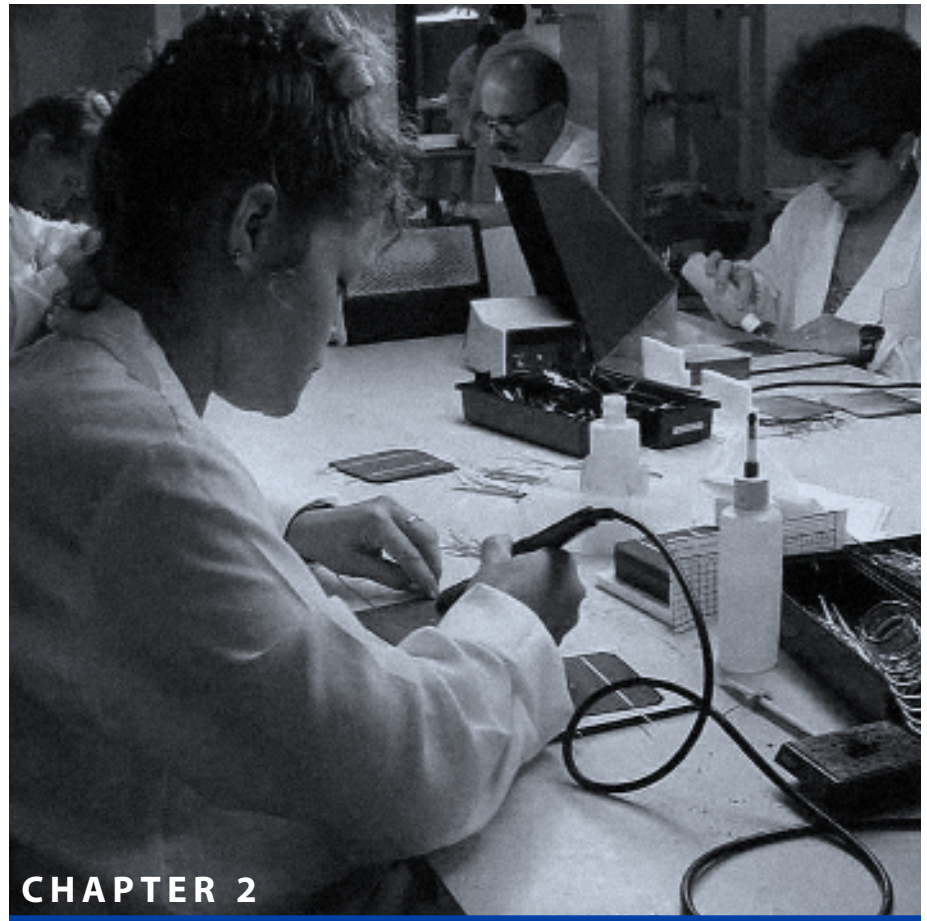


Photo: UNDP Cuba



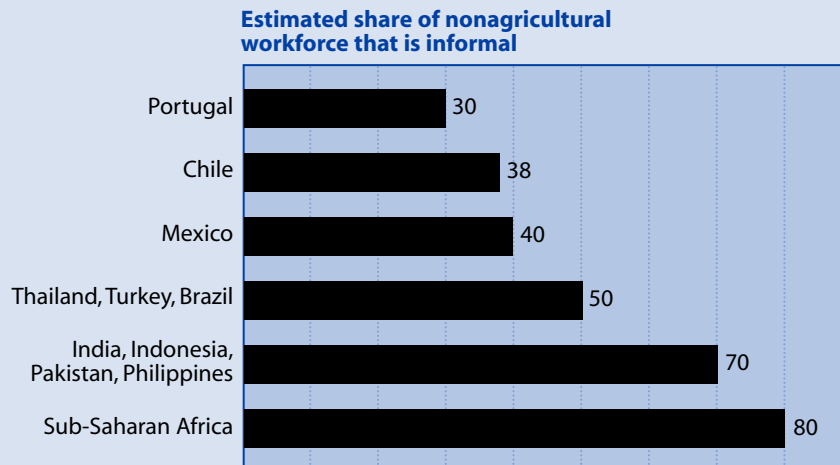
CHAPTER 2

CONSTRAINTS ON THE PRIVATE SECTOR IN DEVELOPING COUNTRIES

Developing countries have remarkable energy and assets, and all segments of the private sector have demonstrated the ability to respond when empowered. But the Commission finds that three major structural challenges confront the private sector in all developing countries, to varying degrees.

- Microenterprises and many small and medium enterprises operate informally.
- Many small and medium enterprises have barriers to growth.
- A lack of competitive pressure shields larger firms from market forces and the need to innovate and become more productive.

FIGURE 2.1 INFORMALITY THRIVES IN POORER COUNTRIES



Source: World Bank and International Labour Organization

WIDESPREAD INFORMALITY FOR MICROENTERPRISES

Microentrepreneurship is a common form of employment in many developing countries (figure 2.1). Almost all microenterprises operate outside the formal legal system, contributing to widespread informality.

Informality provides some benefits in some circumstances. It can act as a form of employment substitution for labourers who have difficulty finding jobs. For example, urban dwellers in Thailand who lost their jobs during the economic crisis of the late 1990s supported themselves by turning to informal street-vending opportunities. In societies that limit the economic role of women, home-based enterprises provide women with opportunities to earn money. If the formal rules, enforcement systems and cultural conditions in a country are so restrictive that most entrepreneurs cannot use their talents, the economy may benefit if they operate informally.

Difficulties in getting finance also trap developing country entrepreneurs in subscale operations. Entrepreneurs and enterprises that operate informally cannot borrow at a reasonable cost because they do not have legal status or title to the land they occupy. Frequently, the only option for access to capital is through illegal moneylenders who charge high rates and who may be able to lend only small sums relative to the needs of a growing enterprise.

The access of businesses that operate informally to the formal legal system and its benefits are limited. In general, the formal legal system should enforce contracts and protect property rights more fairly than informal enforcement systems do. Predictable rules and dispute resolution mechanisms are essential for entrepreneurs to engage in the long-term arrangements that enable them to innovate, to scale up and to diffuse their knowledge and benefits. Side payments to officials that increase predictability in an uncertain world reduce income that

could otherwise be invested in making operations more productive.

Cruel and arbitrary informal enforcement systems limit the ability of entrepreneurs to be productive as well. Local debtor prisons and mafia-like punishments can hurt an entrepreneur's full access to crucial human inputs. According to Hernando de Soto, a third of debtors who obtained credit informally in Egypt spent some time in private jails because they did not pay back what they owed.

Entrepreneurs who operate formally are hurt by the implicit subsidies that informal enterprises receive through uneven enforcement and by poor mechanisms for protecting property and contracts, both of which distort competition. Both aspects create an uneven playing field and reduce formal entrepreneurs' access to inputs and markets, discouraging entrepreneurs who operate formally from making investments to increase productivity.

Informal firms can charge less because they avoid paying taxes or complying with other regulations. More productive formal firms have difficulty capturing market share from informal firms because the formal firms pay taxes and other contributions, which increases their costs significantly. More productive firms are less able to drive the less competitive informal firms out of business. So, poor enforcement permits the informal firms to continue to exist, holding back the productive firms from reaching maximum scale. Yet, given the significant productivity advantage held by formal firms, the inability to compete may reflect an unwillingness to serve some parts of the market rather than the cost advantages offered by informality.

Moreover, worker rights and protections in the informal sector stand up poorly to those in the formal sector. And consumers—able to purchase only goods of inappropriate quality and safety standards—do not have access to the greater choice and lower prices in truly competitive consumer markets.

There are many constraints on entering the formal sector. The overarching issue is one of costs versus benefits for the individual entrepreneur who has to choose between formal and informal operations.

In most developing countries it is costly to be formal. Formal players are often overtaxed (a vicious circle, since they are overtaxed because a few formal companies carry most of the tax weight). Registering a business can be a long and expensive proposition (in Angola it takes 146 days and more than 8 times the per capita income). Regulations and government requirements are complex—and compliance costs high. The opportunities for bribery increase with the complexity of regulations, exposing smaller players who lack the legal resources to defend themselves.

Entrepreneurs also see little benefit in going formal. While formal businesses in developed countries can raise capital by mortgaging their assets, this is often not possible in many developing countries where mortgage laws are weak and banks prove reluctant to finance small players. In theory, being formal would facilitate selling beyond geographic boundaries, but poor local infrastructure and customs abuse limit the opportunities. And bankruptcy laws, which protect formal players in developed countries, are often ineffective in

developing countries, exposing formal entrepreneurs to even more risks (due to more visibility) than if they remained informal.

FEW COMPETITIVE SMALL AND MEDIUM ENTERPRISES

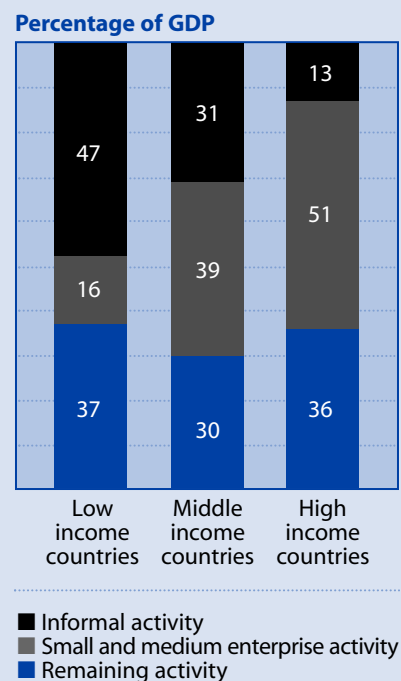
Small and medium enterprises tend to be engines of job creation—seedbeds for innovation and entrepreneurship. By providing new entry and competition, they can boost efficiency and growth and lead to economic development.

Indeed, recent research indicates that economic growth in poor countries is accompanied by a more than proportional growth in the share of the formal small and medium enterprise sector. In low income countries the share of formal small and medium enterprises in employment is about 30% and in GDP about 17%, while in high income countries the shares are about 60% and 50%. Indeed, richer countries see far less informal and much more small and medium enterprise activity (figure 2.2).

The reality in many poor countries, especially in Sub-Saharan Africa, is that the small and medium enterprise sector is relatively marginal in the domestic ecosystem. Why are small and medium enterprises not able to “graduate” to the ranks of larger companies?

For this evolution to be possible, it is essential that a reasonably level playing field and supporting institutional structures exist between (often larger) incumbents and (often smaller) new entrants.

FIGURE 2.2 SMALL AND MEDIUM ENTERPRISES BECOME MORE IMPORTANT AND INFORMALITY LESS IMPORTANT AS COUNTRIES BECOME WEALTHIER



Source: Ayyagari, Beck, and Demirguc-Kunt (2003)

Rules that constrain market entry and expansion have a chilling effect on small and medium enterprises at the expense of established larger firms. Small and medium enterprises often could compete effectively in niche markets, but the advantages that accrue to established large players fend off competition from the small and medium enterprise sector. Without the reasonable compliance costs that exist only in a fairer system of competition, small and medium enterprises cannot grow and become more productive. Ineffective or arbitrary tax laws, onerous business regulations and other restrictions penalize them.

Widespread informality and the lack of skills also affect the ability of entrepreneurs to scale up a business. While often animated by innovative ideas or addressing untapped markets, small and medium enterprises suffer from lower total factor productivity, by using older technologies or employing inferior workforce practices. The cost of business services is often more than small and medium enterprises can pay, or is not in tune with their needs. Lower export sales from small and medium enterprises come in large part from lack of access to knowledge about foreign standards of quality.

Perhaps most important, small and medium enterprises lack access to financing and long-term capital, the base that companies are built on. High risks associated with small and medium enterprises, whether real or perceived, exist in the absence of financial instruments that manage and diversify the risk. Banks also face high costs or cannot acquire information that they can trust, even when small and medium enterprises are credit-worthy. These factors raise interest rates and reduce lending volumes, setting up price and quantity barriers to small and medium enterprise growth. Small and medium enterprises have to resort to financing from networks of family or friends, from retained earnings, or from short-term credit from other small buyers or suppliers, rather than from larger institutions providing dedicated long-term financing vehicles for specific purposes.

LACK OF COMPETITIVE PRESSURE ON LARGE COMPANIES

Large companies form the hub of networks and clusters and, by the virtue of their size and range of business activities, provide the spark for the private sector ecosystem. But in many developing countries large incumbent companies can also stifle entrepreneurial energy and initiative. Too often, they can take advantage of weak institutional environments to raise anticompetitive barriers and protect their dominant position. While local informal markets can often function without much regulation, more mature and complex markets need appropriate regulations to function effectively.

A dynamic financial sector, in which new entrants and incumbents can get finance under competitive terms, is also important for creating competitive pressures in the market. But companies with a protected position in these markets often have strong incentives to use their lobbying power to slow government progress in improving the institutional infrastructure for markets.

Such practices directly hurt poor people, through higher prices and lower quality products. Poor people benefited from the opening of competitive markets in India in the early 1990s. Until then the population was effectively subsidizing a large part of the private sector, which was selling low quality products at high prices—made possible by controls on entry by domestic competitors and severe quotas and high tariffs on imports. Such anticompetitive policies are often perpetuated by an unlikely

alliance between large protected incumbents and poor people, who fear a loss of jobs in competitive markets.

Corruption combined with weak and arbitrary legal enforcement buttresses incumbent firms at the expense of potentially more competitive ones. Specifically, incumbents might receive subsidies, special licenses or other privileges that preserve their position and dampen the incentive to innovate and reduce prices. Such firms may respond to perverse incentives to strip assets or dole out contracts to uncompetitive suppliers even when more efficient providers exist. The poor domestic macro environment encourages wasteful rent-seeking and retards the growth of competitive firms based on productivity.

These firms might also indirectly starve competitors from receiving capital by contributing to an environment that keeps finance underdeveloped. Large firms thus command the lion's share of resources in an underdeveloped financial system.

FOUNDATIONS FOR ENTREPRENEURSHIP—NOT YET IN PLACE

Building a sound private sector requires a strong foundation in the global and domestic macro environments, physical and social infrastructure and rule of law (figure 2.3).

Global macro environment

The foundations for growth in the private sector start with a well-functioning global macro business environment involving a dynamic global economy that provides markets, as well as adequate trade

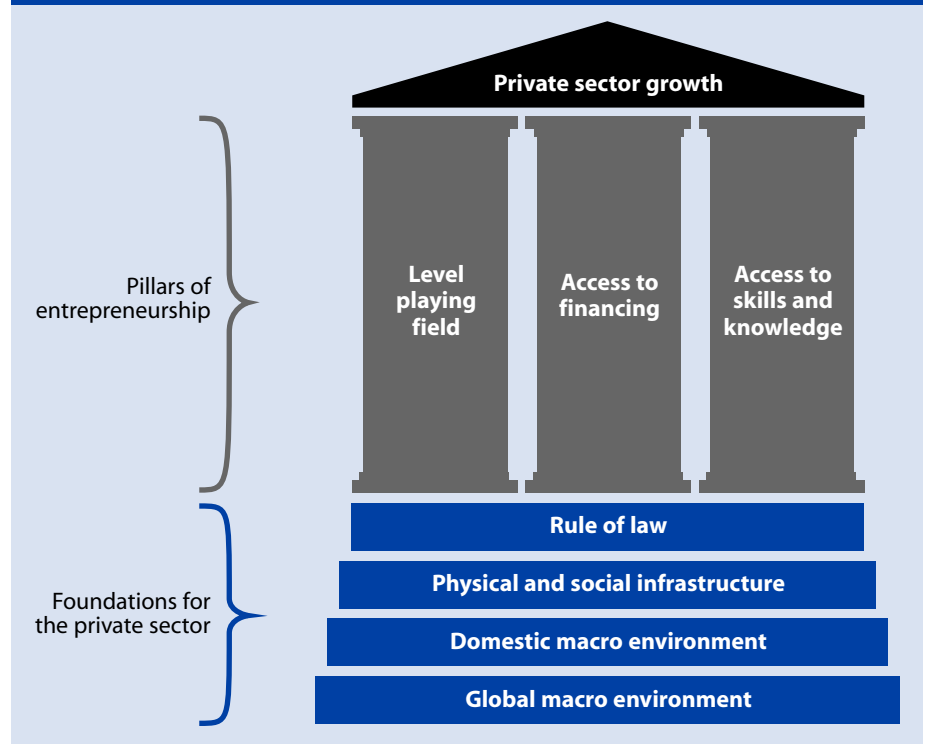
rules that enable competitive access to market opportunities. The open exchange of goods, capital and information—and the transfer of technology and ideas—stimulates private sector development. This occurs through several mechanisms: open markets, good-quality foreign investment, effective development aid and efficient transfers of technology and knowledge. It requires such reforms as dismantling the agricultural subsidies and other forms of protection that so evidently impede export-oriented private sector development in the rural areas of developing countries.

There is broad agreement that open markets have supported economic growth. The advantages, while well catalogued, merit repeating. An open trade policy fosters productivity growth by opening the private sector to competition. Free trade helps countries allocate their resources towards their most productive areas of comparative advantage. Cheaper imports raise the domestic standard of living and allow for the use of lower cost inputs as the private sector produces for domestic or foreign customers. Such a regime provides open market access through lower tariff and nontariff barriers.

Domestic macro environment

The central elements of a strong domestic macro environment for business include peace and political stability, good governance with policy predictability, transparency and accountability, and sound macro-economic policies. For businesses, internal or external conflict increases cost and uncertainty, deterring both domestic and foreign investment. Worse, conflict forestalls private sector development, because it often leads to the tragic destruction of

FIGURE 2.3 FOUNDATIONS FOR THE PRIVATE SECTOR AND PILLARS OF ENTREPRENEURSHIP



human capital, the misallocation of scarce public funds, the devastation of land, the seizure of natural resources and the elimination of market access.

Physical and social infrastructure

A country's physical and social infrastructure includes roads, power, ports, water and telecommunications as well as basic education and health. Building up these basic services has a dual benefit: improving the lives of poor people directly and enabling the growth of businesses.

Technical inefficiencies in roads, railways, power and water alone caused an estimated \$55 billion a year in losses in the early 1990s—an amount equal to 1% of the GDP of developing countries or twice the annual budget for financing infrastructure in the developing world. These losses fall on firms large and small—and on individuals, especially the poorest.

Low quality roads can shut small producers off from regional markets—and encumber large producers with shortages of critical inputs.

Well-maintained infrastructure improves commerce by speeding the transport of goods and raw materials, sustaining energy-intensive production and making information readily accessible and communication timely. Poor physical infrastructure often precludes business activity.

Ensuring connectivity through telecommunications and information technology has become particularly important in recent years, helping to overcome some of the barriers of inadequate physical infrastructure. Efficient access to information is clearly a vital part of the basic infrastructure need of modern economies.

Maintaining high quality physical infrastructure is largely, but not solely, a matter of capital investment. Efficient contracting, open bidding, regulatory credibility and private and public managerial capability carry weight as well.

Studies demonstrating the social and private returns from investments in education and health spotlight their efficacy. High levels of investment in human capital, especially in education and health, lay the groundwork for private sector growth. A healthy, educated workforce is a productive workforce. One need look only at countries ravaged by poor health or disease to see the deleterious effects of an underfinanced or inadequate health infrastructure on previously productive economies. Private firms profit from investments in education, from primary to university, from universal to targeted. Ensuring that such education is appropriate for a future workforce is a core task of a well-functioning education infrastructure. Educating women has particularly positive effects on their future earnings—and society's.

Investments in health and education involve both the public and private sectors, and counter to conventional belief, many education and health services in developing countries are delivered through private initiatives, including cooperatives and mutual health insurance organizations. In some systems 70–80% of health care expenditures are through private actors. Often, but not always, private involvement is a response to government underinvestments.

Improving the social infrastructure and ensuring that those surviving on the lowest incomes have access to affordable and high quality health and education services is an important foundation for private sector development.

The rule of law

The rule of law means that government decisions are made according to a set of written laws and rules, to be followed by every citizen. The rules are applied consistently, administered by a professional bureaucracy and adjudicated by a fair and transparent judiciary that is adequately compensated. In nearly all cases, courts provide reasons for their decisions based on the law, through some form of due process. Countries may subscribe to different legal systems arising from different political and social cultures, but the fair administration and enforcement of a just system of laws is a cardinal principle. Both elements matter—laws and their administration.

Laws form an intrinsic layer of the foundation for a robust private sector. Without a transparent legal framework and a fair judicial and administrative system, other efforts to foster private sector development cannot work as intended, and may even do harm. Home governments must establish the “rules of the game”, a system that reduces transaction costs by making them predictable and enforceable. Legal and administrative systems influence whether and how transactions take place.

The rule of law manifests itself in the private sector with commercial laws, customs laws and contract laws, among others. Critically, the assignment and protection of

property rights circumscribe private sector behaviour. Confusing and contradictory legal systems make formal business practices difficult and push businesses to become or remain informal. Poor legislation buttresses oligarchic and corrupt firms against competitive forces, often at the expense of small and medium enterprises. Cosy relationships between business and regulator impair the development of open, free market competition. The poor are likely to be the first victims of lawlessness.

Even though a written set of laws may exist, the legal system in many developing countries works informally. In the shift from informal to formal systems, many countries have old and new systems coexisting, often in conflict. The loser is often the more formal new system, implemented in a shallow and ineffective manner. One estimate suggests that as many as 80% of the legal issues facing the poor are addressed through customary or informal systems.

Corruption and confusion over the enforcement of rules are often to blame for high compliance costs. Bureaucratic red tape, backlogs, arbitrary decisionmaking and other onerous requirements and inefficient practices hamper private activity. Arbitrary or corrupt enforcement subvert laws intended as benevolent protections, including laws for worker safety, environmental protection and consumer safety. And corrupt practices distort prices and markets, and hinder free and fair competition.

The World Bank estimates that corruption can reduce a country's growth rate by 0.5 to 1.0 percentage points a year. Transparency International's Corruption Perception Index could, with

very few exceptions, almost be ordered by income—poorer countries are almost universally rated more corrupt, though there is plenty of recent evidence that corruption is not limited to lower income categories.

THREE PILLARS OF ENTREPRENEURSHIP—TOO OFTEN MISSING

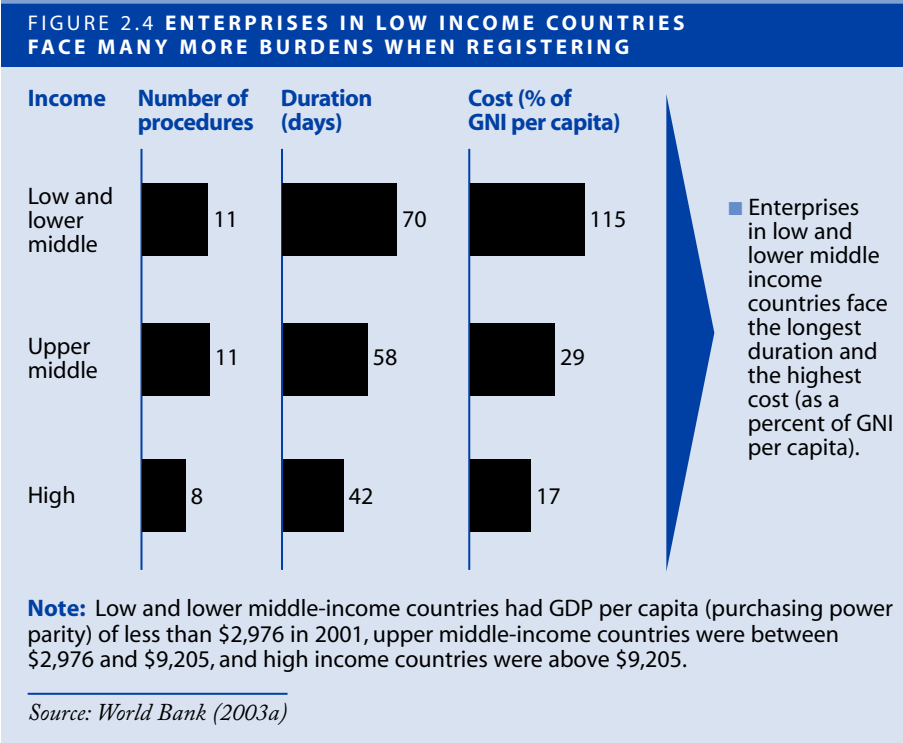
Even with strong macroeconomic and institutional foundations, three additional factors are indispensable for entrepreneurship and the private sector to flourish in an economy: a level playing field, access to finance, and knowledge and skills.

A level playing field— with fair rules, fairly enforced

Perhaps most important in allowing entrepreneurship and the private sector to blossom is a level playing field for firms competing in the domestic market. That can be created only by a system of rules and enforcement mechanisms that is fair, trustworthy and effective. Predictable rules ensure that entrepreneurs have open access to markets and can do business efficiently. And basic trust in the system encourages entrepreneurship and attracts talent (local, foreign and diaspora) to embark on entrepreneurial ventures.

Good rules are a critical element in creating a level playing field, and effective regulations are essential for the market economy. Rules, if excessively complex and incorrectly applied, can turn into significant barriers for enterprises and hamper business growth. This applies to rules for entry, operating, market and exit.

Entry rules. Excessive procedural requirements for business registration



and licensing procedures raise the cost of entry into the formal sector and tilt the playing field in many developing countries (figure 2.4). For example, the World Bank's Cost of Doing Business survey estimates that starting a business requires \$5,531 in Angola (more than eight times the per capita income) and about \$28 in New Zealand (far less than 1% of the per capita income). Cumbersome entry regulations are directly correlated with lower productivity. When countries are ranked by ease of starting a business, the top quartile of countries has labour productivity of about \$40 per worker, almost twice that of the bottom quartile. Longer registration processes are directly associated with higher levels of corruption.

Operating rules. Disclosure requirements can have a positive impact at the industry and business environment by giving consumers and investors the information they

need to make choices about the products they purchase and the capital they allocate. Labour market rules are critical to protecting employees from exploitation. But a number of developing countries have excessively complex labour rules, more than wealthier countries. For laying off employees, companies in middle and low income nations face higher barriers on average than their counterparts in developed economies. The mechanisms for social dialogue to find ways of mitigating the effects of layoffs, and safety nets to protect the poor are often weak or non-existent in most developing countries. Moreover, rigid employment regulations are associated with higher female unemployment. Note, however, that few of these rules are regularly enforced, making the case for simpler rules with

better enforcement. Complex tax rules and structures also impose high costs that fall more on small and medium enterprises than on large enterprises, which can afford tax experts.

Credit rules. Many countries lack rules for sharing credit information, which makes it virtually impossible for creditors to check how indebted a potential client already is. In addition, creditors have limited protection in the case of default, significantly lessening their willingness to assume the risks associated with small and medium enterprise lending.

Tax rules. High tax rates and complex tax administration is a significant constraint for small and medium enterprises and can lead them to the informal sector if tax burdens become excessive.

A large informal economy can mean lower government revenues and higher taxes for firms in the formal economy, creating more incentives for informal operation. For example, in Brazil the informal economy grew as tax revenues increased from 24% of GDP in 1991 to 29% in 1999.

Market rules. Barriers in the land market are high in many nations. For example, it takes about 168 steps, involving 53 public and private agencies and 13–25 years to acquire “informal” land and receive legal title to it in the Philippines. This arduous process discourages people from formally purchasing land, making it impossible to use land as collateral for getting credit, one of the main sources of capital in developed countries.

Product market barriers also stifle growth. Subsidies and trade barriers in the developed world are the biggest culprits. But many developing countries also raise barriers to entry—say, by forbidding small companies to distribute electricity in rural areas, even when state monopolies do not serve those areas.

Restrictions on pricing can also cloud the business environment. For example, many governments charge excessively high prices for fixed-line domestic and international telecommunications services. The monopolies that operate in these conditions are highly profitable as a result, but their capital and labour productivity are low. The high prices provide few incentives for telecommunications players to use their resources more effectively.

Exit rules. Inadequate bankruptcy rules and protections can create additional hurdles for financing enterprises. Countries with better insolvency regulations tend to have more and cheaper lending.

Poor enforcement by formal institutions permits enterprises to avoid some or all of these rules, advantaging some of them over others. Breakdowns in formal institutions occur when officials do not have the skill or will to carry out their oversight functions. Government officials may not have the will to enforce the laws because the institutions they work for do not provide the right incentives. The institutions may not reward officials for applying the law fairly and equally, and the organizations may lack transparency and may not supervise officials sufficiently. In addition, government officials may

not have the skills and resources they need to enforce the laws. They often require additional training or tools.

Access to financing

While foreign direct investment has had an essential role in the development process, it is impossible for a country to progress without domestic investment based on domestic savings. This requires domestic financial institutions that can efficiently manage risk and allocate capital to productive investments. Many developing countries have had weak, state-dominated financial sectors unable to act as a catalyst for development. But where genuine reform has been implemented, the benefits have been quick and evident, even if creating and restructuring an efficient domestic financial sector is a long task.

Large companies are well served by existing banking systems, and there has been good progress in microfinance over the last 10 years—with 41 million poor people served in more than 65 countries. But the progress on small and medium enterprise financing has been slow at best. It is not only about money needed, though. Small and medium enterprises are risky ventures. They require risk capital, but the sources of such capital are difficult to tap. So small and medium enterprises generally have to turn to classic debt financing. This can be difficult for them, because few entrepreneurs in developing countries can leverage assets as collateral the way they do in developed countries. Why? Mainly because of informal property rights and the lack of mortgage markets. Collateral requirements act as a screen that selects wealthy borrowers and crowds out many entrepreneurs with high growth potential.

Most emerging markets finance up to 90% of their investments locally, although for Sub-Saharan Africa the figure is closer to 65% (and most productive enterprises generate revenue in local currency, so the reliance on local financing is sustainable). Private credit as a percentage of GDP rises from 12% in low income countries to 25% in lower middle-income countries, 30% in upper middle-income countries and 85% in high income countries.

A web of factors is at work, more than just the lack of capital.

- Rules and their enforcement are often at the core. Most countries have weak property rights, making the use of assets as collateral difficult. Even when property rights are well defined, the enforcement of mortgage contracts is often impossible, for both political and judicial reasons. In addition, bankruptcy laws are typically lacking, increasing the risk to creditors and further deterring them from investing in small and medium enterprises.
- Poor financial institutions are also a problem. Domestic financial institutions can operate in oligopolistic or monopolistic conditions, with limited shareholder pressure to enter new and more difficult markets, such as lending to small and medium enterprises. Added to the lack of incentives is the public borrowing that crowds out private borrowing.
- Even when financial institutions have the will, they often lack the skills for small and medium enterprise lending. Banks are

accustomed to full-blown risk assessments working with large clients—too costly for small and medium enterprises.

At the other end of the spectrum microfinance institutions lend with very limited analysis, relying mostly on social networks for repayment. This does not work well for the larger amounts that small and medium enterprises require.

- A lack of reliable credit information also hampers the growth of small and medium enterprise lending—usually because there are no credit information agencies and disclosure requirements are weak or not enforced.
- Investors lack exit opportunities. Capital markets are absent or highly illiquid in many poor countries, making public offerings impossible. Private offerings can work, but most markets are far from liquid, with very few transaction opportunities.
- Entrepreneurs often lack the skill and the will for receiving risk capital. On skill, management talent is limited. On will, private equity investors report the reluctance of small and medium enterprises to open their books to outsiders in environments where parallel accounting is widespread.

Access to skills and knowledge

Technological innovations and the shift towards knowledge-based economies make human capital investment a prerequisite for sustained economic growth and central to the start-up, growth and productivity of firms. Human capital can determine the potential for a firm's growth and survival.

It contributes directly to a firm's productivity by enabling the adoption of innovative technologies and processes. A firm's competitive advantage comes from its entrepreneurial capabilities; its management and technical know-how, including labour-management relations; and the skills, education and adaptability of its employees.

The level of education matters, and the skills of employees need to be continually upgraded through on-the-job training to increase the firm's productivity and its ability to absorb new technologies. In Costa Rica, Mauritius and Singapore the private sector has benefited from a virtuous cycle with formal education reinforced by on-the-job learning and training. Costa Rica has the most software exports per capita in Latin America, making it a technological hub in the region, thanks to its investments in both basic education (producing one of the highest literacy rates) and technical education.

Many developing countries suffer from low levels of human capital investment, aggravated by the outward migration of highly skilled professionals. The cumulative "brain drain" since 1990 has been estimated at 15% for Central America, 6% for Africa, 5% for Asia and 3% for South America. The International Organization for Migration estimates that some 300,000 professionals from the African continent live and work in Europe and North America.

By some estimates up to a third of R&D professionals from the developing world reside in OECD countries.

This persistent brain drain deprives developing countries of the know-how of thousands of their most talented people. It reduces the stock of human capital at home, erodes the domestic tax base and shrinks the educated middle class, a stabilizing factor in most societies.

The migration of talented risk-seeking entrepreneurs from the developing world seeking opportunities in more entrepreneurially minded societies spotlights the obstacles to starting and scaling up businesses in their native countries. The underlying cause is a disabling social environment that limits both the number of potential entrepreneurs and the degree to which they can unfold their potential.



This diagnosis of the structure of the private sector and the constraints to its rapid growth applies in differing degrees across a wide range of developing countries. The balance among the different factors varies with income, institutional development and the composition of the private sector. Addressing the constraints to unleash the potential of the private sector will require programmes tailored to the needs of individual countries, but the underlying approaches will be broadly similar. We turn to them now.