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?”

<table>
<thead>
<tr>
<th>No obstacle</th>
<th>Minor obstacle</th>
<th>Moderate obstacle</th>
<th>Major obstacle</th>
<th>Don’t know</th>
</tr>
</thead>
</table>

- 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)
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 …
    - Poor complementary factors …
      - geography
      - human capital [BC: availability of skills]
    - [BC: infrastructure]
- finance?
  - If so, is it because of …
    - Market failures
    - Government failures
      - micro risks: [BC: customs, taxes, crime, corruption, regulation]
      - macro risks: [BC: macro / policy stability]
    - Poor access to international finance [BC: macro / policy stability]
    - Poor local finance
      - Poor intermediation [BC: access to & cost of finance]
      - Low domestic saving

**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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