

**Bring Me Sunshine:
Which parts of the business climate
should public policy try to fix?**

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Outline of presentation

- What is the business climate?
- 3 sources of information about the business climate & its effects
 - Cross-country econometric studies
 - Surveys of business managers
 - Case studies
- Some simple messages
- What should policymakers make of all this?

What is the business climate?

- The firms in any economy transform inputs into outputs
- Usually they *add value*: the outputs are worth more than the inputs
- How much value they add depends on
 - Technology
 - The state of competition in their input and output markets
- But two firms with the same technology & facing the same competitive conditions can still differ in productivity because of
 - **Internal factors** ... the talent of managers, motivation of workers, 'corporate culture'
 - The **external environment** ... the institutional and other factors that affect productivity but are not under the firm's control
- **This external environment is what we call the 'business climate'**

The business climate in practice

- Usually measured along a number of agreed dimensions
 - Physical infrastructure
 - Legal system
 - Financial system
 - Taxation
 - Regulation
 - Macroeconomic stability
 - Crime & corruption, 'social capital'
- We can ask how much the business climate matters to firms
 - If the Russian legal system were as reliable as that of (say) the Netherlands, how much higher would be the productivity of Russian firms?
- But not all aspects of the business climate can be influenced by policy
 - Some are difficult to change (corruption?)
 - Some cost more than others (banking system versus legal system?)

How can we get information about the business climate & its effects?

- The policy-maker's perspective: need information about
 - The **relative benefits** of improving different dimensions of the business climate – how much will an improvement along each dimension raise the productivity of that country's firms?
 - The **relative cost** of making these improvements

How can we get information about the business climate & its effects?

- The policy-maker's perspective: need information about
 - The **relative benefits** of improving different dimensions of the business climate – how much will an improvement along each dimension raise the productivity of that country's firms?
 - The **relative cost** of making these improvements
- The research literature is huge and is not directed toward the policy maker's question
- The literature is (mostly) not self-contradictory or confused – but needs to be interpreted carefully

We suggest approaching the policy-maker's question by using the analogy with a doctor trying to decide how to treat a particular patient

- Her patient has an illness with real causes but she can't perform unlimited experiments on him to find out what they are
- She has to bring together many sources of information

3 sources of information for the **doctor or** policy-maker

1. Scientific studies of the average or typical behaviour of a sample of
 - **Patients (either the whole population or a subset of 'similar' ones)**
 - Countries (either all countries in the world or a regional or other subset)
2. The reported impressions of the problem coming from
 - **The patient**
 - Managers of firms in the country
3. The case history
 - **The peculiarities of the patient and their responses to various treatments in the past**
 - The country's recent history, individual characteristics and responses to shocks and to past policy initiatives

Source #1

Scientific studies of typical behaviour

- Strong points
 - Large sample size & relative data uniformity enable statistical hypothesis testing; avoids biases of ‘hunch’ assessments
 - Can go beyond simple correlations to test for **direction** of causality
 - Does breast-feeding lead to higher IQ in children?
 - Do better institutions lead to higher growth? (e.g. Acemoglu et al 2001)
- Weak points
 - Sample size (of countries) usually not large enough to compare different dimensions of business climate – just test some dimension against a null hypothesis that *none* of them matters
 - Assumes a common average behaviour of subjects, although they may be quite heterogeneous

The average citizen of today's world ...

- ... is 28 years old
- has 2.65 children
- must work to support one quarter of an elderly dependent
- owns nearly half a mobile phone
- and is a hermaphrodite ...

- The message: averages are interesting, but the behaviour of the average person is not always a helpful guide to the behaviour of a specific person
- Both the doctor and the policy-maker need more specific information

Source #2

Reported impressions of managers

- Strong points
 - Gives us a direct answer to the question how much each dimension of the business climate matters for productivity
 - Tells us the *relative* importance of different dimensions
 - Can be country-specific and still have large sample size, which reduces measurement error
- Weak points
 - Can't tell us the relative costs of fixing different dimensions
 - Depends on managers' opinions, which might be biased (and ignores views of potential managers ... new entrants)
 - Ignores country-wide productivity effects that managers don't perceive (network externalities or general equilibrium effects)

The questions put to managers:

“Can you tell me how problematic are these different factors for the operation and growth of your business?”

No obstacle	Minor obstacle	Moderate obstacle	Major obstacle	Don't know
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- Telecoms, electricity, transport
- Tax rates, tax admin
- Customs, business regulations
- Labour regulations
- Skills shortages
- Macro instability, policy uncertainty
- Legal system
- Corruption
- Crime
- Access to finance
- Cost of finance

How to interpret the answers?

- Many dimensions of the business climate can be thought of like a public good
 - All firms in the region or country face the **same supply**
 - This constrained supply may be far from the optimum
- The manager is reporting a valuation of the public good: *how much would an improvement in its supply improve the operation of the firm?*
- This allows us to make 2 predictions:
 - Between countries, less rich countries should have a lower supply of public goods, so should value them more
 - Within a country, more productive firms should value the public good more (like fitter joggers should value the public park more)

How to interpret the answers ... carefully



- Other dimensions of the business climate are not like public goods – they vary across firms
- Finance is the most important
- It functions by *not* giving access to all firms but by discriminating between productive and unproductive projects

This allows us to make 2 more predictions

- Within countries, more productive firms have lower valuations (are less financially constrained)
- The more so, the more developed is the financial system

What do the business climate data show?

Across countries

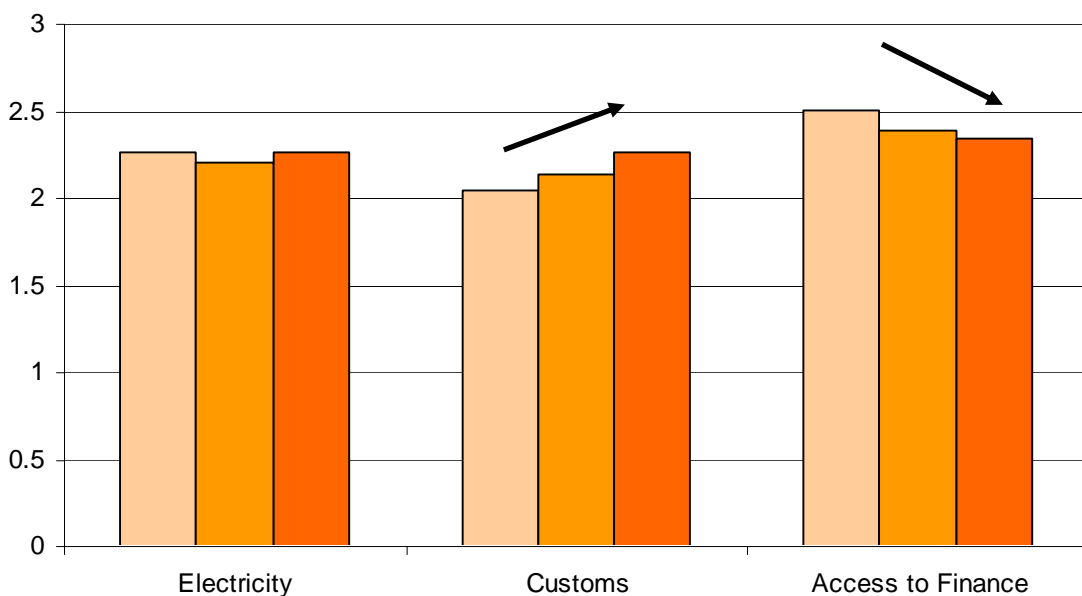
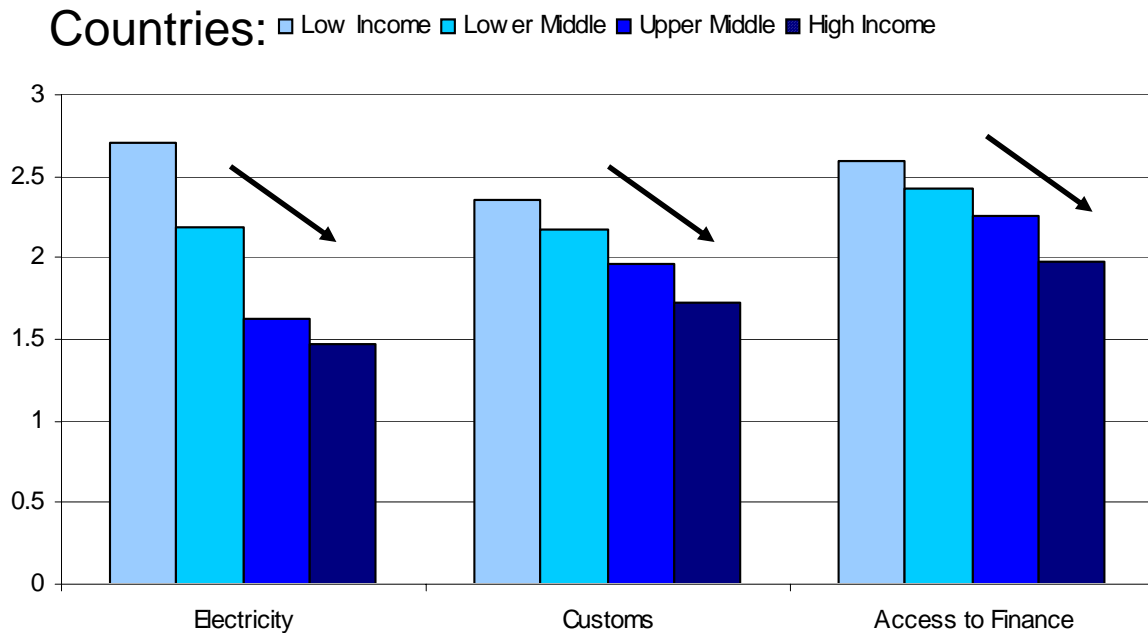
- In most dimensions valuations are higher in poorer countries
- We don't know if this is because higher public good supply causes higher productivity, or because richer countries can afford higher supply (that's why we need cross-country regression studies to establish causality)

Within countries

- In dimensions that are clearly like public goods we see that more productive firms have higher valuations
- For some dimensions where private substitutes exist (electricity, telecoms) we see no clear relation
- For the financial system, as predicted, more productive firms have lower valuations

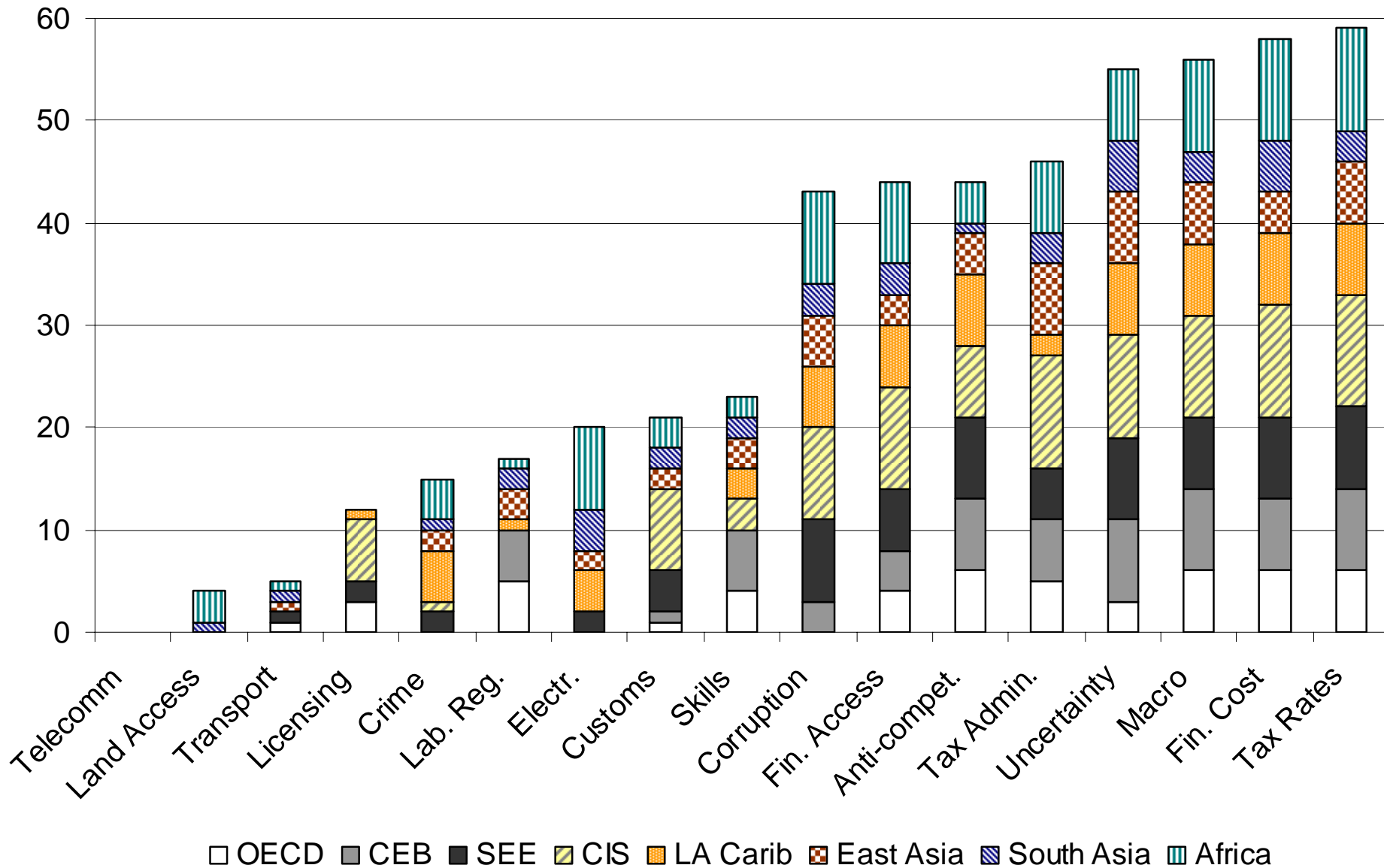
- Across countries:
As predicted, complaints are less in richer countries

- Within countries:
As predicted, for customs regulations (higher productivity firms complain more) & for finance (higher productivity firms complain less)



Firms: ■ Low ■ Middle ■ High

The data show: The relative importance of constraints by country group



Using the business climate data in a diagnostic framework

- The scientific studies using cross-country data are based on a standard growth model
- Hausmann, Rodrik & Velasco argue a growth model can also be used by the policy-maker to prioritize policies
- They argue countries divide into those where the fundamental type of constraint is a shortage of
EITHER **Investment opportunities**
OR **Finance**
- We can combine the 'top down' diagnostic approach with business climate data to help pin down the main binding constraints on growth in a country

Diagnosing the binding constraint in country x

TOP DOWN ANALYSIS

Is growth depressed by a shortage of

profitable investment opportunities?

If so, is it because of ...

finance?

If so, is it because of ...

Poor complementary factors ...

Market failures

Government failures

Poor access to international finance

Poor local finance

[BC: macro / policy stability]

geography

[BC: infra-structure]

micro risks:
[BC: customs, taxes, crime corruption, regulation]

macro risks:
[BC: macro / policy stability]

Poor intermediation
[BC: access to & cost of finance]

Low domestic saving

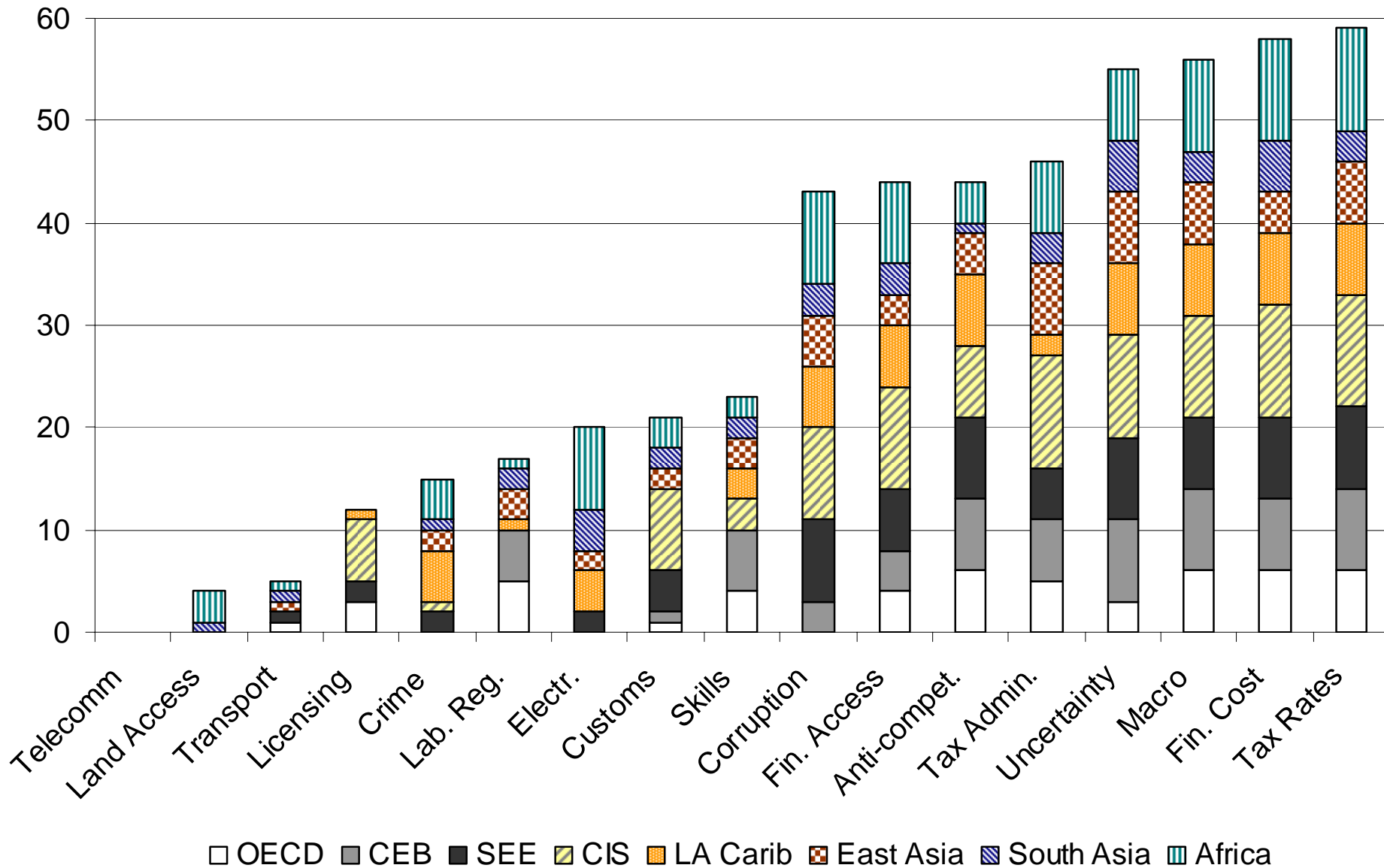
human capital
[BC: availability of skills]

BOTTOM UP: manager survey data on the business climate

Source #3: Case studies

- Strong points
 - Good at suggesting hypotheses
 - Can illuminate relative costs and feasibility of different policy measures
 - Can illuminate interactions between dimensions
 - E.g. the interaction between corruption and nature of comparative advantage (corruption can be more costly in a resource-based economy than in a manufacturing one)
- Weak points
 - Cannot test hypotheses, can only make them sound plausible
 - Very vulnerable to biases (political or other) in the researcher and the reader

The data show: The relative importance of constraints by country group



Overall: some simple messages

- The **supply of telecoms infrastructure** is not worth significant investment from the government budget - much better to let private entry take care of it.
- **Electricity supply** can be a big problem but only in Africa and some parts of Asia.
- **Tax rates and inefficient tax administration** are a big problem, almost everywhere. Doesn't mean that public sector should be small, but should be efficiently financed .
- **Labour regulation** is not really a problem, except in some relatively rich countries.
- **Crime and corruption** are a serious problem in some parts of the world, though not in all - needs further investigation to find affordable solutions
- Slow, inefficient or corrupt **customs procedures** impose a big cost on firms
- **Development of financial systems** is important: not so all firms can access finance, but so institutions can discriminate better between good and bad projects

What should policymakers make of all this?

- What should they conclude when there is disagreement or uncertainty in the literature?
 - Most of the different findings are not contradictory but complementary, if properly interpreted
- How can they use the findings to prioritize
 - Their budgetary resources
 - Their legislative attention
- We suggest a set of questions they can ask when lobbied by interest groups seeking action on some aspect of the business climate
- These questions are also useful when evaluating reform proposals coming from international agencies

Questions for policy makers to ask:

- Where does this aspect of the business climate fit in the diagnostic tree diagram? Is its importance corroborated by the 'top down' analysis?
- How highly does it rank as a complaint in the policymaker's country?
- Does cross-country regression analysis suggest it is more important for economic performance than it seems to managers?
- Do case studies suggest that this aspect of the business climate is more or less important for this country's performance than in other countries?
- Are there alternatives that have lower costs or greater probability of success ?
- What types of firm are lobbying for this change? Will a reform that aids these types of firm benefit the economy as a whole?

Note the similarity with questions a doctor can ask about a patient:

- What does the patient himself say about his condition?
- What do scientific studies suggest about the factors that influence the health of typical patients like this one?
- Does the patient's personal history lead one to suspect particular susceptibilities that make him different from others?
- Are there alternative treatments that would achieve the same outcome but with fewer side-effects or with more certainty of success?
- Is the patient asking for treatment out of other concerns than his health (e.g. a desire to qualify for sick pay)?

A final thought

- Economics is not medicine
- But both doctors and policymakers face a similar problem:
 - Every patient seems unique
 - But you can't perform all the experiments you need to understand their uniqueness without killing the patient...

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