

Case study commissioned by the Department for International Development, UK

A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

**The Importance of the Enabling Environment for Business and Economic Growth:
A 10 Country Comparison of Central Europe and Africa**

Prepared by

Graham Bannock, Matthew Gamser and Mariell Juhlin
Bannock Consulting Ltd, UK

November 2003

Key Messages

1. Comparison of the measures adopted for the improvement of the environment for private sector development in Central Europe and Sub-Saharan Africa indicates that appropriate measures can make a real difference to economic performance.
2. Policies need to be implemented in consultation with the private sector and all levels of government. These policies should be more concerned with helping the private sector to help itself by removing obstacles rather than with providing financial or business support.
3. A strong lead Ministry with a clearly defined role for promoting private sector development is needed. The measures taken should include the reduction of barriers to formal sector activity with the aim of promoting growth and reducing the size of the informal sector, for example by establishing clear property rights and minimising the regulatory costs of doing business.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

This study reported under the title: 'Indigenous Private Sector Development and Regulation in Africa and Central Europe: A 10 Country Study (2002)' was funded by DFID who also made valuable comments on successive drafts. The authors wish to acknowledge the integral contributions of the following, country-based researchers to this paper: George Manu (EMPRETEC Ghana Foundation, Ghana), Laszlo Kallay (Institute for Small Business Development, Hungary), Dr. Mwangi S. Kimenyi (KIPPRA, Kenya), Lars N Grava (SIA Synergy Consulting, Latvia), Jason Agar (Kadale Consultants, Malawi), Aleksandra Sztetyllo (Polish Foundation for Small and Medium Enterprises, Poland), Chris Darroll (Small Business Project, South Africa), Tom Wayman (Compliance Alliance/CDCL, Tanzania), Alix Audibert (Uganda), Philip Leonard and Simon Capper (DCDM Consulting Ltd, Zambia). We would also like to thank Andrew McCann, UK, for help with statistical analysis

Introduction

1. At the beginning of the 1990s both central Europe and much of sub-Saharan Africa were at painful, difficult points of transition. Their command-and-control economies were crashing, their large, mostly state-owned, companies were floundering, and their people clamoured for change. Poverty was increasing by all measures. Both regions suffered from low tax compliance and inherited obstacles to enterprise, an overly bureaucratic legislative framework and an associated tendency towards corruption. Bowing to public and economic pressure, most governments in these regions committed (at least in rhetoric) to introduce more market-oriented systems. These reforms did not get fully underway until the mid 1990s following independence from communist regimes in central Europe around 1990 and the general transition to multi-party democracies in the African countries at about the same time.

2. By the end of the 1990s, problems remained in both regions, and poverty was far from eliminated in either. At the same time, economic growth had been far stronger in central Europe than in Africa. Within Africa, certain countries, such as Uganda, Ghana and (to a lesser extent) Tanzania outperformed their neighbours during the period 1995 to 1999. Our research on 10 countries in the 2 regions found a strong correspondence between per capita GDP growth and the degree to which their governments had put in place machinery and policy measures to promote indigenous private sector development.

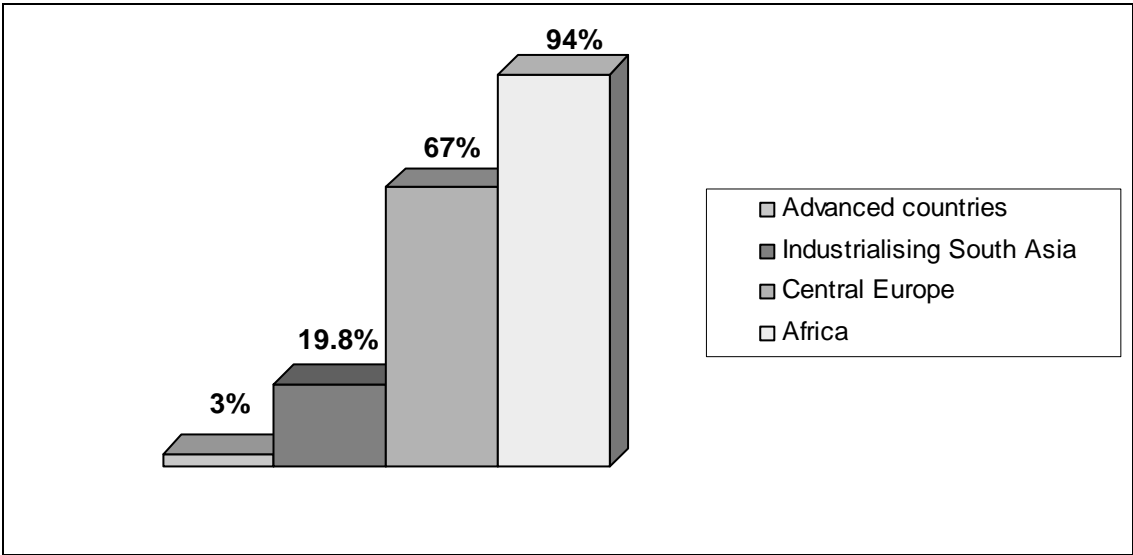
Why should governments care about indigenous enterprises?

3. Indigenous firms, particularly small and medium-sized enterprises, play a key role in all market-driven economies: as employers, as suppliers of basic goods and services, and as partners to larger firms in supply and service chains. Inappropriate regulation creates obstacles to this process by raising the costs of business entry and growth. In particular, regulation and inadequate institutions for property rights and the

rule of law create barriers to transition from the subsistence and very small scale economy to the modern more productive sector. Regulatory costs bear most heavily on the smallest firms, which are almost exclusively indigenous enterprises, and which account for a substantial share of employment.

4. Even though regulations may not be fully enforced in the informal sectors, which are very large in Africa (and still significant in Central Europe), these regulations act as a barrier to development by keeping a large proportion of the population out of the formal economy. They also promote corruption. Modern day business enterprises in Africa and the transition countries suffer regulatory barriers which were largely absent in 18th and 19th Century Europe and North America when these areas were industrializing. Moreover regulatory costs now in most respects (and in relation to incomes), seem to be much higher in the developing world than in the advanced countries. As the chart below demonstrates, business entry costs as a percentage of GDP per capita are less than 3% in the best performing of the advanced countries, 67% in Central Europe and 94% in Africa. These costs also seem to be significantly lower in industrializing South Asia than in Africa.

Business Entry Costs as a Percentage of GDP/Capita Today



Source: Derived from Djankov et al, 2000¹

How can governments improve the environment for indigenous enterprises?

5. Governments can support the growth of indigenous enterprises in two fundamental ways:

- (i) Establishing the institutional machinery to deal with the private sector in a more co-ordinated, efficient and appropriate manner, and
- (ii) Implementing policy measures to make it easier to do business, primarily by lowering the costs of operating legally.

6. Our research considered how the business environment had changed in the 10 countries over the past 10 years. In-country consultants were asked to describe the changes based on a detailed series of questions. From their reports and further desk research we constructed a list of questions susceptible to yes/no answers on policy measures taken and the government machinery used for implementation. The questions were as follows:

Institutional Machinery

- (i) Does the government have one lead Ministry for private sector development?
- (ii) Is this Ministry also charged with de-regulation/regulatory reform?
- (iii) Does the government undertake extensive consultation with the private sector in making policy?
- (iv) Does the country have an SME Act?
- (v) Does the government practice decentralised implementation of policies?
- (vi) Does the government monitor the impact of policy changes?
- (vii) Has the government invested in formalizing the policy-making and execution processes?

Specific Policy Measures

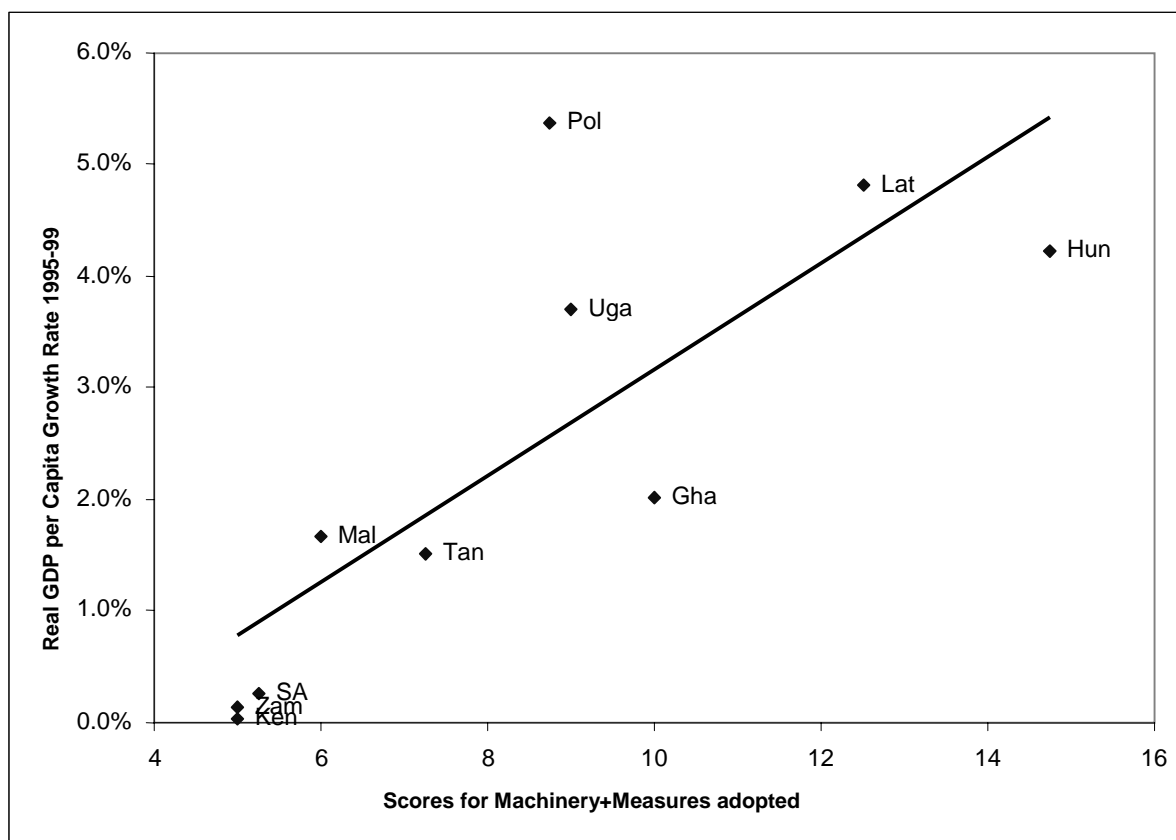
- (i) Has the government undertaken structural adjustment or other significant macro-economic reforms?
- (ii) Has the government sought to reduce costs of business registration and/or licensing?
- (iii) Have measures been taken during the period to improve the rule of law in place over business transactions?
- (iv) Have improvements been made to systems for recovering collateral?
- (v) Have measures been taken to improve land titling and land use rights?
- (vi) Has employment law been simplified (to make it easier to hire, fire and comply with employment regulations)?

7. To compare performance between the 10 countries we first constructed a matrix in which each question concerning institutional machinery or policy elements was given a “yes” or a “no” answer. For yes answers, a date of adoption was noted, if it was post-1995 so as to take account of the partial potential impact of measures not in force for the whole period. “No’s” were valued at zero and “Yes’s” as 1 or a fraction thereof, according to the date of adoption². For example, an adoption in 1997 was given a value of 0.5 and 1995 a value of 2.³ These values were then related to the average rates of growth in GDP per capita for the period 1995-99⁴ shown in Table 6.1 using least squares regression.⁵

8. The results of this exercise are shown in the Chart below. Those countries which have adopted the most elements of machinery and policies have the highest per capita GDP growth rates. In purely statistical terms the results are quite robust: the line of best fit shown on the chart accounts for over 70% of the variations between the two sets of variables and the probability that this result is by chance only is less than 1%.⁶

9. Despite the robustness of the overall result some qualifications are necessary: the numbers of years used in the analysis were few and many factors impact on economic performance in addition to those captured in our analysis, for example regional effects, commodity prices and political factors.

GDP per capita growth rate 1995-1999 against Sum of Machinery and Measures
(excluding SME Act)



Source: Study report

10. Looked at another way, the 10 countries fall into 3 distinct groups. Hungary, Latvia and Poland, which implemented the most changes in institutional machinery and policy environment during the period, increased per capita GDP on average by 4.8 percent, while Kenya, Malawi, South Africa and Zambia, which made few changes, grew by only 0.5 percent. Ghana, Tanzania and Uganda, which implemented some changes

(notably in decentralizing policy implementation, fiscal and trade administration simplification, and removal of barriers to accessing finance), saw per capita GDP grow at 2.4 percent, half that of the central European countries, but almost 5 times the rate of their fellow African countries.

GDP Performance and Enabling Environment Reform

Changes	Few	Some	Many
Average real annual GDP per capita growth rates 1995-99	0.5%	2.4%	4.8%
Countries	<ul style="list-style-type: none"> • Kenya • Malawi • South Africa • Zambia 	<ul style="list-style-type: none"> • Ghana • Tanzania • Uganda 	<ul style="list-style-type: none"> • Hungary • Latvia • Poland

Source: Study report

11. Is there also a correspondence between equity in wealth distribution and how governments have transformed the enabling environment for indigenous firms? The average Gini coefficients⁷ are lower in countries which made the most changes, indicating that incomes in these countries are relatively more equal. However, the Gini data is fragmentary, and cannot permit dynamic comparisons in the same way as per capita GDP. More data is needed on income equality and other poverty measures to more fully appreciate the impact of enabling environment changes.

Conclusions

12. It cannot be assumed that adoption of all the favoured institutional and policy mix alone will bring higher GDP growth. Nonetheless, our research indicates that much more attention should be given to the enabling environment for indigenous private sector growth (much of which are small and micro enterprises) as a means for promoting

employment, output and poverty alleviation. The policy makers of central Europe, who gave more attention to improving conditions for their entrepreneurs, have reaped wider rewards in the form of higher economic growth.

13. This analysis suggests that business enabling environment reform is good for economic growth. Our field experience in specific regulatory and other business environment reform projects, coupled with an analysis of where progress has been made in these 10 countries, suggest that the following measures can make a significant difference:

Institutional

- (i) Sound and stable macro-economic policies are an essential basis for development, but they are not sufficient to encourage business growth.
- (ii) A lead Ministry covering private sector development needs to be strong and influential, and its role clearly identified.
- (iii) An SME Act is not necessary in all countries, but where policy and commitment is weak, it may help to provide a legal basis for reforming the policy environment, and monitoring the implementation of reforms.

Policy Machinery

- (i) Consultation with the private sector, and with all levels of Government, is essential to design and monitor effective policies and regulations.
- (ii) Policies should be more concerned with helping the private sector to help itself – that is by removing obstacles rather than in providing financial or business support measures.
- (iii) All governments need a central point for regulatory reform to monitor new and existing legislation, to promote change, and to act as an advocate both within and outside government.

- (iv) Mandatory policy/regulation impact assessment procedures are necessary.
- (v) Implementation of policy should be transparent, consistent and fair, with accessible/effective appeal systems.

Policy Formulation

- (i) Fiscal policies should be directed at reducing barriers to formal sector activity (thus reducing the size of the informal sector). Compliance costs of the tax system can be lowered by simplification and the adoption of user-friendly unitary tax authorities.
- (ii) The (real and informal) costs of business registration and licensing need to be brought down drastically, and uncoupled from raising revenue.
- (iii) Lack of effective systems to grant legal title or use rights to property greatly inhibit access to capital by the entrepreneurial poor.
- (iv) Banking and other financial institutions should be regulated in ways that minimise costs and promote competition.
- (v) Systems for exit from business through bankruptcy or liquidation need to be modernised.
- (vi) Alternative dispute resolution mechanisms are particularly needed in Africa where relatively low cost legal services are unavailable.
- (vii) Rationalisation of customs procedures is necessary so as to facilitate trade, and thereby private sector development.
- (viii) Policies on business support services need to be redirected towards facilitating private provision, and providing information and easing compliance with regulations.

Notes

¹ "Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer. *The Regulation of Entry*. NBER Working Paper w7892, September 2000. The data refer to the costs of setting up a limited liability company and are used here as a rough proxy for overall regulatory costs.

² Yes's and No's were allocated by our local consultants but in some cases the authors modified these, usually in a negative direction.

³ The growth rates and therefore the results were sensitive to the period chosen. 1995 was selected as the mid-decade point at which most countries had achieved a measure of adjustments to earlier political and economic traumas. 1999 was the latest year for which GDP data was available for all countries.

⁴ Least squares regression is a mathematical technique which is used to calculate an equation giving the best fit to sets of independent variables (in this case policies) and dependent variables (GDP growth rates) and thus the relationship between the two.

⁵ R^2 was 0.71 and the P-value 0.004.

⁶ Growth rates from World Development Indicators, World Bank, 2001.

⁷ The Gini index is a measure of the distribution of income in the population ranging from zero to one. Lower numbers mean more unequal distribution. Most recent Gini numbers are by country and year: Hungary 24.44 (1998); Latvia, 32.37 (1998); Poland 31.6 (1998); Ghana 39.55 (1999); Uganda 37.36 (1996); Tanzania 38.16 (1993); Kenya 44.54 (1997); Malawi 50.31 (1997); South Africa 59.33 (1995); Zambia 52.6 (1998). Gini numbers are taken from the World Bank's *World Development Indicators* report (2001).