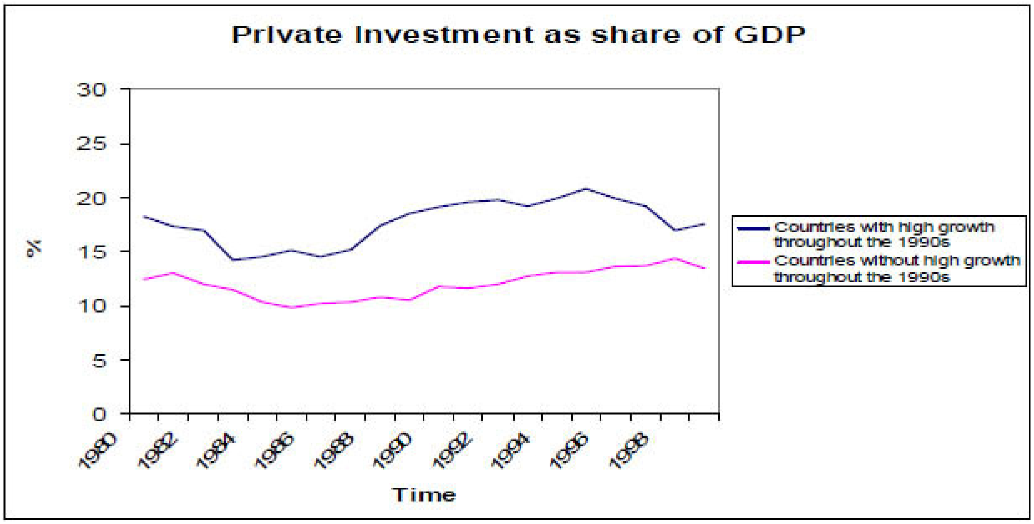
DEVELOPMENT EFFECTIVENESS UNIT

Private Investment and Public Investment

Sustainable and significant economic growth is a recent phenomenon, and no country has achieved it without considerable private investment. 18 countries that sustained a high growth rate throughout the 1990s[1], for example, have had consistently higher private investment than those countries that did not experience sustained growth[2].



The public sector plays a crucial role in creating business environments that facilitate productive investments. However, governments are typically not a significant source of investment capital. The size and therefore the potential impacts of private capital are beyond that of public funding. Private equity and debt flows to developing countries surged to $415 billion and $228 billion respectively in 2006, while public debt flows have turned negative since 2003, reaching minus $76 billion in 2006 as many middle income countries repaid existing debts.

While availability of capital matters, simple increases in investment do not automatically produce growth. Exceptionally high investment levels in centrally planned economies did not result in sustained growth. Increased resource allocation to education by itself does not necessarily lead to growth. What matters is not just the amount of resources, nor the destinations of resources, but how well the resources are used. In other words, the quality of investment matters.

This is where private investment differs from public investment. Why? When markets function reasonably well, private firms face competition. Competition forces firms to develop, adapt, and adopt better ways of doing things, including not just technological innovations that result in new patents, but also better production processes, delivery mechanisms, and consumer relations.

[1] "Sustainable growth" as defined in *Economic Growth in the 1990s: Learning from a Decade of Reform* (World Bank, 2005.) Two criteria used are: (i) economies were catching up with advanced economies over the 1990s (i.e. per capita income growth of at least 1.7 percent a year), and (ii) economies did not experience output collapses in the 1980s (i.e. per capita income growth of at least 1 percent a year during the 1980s.)

[2] Measured by private gross fixed capital formation as share of GDP.

Box 1: Privatization of Kenya Airways

In the early 1990's Kenya Airways was a struggling state- owned airline with massive accumulated losses and crippling debt arrears. The airline's prospects of achieving commercial success were severely constrained by political interference in key areas of operation, such as route and fare structures, fleet acquisition decisions, hiring and promotion practices.

With support from IFC, Kenya Airways was privatized in 1996. The firm undertook major restructuring of operations and management. Routes were redrawn, fares and the fleet were rationalized. Management was overhauled, with substantial downsizing. The entire staff was put through training to create a corporate culture oriented towards customer service and commercial viability, as opposed to the former pre-occupation with self-administration.

Since going public, Kenya Airways has flourished. It is now a well-managed airline and operates with a strong international partners. It has announced record profits in the last two years. It has added large numbers of aircraft to its fleet, and customers have benefited from the introduction of a variety of new routes and better service. For these

Public enterprises may also face competition. However, they are often burdened with rigid rules regarding employment and procurement, as well as conflicting incentive structures, making it harder for them to respond to market signals in timely and competitive manners. Free to adjust course quickly, private firms tend to reap the benefits of competition better than public enterprises (Box 1). Among them, the more productive ones become larger, thrive longer, pay higher wages and often develop several subcontracting chains.

Not all private firms respond to competition well. As a result, unproductive firms fail and exit the market. While this may result in loss in employment, the exit of unproductive entities allows the limited resources in society to be allocated to more productive firms, thus raising overall productivity of the economy. Generally, 5-20% of companies enters and exits the market each year, creating a dynamic environment.

Lastly, the success standards used for private investment are different from those used for public investment. Success of public investment is typically measured using an objectives-based approach. As such, goals are defined for each project, and later public institutions gauge how closely these objectives were met. There is often little scope for external benchmarking. It is not unusual for public institutions to achieve success rates as high as 80%. On the other hand, success of private investment is measured on market-based benchmarks. Private institutions' investments must outperform competition, leading on average to a success rate of around 50%.

Box 2: Privatization in Jordan

The World Bank Group has been assisting Jordanian privatization since 1995 in collaboration with other development partners. Prior to 1995, Jordanian state-owned enterprises (SOE's) were concentrated mainly in the infrastructure sectors (transport, electricity, water and telecommunications).

The Government's privatization program was aimed at raising enterprise efficiency. The sale of shares to reputable strategic investors was expected to improve the operational performance of those companies that suffered from administrative interventions, limited autonomy, inadequate investment capital, and poorly designed incentive structures.

As a result of the completed privatizations, there are significant consumer benefits of the now better performing businesses. For example, the Public Transportation Corporation (PTC) transaction yielded immediate results. With private investment, buses became more frequent and rider-ship increased dramatically, while the fares were stagnant. On a more qualitative level, the buses are newer, cleaner and cause less pollution.

Another area of dramatic improvement following the introduction of private enterprises has been the provision of water services in the Greater Amman area. City water is a scarce commodity in Jordan, and as a result of leakage and illegal connections up to 55% of water usage was unaccounted. Broken meters and "private arrangements" resulted in inequitable access and cost sharing, with many households forced to buy water from truck suppliers at much higher prices. In the first 6 months alone of the Greater Amman Water Management Contract, outstanding leaks were halved; service improved to 68% of leaks being repaired within 24 hours and a central complaints and control centre for all of Amman was established and was functional. These are just the headline figures for a service that has been greatly improved as a result of the Jordanian government's approach to invigorating public service through the use of private expertise and capital.

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