

## Private Sector Development and Growth

A vigorous and well-regulated private sector is one of the most important drivers of growth and development in a country. Private Sector Development (PSD) is intimately related to innovation, creative destruction, job creation, technology adoption, and productivity improvements, which are central to understanding the microeconomics of the growth process. However, it is only with the recent worldwide collection of firm-level data and systematic measurement of the business environment that research has been able to begin to explore the role of policies in aiding private sector development at the microeconomic level.

Private Sector Development research at the Bank has initially had its greatest impact in providing diagnostic tools. Design and implementation of surveys across a range of countries have focused attention on the role of policy in the development of the private sector, spurring business environment policy reforms in many countries. It has also provided new insights and hypotheses to guide research going forward. In the last two years the Bank's research group has built on these initial diagnostics through more in-depth impact analysis of policy reforms, through the initiation of new randomized experiments to learn about the impacts of different policies designed to help the private sector, and through construction of new specialized datasets on entrepreneurship and innovation.

### *Research has drawn attention to the importance of the investment climate and the extent to which it differs within and across countries*

The Bank's Enterprise Surveys (formerly known as Investment Climate Surveys), initiated as a joint DEC-PSD program, was launched in 2001 have collected comparable data on thousands of firms in over 100 countries. The data are used for benchmarking key indicators across locations (countries and subnational regions) and for evaluating the impact of different investment climate policies on firm performance, including growth, innovation, productivity, and job creation. In some countries, survey coverage has now expanded to incorporate rural and informal enterprises, and the recent availability of two surveys (and more in the future) taken at different times allows studying the effects of investment climate policy changes. Five policy areas receive particular attention: product market regulations and competition; labor regulations and human capital constraints; access to finance; infrastructure services; and governance and the rule of law.<sup>1</sup> Together with the Doing Business indicators, the Enterprise Surveys have allowed countries to benchmark indicators of their business environment against one another, spurring reform efforts.

The Enterprise Surveys are a critical input into country-specific Investment Climate Assessments (ICAs). These in turn have been incorporated in numerous Country Assistance Strategies and Poverty Reduction Support Credit and Bank projects. Improving the investment climate, the subject of the [\*World Development Report 2005: A Better Investment Climate for Everyone\*](#), is now one of the two pillars of the World Bank's current development strategy.<sup>2</sup>

## What we know

### *Entry, exit, and competition are key determinants of innovation.*

Regulatory barriers to entry and exit—from licenses and permits to bankruptcy laws—reduce competition and impose significant costs on firms.<sup>3</sup> Net entry contributes up to 30 percent of productivity growth in countries like Latvia where it takes less than 10 days to register a firm, compared to less than 5 percent of productivity growth in Argentina, where it takes over 60 days to register a firm. Firms facing greater competition are two-thirds more likely to innovate or introduce a new product.<sup>4</sup> Such research has contributed to numerous reforms to simplify regulations and easy entry in countries such as Algeria, Cambodia, Moldova, Mozambique, and Uganda.

### *Improvements in regulations have had significant economic effects*

Rigorous impact evaluations are beginning to reveal the effects of reforms spurred in part by the earlier research efforts. For example, municipal simplification of entry regulations in Mexico led to a 5 percent increase in the number of registered businesses, a 3 percent increase in employment, and a reduction in consumer prices.<sup>5</sup> Bankruptcy reform in Colombia reduced the duration of reorganization proceedings and led to better separation of viable from unviable firms.<sup>6</sup>

### *Small firms often face greater growth obstacles, and as a result, can realize rapid gains from relaxing their constraints*

The costs of regulatory burdens, bribes, weak property rights, poor infrastructure, and low access to finance are up to one-third higher for smaller firms than for larger or foreign firms. Some of this is due to fixed costs, which are proportionately higher for smaller firms. But some is due to the alternative means of larger firms to compensate for a weak investment climate (such as purchasing generators, obtaining capital overseas, or even influencing officials in ways that favor them).<sup>7</sup> As a consequence, many small firms are operating below their optimal size. Randomized experiments in Sri Lanka and Mexico which gave microenterprises grants of capital stock found real returns on capital of over 5 percent per month, showing that the average small firm does have the ability to experience rapid growth when constraints are relaxed.<sup>8</sup>

### *Effective regulation, rather than ownership, is essential to improving infrastructure services and expanding their contribution to growth and poverty reduction*

Private sector participation in infrastructure has prompted increased investment and expanded services coverage.<sup>9</sup> Between 1990 and 2001 more than \$750 billion was invested in 2,500 private projects in developing and transition countries. The last 15 years of experience with privatization clearly demonstrates that regulation can safeguard the interests of both investors and customers—and is crucial to attracting the needed long-term private investment.<sup>10</sup> Regulatory processes must encourage competition, be open and transparent, and be designed before privatization. Moreover, regulatory practices and infrastructure development should

ensure more broadly that services are provided equitably and that the poor enjoy adequate access.<sup>11</sup> Some of the strongest results are seen in telecommunications, where privatized networks subject to competition have frequently expanded two to three times faster than state-owned monopolies.<sup>12</sup> Continuing to get infrastructure reform right is essential to achieving the Millennium Development Goals for increasing growth, reducing child mortality, and empowering women.<sup>13</sup>

## Current and future research directions

### *Understanding the consequences of the financial crisis for the private sector*

Current work is heavily focused on understanding both the consequences of the recent global financial crisis on the private sector, and the role of the private sector in generating employment and recovery. Little is currently known about which private sector development policies work in getting firms to start hiring workers again, and whether micro, small, or medium to large firms are the quickest to respond with hiring when policy actions take hold. Our research exploits ongoing randomized experiments and survey work in India and Sri Lanka to provide answers. A randomized experiment in Sri Lanka will also investigate the role of capital and business training in getting women to not just enter self-employment in response to the crisis, but to enter in industries and sectors with better long-term growth prospects. We will also conduct an evaluation of Mexico's wage subsidy employment preservation program that was announced in the wake of the crisis. Finally, we will also study the impact of the crisis on labor supply—namely the supply of migrants during a crisis—and assess how much credit constraints limit the supply of migrants by conducting a randomized experiment in the Philippines.

### *Promoting entrepreneurship, firm productivity, and growth*

Central to ongoing work on understanding the determinants of firm entry, exit and performance, and their consequences for economy-wide productivity and growth are the interacting themes of entrepreneurship and firm dynamics. A better understanding of the determinants of entrepreneurship and of how changes in the composition of the private sector over time affect firm productivity and growth are essential for understanding the microeconomics of growth. The existing literature has only recently begun to study the role of the business environment in driving firm dynamics and entrepreneurship, and this work seeks to prioritize the types of policy interventions with the greatest impact in unlocking drivers of private sector development. The findings of such work can help the World Bank develop policies to encourage new firm entry, promote self-employment, and enhance the growth of firms, both small and large.

### *Ongoing work*

Areas under investigation include:

- *What are the determinants and consequences of informality?* Informal firms account for roughly one-third of production and one-half to three-quarters of the non-agricultural

labor force in developing countries, and the informal sector is particularly important as a source of employment for the poor. However, limited data and a focus on formal firms means relatively little is known about the productivity of informal firms, the barriers they face for growth, and their spillover effects on the formal economy. Our research couples the detailed business environment data collected by the Bank with analysis of detailed firm-level cross-country data, and the development and analysis of new in-depth single country surveys.

- *What is the impact of corporate governance on firm performance?* Corporate governance covers a broad range of issues of allocation of control rights within a firm, and thus defines how the authority is exercised and the quasi-rents generated by firm are allocated among different classes of stakeholders. A more narrow definition of governance covers the mechanisms by which suppliers of finance assure a return on their investment. Papers under this area investigate the impact of the institutional development and business environment on firms' governance structures, and how internal and external governance affects firm performance. Ongoing research focuses on detailed firm surveys in *China* and *Russia*, countries in which many firms have experienced rapid changes in corporate governance.
- *Impact evaluations of business training and other enterprise support programs.* Many micro, small, and medium enterprises in developing countries are informally run, with limited recordkeeping, no forward planning, and little awareness of formal management practices. Yet better management is strongly associated with higher productivity. As a result business development services, including business training are an important component of many Government and civil society efforts to foster private sector development. Currently there is little evidence such efforts work. New randomized experiments in *Bosnia-Herzegovina*, *India*, *Mexico*, *Pakistan*, and *Sri Lanka* are investigating the role of training and better business practices in improving the productivity of firms.
- *How does microeconomic efficiency affect aggregate growth?* The work explores the aggregate consequences of microeconomic efficiency and firm dynamics. It investigates the extent to which the inability to allocate resources to their most productive uses underlies less developed countries' lower productivity and income levels. There is broad agreement that long-run differences in per capita income across countries mostly reflect differences in productivity. In turn, poor countries' low aggregate productivity can be the result of low productivity of the average firm (or plant), or of an inefficient allocation of factors of production across firms. The research builds from disaggregated, firm-level data to assess the aggregate productivity consequences of microeconomic allocation. It examines the extent to which key dimensions of the business environment affect the efficiency of the allocation of resources and the speed with which reallocation occurs.

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## Notes

Most research documents cited in this summary are available through the World Bank's research archives at <http://econ.worldbank.org/docsearch> or the Bankwide archives at <http://www-wds.worldbank.org/>.

1. See <http://www.enterprisesurveys.org> for links to data, reports, standard tables and methodology.
2. It complements the second pillar, investing in and empowering people to take advantage of these opportunities.
3. For evidence that entry restrictions can hamper entry and reduce growth, especially in industries which naturally have high entry see L. Klapper, L. Laeven, and R. Rajan. 2006. "Business Environment and Firm Entry: Evidence from International Data." *Journal of Financial Economics* 82(3): 591–629.
4. *World Development Report 2005: A Better Investment Climate for Everyone*. Washington, DC: World Bank.
5. M. Bruhn. 2008. "[License to Sell: The Effect of Business Registration Reform on Entrepreneurial Activity in Mexico](#)." Policy Research Working Paper 4538, World Bank, Washington, DC.
6. X. Gine, and I. Love. 2007. "[Do Reorganization Costs Matter for Efficiency? Evidence from a Bankruptcy Reform in Colombia](#)." World Bank Policy Research Working Paper 3970.
7. See T. Beck, A. Demirgüç-Kunt and V. Maksimovic. 2005. "Financial and Legal Constraints to Growth: Does Firm Size Matter?" *Journal of Finance* (1): 137–77.  
M. Hallward-Driemeier and D. Stewart. 2004. "[How Do Investment Climate Conditions Vary Across Countries and Types of Firms?](#)" A background paper for the *World Development Report 2005: A Better Investment Climate for Everyone*. Washington, DC: World Bank.  
D. Dollar, M. Hallward-Driemeier, and T. Mengistae. 2005. "Investment Climate and Firm Performance in Developing Economies." *Economic Development and Cultural Change* 54(1): 1–31.
8. S. de Mel, D. McKenzie and C. Woodruff. 2008. "Returns to Capital in Microenterprises: Evidence from a Field Experiment." *Quarterly Journal of Economics* 123(4): 1329–72. (Available as [World Bank Policy Research Working Paper 4230](#).)  
D. McKenzie and C. Woodruff. 2008. "Experimental Evidence on Returns to Capital and Access to Finance in Mexico." *World Bank Economic Review* 22(3): 457–82.
9. For a comprehensive summary of the latest research findings, please see [Reforming Infrastructure: Privatization, Regulation, and Competition](#). Policy Research Report. Washington, DC: World Bank, 2004.
10. The appropriateness of privatization differs by sector. Telecommunications provide the most compelling case in developing countries, while power and especially water are more problematic. In the water sector, concessions and leases are recommended as more effective ways to achieve the efficiencies of competition while retaining strong public oversight.
11. I. Kessides. 2005. "Infrastructure Privatization and Regulation: Promises and Perils." *World Bank Research Observer* 20(1): 81–108.  
R. Zagha, ed., [Economic Growth in the 1990s: Learning From A Decade of Reform](#). Washington, DC: World Bank.
12. Specific examples: *Telecommunications*: Jamaica's telecommunications firm increased its annual network expansion rate from 4.5 percent in the 11 years before privatization to 18 percent in the 4 years immediately following.

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*Electricity:* Argentina's installed capacity grew from 13,267 megawatts in 1992 to 22,831 megawatts in 2002 and energy losses have shrunk from 21 percent in 1986 to 9 percent in 1996.

*Water:* Access to safe water increased by more than 30 percent after privatization in Manila and 25 percent in Conakry, Guinea.

13. Kessides, I., ed. 2000. "[Romania: Regulatory and Structural Assessment in the Network Utilities.](#)" Working Paper 36057, World Bank, Washington, DC.
- Kessides, I., ed., 2000. "[Hungary: A Regulatory and Structural Review of Selected Infrastructure Sectors.](#)" World Bank Technical Paper 474, Washington, DC.
- Kessides, I. 1997. "[Regulation of the Argentine Network Utilities: Issues and Options for the National Government.](#)" Economic Note 16, Latin American and Caribbean Region, World Bank, Washington, DC.